LEGISLATIVE AUDIT DIVISION

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MEMORANDUM

TO: Legislative Audit Committee Members

FROM: Angie Grove, Deputy Legislative Auditor

CC: Dan Bucks, Director, Department of Revenue
Alan Peura, Deputy Director, Department of Revenue
Gene Walborn, Administrator, Business and Income Taxes Division
Ed Caplis, Director, Tax Policy and Research

DATE: June 2009

RE: Performance Audit Follow up (08SP-05): Improving Taxpayer Compliance in Montana Through Audit Efforts (orig. 06P-10)

ATTACHMENT: Original Performance Audit Summary

INTRODUCTION

In June 2006 we presented our performance audit of *Improving Taxpayer Compliance in Montana Through Audit Efforts*. The audit made six recommendations to the Department of Revenue. In August 2007 we began gathering preliminary information from the department on their progress in implementing the recommendations. Because the department was still in the process of implementing the audit recommendations, we allowed them additional time before finalizing our follow-up. This memo summarizes the results of our follow-up work, in addition to presenting background information.

Overview

Audit recommendations stressed focusing compliance audit activities through strategic planning, the establishment of measurable performance results, and the completion of a tax gap analysis for gaining a clearer picture of taxpayer noncompliance in Montana. The Department of Revenue has taken varying degrees of action on each of the six recommendations addressed to them in the performance audit.

BACKGROUND

The Department of Revenue (DOR) administers Montana's tax laws and operates as the state's general tax collection agency. Responsibilities for revenue collection include appraising taxable property values, assessing tax liability, and auditing for taxpayer compliance. Three of the main revenue components of the state's General Fund are individual income, corporate license, and natural resource taxes. In fiscal year 2008, DOR collected approximately $1.5 billion in taxes and fees.

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Audit is one of the tools used by DOR to support its compliance function. All audit activities are consolidated in the Business and Income Taxes Division (BITD). Under this division, there are three bureaus associated with collecting taxes: Accounts Receivable and Collections Bureau, Income and Withholding Tax Bureau, and Business Tax and Valuation Bureau. Audit staff are located in Helena and in several cities around the state. Staff perform both office audits and field audits. In fiscal year 2008, compliance efforts yielded audit collections of $57.6 million.

FOLLOW-UP AUDIT FINDINGS

The performance audit report included six recommendations to the department. These recommendations stress focusing compliance audit activities through strategic planning, the establishment of measurable performance results, and the completion of a tax gap analysis for gaining a clearer picture of taxpayer noncompliance in Montana. The following summarizes information relating to follow-up audit work and the implementation status of the recommendations.

Recommendation #1

We recommend the Department of Revenue:

A. Complete strategic planning for its audit activities to focus efforts on reducing taxpayer noncompliance.

B. Establish priorities for achieving audit goals and objectives.

C. Expedite completion of the Business and Income Taxes Division compliance plan.

Implementation Status – Partially Implemented

The department has partially implemented this recommendation. The department has not completed strategic planning nor completed a compliance plan due to the absence of a Montana-specific tax gap analysis and the information it would reveal. However, the department has met the intent of the recommendation to focus audit activities through other means. They have been utilizing the Integrated Revenue Information System (IRIS) to identify tax areas in which there are higher levels of noncompliance. They are able query the system to sort data based on certain criteria and then increase or decrease audit efforts based on the results. In addition, department managers from areas such as audit, legal, and information services meet weekly to discuss compliance issues. The group reviews problem areas and attempts to identify issues that they believe should be priorities. In addition, they discuss how staff could be reorganized to work around any new priorities. They also discuss what is working and what is not and why. Further, as a result of the compliance group meetings, the department has introduced proposals for new legislation.

Recommendation #2

We recommend the Department of Revenue:

A. Identify performance goals for existing and future compliance audit activities in the areas of productivity, duration, and intended effort.

B. Identify and collect performance data for each audit activity for comparison with performance goals.

Implementation Status – Partially Implemented

The department does not have official performance goals related to compliance audit activities and reports that the development of performance goals would be related to the data revealed by a Montana-specific tax gap analysis. There are general expectations for auditors related to the number of audits completed each year, but these numbers are flexible as it is expected that some audits will be more time-consuming

than others. The department has proposed a new means of measuring the success of compliance efforts by comparing the number of dollars spent on compliance versus the number of dollars recovered. The target goal is to collect $8 for every $1 spent on compliance activities. In fiscal years 2007 and 2008, compliance efforts yielded audit collections of $59.0 and $57.6 million respectively. These figures translate into a collection of $7.60 for every $1 spent on compliance. In terms of data collection, the department is utilizing IRIS to identify and collect performance data for its audit programs and also for the new discoveries it is querying in IRIS.

Recommendation #3

We recommend the Department of Revenue:

A. Conduct tax gap analyses that specifically measure compliance with Montana's tax laws at intervals that, at a minimum, correspond with strategic planning cycles in order to recognize a need to make corrections to compliance activities.

B. Report the results of tax gap estimates to the Legislature with recommendations to address the tax gap.

Implementation Status – Not Implemented

The department has not completed a tax gap analysis. A formal request for funding and FTE was presented to the Legislature in 2007, but the request was denied. Department staff report that the request was not pursued during the 2009 Legislative Session, as they did not believe that there was legislative support for the request. The department has completed an abbreviated tax gap analysis by using federal tax data. They took the percentage of federal tax dollars collected that Montana represents and applied that to the federal tax gap. The number was altered to compensate for the fact that the composition of taxpayers in Montana is different than federal taxpayers. From this simulated tax gap analysis, the department estimates that Montana's corporate and individual income tax gap is approximately $200-$300 million.

Recommendation #4

We recommend the Department of Revenue:

A. More effectively deploy audit resources by directing audit activities to focus on the following factors to achieve the greatest benefit:

- **Areas of greatest taxpayer noncompliance as identified in the tax gap.**
- **Opportunity to generate the highest net returns.**
- **Areas with the strongest legal enforcement and collection tools.**
- **Opportunities to provide staff training.**
- **Opportunities to reduce inequities in filing rates among major tax filing groups.**

B. Conduct an analysis of the department's existing legal, enforcement, and collection tools to improve the department's ability to secure tax compliance from nonresidents.

Implementation Status – Being Implemented

Although a tax gap analysis has not been completed, the department has been able to identify areas of noncompliance through weekly compliance meetings, staff observations, and IRIS discovery queries. IRIS also allows the department to track which initiatives are generating the highest net returns and shift audit staff accordingly. During the 2007 Legislature, the department gained two tools for improving tax compliance from nonresidents. The first was a mineral withholding system for mineral royalties. The

second was the ability and resources to hire attorneys and collectors in other states to collect established tax debts. The department recognizes that the sale of property in Montana by nonresidents represents an area of high taxpayer noncompliance. During the 2009 Legislature, a bill was proposed that would have given the department the ability to withhold taxes on nonresident property sales; this proposal was denied. In order to increase compliance in this area, the department has developed detailed brochures to be given to title companies and real estate agencies that outline the tax obligation that goes along with a property sale. They also are including a "coupon" that can be given to a property seller's accountant that contains instructions for remitting taxes to Montana.

Recommendation #5

We recommend the Department of Revenue conduct an analysis of existing staff capabilities to maximize resource allocation among audit functions and ensure staff skills and competencies align with Business and Income Taxes Division responsibilities.

Implementation Status – Being Implemented

The department has been utilizing management reports from IRIS to determine which compliance areas should receive the highest priority and has been shifting existing staff to these areas. IRIS allows the department to carry out the same processes they were doing previously, but faster. This allows for positions to be taken out of areas such as error correction to work on new initiatives. When staff are moved to a new work area, training mostly takes place in the form of in-house mentoring. In addition, staff undergo training from the Multi-State Tax Commission and private organizations as available.

Recommendation #6

We recommend the Department of Revenue:

A. Create an internal working group consisting of members from audit, legal, and information technology services to identify information needs, determine current barriers to obtaining data, and undertake necessary steps to obtain needed data.

B. Expedite integration of data from the IRS and other state government agencies into the data manager module within IRIS.

C. Seek Memorandums of Understanding and statutory authorization to access data maintained by other state agencies to include taxpayer or business identification numbers.

D. Enact necessary changes to increase electronic filing of income and withholding information.

Implementation Status – Implemented

Although the department has not specifically developed an internal working group whose sole focus is managing information needs, the weekly compliance meeting fills this role by identifying specific information that is needed. The department currently has Memorandums of Understanding for data sharing with other agencies, such as the IRS, the Department of Public Health and Human Services, the Department of Natural Resources and Conservation, the Department of Justice, and Fish, Wildlife and Parks. This data is utilized by the department to cross-match information and identify areas of taxpayer noncompliance. During the 2009 Legislature, the department sought to increase the amount of data shared with the department by the Secretary of State's office. This proposal did not pass. Per the department, approximately 50 percent of the data received from outside sources is integrated into IRIS by automation. Department staff continue to work on methods for increased automation. Currently, the department offers a number of services online, including filing individual and business income tax returns, filing for liquor license renewal, reporting mineral royalty withholding, and managing taxpayer accounts. The department plans to make eight new tax types available for online filing in June 2009. With these additions,

99 percent of tax filing will be able to be done online. Data shows that consumers are utilizing the availability of online services. During the 2008 filing season (spring, 2009), 72.5 percent of all individual income tax returns filed in 2009 were done electronically. Electronic filing for corporations became available last year and during the 2008 filing season, 6 percent of corporate filings were received electronically. In terms of payment processing, the department reports that during the 2008 filing season, through May 31, 2009, 4.6 percent of all payments received and 59.2 percent of all refunds paid out were done so electronically. It should be noted that these payments and refunds, while processed during the 2008 filing season, may not necessarily be for 2008 taxes.