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Federal Audit Reports Enforcement Activities (DOR -- Tax Administration)

[LFB 2013-15 Budget Summary: Page 404, #3; and Page 407, #8]

CURRENT LAW

The Audit Bureau in the Department of Revenue (DOR) receives federal audit reports from the Internal Revenue Service (IRS) that identify audit adjustments made by the IRS to federal tax returns. DOR receives 35,000 and 55,000 reports each year. The reports are received from one to two years after the final IRS adjustment is made. Currently, there are six positions in the Audit and Compliance Bureaus that use the federal reports to make assessments and collect delinquent taxes in addition to other duties. In 2011-12, the Audit Bureau collected approximately $8 million (including $3 million from a special overtime project), while the Compliance Bureau collected about $21.1 million in delinquent taxes related to the federal audit adjustment reports.

GOVERNOR

Provide $1,578,100 GPR in 2013-14 and $1,975,300 GPR in 2014-15, and 33.00 audit and compliance four-year project positions each year to increase enforcement of state tax laws based on federal audit reports. The funding provided for 2013-14, reflects an October 7, 2013, hiring date to allow the Department sufficient time to advertise and recruit the positions following required personnel procedures. The additional tax enforcement activities would generate estimated increased state income tax revenues of $7 million in 2013-14 and $28 million in 2014-15.

DISCUSSION POINTS

1. DOR receives two types of federal audit reports -- notice of underreported income (CP-2000) and revenue agent reports (RARs). IRS notices of underreported income identify federal

adjustments to income, payments, and credits for unreported income, including interest, dividends, gambling winnings, and stock sales. The IRS compares information reported by employers, banks, businesses and other payers on federal forms, such as W-2s and 1099s, with income and deductions reported on the taxpayers' returns. If the taxpayer failed to report any income, payments, and/or credits, or if certain deductions were overstated on an income tax return the taxpayer is sent a CP-2000.

A revenue agent report is a notice of proposed adjustments to a filed federal income tax return as a result of examination of taxpayer books and records, and an audit conducted by an IRS agent. The RAR is given to the taxpayer, and includes a statement of the items for which the agent proposes adjustments, such as nondeductible expenses, unreported business income, and incorrectly claimed tax credits. The report also includes the examining officer's discussion of factual findings, the legal grounds for the proposed adjustments, and supporting recommendations and work papers.

2. Wisconsin law requires a taxpayer to notify DOR, within 90 days after the final determination, for any year that the amount of federal net income tax payable, of a credit claimed or carried forward, or of a net operating loss or capital loss carried forward, that is reported to the IRS is changed or corrected by the IRS. The IRS notice of amounts due as a result of adjustments advises taxpayers that the IRS adjustments made may apply to their state return, which would require that they file an amended state return.

3. DOR receives the federal audit reports electronically about six times a year. The data is loaded into the Data Warehouse. The Department also receives a few paper returns that are scanned into the integrated tax system. The reports are generally received one to two years after the final IRS adjustment is made. In general, the Department has four years from receipt of the IRS federal audit reports in which to adjust the Wisconsin return. Revenue agents in the Audit Bureau determine whether the issue in the federal report affects the Wisconsin return, and if it was adjusted through an amended state return. The agents then adjust Wisconsin returns based on the federal audit reports, and in some cases where the statute of limitations would allow, make adjustments for other errors on the return. Assessment notices are sent to taxpayers based on staff review of their returns. The Department has automated some of the adjustment process so that billing notices, or requests for more information are automatically sent to taxpayers. However, the remaining adjustments must be reviewed and billed by an agent or auditor because of the complexity of the computations required. Approximately 25% of federal audit report assessments are collected by Audit Bureau staff. Currently, six positions in the Audit Bureau are assigned to work on federal audit reports. Based on experience, Audit Bureau collections average $800,000 per year for each agent or auditor.

4. From June 20 to August 27, 2011, the Audit Bureau engaged in an overtime initiative to reduce the backlog of federal CP-2000 reports. Staff working overtime used the federal reports to adjust state tax returns. The inventory was stratified so that staff focused on the highest dollar value adjustments. During the overtime initiative, staff worked 4,115 hours of overtime, and sent 12,068 bills totaling $11.4 million. Approximately $3 million was collected within 60 days of billing. The CP-2000 inventory was reduced by 15,145 reports.

5. Federal audit report assessments that become delinquent are collected by revenue

agents in the Compliance Bureau. Delinquent assessments are primarily collected through refund offsets, wage attachments, and bank levies. Compliance Bureau staff are not separately assigned to work on delinquent federal audit report assessments. A small number of assessments are written off as uncollectible. Based on experience, Compliance Bureau agents each collect an average of $1.2 million per year.

6. DOR conducted a pilot project in 2012, to determine the level of compliance with the requirement that taxpayers amend their returns to reflect federal adjustments. Of 203 taxpayer returns to which federal adjustments applied, only three had been voluntarily amended. DOR sent 138 letters advising taxpayers to file amended returns. After more than three months, approximately 45% of taxpayers who were sent letters had amended their Wisconsin return. As a result, DOR believes compliance is relatively low.

7. Table 1 shows, for 2008-09 to 2011-12, the beginning and ending inventory of federal audit reports (both CP-2000s and RARs), the number reports received each year, and the number of reports disposed of each year. Disposed reports include reports which are used to make assessments, reports for which the statute of limitations has expired, and reports for which there would be no adjustment to the Wisconsin return. The table shows that DOR receives between 35,000 and 55,000 CP-2000s and RARs each year, and has disposed of over 40,000 of the reports in recent years. However, the inventory of unprocessed federal CP-2000s and RARs has remained over 100,000.

TABLE 1

Federal Audit Report Inventory (Notice of Underreported Income [CP-2000] and Federal Revenue Agent Reports [RARs]) -- 2008-09 to 2011-12

Fiscal Year	Beginning Inventory	New Reports	Disposed -- Completed, Expired, Rejected*	Ending Inventory
2008-09	77,000	45,000	23,100	98,900
2009-10	98,900	36,000	33,100	101,800
2010-11	101,800	53,500	44,900	110,400
2011-12	110,400	41,400	44,000	107,800

*Includes reports for which an assessment has been paid, reports for which the statute of limitations has expired, and reports with no adjustments.

8. Table 2 shows assessments and collections made by the Audit Bureau as a result of adjustments to state tax returns related to the federal audit reports. Assessments, collections, and assessments that have been closed out have all increased since 2008-09. Closed assessments are billings that are paid or that went delinquent. Assessments under appeal are not included. Over 26% of amounts assessed have been collected by the Bureau.

TABLE 2

Federal Audit Reports -- Audit Bureau Collections 2008-09 to 2011-12

Fiscal Year	Assessments	Collections	Closed Assessments	Percent Collected
2008-09	$23,715,100	$5,704,500	12,800	24.1%
2009-10	20,032,500	5,497,200	13,200	27.4
2010-11	28,409,300	7,465,900	16,500	26.3
2011-12	30,598,300	7,990,700	19,300	26.1

Federal Audit Reports -- Compliance Bureau Collections 2008-09 to 2011-12

	Collections
2008-09	$7,324,800
2009-10	12,746,200
2010-11	14,473,800
2011-12	21,093,300

9. The table shows collections of delinquent assessments that are related to federal audit reports from 2008-09 to 2011-12. The table shows that collection of delinquent billings has increased substantially since 2008-09.

10. DOR believes that it would reduce the backlog of federal audit reports, be more timely in assessing taxpayers for unpaid state taxes, and generate increased net tax revenues with the additional positions and related funding.

11. Under the bill the Audit Bureau would be provided $848,000 GPR in 2013-14, $1,042,800 GPR in 2014-15, and 15.0 GPR revenue agent, 2.0 GPR revenue auditor, and 1.0 GPR revenue agent supervisor positions, beginning in 2013-14, to adjust state income tax returns based on federal audit reports. All the positions are four-year project positions. Following a training period, the Department indicates that the positions would begin generating revenue on April 1, 2014. Based on the average annual audit collections for Bureau revenue agents, the new positions would produce additional tax revenues of an estimated $3.0 million in 2013-14, and $12.0 million in 2014-15.

12. The Compliance Bureau would be provided $650,100 GPR in 2013-14, $852,500 GPR in 2014-15, and 14.0 GPR revenue agents and 1.0 GPR revenue agent supervisors positions, beginning in 2013-14, for collection actions related to delinquent federal audit report assessments. All the positions are four-year project positions. (The bill would also provide supplies and services funding of $80,000 GPR in each year for general administrative costs.) The delinquent tax collection agents would also be trained, and DOR would start them on February 1, 2014. The Department estimates that the new collection agents would generate additional estimated tax revenues of $4.0 million in 2013-14 and $16.8 million in 2014-15, based on their average annual collections.

13. In total, net of expenditures, the 33.0 new project positions would produce net tax revenue of $5.4 million in 2013-14 and $14.8 million in 2014-15.

14. The 15 new agent positions in the Audit Bureau would work with the six existing positions on new federal audit reports to reduce the backlog of existing reports. Table 1 shows that, at the end of fiscal year 2011-12, there was an inventory of 107,800 federal audit reports. The number of new reports provided by the IRS each year has ranged between 36,000 and 53,500. DOR estimates that it would almost eliminate the backlog sometime during fiscal year 2017-18. The 33.0 positions provided would expire in October, 2017. At that time, the Department believes it would be able to complete work on the federal reports it receives with existing staff.

15. The bill includes a provision that allows taxpayers subject to an audit determination by DOR to avoid liability for tax, interest, and penalties asserted on a tax issue if certain conditions related to past audits are met. The bill includes exceptions including: (a) the liability asserted by DOR in the current determination is the result of an amendment to law, promulgation of rule, guidance published by the Department, written guidance that was provided to a person who is a party to an audit determination, or final and conclusive decision of the Tax Appeals Commission (TAC) or courts since that prior determination; (b) the taxpayer did not give the Department employee adequate and accurate information; and (c) the issue is settled by written agreement between the taxpayer and Department. DOR is concerned that the provisions in the bill are insufficiently specific, which could lead to taxpayer challenges of non-audit determinations being subject to these provisions. DOR recommends that the provisions be amended to specify that the exceptions apply to audit determinations, that the exception for not providing information applies specifically to information regarding the tax issue in the prior audit determination, and the exception for settling the issue through a written agreement apply specifically to a tax issue settled in the prior audit determination.

ALTERNATIVES

1. Approve the Governor's recommendation.

2. Modify the Governor's recommendation to specify that the provisions that provide exceptions from reliance on past audits in current audit determinations be modified to specify that the exceptions apply to audit determinations, that the exception for not providing information applies specifically to information regarding the tax issue in the prior audit determination, and the exception for settling the issue through a written agreement apply specifically to a tax issue settled in the prior audit determination.

3. Delete the additional funding and positions recommended by the Governor.

ALT 3	**Change to Bill**	
	Funding	Positions
GPR	- $3,553,400	- 33.00
GPR-Tax	-35,800,000	

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