Improving Tax Collections

Making Sure All Taxpayers Contribute What They Owe

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Special Series: Balanced Solutions for 2011

All Montanans want a state we can be proud of--a state where our children can learn, grow, prosper, and stay to raise their own families. That future depends on our ability to invest in the public structures that educate our children, keep our communities safe, protect our land and water, and provide health care and other services when we struggle to make ends meet.

Like all other states, the Great Recession is threatening Montana's ability to adequately invest in these public structures. State revenues have fallen, and legislative staff is estimating that the next legislature may face over a $360 million revenue gap.

Montana deserves a balanced approach to this revenue crisis that looks not just at dramatic and harmful cuts to public services, but also targeted efforts to increase revenue. This brief is one in a series of MBPC reports that explores policies to responsibly raise revenue in the state.

Most Montana families and businesses lawfully pay the taxes they owe, and in the process they help fund public education, infrastructure, public health, and job training programs that move our economy and our communities forward. Unfortunately, not all taxpayers are paying the money they owe, and the result is less funding for the public structures and services that drive growth and recovery.

The Department of Revenue has estimated that the state has a tax gap of $312 million.[1] The tax gap is the difference between the amount of tax legally due in a given year and the amount that taxpayers voluntarily pay in a timely manner. Recently, the Department of Revenue has substantially improved audit collections. However, in order to further close the tax gap and raise needed revenue for public services, additional tools are needed. By implementing these tools, Montana can improve tax compliance, maintain a system where everyone plays by the same rules, and raise revenue for essential public services, simply by enforcing our current tax laws.

State leaders are facing revenue challenges, which they can address by:

1. Cutting public programs and, thereby, cutting jobs;
2. Raising taxes on those who already voluntarily comply with the tax laws;
3. Closing tax loopholes; and/or
4. Collecting taxes due from those who are not complying with Montana's tax laws.

Montana's revenue challenges are big enough that any one of these choices will not solve the entire problem. However, the first choice for Montana should be to improve compliance and collect the taxes that are already due to Montana.

Noncompliance occurs because of lack of taxpayer knowledge, unintentional error or intentional avoidance. Regardless of the cause, noncompliance is extremely detrimental to Montana. **The $312 million tax gap means other taxpayers would have to pay about 21% percent more in taxes to subsidize those who do not pay the taxes they owe.**[2] In addition, the tax gap is economically inefficient and creates an uneven and uncompetitive playing field. Firms that do not pay their taxes may be able to unfairly undercut prices of those firms that do pay their taxes. This is true even if the noncompliant firm is a less efficient business.

Just as importantly, the American tax system relies on a substantial amount of voluntary compliance. If people aren't confident that their neighbors are paying what they owe, they may come to feel justified in avoiding their tax responsibilities also.[3]

State leaders can find common-sense policy solutions that ensure that all taxpayers are paying the taxes they legally owe. The following is a list of tools that should be considered to improve compliance.

Adequately Fund Department of Revenue Compliance Efforts

A simple and sensible way to raise revenue during the current revenue challenge is to increase the resources the Department of Revenue has to collect unpaid taxes. In fact, there are very few, if any, investments the state could make that would yield a higher return. Simply by enforcing laws that are already on the books, we can ensure that everyone is paying what they owe and contributing their share to our investments in our common good.

Fortunately, by modestly increasing staff, the department has already been able to substantially increase compliance efforts in recent years. Audit collections have increased by 178% since 2002.[4] The department has achieved an $8.10 to $1 return on investment in compliance efforts. In other words, for every $1 invested in compliance and audits, the department has been able to collect $8.10 in unpaid taxes.[5]

Unfortunately, the Department of Revenue is one of only a few state agencies whose budgets were cut below present law during the 2009 legislative session.[6] The state simply can't afford to inadequately invest in the Department at a time when it's essential to collect every dollar owed. To secure our investments in education, health care, and natural resources, state leaders should maximize investments in the department's tax compliance efforts.

Automatic Withholding of Income for Non-Resident Real Estate Sales

Non-residents of Montana are much less likely to report or pay taxes on profits from the sale of real estate in Montana.[7] In fact, research indicates that non-residents fail to pay 70% of the time, while residents fail to pay just 10% of the time. The failure to pay taxes on real estate sales by non-residents costs the state roughly $1.5 million in unpaid taxes each year.[8]

It is only fair to the vast majority of Montana residents who report and pay the taxes resulting from their real estate sales, that non-residents similarly comply. A simple and efficient way to ensure compliance is to pass legislation that would require the automatic withholding of income taxes of non-residents for sales on Montana real estate.[9] Not surprisingly, compliance rates are the highest for income sources that are subject to withholding and third party reporting. In addition, non-residents can often claim a credit for taxes paid in Montana in their resident state. Therefore, paying the taxes they owe in Montana will not necessarily even cost the taxpayer more. Revenue will just be redirected to Montana, the state where the income was earned.

Montana simply can't afford to have a 70% non-compliance rate by non-residents and thereby give away over $1.5 million each year. Automatic withholding would ensure that non-residents pay what is owed, like almost all Montanans already do, without increasing taxes for anyone in the state.

Prevent Abusive Tax Shelters

The IRS requires the reporting of certain types of transactions that are likely or known to be abusive tax shelters. Requiring the same reporting at the state level and establishing penalties for failure to report and underreporting would assist in the identification of abusive tax shelters. In the 2009 session, proposed bill HB 650 would have created these requirements and penalties (among other things). If passed, these additional tools to prevent abusive tax shelters are expected to generate $2.5 million in the 2013 Biennium.[10]

Improve Uniformity Between Individual and Corporate Taxpayers

The number of years in the past that the Department of Revenue may audit a tax return and assess additional taxes is known as the statute of limitations. Currently, the statute of limitations for individual taxpayers is 5 years, but for corporate taxpayers it is only 3 years. This two-year difference should be corrected so that all taxpayers, including corporations, have the same 5-year statute of limitations. Corporate tax returns are often more complicated and require a longer time of analysis to indentify noncompliance. If adopted, this additional 2 years in the corporate statute of limitations is anticipated to generate $5.8 million in the 2013 Biennium.[11]

Improve the Compliance of Multistate Corporations

Corporations that do business in multiple states are required to report income to the states where they earned the income. Requiring corporations to disclose inconsistencies between their Montana return and their return in other states (including when audits modify the returns in other states) will assist the Department of Revenue in identifying income that escapes taxation in any state. This change will create substantial audit collections in some years, but is not expected to be a consistent source of revenue from year to year.[12]

Create Requirements for Large Centrally Assessed[13] Property Protests

In order to ensure accurate appraisals for contested property taxes of centrally assessed property, Montana could prohibit contingent fee appraisals and require that all large protests be accompanied by a professional appraisal. These two provisions would improve accuracy, speed the process of contesting property taxes, and lessen the instances of unwarranted protests. If passed, the two provisions would generate approximately $1 million in the 2013 Biennium.[14]

Temporary Tax Amnesty

Some states and the federal government have attempted to increase compliance by offering a temporary amnesty period that encourages taxpayers to pay delinquent taxes and avoid criminal prosecution, civil penalties, and a portion of the interest that is due.

This option was included in the Legislative Fiscal Division's report of possible solutions for closing the revenue gap. They estimated that it would bring a one-time return of $10 million for the 2013 Biennium.[15] Ten states have utilized a temporary tax amnesty in the last couple of years in order to bring in money that helps bridge the gap until revenue returns.[16]

Of all the compliance options discussed in this paper, tax amnesty should be greeted with the most caution. Tax amnesty programs may lead to perceptions of unfairness by penalizing similar taxpayers differently, just on the basis of when they decided to pay their debts. In addition, if delinquent taxpayers begin to expect a tax amnesty every time revenues are down, they may hesitate to settle their debts during normal times.

Conclusion

Montana has dramatic revenue challenges brought on by the recession. Fortunately, there are many solutions to this problem. Of all the options available for reversing Montana's revenue decline, our first choice should be improving tax compliance.

By enhancing the enforcement of laws that are already on the books, we can find new revenue for education, health care, and other services that support families, businesses, and communities struggling with the recession.

To spur our economic recovery, we need to continue investing in education, job training and more. However, to make those investments, we need to find new revenue. The first step in tackling this problem is simple – it's time for Montana to better collect the revenue it is already owed.

Endnotes

1. Montana Department of Revenue, "Biennial Report: July 1, 2006 to June 30, 2008," January 13, 2009.
2. Montana Department of Revenue, "Biennial Report: July 1, 2006 to June 30, 2008," January 13, 2009.
3. Jason Furman, "Closing the Tax Gap," Center on Budget and Policy Priorities, April 10, 2006, http://www.cbpp.org/files/4-10-06tax3.pdf.
4. Montana Department of Revenue, "Biennial Report, July 1, 2006 to June 30, 2008," January 13, 2009, p. 10.
5. Montana Department of Revenue, "Business and Income Taxes Division –Compliance and Collections Fiscal Year End 2010 Report," October 10, 2010, http://revenue.mt.gov/content/publications/business_income_tax_reports/Fiscal_Year_End_Report_2010.pdf.
6. Montana Budget and Policy Center, "The 2011 Biennium Budget: Maintenance, Recovery, and Future Cuts," February 12, 2010, http://www.montanabudget.org/reports/reinvesting-montana.
7. Statement by Representative Dick Barrett, HB0647 Provide Tax Withholding for Nonresident Sales of Montana Real Estate, Montana State Legislature, House Taxation, 2009 Sess., March 18, 2009.
8. Governor Brian Schweitzer, 2013 Beinnium Executive Budget, November 15, 2010, http://budget.mt.gov/execbudgets/2013_Budget/default.mcpx.
9. See proposed HB 647 (2009 legislative session) http://laws.leg.mt.gov/laws09/LAW0203W$BSRV.ActionQuery?P_BLTP_BILL_TYP_CD=HB&P_BILL_NO=647&P_BILL_DFT_NO=&P_CHPT_NO=&Z_ACTION=Find&P_SBJ_DESCR=&P_SBJT_SBJ_CD=&P_LST_NM1=&P_ENTY_ID_SEQ=
10. Expected revenue from annual audits related to abusive tax avoidance would be $0.5 million per year. Additional revenue from penalties would be $0.5 million per year. Legislative Fiscal Division, "Fiscal Note 2011 Biennium HB0651," March 26, 2009, http://data.opi.mt.gov/bills/2009/FNPDF/HB0651.pdf.
11. Governor Brian Schweitzer, 2013 Beinnium Executive Budget, November 15, 2010, http://budget.mt.gov/execbudgets/2013_Budget/default.mcpx.
12. Legislative Fiscal Division, "Fiscal Note 2011 Biennium HB0651," March 26, 2009, http://data.opi.mt.gov/bills/2009/FNPDF/HB0651.pdf.
13. Property owned by a corporation or person operating a single and continuous property operating in more than one county or more than one state including but not limited to utilities, rail roads, pipelines, etc.
14. Legislative Fiscal Division, "Fiscal Note 2011 Biennium HB0651," March 26, 2009, http://data.opi.mt.gov/bills/2009/FNPDF/HB0651.pdf.
15. Legislative Fiscal Division, "Reference Book," July 13, 2010, http://www.leg.mt.gov/content/Publications/fiscal/Legislative-Options/July-2010/RTIC.pdf.
16. National Conference of State Legislators, "Actions & Proposals to Balance the FY 2010 Budget," http://www.ncsl.org/?tabid=17255.