

**Testimony to the Montana House Appropriations Committee on HB 2**

**Montana Department of Revenue Budget**

**Dan Bucks, Director of Revenue**

**March 4, 2011**

I wish to thank Chairman Beck and the members of the General Government Subcommittee especially, Rep. McChesney and Edmunds, for their careful attention to our budget. We appreciate the highly professional and thoughtful manner in which the subcommittee conducted its work.

It is a privilege and honor to talk to you today about the budget of the Montana Department of Revenue. It is an honor because I believe that this department—which has long benefitted from a talented work force committed to excellence in public service—has transformed itself over the last six years into a high performing, efficient and effective organization that serves Montanans well. It has done so with the help of the Legislature and the support of the Governor.

The Montana Department of Revenue is responsible for more than \$2.6 billion in state and local revenue each year. If the Department were a business, these revenues would be twice as large—as measured by Montana sales—as any other business operating in our state. We have more contact with more citizens and businesses than any other state agency. The product we produce—revenue—is the life blood of most of Montana state and local government. Yet, we are much smaller than several other state agencies in terms of the number of staff. Given the scope of our work, its importance to government services and our responsibilities to the public, this budget deserves careful consideration.

Over the last two years, we have set records for audit collections—and as a result this 2011 Legislature meets with \$150 million more in the state treasury than would otherwise be the case—\$150 million more that you can devote to the public purposes that you choose.

Over the last six years, we have gone from the bottom to the top rank of the states in our providing and Montanans using convenient and inexpensive electronic filing options. In 2010, 70% of Montana individual income taxpayers filed electronically. And last year our speed of paying refunds to individual income tax taxpayers was at an all-time high.

Our liquor control division has cut our cost of operations as a percentage of sales and increased our operating efficiency by 13% over the last six years. With the help of the Legislature approving a plan for strategic renovations, we have extended the life of the liquor

warehouse by 25 or 30 years—saving taxpayers from a costly warehouse replacement in the next few years—and we have cut energy costs dramatically.

We completed in 2009 the most complex and extensive property reappraisal in history. According to the first time ever independent audit of our reappraisal results, we hit the bulls-eye in measuring the level of market prices for residential and commercial property as of the reappraisal date. We have protected taxpayers and local governments from a constitutional challenge to our property system by reappraising agricultural land on an objective, scientific basis for the first time in 46 years. Time and again we have successfully defended our property valuation of major facilities in the state—protecting homeowners, small businesses and farmers and ranchers from unfair tax increases and ensuring greater stability in local government and school district finances.

These are the highlights. We could discuss more. Suffice it to say that we are proud of what we have accomplished and eager as an agency to do even more—and we can if we are funded as recommended in the Executive Budget.

**The product of the Department of Revenue is revenue properly collected for state and local government, fairness among taxpayers, economic growth and jobs based upon a level tax playing field among businesses, and public trust for the integrity of the law.** Cutting the Department's budget by \$6.1 million, as recommended by the subcommittee, does not make sense in these times. It does not save you money, its costs you \$36 million in lost revenue because you will reduce the ability of the Department to collect revenues due and owing under the law. It does not help the vast majority of Montana taxpayers who pay the right amount of taxes on time year after year. Instead, it hurts honest Montanans by rewarding those who fail to file returns, who dishonestly underreport income, or who are delinquent and fail to pay their taxes. Cutting the Department's budget especially hurts Montana taxpayers by rewarding non-residents and out-of-state companies who neglect or ignore their tax responsibilities to Montana to a disturbingly greater degree than our citizens. Cutting our budget does not help the Montana economy, it hurts it in many ways. It limits the ability of this Legislature to implement policies that you believe are good for our economy. It allows businesses who underpay their taxes to gain an unfair advantage over the businesses that diligently meet their responsibilities—and in the process economic efficiency and growth suffer. It allows money that belongs here in Montana creating jobs for our citizens to escape our borders through out-of-staters who fail to pay the right amount of Montana taxes.

**I would like to turn to the main issue: Cutting the budget of the Department of Revenue by \$6 million will result in a loss of revenue of \$36 million—six dollars of revenue lost for each dollar of budget cut. Whatever your definition of fiscal balance may be, cutting this budget gets you further away not closer to that balance. If you think there is a hole in the state budget, cutting the Revenue Department makes that hole bigger.**

While you may have seen different numbers on the ratio of revenue dollars lost for each dollar of budget cuts—the fact that the loss of revenue is greater than the budget is a settled question. Both your legislative staff and executive branch officials agree on this specific point: cutting our budget cuts revenues by even more.

What is the basis for our six to one ratio? We begin with the fact that the Department of Revenue in FY 2010 was responsible for generating \$48 of state and local revenue for each dollar expended. If you eliminated our \$54 million budget for last year, the lost revenue would have been \$2.6 billion dollars. That average return of 48 to 1 breaks out among three major department functions as follows: \$39 generated for every dollar spent on property tax administration. \$9 for every dollar spent on liquor administration and \$72 for every dollar spent on state level tax collection. That is the average rate of return on the entire Department budget. We understand that no one is talking about eliminating the entire Department budget—but this average rate of return illustrates the link between the funding you provide Department activities and revenues collected.

The immediate question is not what would happen if you cut the entire budget, but what if you cut \$6.1 million from the budget as proposed by the subcommittee? There are many ways to estimate the revenue that will be lost, but the best way is to look at verified data of what has happened when state tax agency budgets have been increased or decreased. We have examples of eight states in the last decade—including our own state—that increased their revenue agency budgets with the intention of improving revenue collections. The return on investment ranged from a low of 5.8 to 1 in New Mexico to 14.7 to 1 here in Montana. All except New Mexico exceeded a 6 to 1 return.

Let's look at the opposite cases. Three states intentionally cut their revenue agency budgets in recent years. These cuts resulted in documented revenue losses ranging from 5 to 15.4 times the amount of the cuts. The agency most like our Department in this group, the California income tax agency, lost 7.2 dollars in revenue for each dollar in budget cuts—and the revenue losses occurred quickly after the cuts occurred. We urge you not to repeat the mistakes made in these states.

Additional evidence comes from the even more recent experience next door in Idaho where their legislature last year funded a major increase in compliance efforts. As indicated in the news report in the materials we have provided, this legislative budget action is bringing in more than twice its revenue goal.

A third way to look at the potential return from investing in tax compliance is the backlog of case work we have in the Department. Nearly half of the non-filer cases we have identified in the last several years remain unworked—15,600 out of 31,900 cases remain unattended because of insufficient staff. The backlog is even greater for non-compliance cases. We have worked

42,000 cases generating \$13 million. Unfortunately, we have 98,000 other cases that are untouched.

Based on the actual experience from several states, the new results from Idaho and our backlog of compliance work, a 6 to 1 ratio is very conservative. It is lower than the overwhelming majority of the documented impacts that have occurred from increases or decreases in state tax agency budgets around the nation—including previous experience right here in Montana.

Why is the 6 to 1 ratio higher than what you have heard from your staff? We respect your staff and their work. However, they left out two things from their analysis. They did not consider the impact of our budget in generating voluntary compliance revenues, and they excluded property taxes. I will focus for the next few minutes on these areas because they have not been sufficiently considered in the revenue impact analysis. However, these next remarks should not obscure the clear fact that our state audit and compliance work has been producing record results—the extra \$150 million in the bank over the last two years that is now available to this Legislature. This \$150 million was generated by our achieving a record level of audit productivity higher even than the conservative 6 to 1 return we urge you to use in making decisions on our overall budget.

Voluntary compliance revenue collections do not occur automatically without any effort. If we did not design effective forms and instructions—if we did not provide convenient electronic filing methods—if we did not answer taxpayer questions—if we did not open the mail and deposit the payments—if we did not pay refunds promptly or send notices of taxes due monthly, voluntary compliance revenues would fall dramatically. We know from Montana's own experience with the notorious failure of the POINTS computer system a decade ago that bad service results in lost revenue—over \$20 million of lost revenue as documented by the Montana Legislature when it pulled the plug on POINTS in 2003. Budgets for taxpayer services affect voluntary compliance revenues—which is why revenue ratios are greater than 6 to 1 in almost all the states where tax agency budgets were increased or decreased.

The impact of the budget on property taxes obviously needs to be considered as well. Property taxes are a \$1.25 billion business each year. Not a single dollar of property tax is collected each year except through the actions of the Department. In a sense, property taxes are equivalent to audit collections for state taxes. The property tax dollars are directly generated in proportion to the extent of Department efforts.

Each year from January into November the Department recreates the local property tax rolls and billing information. We inventory the changes in the local levy districts, gather personal property and centrally assessed information and assess values for that property, identify and value changes to real property, record changes of ownership, issue assessments, respond to appeals and then certify values to more than a thousand local governments and school districts.

Once budgets are set, we then gather local budget and mill levy information and create approximately a million individual property tax billing files to transfer to county treasurers who then process and send the individual bills to taxpayers. In between time we do physical surveys of property for the next appraisal cycle. And in January we start all over again.

The budget and staffing for property tax work has shrunk significantly over the last fifteen or more years while the number of parcels of property have increased substantially—without any major changes in technology to help manage the increased workload per person. We offer some examples—based on institutional memory—of the reduction in staff in eastern and north central Montana. In both cases our staff is about one-third less, while the amount of property parcels has increased. So we are stretched very thin in our property tax functions. A map of current staffing displays the distribution among the counties of our property tax staff.

Now the subcommittee's budget recommendation would cut almost \$1 million annually or \$2 million over the biennium from the property tax budget—which would require us to hold open 17 additional positions beyond the vacancy savings you otherwise require. Some subcommittee members asked us to establish priorities for budget cuts, so let's go through a decision process for where these 17 additional vacancies would occur. We could start by eliminating our central property office in Helena which has a few more than 17 staff members. Because this is the nerve center that controls the information flow for the entire property tax system, eliminating the central office would risk losing all \$1.25 billion in annual property collections in Montana and bring all local governments and schools in Montana to a halt. If the worst case occurred, that is a revenue loss of \$1,250 for each dollar of budget savings. The risks under this option are not acceptable. Or we could just eliminate the property tax function in one county—let's say Cascade County with its 18 positions. That would fit with the proposed budget cut, but it would eliminate \$82 million in annual property tax revenue and also eliminate all local government functions and schools in Cascade County. That is an 82 to 1 loss. Great Falls and surrounding communities would probably not consider that a reasonable option, nor would we. So we could instead shut down operations in the twelve smallest counties. \$33 million of annual property tax dollars—or 33 times the budget savings—would be lost, and local governments and schools would be eliminated in these counties. That's not reasonable either.

So what would we actually choose to do under the subcommittee recommendations? 17 positions would be held vacant in the largest 12 counties with current staffing from 6 to 29 staff members each—because that's where the property tax positions mostly are. One function that would cease in these counties would be the annual identification of new construction. Only about 20% to 30% of new construction would be picked up each year through the cyclical reappraisal reviews. The revenue loss under the 101 state mills for the state general and University funds would be between \$7 and \$8 million a year. At the local level, assuming that property taxes would be shifted through mill levy increases, 70% to 80% of new construction in a given year would be tax free and between \$30 and \$40 million in local property taxes would be unfairly shifted to existing property owners. The loss in state revenue—not counting the

disruption to schools, counties and cities—would about \$7 to \$8 for each dollar in the property tax budget cut. That is slightly more than the general 6 to 1 ratio we use to project the overall \$36 million loss in state revenues from the subcommittee recommendations. So the least damaging option still loses several times the revenue compared to budget savings—and produces inequities in the distribution of property taxes.

This property tax exercise is a good illustration—but only one illustration—of what happens to the entire state and local tax system when the Revenue Department's budget is cut. We could go through similar examples for every other part of the Department—all of which are affected by the subcommittee's recommendations. Each part of the Department affects our ability to produce our results—and most of the parts interact and affect each other. How the parts of the Department work together, how we measure our results and produce continuous improvements in productivity and results for our citizens is explained in the final paper in the materials we have provided to you. I would call your attention in particular to pages 11 and 12 of that paper that displays our record state level audit collections and audit productivity.

Mr. Chairman I am not going to address in detail certain technical subcommittee recommendations that we hope this committee will reconsider. In addition to amendments restoring \$6.1 million to the Department's budget, there are amendments to remove restrictions that limit our efficiency and effectiveness. Those restrictions that we would ask to be removed include one time designations and the absence of FTE authority to match personnel funding.

There are no areas of the Department where a reduction in the budget would not result in a reduction of revenues for state and local governments. You lose six or more times the revenue than you save in expenditures. Taxes end up being unfair. For property taxes, existing property owners lose, and owners of new construction win. At the state level, honest taxpayers lose out to the dishonest and the delinquent. Montanans lose as compared to non-residents and out-of-state companies. Diligent and honest businesses that pay the right amount of taxes face unfair competition from and lose capital to those businesses that help themselves to illegal tax subsidies by underpaying taxes. The result is a misallocation of capital that reduces economic efficiency and the growth of jobs in Montana. So it does not make sense in terms of sound state fiscal policy, tax fairness or good economic policy to cut the Department of Revenue budget. **Our work pays for itself several times over in better revenue collections, supports a stronger economy and creates greater trust of our citizens in the fairness and integrity of our tax system.** We urge you to restore through all the prepared amendments the Department of Revenue's budget to the Executive Budget levels—and in so doing restore \$36 million to the revenue estimates—for a net gain in fiscal balance of \$30 million for the citizens of Montana.



# House Appropriations Committee

Montana Department of Revenue

Budget Exhibits

March 4, 2011

**Montana Department of Revenue**  
**Average Return on Investment in Tax Administration**  
**FY2010**

**Step 1: Total Revenue Generated per Dollar Expended**

<b>48:1</b>
<u>\$2,615,415,319</u>
\$54,620,914

**Step 2: Dividing Revenue Generated per Dollar Expended among Three Major Functions**

Liquor

<b>9:1</b>
<u>\$37,519,372</u>
\$4,007,349

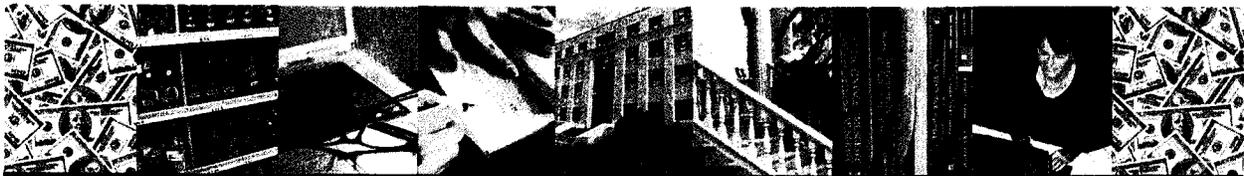
State Level Taxes  
(less 101 mills)

<b>72:1</b>
<u>\$1,329,367,764</u>
\$18,568,662

Property  
(includes 101 mills)

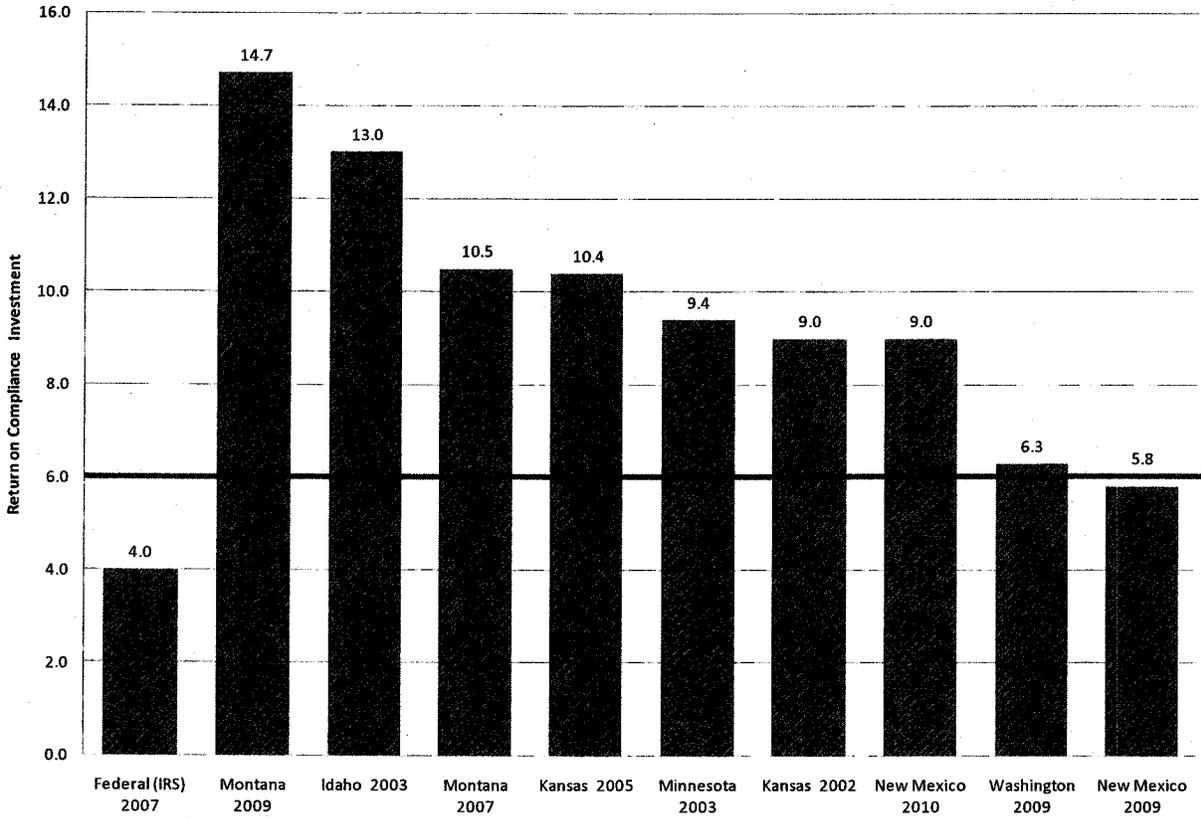
<b>39:1</b>
<u>\$1,248,528,183</u>
\$32,044,903

Note: Expenditures from support divisions (DO, IT/PRO, CSRM) prorated to major functions

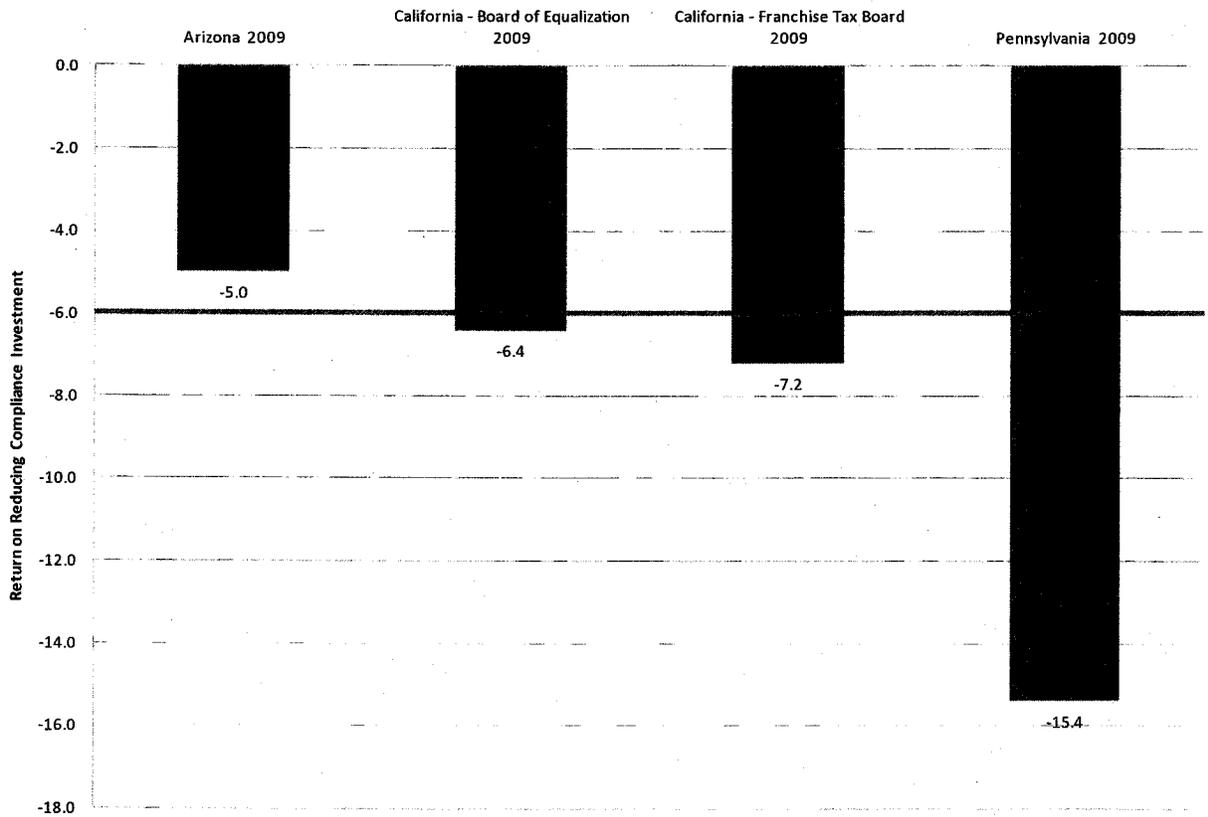


# Montana Department of Revenue

## Impact of Investing in Tax Compliance



## Reduction in Compliance Investment



## Choices for Revenue Agencies, Including the Montana Department of Revenue, Have Consequences

As a standardized practice, other states and the federal government collect information and develop estimates of the additional (or reduction) in tax revenue received for each additional (or reduced) dollar in the compliance department's budget. The examples provided in the table below exemplify the benefits of investing in compliance and the consequences of cutting collecting agencies' budgets.

Revenue Generated (or Lost) From Additions (or Reductions) in Compliance Initiatives					
Government	Year	Investment or (Reduction)	Revenue or (Loss)	Return on Investment	Source
Federal (IRS)*	2007	\$11,100,000,000	\$44,400,000,000	4 to 1	1
Arizona	2009	(\$10,800,000)	(\$54,000,000)	5 to 1	5, 6
California - Board of Equalization	2009	(\$41,500,000)	(\$264,000,000)	6.4 to 1	2
California - Franchise Tax Board	2009	(\$65,000,000)	(\$465,000,000)	7.2 to 1	2
Idaho	2003	\$926,000	\$12,000,000	13 to 1	3
Kansas	2002	\$6,000,000	\$54,000,000	9 to 1	3
Kansas	2005	\$1,440,000	\$15,000,000	10.4 to 1	3
Minnesota	2003	\$10,300,000	\$97,200,000	9.4 to 1	3
Montana	2007	\$1,052,893	\$11,085,122	10.5 to 1	4
Montana	2009	\$1,257,907	\$18,500,242	14.7 to 1	4
New Mexico * (first year)	2009	\$5,000,000	\$29,000,000	5.8 to 1	3
New Mexico * (ongoing)	2010	\$5,000,000	\$45,000,000	9 to 1	3
Pennsylvania*	2009	(\$13,000,000)	(\$200,000,000)	15.4 to 1	7
Washington *	2009	\$10,700,000	\$67,800,000	6.3 to 1	3

\* Projected

Sources:

1. Reducing the Federal Tax Gap - A Report on Improving Voluntary Compliance - Internal Revenue Service, U.S. Department of the Treasury - 8/2/2007.
2. Furloughs at the Franchise Tax Board: Loss is Seven Times Greater than the Savings - California Senate Office of Oversight and Outcomes - 2/12/2010.
3. Idaho's Tax Gap, 2009 Estimating Idaho's tax Gap and Developing Strategies to Reduce It - Idaho Tax Commission - 11/2009.
4. Montana Department of Revenue 2007 Biennium Compliance Package Collections by Month and 2009 Biennial Compliance Package Collections by Month.
5. Stronger Arizona - An estimate of state general fund losses as a result of Arizona Department of Revenue budget cuts.
6. Arizona Department of Revenue - Office of the Auditor General, "division analysis indicates corporate income tax audits result in \$15 in assessments for each \$1 spent, while audits of individual income taxes result in \$5 in assessments for each \$1 spent."
7. The Pennsylvania Budget and Policy Center: 30 Ways in 30 Days: Revenue Collections - Proposed Cuts to Revenue Department Penny Wise and Pound Foolish.

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## Tax auditors bring in more than twice revenue goal

Posted: Friday, February 4, 2011 12:15 am

The Associated Press |

BOISE — The Idaho State Tax Commission’s tax compliance initiative is well ahead of projected goals, with temporary auditors bringing in \$32 million in their first 18 months on the job.

The agency is looking to expand the program by making 48 temporary auditors permanent — and adding more in coming quarters to pursue tax scofflaws.

Tax Commissioner David Langhorst said Thursday that continued expansion hinges on hitting goals every quarter.

That’s a condition Gov. Butch Otter has put on the program.

So far, however, the new auditors are worth their weight in collections.

Last year, auditors brought in \$20.5 million, twice their goal.

Through this year’s first six months, they’ve collected \$12.2 million, already above the full-year, \$11.5 million goal.

The program’s four-year projection is \$67 million in increased revenue.

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### More about State Revenue

- **ARTICLE:** Democrats: GOP lets special interests rob revenue
- **ARTICLE:** State budget takes big hit
- **ARTICLE:** Otter: Revenue supports roads
- **ARTICLE:** Layoffs at Micron could cut revenue
- **ARTICLE:** Two state agencies require furloughs

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## Business and Income Taxes Division

The following provides a discussion for the need to continue to fully fund the Division compliance staff and the need for the additional staff requested in the Governor's budget. In the Governor's budget the request for an additional funding of \$1,000,000 is forecasted to return \$5,000,000 in general fund revenue.

The following discussion highlights several areas of non-compliance that current staff focuses on and the potential issues/work the requested staff would be involved with.

### **Cross-Matches**

The Division uses cross-matching techniques to identify non-filer and non-compliance cases. Cross-matching is a process of matching the Department's information to information received from non-Department data sources. Some of the outside agencies that the Department has information sharing agreements with include: Internal Revenue Service; Department of Justice; Department of Labor and Industry; Fish, Wildlife and Parks; Department of Public Health and Human Services; and the Supreme Court.

**Non-Filer Cases:** Over the last several years, the Division has identified approximately 31,900 non-filer cases. The Division has been able to work 16,300 of these cases. 15,600 of these non-filer cases have yet to be worked and may never be worked with the current staffing levels.

**Non-Compliance Cases:** Over the same period, the Division has identified 140,000 specific cases of non-compliance through our cross-matching techniques. Of these cases, the Division has been able to work 42,000 cases. These 42,000 cases generated almost \$13,000,000 in compliance collections. Unfortunately, there are 98,000 cases that remain to be worked.

### **Pass-Through Entity Compliance**

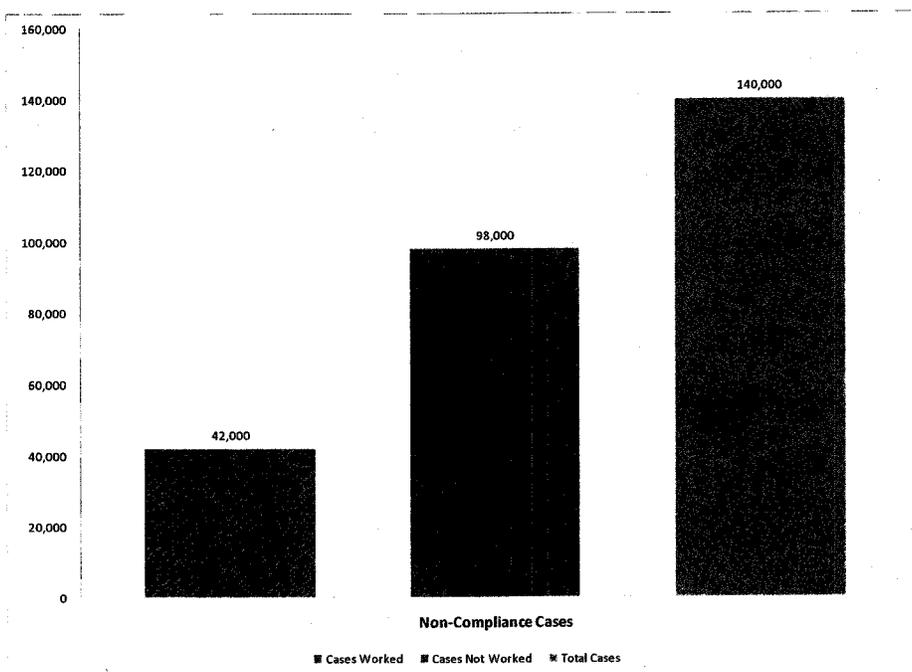
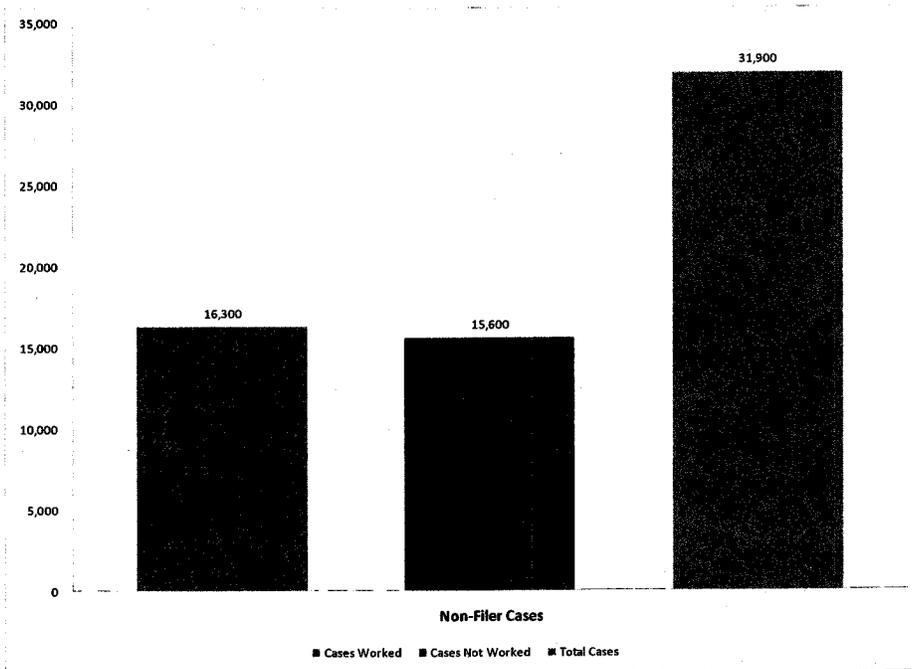
With the continued explosive growth of pass-through entities (partnerships and s-corporations) and the complexity of the pass-through entities multi-tiered structure, the Division is having difficulty providing the necessary compliance coverage.

**Compliance Cases:** The Division has only been able to work a very small number of pass-through entity non-compliance cases. But the cases that were worked in fiscal year 2010 totaled \$7.3 million in compliance collections. With a properly staffed pass-through compliance unit and with the additional requested FTE the Division anticipates that similar results would be achieved in the 2013 Biennium.

### Income Reporting Audits

Because Montana's income tax system is based on the federal system, it is imperative that the Division make sure that the federal information reported on Montana's tax returns is correct.

**Compliance Coverage:** Past experience with IRS audits has shown a very limited coverage of reported income and expenses (federal income tax issues) for tax purposes is actually done. Between the IRS and the Division's field audit staff only 0.6% of the 500,000 individual income tax returns received by the Department are audited in detail for federal income tax issues each per year. Simply relying on the IRS for audit coverage of federal income tax issues doesn't provide the necessary audit coverage to ensure compliance.





**Dan Bucks**  
Director

# Montana Department of Revenue



**Brian Schweitzer**  
Governor

## Property Assessment Division Staffing Levels – past to present

### North Central Montana – Cascade, Pondera, Toole, Teton, Glacier

Year	Staffing Levels
1996	39
2010	27
Decrease in Staff over time	12

North Central Montana has experienced a 31% decrease in staffing level since 1996.

### Eastern Montana – see county detail attached

Year	Staffing Levels
1994	108.5
2010	76
Decrease in Staff over time	32.5

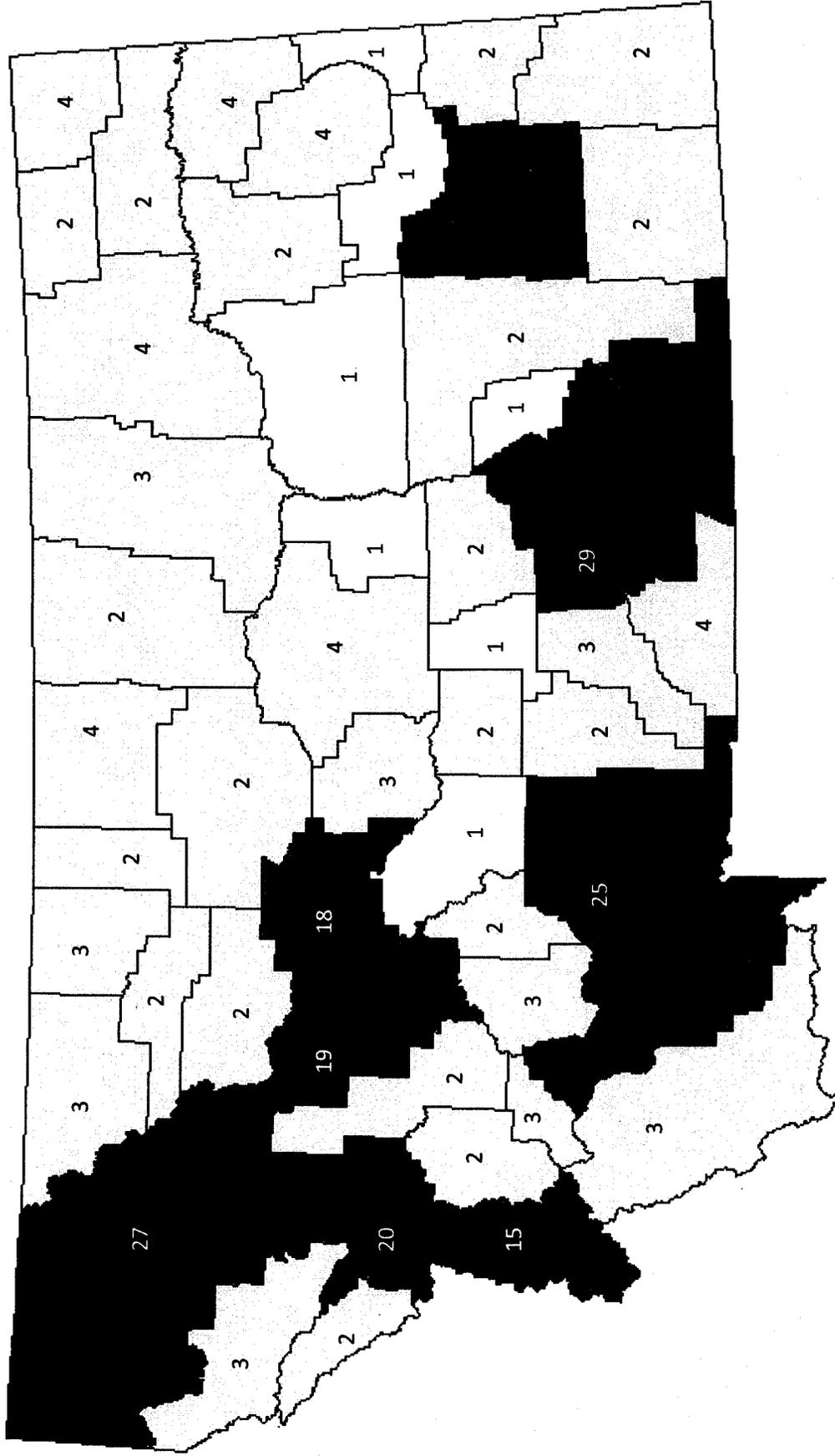
Eastern Montana has experienced a 30% decrease in staffing level since 1994.

Eastern Montana county detail

County	1994 staff	Current Staff	Staff reduction
Big Horn	6	3	3
Carbon	5	4	1
Carter	2	1	1
Custer	8	5	3
Daniels	2.5	2	0.5
Dawson	4	4	0
Fallon	4	2	2
Golden Valley	3	1	2
Meagher	2	1	1
Musselshell	5	1	4
Powder River	4	2	2
Prairie	2.5	1	1.5
Richland	5	4	1
Roosevelt	3	2	1
Rosebud	6	2	4
Sheridan	4	3	1
Stillwater	4	2.5	1.5
Sweet Grass	2	1.5	0.5
Treasure	1	1	0
Wheatland	3	2	1
Wibaux	2.5	1	1.5
Yellowstone	30	30	0
Total	108.5	76	32.5

# Property Assessment Division (PAD) Staff Locations

As of January 7, 2011



Number of Property Assessment Division FTE: 1, 2-4, 5-9, 10-20, 21-30

Total PAD Field Staff - 291      Total PAD Central Staff - 17      Total PAD Staff - 308



**Montana's Department of Revenue:  
A Record of Effective, Efficient  
Tax Administration as a  
Unitary Business Operation**

January 3, 2011



## Montana Department of Revenue Administers Revenue Laws

The mission statement of the Montana Department of Revenue (DOR) describes what the agency strives to accomplish.

*The quality of life for all Montanans is better because we excel at public service and effective administration of the tax and liquor laws. We do this by:*

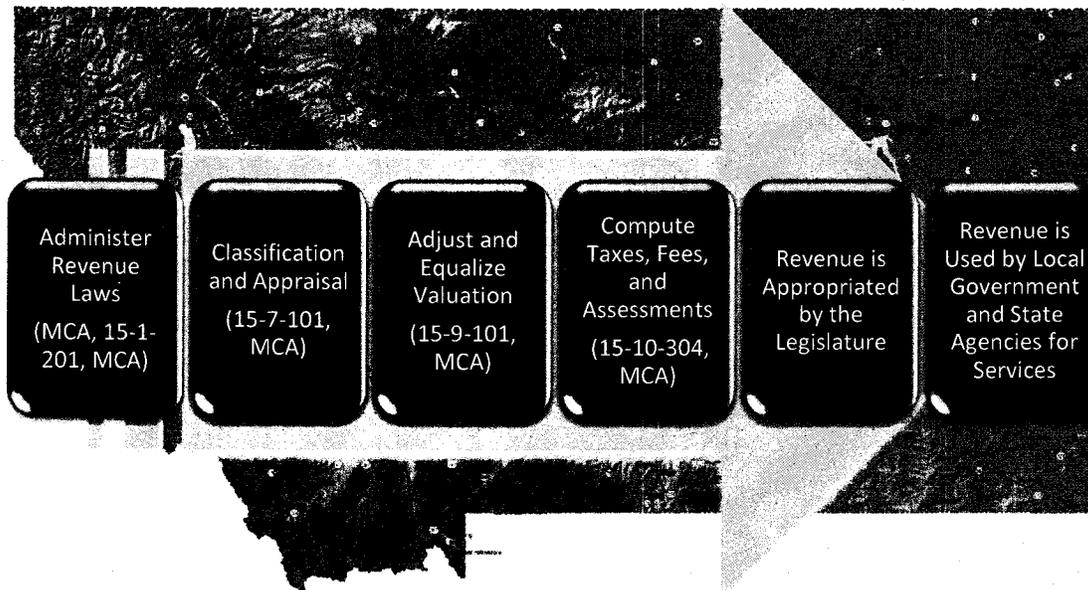
- *Ensuring that revenues intended by the legislature to be raised are collected to serve Montanans,*
- *Advancing equity and integrity in taxation,*
- *Providing effective and respectful service,*
- *Protecting the public health and safety, and achieving efficiency in liquor administration, and*
- *Improving public understanding of Montana's revenue system.*

The DOR pursues this mission within the framework of our core values, which are rooted in the Montana Constitution and in fundamental values proven by human experience to lead an organization or community forward in a continuous positive manner.

These core values include:

- *Respect for all persons*
- *Integrity and justice*
- *Productivity and effectiveness*
- *Teamwork and community*

The duty of the DOR is to administer the revenue laws as defined by statute, set forth in title 15 of the Montana Code, with the exception of gasoline tax. The DOR is also responsible for administering the alcohol and tobacco laws set forth in Title 16 of the Montana Code.



Montana is one of two states that require their state revenue department to appraise all property within the state. This is in contrast to other states, where it is the individual cities and counties appraising property within their boundaries. The Montana Constitution requires the state to classify, appraise, and keep record of all property within the state. Montana law assigns this constitutional responsibility to the DOR. This approach promotes equity in valuation throughout the state.

Additionally, Montana statute (15-9-101, MCA) requires the DOR to adjust and equalize the valuation of taxable property in and among the separate counties and between taxpayers to secure a fair, just, and equitable valuation of all taxable property among counties, between classes of property, and between individual taxpayers.

After receiving the number of mills to be levied for each taxing jurisdiction, Montana statute (15-10-305, MCA) directs the DOR to compute and itemize the taxes, fees, and assessments to be levied on each property's tax bill.

These additional responsibilities place Montana's DOR in a unique position – in terms of share of responsibility for state and local tax systems – compared to other states' revenue departments.

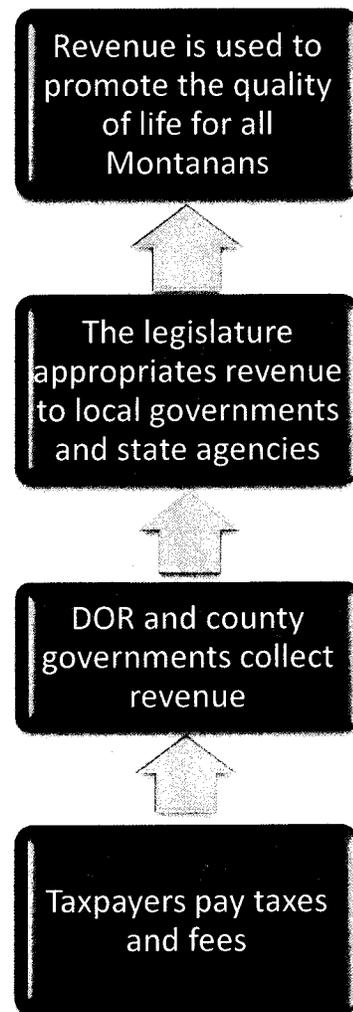
## Montana Department of Revenue Collects Revenue

The product of the Montana Department of Revenue (DOR) is collected taxes that are deposited in both state special revenue funds and the state general fund. These taxes are then distributed by the Montana Legislature to schools, local governments and other state agencies. In FY2010 alone, the DOR collected \$1.5 billion on behalf of schools, local governments and the state. Without the DOR, local governments would not be able to collect \$1.0 billion in property tax revenue. In total, the DOR was responsible for the collection of more than \$2.5 billion in taxes for schools, local governments and the state.

In a similar fashion to the cashier at a restaurant or the collections department of a large firm, the DOR's primary focus – as directed by law – is collecting revenue. The revenue is then appropriated by the Montana Legislature to local government and other state agencies where it is used to promote the quality of life for all Montanans by funding programs enhancing public health, education, law enforcement, utilities, fire safety, roads, parks, and other infrastructure.

To complete its duty to the taxpayers of Montana, the DOR must complete many tasks. The list below highlights many of the ways the DOR has worked to meet its duties to the taxpayer:

- Appraised all real and personal property in the state to meet the Constitutional requirement of equalized property valuations
- Improved equity for all taxpayers by requiring, as much as possible, that those not paying their fair share, including non-residents, do so
- Provided county offices so taxpayers have access to the DOR locally
- Created a customer service center so taxpayers can have their questions answered over the phone or request information
- Assisted small businesses with convenient one-stop licensing
- Increased taxpayer convenience with electronic and paper returns and instructions that translate complex laws into manageable filing steps
- Accounted for all taxes collected and reported the information in a transparent manner
- Managed and kept secure individual taxpayer's personal information
- Returned lost money and property to rightful owners
- Processed paper and electronic tax returns in an efficient manner so Montanans received their refunds as soon as possible
- Controlled and distributed alcoholic beverages in a way that ensures public safety



## Parts Form the Whole at Montana Department of Revenue

The Montana Department of Revenue (DOR) is composed of six interrelated parts that work together to produce local and state revenue, the agency's primary product. Each part contributes to the whole output of the DOR.



The **Information Technology and Processing Division** is integral to the day-to-day functioning of the DOR. The division is responsible for processing tax returns and payments for the 40 taxes administered by the DOR. It provides computer and network support, application development, information security, and help desk support for the revenue collecting units.

The **Citizen Services and Resource Management Division** provides consistent answers and service to Montana citizens, businesses and nonresident taxpayers through a call center, one-stop licensing, forms design, unclaimed property management, and other taxpayer services. The division also provides internal support for accounting, purchasing, and facilities and asset management.

The **Business and Income Taxes Division** administers and ensures compliance with Montana tax law for the majority of state taxes and completes appraisals and assessments of industrial and centrally assessed property.

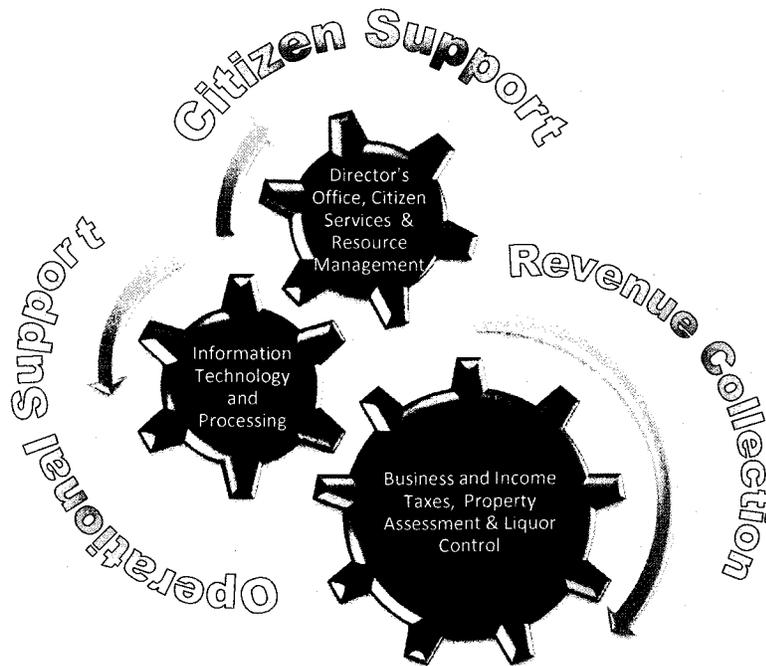
The **Liquor Control Division** administers the state's Alcoholic Beverage Code, which governs the control, sale, and distribution of alcoholic beverages. The division includes liquor distribution and liquor licensing, which generate liquor tax revenue.

The **Property Assessment Division** is responsible for the valuation and assessment of real and personal property throughout the state for property tax purposes, on behalf of state government as well as all local government. The division has a central office located in Helena and four regional areas. A local DOR office is located in each county seat across Montana.

The **Director's Office** supports and guides the agency's operations, and provides critical legal and research functions. It ensures that the DOR values, supports and develops its employees. This division is responsible for the fiscal analysis of legislation and research to support policy-making of the executive and legislative branches. Finally, it makes certain that the laws in Title 15 and 16 of Montana Code Annotated are applied fairly to the citizens and taxpayers of Montana.

## Each Division of Montana Department of Revenue Supports Revenue Collection

The divisions of the Montana Department of Revenue (DOR) support revenue collection as a unitary business operation.



### Direct Revenue Collection

Three divisions – Business and Income Taxes, Property Assessment and Liquor Control – are responsible for the majority of direct revenue collection in the DOR, but these divisions could not operate individually. All three divisions rely on the interaction of all the other functions of the DOR. The various parts cannot operate without each other.

### Operational Support

Not a day's work could be accomplished without the vital services provided by operational support. The DOR cannot function without:

- Computers, the Gentax software system, and the technology support provided by **Information Technology**.
- Offices, pens, lights, computers, workspaces and desks provided by **Resource Management**
- Forms, instructions and other information provided by **Citizen Services**, which help and instruct taxpayers on when, where, or how to file and pay taxes.
- Work done by **Processing**, which ensures that submitted payments are opened, electronically transferred, or otherwise processed.

- Sustained efforts by **Legal Services** to ensure equity under the law and to address noncompliance and support collection activity, which aid the Business and Income Taxes Division, Property Assessment Division and Liquor Control Division to experience a high degree of voluntary compliance and revenue collection.

### **Every Function is Interdependent**

If one of the DOR's interrelated services were to disappear, the result would be failure of the revenue collection process.

*Without tax forms, no payments are made.*

*Without the call center, questions are disregarded, errors increase and taxpayers' voluntary compliance decreases.*

*Without processing, no payments are received or credited.*

*Without computers and software, revenue collection and property valuation slows to a halt, and no information is stored, analyzed or kept secure.*

*Without resource management, revenue is not properly allocated and both local and state offices deteriorate and cease operating efficiently.*

*Without legal services, consequences for non-compliance are not enforced, active compliance is reduced and property values are shifted unfairly among large businesses, homeowners, small businesses and agriculture.*

*Without human resources, no workforce is recruited, trained and paid.*

*Without liquor control, there is no safe distribution of controlled substances.*

*Without assessment and valuation, taxes would be based on speculation.*

*Without research, no information is provided to law makers.*

*Without tax audits, compliance is reduced.*

*Without direction, the DOR functions without purpose.*

As you can see, the DOR functions interdependently. Each function is necessary to meet the DOR's obligation to administer Montana's revenue collection laws.

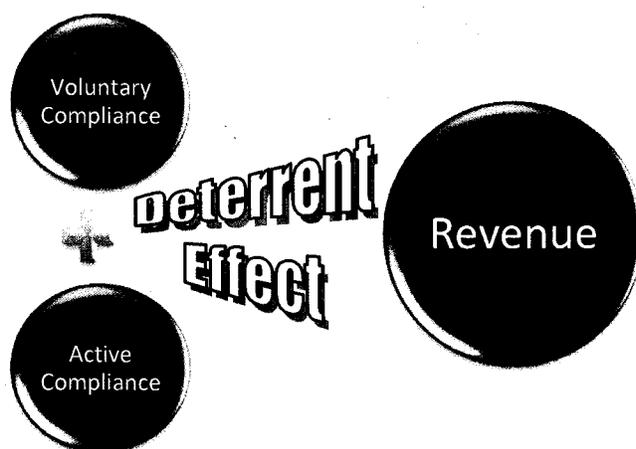
## Montana Department of Revenue's Tax Collection: Two Interrelated Types of Revenue

Tax revenue collected by the Montana Department of Revenue (DOR) can be broken into two related forms of compliance: voluntary and active.

**Voluntary compliance** is met when taxpayers file timely returns, accurately reporting and paying tax obligations. The DOR provides the necessary framework for voluntary compliance by helping citizens understand and comply with the tax law.

The DOR does this by sending tax statements, developing clearly written tax forms, answering call center questions from taxpayers, processing paper and electronic payments, securely storing sensitive information confidentially, correctly assessing property values, managing information provided on the DOR website, developing understandable rules, discussing tax law with constituents, providing prompt refunds, and promptly and fairly applying active compliance, when appropriate. Most of this work is similar to the customer service, billing and collections department of any large firm, but in this case it is on behalf of Montana citizens.

**Active compliance** occurs when taxpayers do not voluntarily comply, requiring the DOR to take active steps to require proper compliance.



**Tax gap** is the cumulative estimate of tax payment noncompliance or, said another way, it is the gap between the amount of annual taxes due under the law and the amount voluntarily paid. Active compliance measures by the DOR are an effort to collect these taxes and close the tax gap, which in turn promotes voluntary compliance and fairness.

Voluntary compliance and active compliance tax payments are intuitively related to one another by way of the **deterrent effect**, in a similar fashion to the enforcement of other laws – for example, the speed limit. When the highway patrol enforces the speed limit, people tend to drive the speed limit. When the highway patrol isn't able to enforce the speed limit, people tend to exceed the speed limit. In the case of tax payment, the DOR's active compliance work creates an incentive, thereby increasing taxpayers' willingness to voluntarily comply with tax law, (Witte R. D. and Woodbury (1985)).

As the DOR's strategies for active compliance increase, voluntary compliance payments increase together with active payments. Similar to the speeding example above, the deterrent effect works in the counter direction, too. If the DOR reduces active compliance measures, payments for both voluntary compliance and active compliance are reduced.

## **Montana Department of Revenue's Compliance Budgets, Revenue Collection Offer Significant Return on Investment**

As a result of the recent recession, many states have experienced reduced budgets. Consequently, some states have conducted analyses in an effort to find which portions of their government's operating costs can be cut with the least effect on services and to total state budgets. Some states have experimented with reducing the budgets from active compliance and collecting other forms of revenue.

The consistent finding is that state departments charged with collecting voluntary and active compliance tax revenue provide a return of between six and thirteen dollars of additional revenue for each additional dollar of budget. Inversely, collection of tax revenue decreases by eight dollars for every one dollar removed from the budget as active compliance is reduced and the deterrent effect is diminished.

**In 2009, California constituents lost an estimated \$465 million in tax revenue by reducing its Franchise Tax Board's compliance budget by \$65 million.**

For example, according to the California Senate Office of Oversight and Outcomes, in 2009 the governor required furloughs of 5,300 workers at California's Franchise Tax Board in order to save an estimated \$65 million dollars in salaries. This resulted in an estimated 14% reduction in the number of hours spent on audit and collection activities and a corresponding reduction in personal, income, and corporate taxes of \$465 million, for a net overall loss of \$400 million (a loss of \$7.15 for every dollar saved).

**Between FY 2006 and FY 2009, Montana constituents received an additional \$29,585,364 in revenue by investing \$2,310,800 in DOR compliance efforts, a return rate of \$12.80 for each dollar invested.**

In contrast, in 2005 the Montana Legislature approved a DOR increase of \$1.12 million (per biennium) to fund services and operating costs to add 8 full-time employees for compliance activities. The employees were added in areas where other states have found significant non-compliance, namely individual income tax and corporate license tax – especially taxes owed by non-residents and out-of-state companies.

During the 2007 biennium, the DOR tracked the result of this investment and found in that biennium, the \$1,052,893 expenditure investment produced \$11,085,122 in additional revenue collected, a return of more than \$10.50 for each dollar invested.

During the 2009 biennium, the DOR continued tracking the return on investment in compliance. The results show expenditures of \$1,257,907, producing \$18,500,242 in additional revenue collected. This is a return of more than \$14.70 for each dollar invested.

**Over the entire period from FY 2006 through FY 2009, the return was \$12.80 for each dollar invested.**

## Choices for Revenue Agencies, Including the Montana Department of Revenue, Have Consequences

As a standardized practice, other states and the federal government collect information and develop estimates of the additional (or reduction) in tax revenue received for each additional (or reduced) dollar in the compliance department's budget. The examples provided in the table below exemplify the benefits of investing in compliance and the consequences of cutting collecting agencies' budgets.

Revenue Generated (or Lost) From Additions (or Reductions) in Compliance Initiatives					
<u>Government</u>	<u>Year</u>	<u>Investment or (Reduction)</u>	<u>Revenue or (Loss)</u>	<u>Return on Investment</u>	<u>Source</u>
Federal (IRS)*	2007	\$11,100,000,000	\$44,400,000,000	4 to 1	1
Arizona	2009	(\$10,800,000)	(\$54,000,000)	5 to 1	5, 6
California - Board of Equalization	2009	(\$41,500,000)	(\$264,000,000)	6.4 to 1	2
California - Franchise Tax Board	2009	(\$65,000,000)	(\$465,000,000)	7.2 to 1	2
Idaho	2003	\$926,000	\$12,000,000	13 to 1	3
Kansas	2002	\$6,000,000	\$54,000,000	9 to 1	3
Kansas	2005	\$1,440,000	\$15,000,000	10.4 to 1	3
Minnesota	2003	\$10,300,000	\$97,200,000	9.4 to 1	3
Montana	2007	\$1,052,893	\$11,085,122	10.5 to 1	4
Montana	2009	\$1,257,907	\$18,500,242	14.7 to 1	4
New Mexico * (first year)	2009	\$5,000,000	\$29,000,000	5.8 to 1	3
New Mexico * (ongoing)	2010	\$5,000,000	\$45,000,000	9 to 1	3
Pennsylvania*	2009	(\$13,000,000)	(\$200,000,000)	15.4 to 1	7
Washington *	2009	\$10,700,000	\$67,800,000	6.3 to 1	3

\* Projected

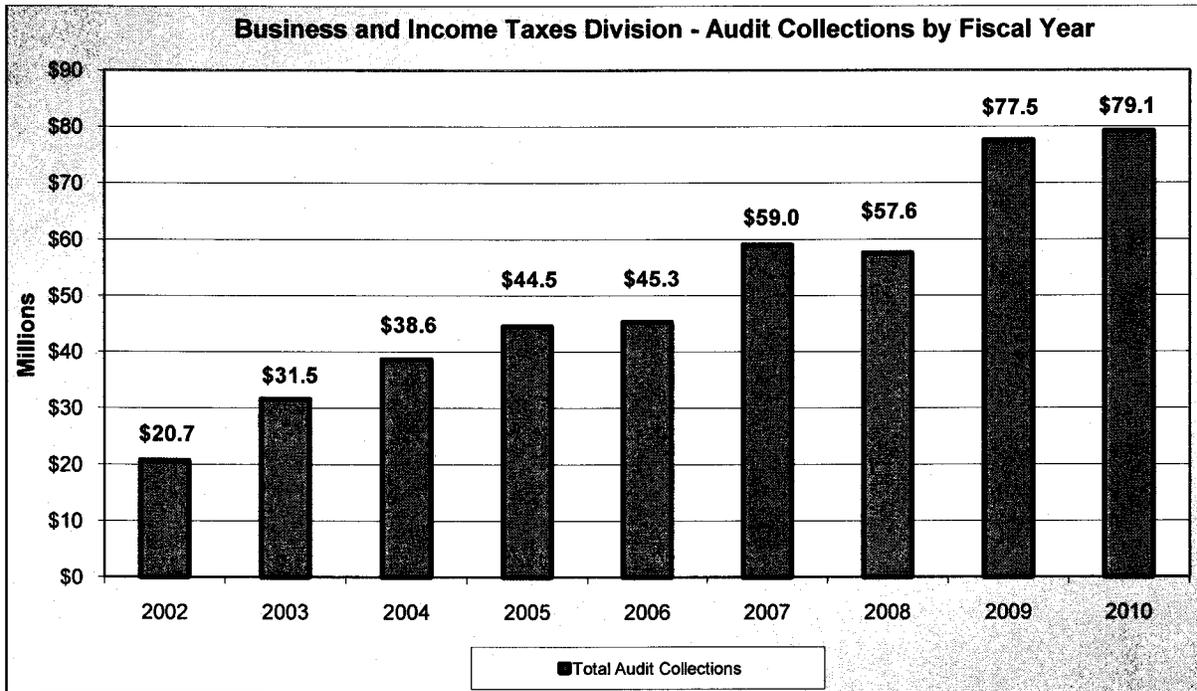
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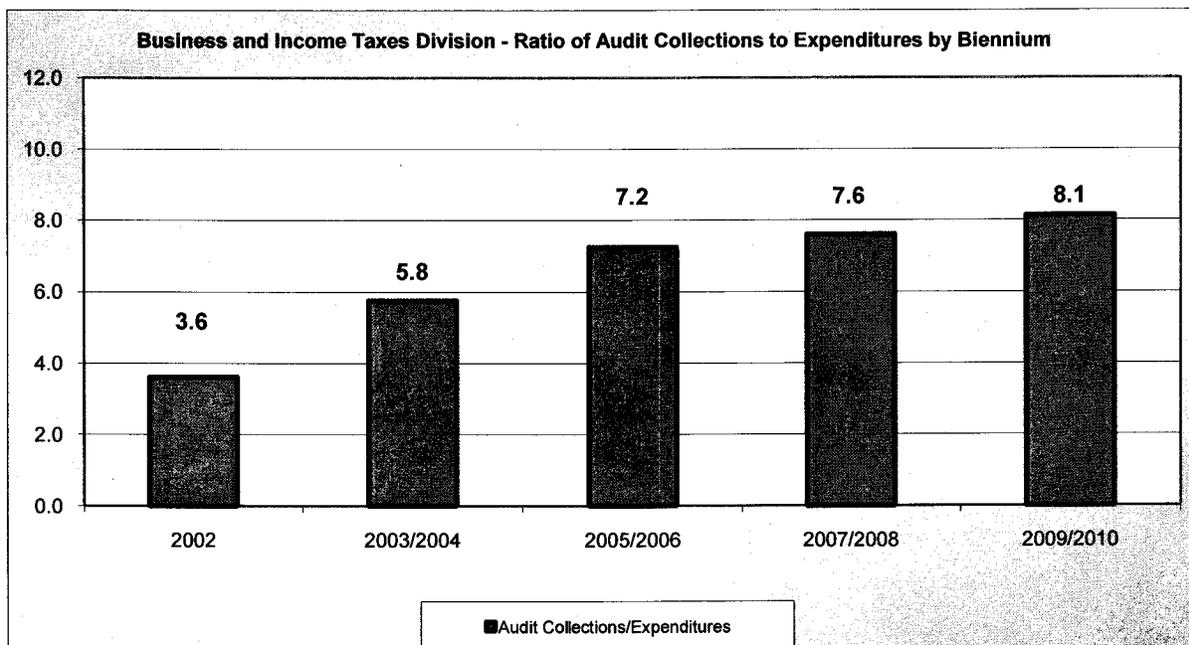
## Overall Results of Montana Department of Revenue (DOR) Increased Compliance Efforts

Montana's recent compliance efforts have yielded increased tax collections. For each dollar the Montana Legislature has invested in compliance efforts, the DOR has returned from \$8 to almost \$15 in increased tax collections.

The table below demonstrates how effective investing in compliance efforts has been.



The second table (see next page) illustrates the overall return on investment the DOR has experienced with its compliance efforts. This ratio takes the audit collections from the above table and divides it by the amount that was appropriated for the Business and Income Taxes Division for each biennium. The overall return on investment of the Business and Income Taxes Division is lower than the marginal return on investment, which measures just the collections and expenditures of specific compliance programs.



**What are the benefits of better tax compliance?**

**Fairness in Taxation:** Honest and diligent taxpayers who pay the right amount of taxes on time are protected from having to pay even more taxes to make up for those individuals and businesses not paying their fair share under Montana law.

**A Stronger, Growing Economy:** The Montana economy grows on a sustained basis if taxes are equalized so that businesses compete on a level playing field and if proper revenues are returned from out-of-state to flow through this state once again.

**A Brighter Future for All Montanans:** The future for all Montanans is improved through efficient public services, solid infrastructure and investments in education for higher paying jobs.

## Successfully Reducing the Tax Gap – Idaho's Experiment

As a state level example, in November of 2009 the Idaho Tax Commission produced a report, *Idaho's Tax Gap*, estimating Idaho's tax gap at \$255,000,000 and developing strategies to reduce it. (In times of budget shortfalls, shrinking the tax gap is a common method employed to increase revenue without increasing taxes.) This report includes three separate methods for estimating Idaho's tax gap, methods for reducing the tax gap, and a discussion of investments in tax compliance, proven return on investment, the multiplier effect, the opposite effect of reducing returns to investment, and the unintended consequences of "across the board" (including revenue collection agencies) budget cuts.

**The major finding of Idaho's research was that reducing the tax compliance budget leads to a projected reduction in tax revenue that is 10 times greater than the expenditure budget, a 10-to 1 ratio of revenue reduction.**

Unrealized potential for both Idaho untapped noncompliance measures are presented below. Idaho's data comes from *Idaho's Tax Gap, 2009*.

### Tax Discovery

Idaho's Tax Discovery Bureau found 55,000 potential cases of individual income tax non-filers in 2009, and were only able to work about 5,000 of these cases. Although, each added employee creates around \$1,000,000 in additional revenue, there existed four vacancies, indicating potential gains from investment.

### Front Line Phone Agents

Idaho's "Phone Power" front line of collection agents collect, on average, more than \$2,000,000, per year, per person, and had four vacancies.

### Compliance Technicians and Compliance Officers

Idaho's compliance technicians and compliance officers work in tandem by phone, mail, and in the field. On average, they collect an estimated \$1,000,000 per person, per year. In 2009, they had six vacancies.

### Auditors and Audit Technicians

Idaho's auditors and technicians collect, on average, \$400,000 per person, per year. In 2009, they had 10 vacancies.

### Investments in Tax Compliance

In 2003, another year of budget shortfalls, Idaho's governor boosted the Tax Commission's compliance budget by \$926,000, allowing the creation of new compliance positions, which, in turn, produced a return of \$10,000,000, an average return on investment of \$13 in additional revenue to \$1 of increased budget. According to the Idaho Tax Commission, this ratio seemed reasonable when compared to the return on investment from other state's compliance efforts.

## **Federal Tax Gap and Compliance**

In 2007, the Internal Revenue Service produced a report on improving voluntary compliance estimating, "the overall (federal) gross tax gap [estimated] to be approximately \$345 billion" and the "overall return from new investments in compliance averages 4:1" (page 2, IRS).

## Summary

The statutory duty of the Montana Department of Revenue (DOR) is to administer the revenue laws as created by Montana's Legislature. Similar to the cashier at the restaurant, the product of the DOR is collected taxes, which are redistributed as revenue to local governments and state agencies.

The DOR is made up of six interrelated parts that work together to produce local and state revenue. Either through direct revenue collection or through operational support, each part of the DOR is vital to tax revenue collection.

Tax revenue collection is made up of voluntary compliance and active compliance. The DOR supports active compliance by providing the necessary framework that allows taxpayers to contribute their fair share of tax revenue in a timely manner.

When appropriate, the DOR uses active compliance measures to induce compliance. Like any other law under enforcement, voluntary compliance is directly related to the amount of resources allocated to active compliance measures by way of the deterrent effect. Montana and other states (as well as the federal government) understand the large return on investment that can be secured by increasing the budget for compliance.

Unfortunately, other states (Arizona, California, and Pennsylvania) have attempted to balance state budgets by removing resources previously allocated to their tax collection agencies. All three states experienced or predict large revenue losses from these shortsighted actions, ranging from a \$729 million loss in California to a \$54 million loss in Arizona.

On the other hand, due to a \$2,310,800 investment between FY2006 and FY2009, the DOR in Montana collected an additional \$29,585,364 in active compliance tax revenue, while ensuring that constituents were treated fairly under Montana's tax laws. Other states have had similar results and have been able to increase state and local revenue without having to increase taxes.

**“Investing in tax compliance to reduce the tax gap is a  
revenue-producing alternate to raising taxes”  
(Idaho Tax Commission, 2009)**

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