# Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873


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## Audit Bureau and Compliance Bureau Revenue Collection Personnel (DOR -- Departmentwide)

This paper includes information related to revenue generating activities performed by personnel in the Audit and Compliance Bureaus of the Wisconsin Department of Revenue (DOR), expanded tax compliance activities undertaken by the Minnesota Department of Revenue (MDOR), and an estimate of additional revenue that could be generated by providing DOR with additional funding and positions for audit and compliance activities.

### Wisconsin Department of Revenue

**Audit Bureau.** The Audit Bureau of DOR is responsible for auditing income, sales, withholding, motor vehicle fuel, and other excise tax returns, and for auditing homestead, earned income, and farmland preservation tax credit returns. The Bureau conducts field and office audits of tax returns and related documents and information. The audits may result in assessments, or refunds. The Bureau also provides taxpayer assistance and information, and stores over six million documents annually.

Adjusted base level funding and position authority for 2009-10 is $26,550,400 GPR, 321.45 GPR positions, $984,800 PR, 12.75 PR positions, $1,351,000 SEG, and 15.75 SEG positions. Consequently, total base level funding for the Bureau is $28,886,200 and the total authorized positions are 349.95.

DOR is required to office audit individual and corporate income and franchise tax returns as it deems advisable. An office audit does not preclude the Department from making field audits of the books and records of the taxpayer or from making further adjustments, corrections, and assessments of income. DOR is required to conduct an income and franchise tax field audit whenever the Department deems it advisable to verify any return directly from the books and records of any person, or from any other sources of information. The Department is also statutorily authorized to conduct office and field audits of state sales, use, and excise taxes.

Typically, office audit programs are based on information generated from the data bases included in the Department's data warehouse. The data warehouse is linked to the Wisconsin income and tax processing system (WINPAS), and includes information from state and federal tax returns, other tax forms, such as 1099 forms, filed by employers and taxpayers, and information from other agencies, such as motor vehicle license data from the Department of Transportation. Examples of office audit projects would be comparing federal adjusted gross income to the amount reported on Wisconsin returns, or computer matching of alimony deductions to alimony income claimed on individual tax returns. Other programs would include comparing information reported by businesses on sales tax returns with the same items reported on federal and state income and franchise tax returns, and reviewing seller and buyer claims for refund of sales, use, and stadium taxes.

The basic steps usually taken by DOR in conducting an office audit and in making an assessment or refund adjustment are:

a. The Department examines returns and tax credit claims to check the correctness of the items reported.

b. DOR may request more information or receipts to clarify or support certain items.

c. The Department decides if an adjustment to the return is necessary, and if so, the taxpayer may owe an additional amount or receive a refund.

d. The taxpayer is sent either an assessment explaining the amount due, or a notice of refund explaining the refund to be issued. The notices show the amount of tax, interest, and penalty (if any), or refund, and explain the taxpayer's appeal rights.

Field audits are often based on information generated from the data warehouse including comparisons of corporate apportionment formula components, such as total sales, to similar items reported on federal returns. Field audits can also be initiated based on findings in office audits, referrals from field staff, Internal Revenue Service (IRS) staff or other sources, and on flaws identified in previous audits. DOR distinguishes between large case and district size audits based on a company's assets ($50 million or more). The Audit Bureau reviews sales/use and franchise/income tax returns of the largest taxpayers, and determines whether a sales/use tax field audit is appropriate on a rotating bases (every four years). The Bureau may determine, based on reviewing returns and prior adjustments, that there are not significant compliance issues that warrant an audit.

The following procedure is generally taken by DOR in conducting a field audit and making an assessment or refund:

a. DOR sends a letter notifying the taxpayer that the relevant tax returns have been selected for examination. The letter includes the date and time for the taxpayer's first meeting with the auditor. At the meeting, the auditor discusses the nature of the taxpayer's business or employment, the accounting or record keeping system used, and other related matters.

b. An auditor will examine the tax returns and the taxpayer's books and records to determine if the correct amounts were reported on the tax returns. If possible, the audit will be conducted at the taxpayer's place of business. In some cases, the auditor will obtain information from third-party sources.

c. After completing the examination, the auditor may determine that adjustments should be made that result in an amount due or a refund. The auditor generally discusses the proposed audit report in a final conference and a complete copy of the proposed report is then given to the taxpayer and the taxpayer's representative. The taxpayer is requested to sign a Notice of Proposed Audit Report form indicating full or partial agreement, or total disagreement with the proposed adjustments.

d. The auditor's proposed field audit report and work papers are reviewed by the Department's central review staff for correctness, uniformity, and proper application of the law.

e. DOR notifies the taxpayer by mail of the results of the field audit. If there are adjustments, the taxpayer will receive an assessment or refund notice. The notice and report will explain the adjustments, the amount of tax, interest and penalty (if any), and the taxpayer's appeal rights. If the field audit results in no amount due and no refund, a letter of notification is sent to the taxpayer explaining that there is no change.

If a taxpayer disagrees with adjustments made to the tax return by DOR, the taxpayer has the following options;

a. Pay the full amount of the assessment without filing an appeal. The taxpayer may contest some or all of the adjustments at a later date by filing a claim for refund. A claim for refund of income and franchise taxes may be filed within four years from the date the assessment was issued. In general, a claim for refund of sales and use taxes must be made within two years after an office audit assessment, and within four years of a field audit assessment. (Sales tax refunds must be passed on to customers based on their valid refund claims.)

b. File an appeal with the Department of Revenue. The appeal must be made within 60 days after the date the taxpayer received the refund or adjustment notice.

A taxpayer has five levels of appeal that can be taken to contest DOR tax return adjustments. The levels of appeal, in order, that are available are: (a) the Department of Revenue; (b) the Wisconsin Tax Appeals Commission; (c) circuit court; (d) court of appeals; and (e) the Wisconsin Supreme Court.

Table 1 includes information about auditors and collection agents in the Audit Bureau. Specifically, the table shows, for 2008-09, the position classification, number of authorized positions, vacancies, average annual collections, and hiring costs per position. The table shows that, on average, revenue collection personnel in the Bureau generate substantially more in revenues than the hiring cost of the position.

**TABLE 1**

**Audit Bureau Auditors and Collection Agents**
**2008-09**

| Position Description | Authorized Positions | Vacant Positions | Average Annual Collections | Per Position Cost to Hire |
|---|---|---|---|---|
| Large Case Field Auditors | 51.30 | 1.00 | $1,900,000 | $120,700 |
| District Field Auditors | 89.80 | 10.00 | 275,000 | 71,500 |
| Office Auditors | 108.60 | 12.95 | 725,000 | 71,000 |
| Excise Tax Auditors | 12.00 | 2.00 | 500,000 | 71,000 |
| Revenue Agents/Tax Representatives | 17.00 | 0.00 | 350,000 | 64,300 |
| Total | 278.70 | 25.95 | | |

*Large Case Field Auditors.* Large case field auditors audit large multi-state corporations for corporate franchise/income and sales and use taxes, with a focus on underreporting of income and sales. These individuals audit corporate franchise/income tax returns for corporations that are identified as large enough for such audits, which are approximately 15% of corporations. Generally, large case field auditor positions are filled by district field auditors or other Bureau auditors. There is usually one to two years of on-the-job training, and it usually takes two to four years before the auditor is fully productive.

*District Field Auditors.* District field auditors audit small to medium sized corporations, pass-through entities, such as partnerships, and individuals for income, franchise, sales and use, and withholding taxes. These auditors also focus on underreporting of income and sales. More businesses are audited by district field auditors than large case auditors, because the time it takes to complete a taxpayer audit is significantly less than that required to complete a large case audit of a multi-state corporation. District field auditors have six months of classroom training, and six months of on-the-job training with an experienced district auditor. It takes from two to four years for the auditor to be fully productive.

*Office Auditors.* Office auditors primarily audit individual income tax returns, and focus on underreporting and non-filing. However, some office auditors specializing in nexus attempt to identify businesses that are not filing franchise or income and/or sales or use tax returns, and others work on underreporting and non-filing by pass-through entities. Typically, office auditors receive two months of classroom training, and four months of on-the-job training with supervisors and reviewers. It usually takes one to two years for office auditors to be fully productive.

*Excise Tax Auditors.* Excise tax auditors are responsible for auditing motor vehicle fuel, cigarette, tobacco products, liquor, and beer tax returns, and the petroleum inspection fee. These individuals focus on underreporting of sales. Excise tax auditors receive six to twelve months of on-the-job training with an experienced auditor, and it takes from two to four years for the auditor to be fully productive.

*Revenue Agents/Tax Representatives.* The functions of revenue agents and tax representatives are similar in that both positions address less complex tax compliance issues than auditors, and the positions are generally assigned to specific tax. However tax representatives typically perform more support functions than revenue agents. Revenue agents focus on underreporting and non-filing, primarily for the individual income tax, but also work on franchise/income and sales and use taxes. These individuals adjust individual income tax returns for tax due based on audit reports from the IRS or information from other agencies or states. The agents and representatives also conduct simple audit projects selected through the data warehouse. The financial and audit skills of an auditor are not required to perform these activities. These staff also assist in processing tax returns, and provide customer service during tax filing periods. Revenue agents and tax representatives require two months of classroom training, and two months of on-the-job training with supervisors and reviewers. It usually takes six to nine months for revenue agents and tax representatives to be fully productive.

The following tables are from the Audit Bureau's annual report for fiscal year 2007-08. Table 2 shows permanent employee staffing for the Audit Bureau for fiscal years 2004-05 through 2007-08. The number of authorized permanent positions was relatively unchanged during those years, while the number of vacant positions increased in the last two fiscal years. The Bureau uses limited-term employees (LTEs) primarily during and after the income tax processing season to assist with homestead tax credit review, customer service in Milwaukee, and tax return storage and disposal.

**TABLE 2**

**Audit Bureau Staffing**
**2004-05 to 2007-08**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| Field Audit Section | 147.00 | 142.65 | 153.95 | 147.90 |
| Central Audit Section | 117.85 | 123.05 | 109.00 | 117.60 |
| Audit Administration | 12.00 | 10.00 | 8.00 | 8.00 |
| Audit Technical Services Section | 17.90 | 17.40 | 17.90 | 18.00 |
| Excise Tax Section | 17.00 | 18.00 | 17.00 | 18.00 |
| Records Management and Office Services Section | 43.15 | 43.05 | 43.00 | 41.25 |
| Total | 354.90 | 354.15 | 348.85 | 350.75 |
| Vacant (included in total) | 16.00 | 16.00 | 22.15 | 25.00 |

Table 3 shows assessments and actual collections (paid assessments plus refunds reduced or denied) from the Audit Bureau's activities for fiscal years 2004-05 through 2007-08. The total revenue effect of Bureau activities includes assessments, refunds, and refunds that are reduced or denied as a result of audit activity or return review and adjustment. The table shows the effect of the Bureau's activities including assessments and refunds. In fiscal year 2007-08, the Department conducted 1,726 field audits which resulted in $277.4 million in assessments, and $113.2 million in additional tax collections. For the same period, a total of 22,028 office audits resulted in $51.9 million in assessments that generated $37.3 million in tax collections. There were 1,269 excise tax audits that resulted in $7.2 million in assessments and $6.8 million in collections. In addition, $25.8 million of refunds were reduced or denied.

Of the total amount collected through audits, $94.3 million (51%) was corporate franchise/income taxes, $43 million (23%), was sales and use taxes, and $10.9 million (5.9%) was individual income taxes. The remaining collections were from audits of other taxes, such as excise and withholding, discovery and nexus actions, and audits of various tax credits. The amounts shown in the table may not accurately measure performance for a specific year because: (a) audit assessments may not be paid in the same year as issued; (b) some assessments are resolved over a period of years; and (c) assessments that are not paid within 60 days become part of the delinquent tax collection system.

**TABLE 3**

**Revenue Impact of Audit Bureau Activities-Paid Assessments plus Refunds Reduced or Denied 2004-05 to 2007-08**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| Assessments | $305,046,000 | $345,489,000 | $328,018,400 | $336,558,596 |
| Paid Assessments | $178,313,100 | $174,561,500 | $181,343,100 | $157,687,600 |
| Refunds Reduced | 30,762,900 | 30,258,100 | 16,672,200 | 25,767,400 |
| Total Revenue | $209,076,000 | $204,819,600 | $198,015,200 | $183,455,000 |
| Percent of Assessments | 68.5% | 59.3% | 60.4% | 54.5% |

A budget reduction provision included in the 2009-11 biennial budget bill (2009 Assembly Bill 75) would delete $709,100 GPR, 16.00 GPR positions, $41,100 SEG, and 1.00 SEG position annually from the Audit Bureau's budget. The deleted positions would not include auditors, but would reduce support staff. An additional $496,600 GPR and $16,900 SEG would be deleted each year, as part of across-the-board budget reductions. Department budget staff indicate that DOR would not be able to absorb the total amount of required reductions in funding for the Department without eliminating positions in addition to those specifically required under the budget bill.

**Compliance Bureau.** The Compliance Bureau is responsible for collecting all delinquent taxes. The Bureau also collects debts for state agencies, and counties and municipalities through the tax refund interception program (TRIP), and provides taxpayer assistance and information.

Adjusted base level funding and position authority for 2008-09 is $11,884,700 GPR, 154.55 GPR positions, $1,249,500 PR, and 11.50 PR positions. Total base level funding for the Bureau is $13,134,200 and 166.05 positions.

DOR considers a tax delinquent when the due date of a specific Department assessment has passed, and statutory appeal rights have expired. Once this has occurred, the assessment is certified as delinquent to the Department's delinquent tax system, and is subject to collection action. When an assessment is certified as delinquent, a delinquent tax collection fee is imposed on the account. The delinquent tax collection fee is equal to 6.5% of the balance or $35, whichever is greater. Interest at the rate of 18% per year is charged on the balance of tax due. Twelve days after appeal rights have expired on appealable bills, any unpaid or partially paid liabilities are transferred to a collection case assigned to the Compliance Bureau. A Notice of Overdue Tax is sent to the taxpayer indicating that the delinquent tax collection fee has been added to their account, and warning the taxpayer of possible actions that could occur if the liability is not paid.

Most delinquent tax bills are assigned to DOR's Central Collection Section for administration. Specifically, the following are assigned to the Section: (a) income tax processing bills, audits, and estimated assessments; (b) out-of-state business tax bills; (c) occasional vehicle sales tax bills; (d) business tax registration fee bills; and (e) additional bills on accounts currently assigned to the Section. Many taxpayers respond to the Notice of Overdue Tax by requesting an installment agreement for paying the amount owed. Those who are unable to pay their total delinquent tax liability may petition DOR, at any time during the administrative process, to accept a compromise amount and work out a repayment schedule. Taxpayers who do not respond to the initial notice may be contacted by telephone or requested to meet with an agent to resolve the delinquency. The Central Collection Section revenue agent responsible for a delinquent account can also take involuntary collection actions, usually through wage attachments or through levies on the taxpayer's accounts in financial institutions. If the Central Collection revenue agent is unable to resolve an account within six months, the accounts are referred to the Special Procedures Intensive Collection Effort (ICE) unit. Accounts not resolved in the ICE unit are referred to a collection agency. Accounts to which in-state business tax liabilities have been added are referred to the Field Compliance section.

Accounts are immediately transferred to the Field Compliance Section after a collection case is created, if the liabilities are for in-state businesses, or if previous liabilities have been referred to the Section. Field revenue agents have the same involuntary collection tools to resolve delinquent accounts as other agents including informal hearings, installment agreements, wage attachments, and levies on assets. The agents make field calls to delinquent taxpayers to arrange for payments or to obtain missing returns. Field Compliance Section revenue agents can also take the following delinquent tax collection actions: (a) filing delinquent tax warrants on an account, which places a lien on any real or personal property owned by the taxpayer in the county of record; (b) garnishments initiated to seize the assets of the taxpayer that are in the hands of a third party; (c) warrant executions initiated to seize property held by the delinquent taxpayer; (d) revocation of sellers permits; (e) holding supplemental hearings before a court commissioner to identify assets that could be used to pay the delinquent liability; and (f) officers of a corporation with responsibility to make tax payments may be found to have personal liability for the debts after investigation.

Field revenue agents give priority to the accounts of active businesses since delinquent business debt can increase rapidly. Agents are expected to contact newly assigned business accounts within 60 days of assignment. Business installment plans that exceed six months must be approved by supervisors. Field agents may negotiate installment plans with individual accounts, or inactive business accounts that last up to one year.

Accounts can be moved to special assignments managed by the Central Collection Section including: (a) assignment to the Special Procedures Unit, if the taxpayer files for protection under federal bankruptcy law; (b) denial, revocation, or suspension of occupational licenses; (c) maintenance and write-off of dormant accounts; (d) filing of probate claims in cases involving an estate; (e) referral to the Office of General Counsel for legal proceedings; (f) issuance of levies against unclaimed property; and (g) acting on taxpayer petitions to compromise. The Compliance Bureau also administers certain automated matching processes.

Table 4 includes information about Compliance Bureau revenue agents and tax representatives. Specifically, the table shows, for 2008-09, the position description, number of authorized positions, vacancies, average annual collections, and hiring costs per position. The table shows that, similar to Audit Bureau personnel, on average, revenue collection personnel in the Bureau generate significantly more in revenues than the hiring cost of the position.

**TABLE 4**

**Compliance Bureau Collection Agents**
**2008-09**

| Position Description | Authorized Positions | Vacant Positions | Average Annual Collections | Per Position Cost to Hire |
|---|---|---|---|---|
| Field Revenue Agents | 73.00 | 3.00 | $1,100,000 | $62,500 |
| Office Revenue Agents | 55.00 | 7.00 | 1,100,000 | 64,300 |
| Tax Representatives | 3.00 | 3.00 | N.A. | 62,600 |
| Total | 131.00 | 13.00 | | |

*Field Revenue Agents.* Field revenue agents focus on delinquent business taxes. Field work is often required to search for assets and take enforced collection actions. Field revenue agents require three months of classroom and intensive on-the-job training, followed by an additional six months of intensive training. These agents are usually fully productive after a year.

*Office Revenue Agents.* Office revenue agents concentrate primarily on income tax delinquencies and out-of-state delinquent accounts. Generally, the workload involves communicating and working with delinquent taxpayers. Agents in the Special Procedures Unit provide specialized collections activities and support to other revenue agents. Agents receive three months of classroom and intensive on-the-job training. An additional three months of training is also required. These staff are typically fully productive in nine months.

*Tax Representatives.* As the table indicates, these positions are vacant. One of the tax representative positions is responsible for prorating tax refunds, and responding to taxpayer questions related to the tax refund interception program. The other two positions are responsible for delinquent account adjustments, answering revenue agent questions about account balances, and ensuring that payments are posted correctly to delinquent accounts.

Table 5, from Delinquent Tax Collection annual reports, shows Compliance Bureau delinquent tax system staffing, by function, for fiscal years 2004-05 through 2007-08. The table shows that, while position authority has decreased slightly during the period, the number of vacant positions has increased significantly in recent years.

**TABLE 5**

**Compliance Bureau - Delinquent Tax Program Staffing**
**2004-05 to 2007-08**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| Field Revenue Agents | 85.00 | 84.00 | 85.00 | 85.00 |
| Central Revenue Agents | 32.00 | 31.00 | 32.00 | 32.00 |
| Support Staff | 27.05 | 27.35 | 24.05 | 24.05 |
| Applications Development Staff | 3.80 | 3.80 | 1.30 | 1.30 |
| Supervisory/ Managers | 13.00 | 12.00 | 12.00 | 12.00 |
| Analysts/ Network Coordinators | 5.00 | 6.00 | 6.00 | 6.00 |
| Collection Attorneys | 2.00 | 2.00 | 2.00 | 2.00 |
| Total | 167.85 | 166.15 | 162.35 | 162.35 |
| Vacant (included in total) | 6.00 | 5.00 | 7.00 | 17.00 |

Table 6 shows delinquent tax collections, refund offsets, and the year-end delinquent tax balance for fiscal years 2004-05 through 2007-08. Cash collections are revenues collected by delinquent collection staff. Refund offsets are tax refunds that are intercepted and applied to the accounts of delinquent taxpayers. Of the total delinquent balance in 2007-08, $89.2 million (9%) was corporate income/franchise taxes, $502.3 million (49%) was individual income taxes, and $310.6 million (30%) was sales and use taxes.

The substantial increase in the delinquent tax balance between 2006-07 and 2007-08, in part, reflects the migration of accounts to a new information technology system the Wisconsin Income and Tax Processing System (WINPAS). As a result, interest charges are updated more frequently and the time period for writing off accounts was restarted. Additional delinquent accounts are added and others accounts are written off during the year. Consequently, the starting balance minus total delinquent tax collections for the year will not equal the ending balance.

**TABLE 6**

**Delinquent Tax Collections Refund Offsets and Year-End Balance**
**2004-05 to 2007-08**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| Starting Balance | $762,477,709 | $729,435,482 | $715,752,354 | $808,354,051 |
| Total Cash Collections | 122,979,555 | 134,333,569 | 123,131,679 | 113,701,120 |
| Refund Offsets | 12,054,958 | 12,855,595 | 14,139,583 | 26,322,200 |
| Total Collections | $135,034,513 | $147,189,149 | $137,271,261 | $140,023,320 |
| Ending Balance | $729,435,482 | $715,752,354 | $808,354,051 | $1,032,017,802 |
| Collections as a Percent of Starting Balance | 17.7% | 20.2% | 19.2% | 17.3% |

Due to across-the-board and other budget reductions required under the 2009-11 budget bill, annual funding of $583,800 GPR and $10,700 PR would be deleted from the Compliance Bureau budget. As noted above, DOR budget staff indicate that the funding reductions included in the budget will require the Department to eliminate positions in addition to those specifically eliminated under the budget provisions.

### Tax Gap

**Internal Revenue Service.** In recent years, the tax gap has been transformed from a relatively obscure statistic to a focal point of congressional and executive branch action. Congress has held numerous hearings and introduced legislation to reduce the gap. The IRS has a section of its website devoted to the tax gap, and has allocated additional resources to enforcement of tax laws. In a 2007 report, the Congressional Research Service noted that recent and projected deficits, and the need for revenue to offset spending or tax reduction proposals, have generated Congressional and executive branch interest in different proposals to reduce the tax gap.

The gross tax gap is the difference between tax liability in any year and the amount of tax that is paid voluntarily and on time. The gross tax gap has three components: (a) non-filing; (b) underreporting of tax owed; and (c) underpayment. The three components are mutually exclusive and add up to the total gross tax gap. The non-filing tax gap is tax not paid on time by taxpayers who have a legal requirement to file a tax return, but do not file on time (or at all). The underreporting tax gap is tax owed by taxpayers who file returns on time, but misreport the amount of tax they owe (for example, by understating income or overstating deductions). The underpayment tax gap is the loss of revenue owed by taxpayers who file on time, but do not fully pay their reported tax due on time.

The IRS has conducted studies of noncompliance since the 1970s. In all of these earlier studies, the estimated tax gap ranged between 16% and 20% of tax liability. The most recent IRS tax gap estimate was released in 2006, and was based on a random audit study of individual income tax returns for tax year 2001, and on adjusting older audit data. The IRS estimated a gross tax gap for tax year 2001 of $345 billion, or approximately 16% of tax liability for that year. By component, the tax gap was: (a) underreporting -- $285 billion or 82%; (b) underpayment -- $33 billion or 10%; and (c) non-filing -- $27 billion or 8%. The individual income tax was the biggest source of the tax gap, accounting for 71% of the gross tax gap. If the estate tax and underreporting of the self-employment tax are added to the individual income tax gap, the share of the estimated tax gap attributed to individual filers increases to almost 85%. Most of the gross tax gap is caused by the underreporting of tax on individual income tax returns. The IRS estimated that underreporting of individual income tax and self-employment tax in 2001 accounted for $236 billion, or 68% of the gross tax gap. Approximately 43% of the gross tax gap is due to underreporting of business and self-employment income on individual income tax returns. Based on these estimates, the most significant (though not the only) cause of the tax gap is underreporting of tax by individual income taxpayers with income from businesses, farms, partnerships and other pass-through entities, and from rents and royalties.

As noted, the gross tax gap represents tax owed and not paid on time. The IRS estimated that $55 billion of the $345 billion tax gap for tax year 2001 would eventually be recovered, either through voluntary late payments, or from IRS enforcement activities on tax year 2001 returns, resulting in a net tax gap of $290 billion. According to the U. S. Department of the Treasury, in 2001, the compliance rate was over 86%, after late payments and recoveries from IRS enforcement activities are included.

A report prepared for an American Bar Association Conference on the Tax Gap in 2007 indicates that, although the IRS has developed "highly sophisticated techniques for estimating the tax gap,… there are some serious conceptual and data issues in the tax gap measurements" (*What is the Tax Gap?*, Eric Toder, Tax Notes October 22 , 2007). For example, measures of the tax gap do not fully capture the amount of tax avoidance from pass-through entities. However, the author concludes that, in spite of large potential positive and negative errors, the tax gap measure gives a reasonably good indication of the order of magnitude of noncompliance.

**State Governments.** In addition to the IRS estimate, states including New York, California, and Minnesota, have developed estimates of the tax gap for various state taxes. The New York State Department of Taxation and Finance estimated the difference between full compliance with all state personal income tax laws (baseline tax liability) and taxes actually paid by taxpayers. The gross tax gap was estimated to be 13.9% of baseline tax liability, and about 82% of the gap was due to underreporting of income by tax filers. The California Franchise Tax Board estimated the personal and corporate income tax gap for 2005-06. The California estimate was, in part, based on the IRS tax gap estimate, and determined that the tax gap represented about 8% of total income taxes collected. Underreporting of income represented about 80% of the gap. The Minnesota Department of Revenue contracted for an estimate of the individual income tax gap using tax year 1999 returns, and an estimate of the sales tax gap using tax year 2000 returns. The Department estimated that, annually, the income tax gap was about $604 million, and the sales tax gap was about $451 million, or, in both cases, approximately 10% of taxes owed. The primary contributors to the income tax gap were self-employed individuals who underreported income, and non-filers. The majority of the sales tax gap was from unreported use tax, mostly by businesses that purchased taxable goods from out-of-state vendors.

**Enforcement of Tax Laws.** Many federal and state public officials view increased enforcement of tax laws as a primary way to reduce the tax gap. Participants at a September, 2007, Joint Forum on Tax Compliance, hosted by the Congressional Budget Office (CBO), the U.S. Government Accountability Office (GAO), and the Joint Committee on Taxation (JCT) generally agreed that heightened enforcement of tax laws was the best (but not the only) way to reduce the tax gap (*Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential*, GAO, June 2008). The participants generally agreed that the following strategies would help the IRS increase the amount of tax collected: (a) increase the number of audits performed per year; (b) focus audits where noncompliance was the greatest; (c) improve the quality of audits; and (d) increase data sharing and partnering with the states. However, the participants also indicated that the IRS could not audit itself out of the tax gap, and other activities, including improving taxpayer services, simplifying the tax code, investing in technology, and increasing information reporting should be part of a comprehensive, long-term strategy for reducing the tax gap.

According to the GAO, devoting more resources to enforcement has the potential to help reduce the tax gap by expanding enforcement activities to reach a greater number of potentially noncompliant taxpayers and assess and collect additional taxes (*Tax Compliance: Multiple Approaches are Needed to Reduce the Tax Gap*, statement of Michael Brostek, GAO, February, 2007). The amount of the tax gap that could be reduced depends on the amount of increased resources, how they are managed, and the indirect increase in voluntary taxpayer compliance that would likely result from expanded enforcement. If resources are used to hire more enforcement staff, the impact on collections may be gradual, as staff are hired, trained, and gain experience. The IRS has estimated that in the first year after expanding enforcement activities, the additional revenue collected is less than 50% of the amount collected in later years. The amount of taxes generated from the same level of assessments can vary depending on the type of tax or taxpayer involved. In a 1998 report, GAO found that five years after assessment 48% of the assessed taxes had been collected from individual taxpayers with business income, while 97% of assessed taxes had been collected from corporations.

The amount of revenue generated also depends upon how additional resources are allocated. To assist in allocating resources the IRS has developed measures of return on investment in terms of the ratio of tax revenue assessed to the cost of the related enforcement activity. Generally the IRS has a return on investment from enforcement activities of four to one; that is, it collects $4 in revenue for every $1 in funding. However, where it has return on investment measures, the IRS has found substantial variation, depending upon the type of enforcement action. For example, the ratio of estimated revenue to administrative costs for pursuing individual tax debts through phone calls is 13:1, compared to a ratio of 32:1 for matching the amount of income reported on tax returns to income reported on information returns. In addition, the IRS lacks information on the incremental returns from pursuing the next best case. Although an enforcement activity may have a high estimated return, that return may fall as future cases are undertaken. It is the marginal revenue gain that is crucial in estimating the direct revenue generated by expanded enforcement.

In addition to the direct revenue effect of expanded enforcement activities, there could be revenue generated due to increased voluntary tax compliance. The indirect effect would include increases in voluntary compliance in the general population resulting from awareness of the enforcement activity, and increased voluntary compliance by the targeted taxpayer in future years.

Both the Treasury Department and GAO support a comprehensive strategy, not just enforcement, to reduce the tax gap. The Treasury's integrated, multi-year strategy for reducing the tax gap includes the following seven components: (a) reduce opportunities for evasion; (b) make a multi-year commitment to research to identify sources of non-compliance; (c) continue improvements in information technology; (d) improve compliance activities; (e) enhance taxpayer service; (f) reform and simplify the tax law; and (g) coordinate with partners and shareholders (*A Comprehensive Strategy for Reducing the Tax Gap,* U.S. Department of the Treasury, Office of Tax Policy, September 26, 2006). In testimony before the U.S. Senate, Committee on Finance, David Walker, Comptroller General of the U.S., indicated that the tax gap can only be reduced through multiple strategies, over a sustained period of time, including reducing tax code complexity, providing quality services to taxpayers, enhancing enforcement of tax laws through tax withholding and information reporting that increase transparency of income and deductions, and evaluating the IRS's efforts to promote compliance (*Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but will Require a Variety of Strategies,* testimony of David Walker, GAO, April 14, 2005).

**Wisconsin.** The estimates developed by the IRS and certain states indicate that the tax gap ranges between 8% and 15% of tax revenues. Based on these estimates, and current revenue estimates for the 2009-11 biennium, Wisconsin's tax gap would be projected to exceed $1 billion. Generally, the primary component of the tax gap is underreporting of business and related income under the individual income tax. To reduce the tax gap, the federal government and the states have taken actions to increase enforcement of tax laws, including increasing audit staff.

Table 7 shows Audit Bureau assessments by type of tax for fiscal years 2004-05 through 2007-08. The table shows that while assessments by type of tax vary from year to year, the level of assessments has remained relatively consistent, ranging between $305 million and $345 million. Also, individual income tax assessments have declined substantially. As noted, Table 2 shows that the level of audit staffing has also been consistent, although the number of vacant positions has increased during the past two fiscal years. With the current level of staffing, the Audit Bureau is able to audit between 1% and 3% of taxpayers in a year. (The percentage of excise tax audits may be higher.)

**TABLE 7**

**Audit Bureau Assessments by Type of Tax**
**Fiscal Years 2004-05 to 2007-08**

| | 2004-05 | 2005-06 | | 2006-07 | | 2007-08 | |
|---|---|---|---|---|---|---|---|
| Tax Type | Amount | Amount | Percent Change | Amount | Percent Change | Amount | Percent Change |
| Individual Income | $64,052,900 | $75,271,700 | 17.5% | $57,418,500 | -23.7% | $19,639,400 | -65.8% |
| Corporate Franchise/ Income | 153,323,100 | 138,708,700 | -9.5 | 175,099,800 | 26.2 | 211,769,300 | 20.9 |
| Sales and Use | 68,674,700 | 109,004,300 | 58.7 | 76,113,400 | -30.2 | 83,708,800 | 10.0 |
| Other | 18,995,200 | 22,504,300 | 18.5 | 19,386,700 | -13.9 | 21,441,100 | 10.6 |
| Total | $305,045,900 | $345,489,000 | 13.3% | $328,018,400 | -5.1% | $336,558,600 | 2.6% |

Additional audit staff would allow the Bureau to increase its audit activities, and likely increase assessments and revenue collections. The full effect of increased audit activities would not be reflected in assessments initially, because audit staff must first be trained, and then they become more efficient with experience. In addition, the assessments and revenues generated would diminish over some period of time, both for specific projects, and for Bureau activities in general, as more and less profitable cases were reviewed. However, given the estimated size of the tax gap and current staffing levels, the point of diminishing returns would not be reached quickly. Increased audit activities would impose costs on taxpayers that were subject to the audit activities. In many cases, this could involve taxpayers that had complied with tax laws, or that would receive refunds.

Table 6 shows that the delinquent balance had increased to over $1 billion in 2007-08, while total collections have remained relatively stable. Table 5 shows that Compliance Bureau staffing levels have been reduced somewhat in recent years, while vacancies have increased. Table 8 shows the increase in the delinquent tax balance by tax type. Over the past two fiscal years there has been a substantial increase in delinquent income and franchise, and sales and use taxes. As noted above, the increase in delinquent taxes, in part, reflects the effects of migration to a new information technology system.

**TABLE 8**

**Delinquent Tax Balance by Type of Tax**
**Fiscal Years**

| | 2004-05 | 2005-06 | | 2006-07 | | 2007-08 | |
|---|---|---|---|---|---|---|---|
| Tax Type | Amount | Amount | Percent Change | Amount | Percent Change | Amount | Percent Change |
| Corporate Franchise/ Income | $27,109,700 | $43,773,900 | 61.5% | $60,971,000 | 39.3% | $89,196,300 | 46.3% |
| Individual Income | 304,922,800 | 321,611,800 | 5.5 | 453,268,600 | 40.9 | 502,333,300 | 10.8 |
| Sales and Use | 210,250,600 | 210,016,100 | -0.1 | 172,951,400 | -17.6 | 310,558,400 | 79.6 |
| Withholding | 139,218,000 | 126,315,900 | -9.3 | 107,046,300 | -15.3 | 114,737,400 | 7.2 |
| Miscellaneous | 12,732,400 | 14,034,700 | 10.2 | 14,129,200 | 0.7 | 15,192,400 | 7.5 |
| Total | $694,233,500 | $715,752,400 | 3.1% | $808,336,400 | 12.9% | $1,032,017,800 | 27.7% |

For a number of reasons, a large portion of the delinquent tax balance is not considered collectible. Delinquent accounts may be written off for the following reasons: (a) taxpayers in bankruptcy; (b) deceased taxpayers; (c) accounts where no personal liability can be assessed, where the balance is less than $50, where deemed uncollectible by two collection agencies, or where deemed uncollectible by a collection supervisor; (d) amounts forgiven in compromise; and (e) amounts assigned to central collection, field compliance, and collection agencies that represent estimated assessments that have not yet been adjusted to the actual liability. The estimated collectible delinquent balance for fiscal years 2004-05 to 2007-08 is shown in Table 9. The collectible delinquent balance was estimated to be over $510 million in 2007-08 and has also increased substantially the past two fiscal years.

**TABLE 9**

**Estimated Collectible Delinquent Balance**
**Fiscal Years 2004-05 to 2007-08**

| 2004-05 | 2005-06 | | 2006-07 | | 2007-08 | |
|---|---|---|---|---|---|---|
| Amount | Amount | Percent Change | Amount | Percent Change | Amount | Percent Change |
| $270,329,200 | $274,840,300 | 1.7% | $361,217,200 | 31.4% | $510,883,100 | 41.4% |

When assessments are not paid by the due date and appeal rights have expired, they are transferred to the delinquent tax system. Each year Audit Bureau assessments become part of the delinquent tax system. In 2007-08, $22.2 million in assessments were transferred to the delinquent tax system. A substantial increase in audit activities would likely lead to an increase in the number and amount of assessments that were transferred to the delinquent tax system.

Similar to the Audit Bureau, additional compliance staff would allow the Compliance Bureau to pursue a greater number of delinquent accounts, and likely generate more revenue collections. Again, the full revenue effect would not be immediate due to personnel training and experience factors. Also, at some point there would be diminishing returns to collection activities, although not in the short term. It should be noted that AB 75 would provide the Compliance Bureau with 3.0 positions and $208,900 in 2009-10 and $402,900 in 2010-11 to implement and administer a financial records matching program with financial institutions to identify accounts of delinquent taxpayers. DOR estimates that the program would generate an additional $13.0 million in annual tax revenues.

In public testimony, the Secretary of Revenue has indicated that the Department would be able to conduct tax enforcement activities that would reduce the tax gap and delinquent tax balance with the Department's current level of staffing and funding through an integrated approach that includes advanced information technology infrastructure, skilled personnel, and modern tax policy. Implementation of the Department's WINPAS system has allowed DOR to reduce limited-term employees by 60%, and improve tax processing workflow to reduce errors and increase productivity.

The Secretary noted that the nature of tax delinquencies is being analyzed and appropriate action plans are being developed. Automatic wage certifications and bank account levies were instituted in the Compliance Bureau, which reduced the time for entering into installment agreements with delinquent taxpayers. In addition, the Bureau formed the Intensive Collection Effort unit as a pilot project to intensively work accounts prior to referral to collection agencies. The unit generated $1.85 million in net revenue collections.

Audit Bureau methodologies are periodically evaluated and modified and resources are shifted to priorities. For example, additional auditors were reassigned to audit pass-through entities using the data warehouse, which resulted in the identification of $16 million in additional revenue. The Bureau is reengineering field audit processes involving audit plans and case management systems, and a new case management system is being implemented by the end of the year. Also, litigation and settlement strategies are being developed around aging audits and appeals.

The Department's general fund tax information technology system (WINPAS) and property tax administration information technology system have replaced a number of out-of-date IT systems, and have improved the efficiency of DOR tax processing and tax administration staff. The Department estimates that the data warehouse that is used in audit selection, process automation, and data analysis has resulted in staff time savings of over 1,750 hours, and has generated approximately $14 million in additional revenue collections.

The Secretary has also noted that modern tax policy and tax simplification results in improved tax compliance and more efficient uses of the Department's resources. Two such tax law provisions are combined reporting and streamlined sales tax.

**Minnesota Department of Revenue**

Beginning with the state fiscal biennium 2002-03, the Minnesota Department of Revenue was allocated funding to conduct a series of expanded tax compliance initiatives. The following summaries describe the funding provided, positions allocated or hired, and the revenues generated by each of those initiatives. The information presented is based on the Department's reports to the Minnesota Legislature. In all cases, the reports were submitted before the end of the fiscal biennium, and the data reflect this. Information is not available to determine the cumulative total costs, position allocations and hirings, and revenues for all of the initiatives. Revenues generated by compliance activities conducted during a particular biennium may be collected in subsequent biennia. Similarly, the total costs of a particular initiative may be incurred after the end of a particular biennium. The net number of new positions created depends upon turnover and other unrelated actions taken on the Department's budget.

*Fiscal 2002-03 Biennium.* The MDOR was first appropriated approximately $7.7 million to: (a) identify and collect tax liabilities from individuals and businesses that currently did not pay taxes, and (b) increase audit and tax collection activity in individual and corporate income, and sales taxes. The Department estimated that it would generate an additional $60 million in revenue from these activities. The appropriation was subsequently decreased by approximately $500,000 in budget reductions. However, the 2002 Legislature appropriated about $2.6 million to augment efforts on the compliance initiative to include insurance taxes and legal gambling. MDOR used a number of methods to identify non-filers, including IRS data and federal tax returns and data exchange with other state agencies. In the January, 2003, report to the Legislature, MDOR noted that, through November, 2007, it had expended $5.3 million of the total amount appropriated, and allocated 88.42 positions to the initiative. A total of $57.3 million in additional revenue had been collected, and it was expected that the $60 million would be collected by the end of the biennium. MDOR estimated that it generated $10.80 in revenue for every $1 spent on enforcement activities.

*Fiscal 2004-05 Biennium.* The MDOR was appropriated $12.8 million to increase audits and collections of individual and corporate income taxes, sales taxes, insurance taxes, gambling taxes, and withholding taxes. It was estimated that $59.8 million in additional revenues would be generated from these activities. Audit and collection activities included written and telephone notices, seizures of property and levies, field investigations, and license revocations. Specific types of taxpayers were targeted for identification of non-filers and for audits. Through November, 2004, MDOR had expended $6.6 million and hired 109 full-time employees. A total of $63.9 million in revenues had been collected, or $8 for every $1 expended.

*Fiscal 2006-07 Biennium.* A total of $17.8 million was appropriated to the Minnesota Department of Revenue in the 2006-07 biennium to collect a projected $90.7 million through expanded tax compliance activities. The additional funding was appropriated to increase audits of, and collections from, non-compliant taxpayers, and of cases related to individual and corporate income, sales and use, withholding and gambling taxes. The Department used the funding for strategic compliance activities, to identify non-compliant taxpayers, and to resolve noncompliance cases. Through November, 2006, the Department had identified over 20,000 noncompliant individual income tax cases, over 2,000 non-compliant sales and use taxpayers, and over 1,000 non-compliant corporate taxpayers. As of November 30, 2006, the Department had expended approximately $9.6 million, hired 134 employees, and generated $74.6 million in revenues. A total of $38.4 million was generated by identifying non-filers and increasing the number of audits, and $36.2 million was from increases in delinquent tax collection activities. In the January, 2007, report to the Legislature, MDOR indicated that it expected to exceed the projection of $90.7 million in revenue collections by the end of the biennium. The Department was generating about $8 in revenue for each $1 expended for enforcement activities.

*Fiscal 2008-09 Biennium.* The Minnesota Legislature appropriated $20.5 million to MDOR in the 2008-09 biennium for expanded tax compliance activities. MDOR estimated that $102.4 in revenues would be generated from the increased compliance activities. The funds were for expanded audit and collection activities for individual and corporate, sales and use, insurance, gambling, and other special taxes. The Department used the funding to identify non-compliant taxpayers, and to resolve noncompliance cases. Through November, 2008, the Department had identified over 23,500 noncompliant individual income tax cases, over 1,600 non-compliant sales and use taxpayers, and over 800 non-compliant corporate taxpayers. As of the end of November, 2008, the Department had expended approximately $11.9 million, hired 138 employees, and generated $87.9 million in revenues. A total of $47.6 million was collected from identifying non-filers and increasing the number of audits, and $40.3 million was from increases in delinquent tax collection activities. In the January, 2009, report to the Legislature, MDOR indicated that it expected to meet the projection of $102.4 million in revenue collections by the end of the biennium. The Department was generating about $7.40 in revenue for each $1 expended for enforcement activities. However, it expected the ratio to fall to $1 for every $5 generated during the remainder of the biennium.

*Fiscal Year 2009.* The MDOR was appropriated $7 million in fiscal year 2009 for stepped-up tax enforcement activities. The Department estimated that an additional $21 million in revenue could be generated. The funding was for increased audit and collection activities for individual and corporate, sales and use, insurance, gambling, and other special taxes. Approximately 6,100 non-compliant individual income tax cases were resolved. About 500 businesses and 260 corporations were identified as noncompliant. As of January 31, 2009, MDOR had expended $2.4 million and hired 74.7 full-time positions. A total of $14.19 million was collected, and the Department expected to generate the estimated $21 million in additional collections. Approximately $10 million was collected from identifying non-filers and through additional audits. A total of $4.2 million was collected in delinquent taxes. By the end of the fiscal year, it was expected that $3 in revenue would be generated for every $1 in expenditures.

**Wisconsin Expanded Compliance Initiative**

As shown in the preceding section, the Minnesota Department of Revenue has been provided resources over the past several fiscal years and has used those resources to conduct a series of expanded tax compliance and audit activities. In each instance, the Minnesota Department of Revenue sought additional resources and set forth a projection of potential revenues to be realized over a time frame based on those resources. In addition, that Department was required to submit reports to the Legislature on the result of its efforts and the use of the additional resources.

This office contacted the Wisconsin Department of Revenue to discuss the addition of resources and the potential to generate additional tax collections for the state.

Provisions included in 2009 Assembly Bill 75 would reduce annual DOR funding (excluding the Lottery) by $5,607,600 GPR, $149,000 PR, and $66,300 SEG, and delete 29.65 GPR positions and 1.00 SEG position, as a result of across-the-board and specified budget reductions. DOR could be provided funding and positions to offset the budget reductions, and directed to allocate the funding and positions to activities that would enhance enforcement of current tax laws, and generate additional revenues. Specifically, the Department could be provided $5,700,000 GPR, 30.00 GPR positions, $150,000 PR, $70,000 SEG, and 1.00 SEG position annually, and directed to use the additional resources to fund expenditures and engage in activities that were related to enhanced enforcement of current tax laws, and that would result in increased state tax revenues.

The funding and positions could be used for (but not limited to): supporting and upgrading information technology systems (including WINPAS and the Data Warehouse); recruiting and hiring auditors, revenue agents, tax representatives and other supporting and related staff; training existing and new staff; and developing and implementing audit and tax collection projects. Existing personnel could be reallocated to enhanced enforcement activities, while new staff was being trained. As noted, certain positions require less training and become proficient once they achieve a certain skill level. Delinquent taxes and taxes owed and not paid on time, or at all, would be targeted. DOR could be required to provide an annual report to the Legislature that included: a description of the allocation of funding and positions; expenditures incurred; activities or projects undertaken (both supporting and direct enforcement); data regarding the type of enforcement actions, number of taxpayers affected, additional amounts assessed and collected, and additional revenues that were generated; and an analysis of the cost-effectiveness of the activities funded by the additional amounts provided by the Legislature.

Based on conversations with the Department of Revenue, analysis of DOR audit and collection projects, such as the pass-through entity and intensive collection effort (ICE), and analysis of specific expanded tax compliance initiatives in Minnesota, DOR could generate an estimated of $25 million additional tax revenues in 2009-10, and $45 million in 2010-11 and annually thereafter, if the Department was provided the funding and positions enumerated above.

Given the time required for planning, hiring, training, and deploying these additional resources, the $70 million of enhanced collections for the biennium is ambitious, but appears reasonable and is consistent with the initial results of the Minnesota experience. Once the Department reports the results of its efforts, the Governor and the Legislature would have the ability to analyze and evaluate the program and determine if other collection opportunities would be possible.

**ALTERNATIVES**

1. Maintain current law.

2. Provide $5,700,000 GPR, 30.00 GPR positions, $150,000 PR, $70,000 SEG, and 1.00 SEG position annually to the Department of Revenue, and direct the Department to use the additional resources to fund expenditures and to engage in activities that are related to enhanced enforcement of current tax laws, and that would result in increased state tax revenues. Require the Department to provide annual reports to the Governor, Legislature, and Joint Committee on Finance by June 30 of each fiscal year, that include a description of the allocation of funding and positions; expenditures incurred; activities or projects undertaken (both supporting and direct enforcement); data regarding the type of enforcement actions, number of taxpayers affected, additional amounts assessed and collected, and additional revenues that were generated; and an analysis of the cost-effectiveness of the activities funded by the additional amounts provided by the Legislature.

| **ALT 2** | | **Change to Bill** | |
|---|---|---|---|
| | Revenue | Funding | Positions |
| GPR | $70,000,000 | $11,400,000 | 30.00 |
| PR | | 300,000 | 0.00 |
| SEG | | 140,000 | 1.00 |
| Total | $70,000,000 | $11,840,000 | 31.00 |

Prepared by: Ron Shanovich