

## Department of Revenue

EXHIBIT 2DATE 2/3/05HD 2

### PROGRAM 01 – DIRECTOR'S OFFICE

DP 105 - Pay Off the IRIS Computer System Loan - An increase of \$2.1 million general fund for FY 2006 is recommended to pay off the loan from the Board of Investments used to fund the Integrated Revenue Information System (IRIS), developed to replace the Process Oriented Integrated Tax System (POINTS).

#### LFD COMMENT

##### *Supplemental Appropriation*

The Governor Martz budget included a request for a \$16.0 million general fund appropriation to pay off the IRIS loan. The Schweitzer budget changes anticipate funding \$13.9 million of the loan payoff with funding in HB 3 for a supplemental appropriation in FY 2005 and this request for the remainder. As a result of repaying the loan, the department would be reducing approximately \$3.0 million per year in payments for the next 5.5 years. The reduction of these payments would eliminate the assessment against personal income tax revenue and would restore \$3.0 million revenue to the general fund each year. The executive recommends the legislature designate the appropriation for this purpose as one-time-only.

#### LFD ISSUE

##### *Impact on Montana Law*

Legislation has yet to be requested to amend Montana law to eliminate the administrative assessment against selected taxes collected by the department in order to fund the debt service on the Board of Investments loan. The legislature may want to enact legislation to repeal 15-1-141, MCA, and amend 15-1-501, MCA, accordingly.

### PROGRAM-07- BUSINESS AND INCOME TAXES DIVISION

DP 111 – Increase Funding for the Department of Revenue – An increase of \$1.12 million general fund for the biennium is requested to fund personal services and operating costs to add 8.00 FTE for compliance activities in four areas where other states have found significant non-compliance with personal income tax and corporate license tax.

#### LFD COMMENT

##### *Compliance Staff and Revenue Generation*

##### FTE Additions

Funding of the adjustment would be used to hire the following compliance staff:

- 6.00 FTE financial operations supervisors (grade 16)
- 1.00 FTE attorney (grade 21)
- 1.00 FTE auditing technician (grade 10)

##### Compliance Concentration

The FTE added by the adjustment would concentrate on compliance in the following four areas where other states have found significant non-compliance with personal income tax and corporate license tax:

- Abusive tax shelters, where compliance or fraudulent transactions are used to hide or disguise income
- Income earned in the state by nonresidents that is not reported or taxed (i.e. capital gains income)
- Income earned by out-of-state businesses that have enough economic presence in the state to owe, but do not pay, corporation license taxes
- Income earned in Montana that flows through one or more pass-through entities to an out-of-state recipient who does not pay Montana income tax

**LFD  
COMMENT  
CONTINUED***Projection of Additional Revenue*

The executive has stated that by hiring the additional compliance staff and concentrating compliance activities in the four areas described above, additional revenues that would exceed the cost of the compliance staff are expected. The additional revenues generated by the FTE and associated compliance activities are expected to be ten times the costs after the FTE are trained and gain experience, but are only expected to generate additional revenues of \$1.1 million, or two times the costs, in FY 2006 and \$2.3 million, or nearly four times the costs, in FY 2007.

**LFD  
ISSUE***One-time Funding*

The executive indicates that \$40,000 in FY 2006 and \$80,000 in FY 2007 are for one-time costs. As such, the legislature may wish to designate funding for these amounts as one-time-only.

**LFD  
ISSUE***Verification of Additional Revenues*August 2002 Special Session FTE Additions

The legislature, in the August 2002 Special Session, added 13.30 FTE compliance staff to the Department of Revenue. The FTE were added during the special session on the assertion that the FTE would generate additional audit related general fund revenue and the additional revenue would exceed the costs of the compliance activities. The 2003 Legislature added the following language to HB 2 that directed the department to report on the additional revenue generated by the new FTE and the costs to achieve the additional revenue:

"The department [Department of Revenue] shall present reports to the revenue and transportation interim committee that show the cost of tax compliance staff and the additional revenue generated from providing the associated tax compliance. The department shall identify the costs and revenue separately for the additional staff added during the August 2002 special legislative session. The revenue and transportation interim committee may determine the frequency for reporting by the department on compliance staff revenue."

Testimony Before the 2003 Legislature

During the hearings of the General Government and Transportation Joint Appropriations Subcommittee of the 2003 Legislature, department management testified that they could track the activities and would be able to fulfill the requirements of the above language.

Report to the Revenue and Transportation Interim Committee

When reporting to the Revenue and Transportation Interim Committee, the department management testified that they could not separately identify the additional revenues generated by the FTE added during the special session.

**LFD  
ISSUE  
CONTINUED**

Potential Legislative Questions

Because the department could not fulfill the reporting requirements they committed to during the 2003 session, the legislature may wish to have the department explain:

1. What changed between the hearing of the General Government and Transportation Joint Appropriations Subcommittee of the 2003 Legislature and the time it reported to the Revenue and Transportation Interim Committee that did not allow the department to track the activities of the compliance FTE?
2. Why did the department not establish a process to monitor the activities of the compliance FTE so it could fulfill its reporting requirements and comply with the law?

Verification of Additional Revenue of the DP 111 FTE

**Methodology for Determining Expected Additional Compliance Revenue**

When determining additional revenue that would be expected from additional compliance FTE, the department follows the same methodology of dividing the annual revenue generated by all current compliance staff in a given compliance area by the number of current FTE providing the compliance activities. This methodology determines the average revenue generated from each current FTE, which the department then assumes would be generated by each additional FTE. When considering the principle of diminishing returns, it is not reasonable to expect that the additional revenue generated from additional compliance activities would produce the same amount of revenue as the average of the current effort. The marginal revenue generated from additional compliance should be lower than the revenue generated from the current compliance unless the compliance area is being significantly under served. If the same amount of compliance revenue could be generated from additional compliance activities without any marginal decrease, one might ask why the department doesn't recommend hiring even more compliance staff to fund. A ten times return of revenue over the costs of compliance activities is a good return on the investment of the compliance staff. The difference between the special session FTE and the FTE of DP 111 is that the FTE of DP 111 are intended to provide compliance in areas that may currently be under served. However, the methodology of assuming that the average revenue from current FTE would be generated by the additional FTE may raise a concern with the legislature.

**Legislative Options for Verifying the Return on Investment**

The legislature may wish to consider options for verifying how much additional revenue is generated by the additional compliance FTE and at what cost the revenues are generated. Given the failure of the department to appropriately satisfy the reporting requirements of the 2003 Legislature, the legislature may wish to consider the following options for verifying the revenues of the DP 111 FTE:

- o Option 1 – Include language in HB 2 that directs the department to implement a process to separately track costs and revenues generated by the additional FTE of DP 111 and report to the legislature on the costs and revenues of the FTE
- o Option 2 – Request a bill to amend the statutory duties of the department to separately track costs and revenues generated by the additional FTE of DP 111 and report the costs and revenues to an appropriate legislative committee
- o Option 3 – Impose no reporting requirements

*Option 1*

Option 1 to include a requirement in HB 2 for the department to separately track and report on the costs and revenues of the FTE added in DP 111 would be similar to the direction of the 2003 Legislature, but would specifically require the department to establish a system for tracking the activities of the new compliance FTE so a recurrence of the conflict between the session and interim responses of the department is not repeated.

**LFD  
ISSUE  
CONTINUED**

The executive indicates that the additional revenues for the compliance activities of this adjustment could ultimately grow to ten times the cost. However, the request also indicates a gradual increase in additional revenues during the introduction phase of this initiative. Full revenue enhancements are not anticipated until after the 2007 biennium. Including the requirement in HB 2 would only require the department to track and report on DP 111 compliance activities during the 2007 biennium and would require the 2007 Legislature to impose similar requirements in order to have the department report the costs and revenues from the DP 111 effort after the 2007 biennium.

Other controls the legislature may wish to use to help ensure that the reporting requirements are satisfied include:

1. Designating the funding for the entire request as one-time-only. With one-time funding for the compliance FTE, the department would have a higher risk on future funding for the function without providing the legislature with appropriate data to support the claims of additional revenue generation from the compliance activities
2. Designate the funding in a separate line item. A separate line item would establish an administrative structure for separately tracking line item expenditures
3. Place restrictive language on the appropriation for the compliance FTE. Restricting the funding for DP 111 would restrict the department from using the funding for other purposes.

The legislature could use any of the above controls to help ensure compliance with its reporting requirements. The following language would require the department to establish a process for monitoring the activities so reporting could be accomplished. In addition to a one-time-only, restricted appropriation in a separate line item, this language would provide maximum legislative control of these expenditures.

"The department [Department of Revenue] shall develop a process for separately tracking costs and revenues associated with the compliance activities funded in item [line item for DP 111]. The department shall present reports to the legislative finance committee that show the costs of providing tax compliance as funded in [line item for DP 111] and the additional revenue derived from the associated compliance activities. The reports must include a breakdown of all costs by second level of expenditure and a comparison between the aggregate tax revenues derived from the individuals or businesses directly audited by the compliance activities funded in [line item for DP 111] and the aggregate tax revenues derived from the same individuals or businesses prior to implementation of compliance activities funded in [line item for DP 111]. The legislative finance committee may determine the frequency for reporting by the department on compliance staff costs and revenue. The department shall provide the same reports to the general government and transportation joint appropriations subcommittee of the 2007 legislature during budget hearings."

"Item [line item for DP 111] is restricted for expenditure on tax compliance activities associated with:

- o abusive tax shelters, where compliance or fraudulent transactions are used to hide or disguise income;
- o income earned in the state by nonresidents that is not reported or taxed;
- o income earned by out-of-state businesses that have enough economic presence in the state to owe, but do not pay, corporation license taxes; or
- o income earned in Montana that flows through one or more pass-through entities to an out-of-state recipient who does not pay Montana income tax."

*Option 2*

Option 2 would consist of a bill draft request to amend 15-1-201, MCA, to include the requirement to develop a process to separately track and report the costs and revenues as directed by the above HB 2 language, but would make the requirement a part of permanent law. Amending Montana law to require the department to track and report would continue beyond the end of the 2007 biennium and not necessitate a positive action by the 2007 Legislature to continue the requirements. The legislature could include similar tracking and reporting requirements as specified for HB 2 in a bill request to implement the requirements.