OFFICE OF THE LEGISLATIVE AUDITOR
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Tax Compliance

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Minnesota has significant tax compliance problems, and the state needs to strengthen its ability to detect and deter noncompliance.

Major Findings:

- Individuals owe, but do not pay, an estimated $600 million in Minnesota income tax annually. For the sales and use tax, this Minnesota "tax gap" is about $450 million.
- In addressing the income tax gap, the Minnesota Department of Revenue has made significant progress targeting nonfilers but not underreported self-employment income.
- The department is not effectively using some important information that would help identify noncompliance.
- On average, income and sales and use tax audits yielded $5 to $7 per dollar spent in fiscal year 2005, not counting revenue gains that may occur later because of better voluntary compliance.
- However, some of the department's audit programs find little noncompliance, and these resources could be redirected to more productive audits.
- Many taxpayers who file returns with a balance due or who owe taxes after an audit do not pay on time. This tax debt totaled over $450 million in 2005.
- Although the department has increased annual debt collections, many of its collection practices are inefficient.
- Taxpayers who call or write with questions often do not get prompt responses, and the department does not do enough to ensure that taxpayers get correct answers.

Recommendations:

- The Department of Revenue should improve its tools for identifying noncompliant taxpayers. To help, the Legislature should require employers to file wage reports in a common electronic format.
- The department should (1) make better use of performance data to evaluate audit projects and (2) modify or reduce resources in those that are unproductive.
- The department should simplify the steps involved in pursuing debt collection cases and put more emphasis on collecting high-dollar debts.
- The department should improve the quality of assistance provided to taxpayers who call or write with tax compliance questions.

Room 140, 658 Cedar Street, St. Paul, Minnesota 55155-1603 • Tel: 651-296-4708 • Fax: 651-296-4712 • E-mail: auditor@state.mn.us

Report Summary

The Minnesota Department of Revenue administers the state's system of income, sales, and other taxes. The individual income tax and the sales and use tax accounted for about 72 percent of state tax revenues (after refunds) in fiscal year 2005. The use tax is like the state sales tax, but it generally applies to purchases made from out-of-state businesses.

The department uses several strategies to boost tax compliance. This evaluation focused on the individual income tax and the sales and use tax, particularly the department's efforts to (1) help taxpayers comply voluntarily through assistance and education and (2) use audits to detect and correct errors in reported tax liability. We also evaluated efforts to collect tax liabilities that are assessed but not paid on time.

The Department of Revenue has had limited success targeting individuals who underreport their income and businesses that underreport their use tax liabilities.

Taxpayers Are Underreporting Their Tax Liabilities By An Estimated $1 Billion Annually

A "tax gap" is the difference between the amount of taxes owed and the amount taxpayers voluntarily report on their tax returns. The Department of Revenue estimated that, annually, the income tax gap is about $604 million (based on 1999 returns) and the sales and use tax gap is about $451 million (based on 2000 returns). For each tax, the tax gap is roughly 10 percent of the taxes owed.

The Department Has Had Mixed Success Targeting Major Contributors To The Tax Gap

For the income tax, the primary contributors to the tax gap are (1) self-employed individuals who underreport their income and (2) taxpayers who do not file at all (nonfilers). The department has made limited progress in addressing underreported self-employment income—largely because of staff turnover among field auditors needed to do the complex audits required to detect it. However, the department has significantly increased its auditing of nonfilers.

The majority of the sales and use tax gap is from unreported use tax, primarily by businesses that purchase taxable goods from out-of-state vendors. The department has targeted its audits at industries with high sales and use tax noncompliance, but has not made much progress in reducing the use tax gap overall. It audits a relatively small proportion of businesses, and it does little to enforce individual filers' compliance with the use tax because it does not consider it cost effective. A multi-state initiative to collect tax on Internet purchases holds promise for addressing use tax noncompliance, but its impact remains uncertain.

The Department Lacks Some Tools That Would Help Identify Noncompliant Taxpayers

The department effectively uses a variety of tools to identify noncompliant taxpayers. However, it is not using some information that would help identify other types of noncompliance.

For the income tax, the department does not adequately match state tax returns with the W-2 Wage and Tax Statements that employers file. It does not participate in the Internal Revenue Service's "Fed-State" tax return processing program, which would allow it to more effectively identify certain types of noncompliance. The department has a backlog of federal field audit reports that can be used to determine whether taxpayers owe additional state taxes, though recent changes will enable the department to reduce this backlog. Until January 2006, the department's income tax data systems lacked drivers' license, motor vehicle registration, and hunting and fishing license data that would particularly help identify unreported self-employment income.

The department has fewer sources of information available to help identify sales and use tax noncompliance. But some data are available, such as sales figures reported on federal tax returns, and these need to be integrated into the department's data systems.

Increased audit activity has been productive, but the department could further increase revenues by modifying some types of audits.

Overall, Audit Productivity Has Improved, But Some Types Of Audits Find Little Noncompliance

Audit productivity—the revenue collected per dollar spent on audits and collection—has improved in recent years. For audits completed in fiscal year 2005, we estimate that the department will collect, on average, about $6.70 per dollar invested in income tax audits and $5.40 per dollar invested in sales and use tax audits.

The department generally groups audits into projects aimed at specific groups of taxpayers or compliance issues. Although overall productivity has improved, these averages mask variation in results among projects. For example, two large sales and use tax audit projects have been less than one-third as productive as the average for each of the past three years. Similarly, some income tax field audit projects have found little noncompliance.

In part, unproductive audit projects persist because the department has only recently begun to use audit performance data to assess and improve them. The department has focused on restructuring and increasing the number of audits it does. Now it needs to do more to fine tune its audit programs.

Collection of overdue tax payments has been increasing, but poor data and inefficient processes impede efforts to more effectively pursue delinquent taxpayers.

Collection Of Past Due Taxes Has Been Increasing, But Over $450 Million Is Still Owed To The State

If taxpayers report a balance due on their tax returns or are assessed additional tax after an audit, they must pay by certain deadlines. If timely payment is not made, the taxpayers' accounts become delinquent and are referred to the department's Collection Division. At the end of fiscal year 2005, these tax debts totaled over $450 million. About 63 percent of debts were for individual income tax liabilities.

The department received additional funding to increase debt collection, and as intended, collections increased from about $164 million in fiscal year 2002 to $191 million in fiscal year 2005. Still, the pace of debt collection has not met the department's goal to collect most debts within a year of becoming delinquent. As of late 2005, 60 percent of debts had been delinquent for more than a year.

Some Collection Practices Are Inefficient, And Collection Resources Could Be Used More Strategically

Cumbersome case routing and inconsistent collection procedures have contributed to inefficient debt collection. Collection work is divided among work groups that each function independently. Combined with a lack of standardized collection procedures, this led to inconsistent treatment of debtors. Also, collection cases are handed off numerous times, adding to case processing time. The department has recently acted to improve its performance management system, standardize application of collection procedures across work groups, and identify problems in case routing. However, these changes have not been in place long enough to assess their impact.

The collection process also lacks strategic focus. Less than 10 percent of cases account for over 70 percent of total tax debt, yet the department does not allocate a greater share of resources to these cases. Moving forward, the division needs to invest in developing and analyzing better data on debts, debtors, and collection results in order to make greater gains in efficiency and effectiveness.

The Department Relies Heavily On Its Website For Taxpayer Education

Education services are intended to help taxpayers understand and voluntarily meet their tax obligations, reducing state and taxpayer compliance burdens. In recent years, the Department has emphasized self-service through the department website, although it still provides direct services, such as taxpayer training, support for volunteer return-preparation programs that help low-income filers, and direct outreach to certain groups of taxpayers.

The department needs to improve access to taxpayer assistance, particularly for taxpayers with limited English proficiency.

However, education efforts targeted at taxpayers with limited English proficiency could be improved. The department has translated some documents into other languages, but its telephone assistance is not well structured for bilingual service.

Taxpayers Who Call With Questions Often Do Not Receive Prompt Assistance

Answering taxpayers' questions is another strategy to improve tax compliance. But in 2005, many callers had a hard time getting through to assistance representatives, particularly around return filing deadlines.

From February through April 2005, department staff were able to answer 64 to 70 percent of income tax assistance calls. One problem is that many taxpayers are not using automated options for learning the status of their refunds. These callers are a drain on telephone assistance resources, limiting the department's ability to assist callers with more complex questions. Access to help with sales and use tax questions is even more difficult. Around the annual sales tax filing deadline in January and February 2005, representatives answered only about half of incoming calls.

The department does not do enough to test the accuracy of the assistance it provides by telephone and e-mail.

The department needs to seek staffing, call routing, and automated solutions to improve the level of service provided.

The Department Does Not Adequately Ensure That Taxpayers Get Correct Answers To Their Questions

Some calls to the income tax assistance line are recorded and later evaluated for accuracy and adherence to department procedures. For fiscal year 2005, the department evaluated about 300 calls and noted a problem in about 30 percent of them. Among the most common problems were failure to verify the caller's identity and inaccurate answers. But not all calls were thoroughly evaluated, and only about one-fifth of the monitored calls involved technical tax questions, for which incorrect answers pose the highest risk to the taxpayer.

The department does not have a systematic quality assessment process in place for sales and use tax assistance calls and needs to establish one. The department also should do more to test the accuracy of staff responses to e-mail inquiries.

The full evaluation report, *Tax Compliance*, includes the Department of Revenue's response and is available at 651-296-4708 or:

www.auditor.leg.state.mn.us/ped/2006/taxcomp.htm

Summary of Agency Response

In a letter dated February 17, 2006, the Commissioner of Revenue Daniel A. Salomone wrote, "Overall, the evaluation concurs with the department's estimate of the scope of noncompliance and recognizes the appropriateness of the strategies the agency employs to improve tax compliance.... The department agrees with the vast majority of recommendations made by the OLA." According to Commissioner Salomone, the department has initiated a variety of actions to improve tax compliance and the delivery of services, and he concluded: "The OLA's evaluation and recommendations provide helpful suggestions for making these efforts more effective and provides a useful tool to guide the department in its effort to improve compliance with the state's tax system."