GOVERNOR'S OFFICE OF BUDGET AND PROGRAM PLANNING

Fiscal Note 2017 Biennium

Bill #	SB0269		**Title:**	Revise individual income tax audit and collection laws
Primary Sponsor:	Ankney, Duane		**Status:**	As Introduced

☐ Significant Local Gov Impact ☐ Needs to be included in HB 2 ☑ Technical Concerns

☐ Included in the Executive Budget ☑ Significant Long-Term Impacts ☐ Dedicated Revenue Form Attached

FISCAL SUMMARY

	FY 2016 Difference	FY 2017 Difference	FY 2018 Difference	FY 2019 Difference
Expenditures:				
General Fund	$0	$0	$0	$0
Revenue:				
General Fund	$0	$0	($10,284,000)	($10,871,000)
Net Impact-General Fund Balance:	$0	$0	($10,284,000)	($10,871,000)

Description of fiscal impact: This bill would generally prohibit the Department of Revenue from performing multi-year audits of individual income tax returns and would reduce the statute of limitations to three years. This would reduce general fund revenue by approximately $10 million in FY 2018, and the revenue reduction would grow in subsequent years.

FISCAL ANALYSIS

Assumptions:

1. This bill would generally prevent the Department of Revenue from performing multi-year audits of individual income tax returns. It would require all audits, once started, to be completed within six months, and would reduce the statute of limitations from five years to three years.
2. The restrictions on auditing in this bill are assumed to apply to most of what the department considers office audits and field audits. These involve department personnel examining a return, possibly along with additional information. Correction of math errors and other inconsistencies on returns are not included. While these corrections may be significant for individual taxpayers, the sum of resulting assessments and refunds should come close to cancelling each other out. Excluding error corrections does not affect the

revenue impacts estimated in this fiscal note. However, if error corrections were to be considered audits, there could be additional large revenue impacts. (See Technical Note 1)

3. Taxpayers who have under-reported income, made invalid deduction or credit claims, or have taken other actions to understate tax liability often have done the same thing for multiple years. Under current law, when the department finds an issue with a return for one year, auditors can check returns for the previous four years to see if the same issue is found with those returns. The department also examines returns from multiple years when it finds that taxpayers have reported income or deductions in the wrong year.
4. Checking to see whether issues identified with a return for one year are also found on returns for previous years does not significantly increase the time required for an audit. Limiting audits to one year would not necessarily increase the number of audits the department could perform each year.
5. The department examined collections in FY 2014 that were due to audit assessments from office and field audits and identified collections due to multi-year audits. The collections due to assessments from additional years in these audits were $8.239 million.
6. This bill would be effective for TY 2016 and following years. The first audits where the department would not be able to look at back-year returns would be performed in CY 2017. Most examination of returns during the first half of the year, which is in FY 2017, generally will involve correcting errors on returns. Thus, no revenue impact is estimated for FY 2017.
7. HJR 2 assumes that income tax audit revenue will grow by 5.7% per year. Assuming that the multi-year portion of audit revenue would grow at the same rate, the revenue reductions would be $10.284 million in FY 2018 and $10.871 million in FY 2019.
8. The statute of limitations determines the time within which a taxpayer may file an amended return and the Department of Revenue may audit a return and assess additional taxes. This bill would reduce that time from five years to three. The department generally only audits returns from four and five years ago as part of multi-year audits. Since this bill would prohibit multi-year audits, reducing the statute of limitations would have little additional effect on collections.
9. Reducing the statute of limitations to three years would prohibit taxpayers from claiming a refund when they file either an amended return or an original return for a period more than three years ago. The department examined returns filed in FY 2013 and FY 2014 from tax years four and five years earlier. Refunds paid out from these filings totaled $2,326,861 in FY 2013 and $2,324,954 in FY 2014. This fiscal note assumes that, when fully in effect, refunds prohibited by this bill would $2.32 million.
10. This reduced statute of limitations would be effective for TY 2016 and following years. The first revenue effect would occur when the new three year statute of limitations applies to TY 2016 returns, which would be filed in CY 2017. The full revenue effect of $2.32 million would not be seen until FY 2022, when all recent tax years would fall under the new statute of limitations. In FY 2021, only one tax year, 2016, would fall under the new statute of limitations. The revenue effect in FY 2021 would be approximately half the long-run effect, or $1.16 million. Revenue effects would first occur when the filing deadline for TY 2016 returns is three years in the past. This would happen in the last two months of FY 2020. The revenue effect in these two months of FY 2020 would be one-sixth of the full-year reduction in FY 2021, or $0.19 million.
11. This bill would reduce the consequences of being caught evading taxes, which is likely to reduce voluntary compliance. This fiscal note does not attempt to estimate the reduction in revenue from reduced voluntary compliance.
12. Changes to the department's data processing systems to comply with this bill would be made as part of the normal annual update process with no additional costs.

Fiscal Impact:	**FY 2016 Difference**	**FY 2017 Difference**	**FY 2018 Difference**	**FY 2019 Difference**
Expenditures:				
TOTAL Expenditures	$0	$0	$0	$0
Funding of Expenditures:				
General Fund (01)	$0	$0	$0	$0
TOTAL Funding of Exp.	$0	$0	$0	$0
Revenues:				
General Fund (01)	$0	$0	($10,284,000)	($10,871,000)
TOTAL Revenues	$0	$0	($10,284,000)	($10,871,000)
Net Impact to Fund Balance (Revenue minus Funding of Expenditures):				
General Fund (01)	$0	$0	($10,284,000)	($10,871,000)

Long-Term Impacts:

1. The shorter statute of limitations would reduce refunds taxpayers could claim with amended or late-filed original returns. (See Assumptions 8 – 10.) Assuming that current-law audit revenue would continue to grow at the rate assumed in HJR 2, the net change in general fund revenue would be -$11.30 million in FY 2020, -$11.00 million in FY 2021, and -$10.52 million in FY 2022.

Technical Notes:

1. The bill does not define the term "audit." The department does a variety of actions with tax returns that could be considered audits. The department corrects math errors and other inconsistencies on returns and supporting schedules. The department matches returns with information reports, such as W-2s and 1099s, and with federal returns to verify the accuracy of income, deductions, and credits reported on a return. Auditors and auditing technicians examine selected returns and related documents to determine whether tax has been calculated correctly, and the department contacts taxpayers and requests explanations and documentation for items or calculations. This fiscal note interprets the restrictions that this bill places on "audits" fairly narrowly. In particular, it assumes that correcting errors on a return does not count as the one allowable audit of that return. If the term were interpreted more broadly, this bill would prohibit the department from correcting a math error on the current return of a taxpayer whose return from a previous year was being audited. It also would prohibit the department from performing an in-depth audit of a return if that return had previously gone through the error correction process. Since about half of returns filed annually are initially rejected by the data processing system and have to be examined and possibly corrected, the department would have to either remove this half of returns from consideration for auditing or delay processing of any returns that might be candidates for further auditing.
2. Sections 1(3)(a) and (b) would allow multiple year audits when there is an understatement of tax liability or overstatement of refund of more than 5%. It is not clear whether this threshold applies to the mis-statement for the year initially being audited or to a suspected mis-statement for one or more additional years. Since the department would not know the amount of any mis-statement until a return was audited, the six month time limit imposed by Section 1(2) would prevent the department from completing many of the multi-year audits that Section 1(3) would allow.

3. Section 1(2) requires the department to finalize an audit within six months. In almost all cases where an audit is not resolved quickly, it is because the taxpayer has not provided information requested by the department. The bill does not provide direction for how an audit is to be finalized in cases when six months have passed and the taxpayer has not provided requested information. If this is interpreted as requiring the department to make a final assessment based on incomplete information, it would move a significant share of the department's interactions with taxpayers that now occur in the audit process to the dispute resolution process. This would result in additional costs for both the department and taxpayers.
4. The bill does not directly address auditing of pass-through entities. However, since the bill would prohibit auditing of individual owners for more than one tax year at a time, it would effectively limit the auditing of pass-through entities to one year at a time unless the pass-through entity had an owner that was a c-corporation.
5. There are many situations where items are carried from the return for one tax year to the return for another year. These include net operating losses, capital losses of more than $3,000, charitable contributions in excess of 50% of adjusted gross income, certain adjustments for allocation of income and expenses between spouses, and certain credits if they are more than tax liability. If the department found an error with one of these items, this bill would prevent it from making the corresponding correction to the return for the year the item was carried to.

Sponsor's Initials	*Date*	*Budget Director's Initials*	*Date*