EXHIBIT 1
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Legislative Audit Division

State of Montana

Report to the Legislature

October 2006

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2006

Department of Revenue

This report contains seven recommendations to the department. Issues addressed in the report include:

- **Financial Accountability**
  - **Reconciliation controls**
  - **Unrecorded revenue and expenditures**
  - **Debt collection program**
- **Improving tax compliance for:**
  - **Combined oil and gas severance taxes**
  - **Corporation license taxes**
  - **Individual income taxes**
- **Noncompliance with state statutes**

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Corporation License Taxes

The department does not have adequate procedures to ensure all new corporations, limited partnerships, limited liability companies, and limited liability partnerships file timely tax returns or the Secretary of State is notified, as required by section 15-31-523, MCA.

Section 15-31-603, MCA, requires the Secretary of State to provide a list of all new corporations, limited partnerships, limited liability companies, and limited liability partnerships, foreign and domestic, to the department each month. The department can use this list, required since October 2001, to identify and communicate tax reporting responsibilities to potentially new taxpayers and to identify entities that may not be paying their tax liabilities. The department is required by section 15-31-523, MCA, to report corporation license tax nonfilers or delinquent filers to the Secretary of State so the suspension, forfeiture, or dissolution of corporate rights provided in law can be made.

We observed the department's electronic comparison of the Secretary of State's information to IRIS data for the months of March and June 2006. Department personnel electronically compare the names and addresses of new foreign and domestic corporations from the information electronically provided by the Secretary of State, but exclude the other entities. The department could expand its ability to identify potentially new taxpayers by comparing all entities provided by the Secretary of State. For example, the March 2006 information originally provided by the Secretary of State contained 1,888 entities, of which 594 were new foreign and domestic corporations. Department personnel told us that when the corporation license tax was implemented into IRIS, the only functionality for the comparison that was programmed was what existed for the previous system, which was limited to new foreign and domestic corporations.

If the name and address on the Secretary of State's information nearly matches IRIS data, the electronic comparison requires department personnel to review the information from both sources to

determine if there is a match or not. If there is any question whether the information matches, department personnel treat the entity as if it does not match an entity on IRIS. This process could work more efficiently if the Secretary of State gathered the taxpayer ID and provided it to the department with the other entity information.

The department does not notify the Secretary of State when a corporation does not file or is delinquent in filing, unless department personnel know the corporation is currently operating. Department personnel do not check with the Secretary of State or its website to see whether the corporation is active. Department personnel indicated that past history has shown most corporations that do not file returns have already voluntarily dissolved or are no longer active corporations. In addition, when returns come into central cashiering, they can get backed up and may not be entered into the system right away. The department should develop procedures to ensure the Secretary of State is notified of nonfilers and delinquent filers in a timely manner.

Recommendation #5
We recommend the department:

A. Work with the Secretary of State to obtain the information necessary for an efficient comparison of new entity information.

B. Compare information to department records for all of the entities the Secretary of State reports.

C. Implement more effective procedures for identifying and reporting corporation license tax nonfilers and delinquent filers to the Secretary of State as required by state law.

Individual Income Taxes

The department's individual income tax booklet for tax year 2005 was inconsistent with one state law and did not disclose requirements from four state laws that could either benefit taxpayers or facilitate taxpayer compliance.

Recommendation #4

We recommend the Department of Revenue work with the Board of Oil and Gas Conservation to develop and implement procedures for cross-matching oil and gas production and sales data to ensure all oil and gas severance taxes owed are reported or assessed in accordance with state law.

Partially Concur. The department agrees to work with the Board of Oil and Gas Conservation (BOGC) on the development and implementation of a process to systemically cross-match BOGC well data with department tax data. To accomplish this, the department will: 1) work with BOGC on the development of the data requirements to conduct the cross-match; 2) enter into an MOU with BOGC which will contain the data requirements, timelines and responsibilities; and 3) work with the department's programming staff to develop electronic non-filer and/or missing lease letters. It is anticipated this process will be in place by the end of 2007.

The audit noted the department was not complying with the provision of 15-36-313 (1), MCA, which requires the immediate issuance of an estimated tax assessment for operators who have failed to file an oil and gas production tax return. The department believes that while estimated tax assessments are a useful enforcement tool, there are more efficient and effective ways to enforce compliance. These other enforcement tools include issuing administrative subpoenas and orders to show cause for non-filing. The department intends to continue to use estimated tax assessments when appropriate, but will be focusing on enforcement by using these other tools. To specifically address the audit findings, the department will seek legislation to strike the requirement to immediately issue an estimated assessment. The proposed legislation will continue to give the department the authority to issue estimated assessments when appropriate.

Recommendation #5

We recommend the department:

A. Work with the Secretary of State to obtain the information necessary for an efficient comparison of new entity information.

Concur. The department is working with the Secretary of State in order to receive approximately seven additional files which will include data the department has been missing. This process is limited to an initial comparison by name only. In order to make this an efficient process; however, the Secretary of State would need to require a taxpayer identification number; i.e., federal employer identification number or social security number which they do not currently require. Otherwise, the comparison process has marginal value.

In the June 2006 Performance Audit titled "Improving Taxpayer Compliance in Montana Through Audit Efforts" the Legislative Auditor recommended that the department:

Establish priorities for achieving audit goals and objectives, and more effectively deploy audit resources by directing audit activities. The department will continue to work with data provided by the Secretary of State. As long as SSN/FEIN numbers are not required by the legislature or the Secretary of State; however, this data will likely have marginal value and will not be assigned as high a priority for compliance use as other data that can be cross-matched on a more efficient and effective basis.

B. Compare information to department records for all of the entities the Secretary of State reports.

Concur. The department will continue to compare department records with the information the Secretary of State reports. However, as previously mentioned, this is currently an inefficient process as there is not a taxpayer identification number included in these reports. The department will work with the Secretary of State's office to see if they can revise their process to capture a taxpayer identification number.

C. Implement more effective procedures for identifying and reporting corporation license tax nonfilers and delinquent filers to the Secretary of State as required by state law.

Concur. The department will work toward implementing more effective procedures to identify and report corporation license tax non-filers and delinquent filers to the Secretary of State as required by state law. As previously described this process is limited and inefficient without a common taxpayer identification number to compare data against. A common denominator is necessary to make this exchange of information a worthwhile exercise.

Recommendation #6

We recommend the department:

A. Comply with section 15-30-112, MCA, concerning the income limitation of dependents other than taxpayers' children.

Concur. The $800 income limitation has been included in the instructions within the 2006 individual income tax booklet to comply with current law. The department will seek legislation to apply the inflation factor to the $800 income limitation in future tax years to be consistent with how the department applies the inflation factor to the exemptions provided for in this section of law.

B. Improve the tax booklet by including all information affecting individual income tax computations contained in state law.

Concur. Sections 15-30-105(2), 15-30-121(1)(i), and 15-30-106, MCA, identified in the audit as laws not included in the 2005 individual income tax booklet have been included in the 2006 tax year booklet. The department is reviewing what can be done to improve