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Report on
Personal Income Tax Compliance
in Oregon

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Individual Taxpayer Compliance in the State of Oregon

A Report to the Seventy-fifth Legislative Assembly

Presented by the Oregon Department of Revenue

January 30, 2009

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Executive Summary

In February 2008, the Department of Revenue launched a comprehensive study of individual income tax compliance in Oregon. Prompted by a request from the Legislature during the 2008 special session, we began building a report that:

- Estimates the level of individual taxpayer compliance in Oregon;
- Identifies behavior that contributes to noncompliance;
- Identifies initiatives and makes recommendations to improve the level of compliance.

We consulted with external sources and identified best practices of other states and the IRS in making our recommendations. We engaged in several data-gathering activities including a survey by Oregon State University that measured taxpayer attitudes, internal focus groups with key staff, and a thorough review of income tax compliance best practices across the country.

These are the major report themes:

- Along with Oregon, the Internal Revenue Service and other states face significant compliance issues.
- The tax compliance rate provided is truly an estimate. Estimating the tax compliance rate is an extremely complex endeavor, and measuring improvement in compliance will be equally complex.
- We use a balanced approach of education, assistance, and enforcement to encourage compliance.
- Third-party reporting and verification are crucial to improving compliance.
- When the public perceives that tax laws are enforced, they are more likely to be compliant.
- The complexity of the tax code contributes significantly to noncompliance.
- Optimizing audit case selection and processes can provide a better return on investment.
- Disclosure laws hinder our ability to partner with other agencies in compliance efforts and enforce multiple state programs (i.e., unemployment, workers' compensation).

Some of what we learned surprised us, some affirmed what we're presently doing to ensure compliance, and some have already led us to make changes in the way we do business. We've spent considerable time evaluating our processes and considering best practices that would move us toward increased compliance.

As a result of this process, we've identified:

1) Initiatives we can undertake immediately with no additional resources needed, including adopting collection and audit best practices, collaborating with other state agencies, improving some of our current processes, and exploring better ways to measure our performance;
2) Suggested actions you, the Legislature, can consider, ranging from expanding our disclosure authority when working with our partners, to establishing specific statutes relating to our enforcement activities.
3) Initiatives we could undertake if provided with additional resources, including updating outdated systems, establishing additional revenue-generating positions, and carrying out comprehensive outreach efforts.

The report also contains several appendices that elaborate on some of the detailed issues.

Compliance is our business. We believe strongly in our mission to "make revenue systems work to fund the public services that preserve and enhance the quality of life for all citizens." When individual income taxpayers intentionally or unintentionally do not pay what they owe under the law, it affects all of us.

We believe there is a significant gap between the amount of tax that should be reported and paid and the amount that actually is paid. Measuring the gap is extremely difficult. While we estimate the compliance level in Oregon to be over 80 percent, we believe we could be doing more to impact compliance and to reduce the gap by adopting best practices, recommending legislative changes, and adding resources. We look forward to working with you to find solutions, and will provide updates throughout this process.

Introduction to Oregon's Tax Gap

Kathy and John bought a small Oregon farm in 1985. They built a new addition onto the barn this year. In preparing their taxes they needed to calculate depreciation of their farm assets. They made several mistakes due to the complexity of accurately calculating depreciation expense. First, they failed to allocate their original purchase price across all of their farm assets. The farm's total purchase price should have been allocated across the barn, land, and farmhouse. They can deduct the cost of the barn over time, but not the land and farmhouse. They also began using their truck this year for other than purely farm business; they can only deduct a portion of their truck's purchase price in proportion to the amount of time it is used for the farm. Finally, they deducted the entire costs of the new barn addition, when they should have set up those costs as a new asset and spread the costs over the addition's useful life. All of these behaviors were unintentional, but reduced their tax liability substantially.

Tom is a mechanic who has owned a repair shop for over 10 years. His customers love him because he offers some of the best rates in town. In fact, he offers his customers a 15-percent discount if they pay in cash. Tom does not record these cash transactions in his accounting software, and therefore does not recognize that income on his income tax return.

These situations illustrate just two of hundreds of examples of noncompliance that combine to create Oregon's "tax gap" – the amount of personal income tax due, but unreported and uncollected by the Department of Revenue for any given year. For purposes of this report, **"compliance" refers to the behavior of reporting and paying Oregon personal income tax voluntarily and on time, and "noncompliance" refers to anything else.** In both examples above, taxpayers avoid paying required taxes, either unintentionally, as in the first example, or intentionally, as in the second. The resulting gap causes the government ultimately to reduce services or raise taxes for others to make up for the shortfall.

The challenges of measuring Oregon's tax compliance rate

Because a taxpayer's true tax liability is measurable only by the taxpayer, it is difficult to measure both the true tax liability owed to the state, and consequently, the tax gap. Oregon's income tax system relies on taxpayers doing all of the following accurately: reporting all of their income; classifying their deductions and credits; and calculating, reporting, and paying their tax. In a very complex tax system (especially to those unfamiliar with accounting, record keeping, and the tax code in general) this can be a daunting, error-filled task. Because reporting, calculating, and paying taxes is the taxpayer's responsibility, Oregon's income tax system relies on voluntary compliance. This does not mean that paying taxes is voluntary, rather, the reporting of tax owed is meant to be voluntary. Taxpayers are the only ones who have all the information needed to file an accurate tax return. We have some pieces because of third-party reporting, but some transactions, such as sales on eBay, for example, are not verified by a third party.

While taxpayers may be the only source of complete information regarding their liabilities, third-party reporting and withholding enhance compliance because we are less reliant on taxpayers as sole sources of information. According to a report from the Government Accountability Office, those subject to substantial information reporting and withholding are 99-percent compliant, whereas self-employed individuals who are subject to little or no information reporting and withholding are 46 percent compliant. The same challenge applies to estimating the level of compliance over the entire population. Estimating the tax gap is difficult because much of the income is not subject to third-party reporting or withholding.

How we estimated Oregon's personal income tax compliance level

We chose the IRS net misreporting percentage method to measure Oregon's compliance rate after identifying three possible approaches. It's important to note that each approach measures different characteristics of tax compliance. All three approaches have both strengths and weaknesses in terms of their applicability to Oregon. We chose the one that offered the most comprehensive measurement of the compliance rate for federal tax returns as they relate to Oregon.

The three approaches we considered are:

- IRS net misreporting percentage. This approach relies on the IRS National Research Program which reviews and audits 45,000 returns annually. Information about audit adjustments is gathered and a "misreporting" percentage is calculated for each line item on the Federal 1040. This approach assumes Oregon taxpayers' filing behavior is the same as the national average. This approach also assumes Oregon taxpayers' misreporting percentages for additions,

subtractions, credits, and residency status are the same as the IRS misreporting percentages. The IRS misreporting percentages were calculated using 2001 federal return data, and the results were published in 2005; we applied the misreporting percentages to 2006 Oregon personal income tax returns. Therefore, any anomalies in either tax year may impact our Oregon estimate.

- Adjusted gross income (AGI). This approach estimates the tax compliance rate by comparing AGI figures reported on tax returns with estimated income from an independent source (Bureau of Economic Analysis). The AGI gap estimation using this approach is really a measure of an income gap, rather than a tax gap. This approach is based on data from income payers rather than from income recipients. Some of the components necessary to correct differences in calculations are not available; therefore, certain amounts must be approximated. It is worth noting that this approach results in higher compliance percentages than when using the IRS approach.
- Census' American Community Survey. This approach relies on approximations of income and filing status from a national census survey. The survey data only includes income that is received regularly and excludes one-time payments, such as capital gains. In addition, filers with income below tax return filing thresholds have been excluded from the analysis. Income data compiled through the survey is considered less accurate than income reported on individual tax returns. This approach also results in a higher estimation of the compliance rate than when using the IRS approach.

We also looked at what five other states and the IRS used to estimate their personal income tax compliance rates (Table 1. Approaches Used by Other States and the IRS).

- Idaho based their 1999 study on the IRS approach from the Tax Compliance Measurement Program. Their compliance rate for personal income tax was 82.9 percent based on 1994 returns.
- In 2004 Minnesota used census data to approximate income and number of returns and compared the result to the actual 1999 data. They estimated their tax compliance rate to be 89.5 percent.
- California's study in 2005 was based on IRS data from 1988. That state looked at the combined compliance rate for both personal income tax and corporate taxes. We were unable to draw a meaningful comparison to Oregon's personal income tax program.
- New York used census data in 2005 to estimate the number of filers and their true income, estimating their state's compliance rate to be 86.1 percent.
- Montana's 2006 study yielded an estimate of 78-82 percent; their calculations were based on IRS misreporting percentage information.
- The IRS completed a tax gap study in 2005 based on 2001 federal returns. The study focused on national misreporting without estimating individual state compliance. The IRS estimated the national compliance rate between 83.4 and 85 percent.

The Department of Revenue chose to estimate Oregon's tax compliance rate using misreporting percentages from the IRS National Research Program and applying those to Oregon's 2006 tax return data. We chose this method because the IRS study was based on federal returns filed rather than census or other data. This is important, because Oregon taxable income begins with a calculation of federal taxable income. For example, our methodology assumes that, if wage income is underreported by two percent at the federal level, it is also underreported to Oregon by 2 percent.

The method we chose has many assumptions including 1) that 2001 is a "typical" tax year, 2) that the compliance level remains steady in all economic climates, and 3) that the misreporting percentage of each income and deduction item is the same in Oregon as on the federal level. To the extent these assumptions may not be accurate (there is no typical tax year, for example), the Oregon compliance level estimate could be significantly over- or understated.

Table 1. Approaches Used by Other States and the IRS

Approach used to estimate compliance rate	Idaho	Minnesota	California	New York	Montana	IRS	Oregon
IRS net misreporting percentage	82.9%		85.0%		78.0-82.0%	83.4-85.0%	81.5%
Adjusted gross income (AGI)							83.7%
Census' American Community Survey		89.5%		86.1%			88.9%

It is important to note that IRS' estimate of the federal compliance rate only accounts for the legal sector of the economy. Although income from illegal activity is taxable, it is extremely difficult to estimate. Since we chose to estimate Oregon's compliance rate using the IRS method, we also have not accounted for income from illegal activities.

We believe we chose the method that most closely approximates Oregon's compliance rate, but we also understand there are several limitations to this analysis. Some factors are specific to Oregon and do not apply to federal returns, such as taxability of certain types of income (e.g. income earned by tribal members in "Indian country" is not taxable by Oregon). Also, each Oregon subtraction, addition, and credit is unique to Oregon. Other research suggests that Oregon returns are actually more accurate than the national average (due to the state's strict requirements for licensed tax preparers).

According to a 2008 Government Accountability Office analysis of the IRS's 2001 National Research Program data, "Oregon returns were more likely to be accurate… compared to the rest of the country after controlling for other factors likely to affect accuracy. In dollar terms, the average Oregon return required approximately $250 less of a change in tax liability than the average return in the rest of the country. For Oregon's 1.56 million individual tax filers, this equates to over $390 million more in federal income taxes paid in Oregon than would have been paid if the returns were as accurate as similar returns in the rest of the country."

Specific issues relating to part-year residents and nonresidents also contribute to the challenge of estimating Oregon's tax compliance rate. People new to Oregon may be unfamiliar with our tax laws and may not report their income correctly, especially if they've moved from a non-income taxing state. Individuals moving out of Oregon also make mistakes by failing to accurately report their Oregon-source income and pay the associated tax to Oregon.

Especially challenging for Oregon is the fact that we are bordered to the north by a non-income taxing state. Many Washingtonians cross the border to work for Oregon employers or operate their businesses in Oregon. Employer reporting of nonresidents' Oregon wages encourages compliance. Nonresident employees who work in Oregon for out-of-state employers must file and pay tax to Oregon whether or not their employer has withheld Oregon income tax from their wages. Since self-employment income can have little to no third-party reporting, ensuring compliance for nonresident self-employed taxpayers is extremely difficult. Some Oregon taxpayers try to evade Oregon taxes by pretending to live in Washington or other states.

Federal laws can create opportunities for noncompliance. For example, the Amtrak Reauthorization and Improvement Act of 1990 (Amtrak Act) prohibits states from taxing wages of certain nonresident employees (such as certain truck drivers and railroad employees) who have regularly assigned duties in more than one state. This federal law is often misunderstood and some nonresidents will claim all their Oregon income is exempt under the Amtrak Act.

Best estimate of Oregon's tax compliance rate

Taking all of these issues into consideration, we estimate that for tax year 2006, Oregon's personal income tax voluntary compliance rate is approximately 75.4 percent. An additional 4.2 percent is withheld from wages but not claimed on tax returns. The department brings in another 1.9 percent through audit, collections, and filing enforcement. This leaves a net compliance rate of 81.5 percent, or a net tax gap of about 18.5 percent. For 2006, this indicates that roughly $1,247,700,000 was not reported or paid.

Table 2. Voluntary Compliance

2006 tax year	Amount	Rate
Voluntarily reported tax	$5,069,200,000	75.4%
Voluntary withholding payments not claimed on timely returns	284,100,000	4.2%
Other receipts (enforcement and collection activities)	130,300,000	1.9%
Net tax gap	1,247,700,000	18.5%
Total tax	**$6,731,300,000**	**100.0%**

Key areas of noncompliance

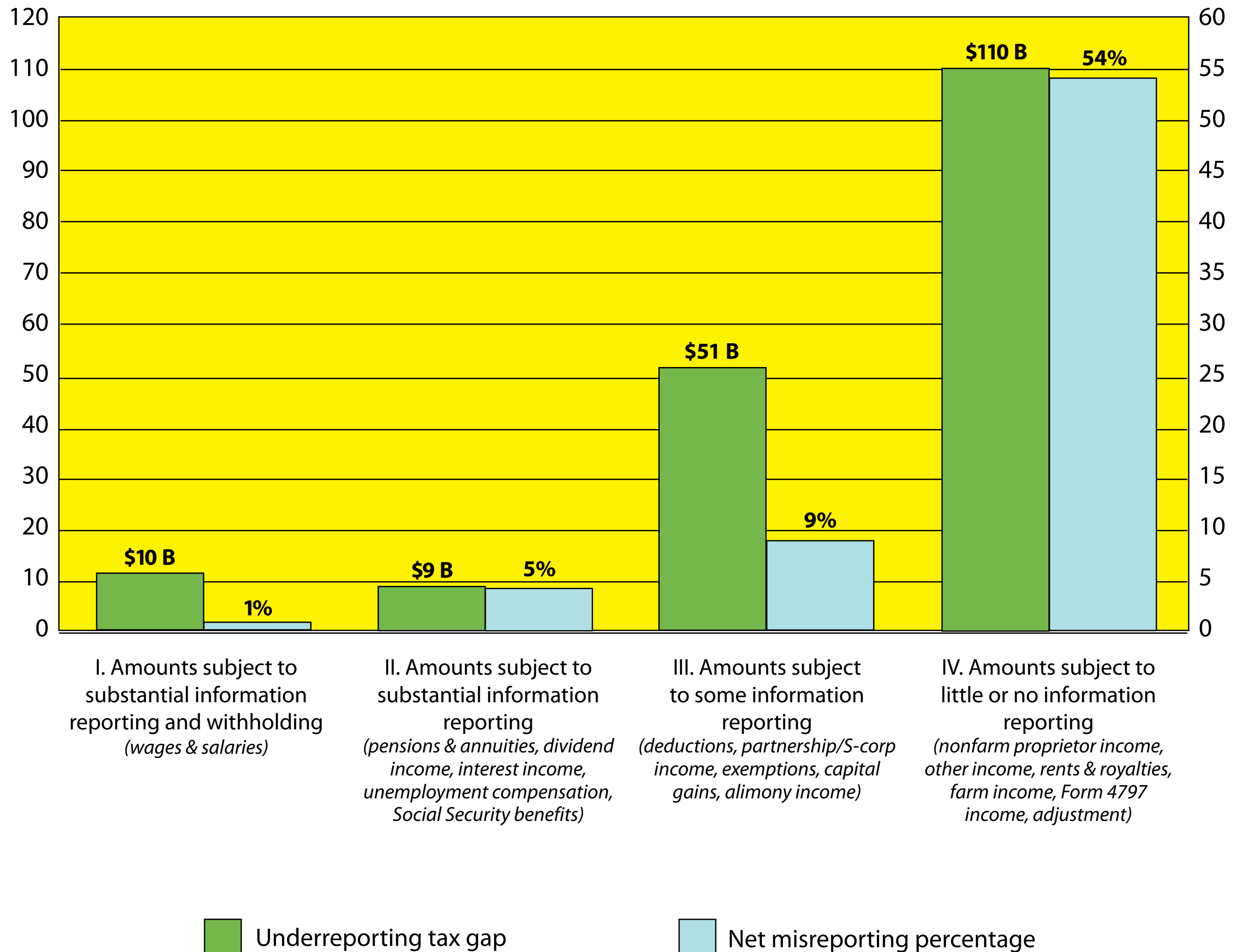
Taxpayers are more compliant when their income is easily visible to tax administrators. In a 2007 study, the IRS correlated misreporting percentages to the 'visibility' of the income. Income with the 'highest' visibility is that which is both reported and withheld on (wages and salaries). Wages and salaries have the lowest misreporting percentage because employees' earnings are reported and taxes due on the income are withheld. In order to get credit for the payment (or a refund of excess taxes paid) taxpayers have incentive to file their returns and include the wages. Employer reporting also makes it easier to find individuals who don't file or don't include the income because it is electronically submitted and can be matched to the individual.

At the other end of the spectrum is income that is neither reported by a third party nor withheld upon. Cash transactions may or may not have a paper trail readily available to taxing authorities. These income categories

are considered "low" visibility. According to the IRS study, they also have the highest rates of misreporting. Misreporting can range from unintentional misreporting to those taxpayers who are actively evading tax or sheltering income. Low visibility income and expenses are much more difficult to identify and correct and generally take an in-depth audit to accurately account for.

Figure 1. Tax Year 2001 Federal Individual Income Tax Underreporting Gap

Misreporting of Income and Offsets by "Visibility" Categories (Internal Revenue Service, Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance, 2007)



Based on updated estimates derived from the Tax Year 2001 National Research Program study of individual income tax reporting compliance.

Table 3. Federal Misreporting Percentage for Tax Year 2001 (IRS 2005)

Type of income	Misreporting percentage
I. High visibility (amounts subject to substantial information reporting and withholding)	
Wages and Salaries	1.20%
II. Medium high visibility (amounts subject to substantial information reporting)	
Interest and dividends	3.70%
Pensions and IRA income	4.10%
Unemployment income	11.10%
III. Medium Visibility (amounts subject to some information reporting)	
S Corps, partnerships, trusts, etc	17.80%
Capital gain	11.80%
Alimony income	7.20%
IV. Low visibility (amounts subject to little or no information reporting)	
Business income	57.10%
Farm income	72.00%
Capital gain	11.80%
Other gain	64.40%
Rents, royalties, etc	51.30%
Other income	63.50%

The diagram in Appendix B (page 23) shows the full-year Oregon resident tax computation and examples of elements for each component of Oregon personal income tax. Appendix C (page25) displays the tax gap numbers in greater detail, along with a discussion of areas of noncompliance.

What we learned about compliance in Oregon

Why are some taxpayers noncompliant? Are most instances of noncompliance intentional or unintentional? What types of behaviors result in noncompliance? These questions were at the heart of our research into the causes of Oregon's tax gap.

For answers to these questions, we commissioned a study by Oregon State University to examine taxpayer attitudes and behavior toward taxes. Additionally, we conducted several focus groups with department staff to collect anecdotal evidence of taxpayer behavior. Finally, we compiled an extensive body of independent research to supplement the studies.

Some interesting attitudes and facts about compliance emerged from the research:

- Taxpayers feel that not paying taxes is a very serious issue and people will be caught, especially when they cheat by "large amounts." (OSU survey)
- The use of tax preparers and tax preparation software has increased significantly in Oregon over the past 28 years, possibly leading to improved compliance. More than half of respondents used professional preparers, while only 17 percent prepared their own returns using paper forms. (OSU survey)
- When third parties provide us or the IRS with verification of payments made to taxpayers, the taxpayer is much more likely to make an accurate initial report. (Government Accountability Office report and IRS 2006 Comprehensive Strategy for Reducing the Tax Gap)
- When income is subject to withholding as well as third-party reporting, compliance is even higher, because taxpayers must file a return to get a refund. (IRS 2006 Comprehensive Strategy for Reducing the Tax Gap) (See initiative A-9 and recommendation B-5)
- Department of Revenue staff believes strongly that compliance would increase if the department were

perceived to be more aggressive in collections and other enforcement. (Focus group survey)

- Interviews with key stakeholders from the licensed tax professional community, Legislature, local government, and others also reveal that some believe that we need to increase our enforcement efforts. Increased enforcement efforts may bring in more dollars to the state, increase compliance, or both. (CGI analysis)
- Increased education and easier filing methods (such as e-file) encourage filing but may also enable more fictitious and/or fraudulent returns. (Beebe, D., 2008)
- Taxpayers are compliant for two main reasons. They either have moral/social reasons for complying, or, they believe the likelihood of being audited or penalized for not complying is higher than reality. (Mikesell, J. and L. Birskyte (2007))

The next two sections describe behaviors and attitudes leading to unintentional and intentional noncompliance. We believe that unintentional noncompliant behaviors are best addressed with increased education and assistance, while intentional noncompliant behaviors are best addressed with increased enforcement. We also believe some changes in the tax structure would reduce both types of noncompliance. However, as long as Oregon's personal income tax is based on the definition of federal taxable income, Oregon is limited on how much simplification of the tax code can be accomplished.

Unintentional behaviors that reduce compliance

Maria is an administrative assistant with a small architectural firm. She frequently plays the Oregon Lottery, both for fun and because she has recently had some good luck with large payouts. Just last week, she won a $1,000 prize and a $300 prize in scratch-off games. Maria doesn't realize she needs to report this income because her parents or friends told her it isn't taxable. She should report $1,300 of gambling income on her federal return and subtract the $300 prize on her Oregon return.

Lottery winnings are just one example where law-abiding taxpayers frequently misreport their income. Maria is unaware of this law along with hundreds of other Oregon-specific tax codes that confuse her around tax time. In fact, both the OSU study and the internal focus groups consistently pointed out that the **primary reason for unintentional noncompliance is the underlying complexity of the tax code.**

Why is Maria confused?

Taxability of lottery winnings is confusing, making compliance a challenge for taxpayers and enforcement more difficult for us.

All lottery winnings are taxable at the federal level, but Oregon does not tax Oregon Lottery winnings below $600. Many taxpayers believe that the income is not taxable if they don't get a report of the income (a Form 1099 or W-2 G) from the payer at tax time.

For taxpayers who report their small Oregon Lottery winnings on their federal return, a subtraction is allowed on the Oregon form. Since each instance of a small lottery win is a potential subtraction, there is no absolute maximum subtraction. Also, taxpayers who won prizes that are paid over multiple years may have won large prizes that are not taxable by Oregon (no Oregon Lottery prize was taxable by Oregon until 2001). So that subtraction line contains both winnings limited to $600 per occurrence, and winnings with no limit, making it more difficult to screen obviously noncompliant entries.

In both 2005 and 2006, about 500 taxpayers claimed this subtraction on their Oregon returns. Subtracted amounts ranged from $1 to over $500,000, with a median amount of about $600 in 2006 and about $800 in 2005. The low number of subtractions indicates that there might be too few taxpayers reporting these winnings on their federal income tax forms. Because of the confusion about which part of lottery winnings are taxable, under-reporting this income on the federal return might be primarily due to misunderstanding.

This is an example where complexity appears to reduce compliance.

Many taxpayers prepare their returns themselves and must rely on general instructions for a very complicated set of tax laws. Without a professional tax preparer, taxpayers are likely to get confused about things such as which sources of income are taxable (like some Lottery winnings) or how to compute

the taxability of certain income (such as gains on sales of mutual funds). They may also simply be uneducated about record keeping and financial matters in general, which makes compliance difficult.

Another factor that contributes to unintentional noncompliance involves individual state requirements that taxpayers may not understand. Taxpayers may be unaware that they need to file in Oregon if they are nonresidents or part-year residents with Oregon income. This type of situation is best addressed with education.

State and federal law both have a "pay as you earn" tax concept, meaning tax may be paid through estimated tax payments or withholding. Some taxpayers who are subject to withholding on their wages unintentionally miscalculate the number of exemptions they claim on their Form W-4. They do not have as much income tax withheld from each paycheck as they should and are under-withheld for the year. Sometimes these taxpayers are unable to come up with the difference the following April. In following years the problem of being under-withheld compounds and the taxpayer ends up owing tax, penalty, and interest for multiple years.

In summary, unintentional noncompliant behaviors include making errors due to the complexity of the federal and state tax laws, not filing required returns because of a lack of understanding of who is required to file, and general confusion about the accurate use of Form W-4.

Intentional behaviors that reduce compliance

Scott operates a landscaping business in Bend. He has clients in town, but also performs lawn care services throughout the county. Scott owns a pickup truck and equipment trailer that he uses to transport his equipment, but he also uses them for weekend fishing and hunting trips, and for taking his children to their various activities after school. For the most part, Scott visits the same clients on a weekly basis, so he is familiar with the distances he drives each day. He does not use a mileage log to keep track of his daily miles driven for the business, nor does he keep track of his personal mileage in the truck. At the end of the year, however, Scott tells his CPA that he used his truck exclusively for the landscaping business. As a result, when preparing Scott's tax return, the CPA will include 100 percent of the expenses associated with the truck and equipment trailer as business expenses, thereby over-reporting expenses on Scott's Schedule C, and underpaying the personal income tax he owes from his business.

In contrast to unintentional noncompliance, intentional noncompliance can be a direct result of specific attitudes toward taxes, the government, or money in general. The OSU survey pointed out that most Oregonians believe money is the primary motivation for cheating on taxes. **The top two reasons respondents believe people cheat on taxes were the ability to get away with it and the want or need for money.** For complete details, please refer to Appendix E – the OSU Survey Executive Summary.

Other attitudes that affect compliance can come from friends, family members, social networks, and coworkers who may encourage noncompliance. Department enforcement activities indicate certain industries, such as construction and agriculture, have high levels of noncompliance. Some within these industries feel that "everyone is doing it," and they also rely heavily on cash payments and thus have no third-party reporting mechanisms.

When businesses don't pay their taxes, they have more cash available for business needs. This is especially true for employers who withhold income taxes from their employees' wages, but fail to send them to the department or hold on to them longer than allowed by law. Business owners who pay their fair share of taxes (including unemployment, workers' compensation, and transit taxes) and pay payroll withholding taxes on time are at a disadvantage; they must make enough income from their businesses to cover these business expenses. Business owners who do not pay their taxes or who do not pay payroll withholding taxes on time can bid lower for certain jobs and have an unfair competitive edge in the marketplace.

For example, Gordon operates a hardwood flooring restoration business. As he bids on specific flooring jobs, he must bid a price high enough to cover his expenses, including taxes. Pat also operates a similar business. Pat has not filed tax returns for several years and does not pay any taxes. He is able to bid a lower price and still make a similar amount of profit from the job. Because Gordon is "playing by the rules," he does not win the bid; Pat, who does not play by the rules, successfully wins the job with a lower bid.

According to the OSU survey, most people believe that people who cheat a little will not be caught. The perception of not getting caught appears to be the most important factor in Oregonians' intentional noncompliance. (OSU Survey) Some taxpayers think there is a very low possibility that they will ever be audited or asked to verify what they report on their tax returns. Other taxpayers and practitioners purposely create complex or convoluted tax transactions, knowing it is more challenging for us to determine if the correct tax is being paid.

Some part-year and nonresident taxpayers purposely don't file in Oregon. For example, Sharon operates a

cleaning service out of her home in Longview, Washington. She has clients in both Oregon and Washington. Because Sharon performs services in Oregon, she is required to file a nonresident return, reporting income earned in Oregon. However, because she is self-employed, there is no third-party reporting of her Oregon source income. It is extremely difficult to identify this type of noncompliance. Sharon's nonfiling behavior with Oregon is unlikely to be detected through typical data matching processes (such as using federal tax data).

Many cash transactions are difficult, if not impossible, to identify, even through an audit. Carla charges $30 for a haircut. When her customer pays, Carla puts the cash in her purse rather than in the cash register. Carla gave her business records in the form of cash register receipts to her tax consultant to have her tax return prepared. She didn't tell her consultant about money from sales that didn't make it into the cash register (skimming). The more a business conducts cash transactions, the easier it is to omit "low visibility" income.

We are finding more cases involving intentional noncompliance in flow-through entities (partnerships, S-corporations, and limited liability companies). For example, foster care payments from a state agency are not taxable if the payments are for the care of qualified foster children and adults in the care provider's residence (IRC Section 131). A recent audit uncovered the following scenario: An adult foster care business was operating as a partnership with two foster homes. Income and expenses were correctly allocated; however, the taxpayers (partners) were each claiming to live in one of the foster care homes, which was not true. The partners said that each of the foster homes was their primary residence so that the state-paid foster care income was not taxable.

We will continue to focus on auditing flow-through entities, but we will need a better system to capture partnership return data and track partnership income as returns are filed. See recommendation C-3. This system will need to be coordinated with our review of our major systems in initiative A-8.

Some taxpayers have entered into abusive transactions to avoid tax. The IRS has developed a list of specific transactions now referred to as "listed" and "reportable" transactions; both Oregon (through SB 39 in the 2007 session) and the IRS impose penalties if a taxpayer fails to disclose that they participated in or promoted one of these transactions. However, the transactions are usually very complex and difficult to identify. We will continue to train our auditors to recognize and address these abuses as we implement our focused audit areas.

Sometimes intentional noncompliance stems from life situations that leave taxpayers in a position where they cannot pay their taxes. A recent divorce, loss of a job, or unexpected medical situations can devastate a family's financial resources, leaving them unable to file or forcing them to choose between paying taxes and other obligations.

Taxpayers engage in a variety of intentional behaviors that contribute to the tax gap. Many involve small or cash-based businesses, lack of third-party documentation, nonresidents, and social attitudes toward paying taxes. The recommendations at the end of the report specifically address these issues.

Department compliance efforts

We strive to improve compliance using three distinct approaches, based on three stages of the return filing process: 1) before a return is filed, through education and assistance; 2) after a return is filed, through audit and verification; and 3) when taxes are unpaid, through filing enforcement and collection activity.

Education and assistance

To deal with unintentional noncompliance, we devote resources to education and assistance. We believe, along with the IRS, that a significant amount of unintentional noncompliance results from lack of knowledge about tax laws.

Filing relies on taxpayers voluntarily gathering their information and filling out the tax forms, so education and assistance are essential to facilitating compliance. We realize that the tax system is complex and that many taxpayers would be unable to file a correct return without education and information. This includes a variety of activities from forms design to providing one-on-one tax assistance. At present, there are 65 positions in the personal income tax program devoted to education and customer service, which includes 23 positions in our call center. The amount of resources allocated to this area is based on historic demand for these services.

We use several methods of providing assistance to reach as many taxpayers as possible. We offer face-to-face contact in Salem and at our 10 field and satellite offices throughout the state. These services are in addition to providing call center support. Our offices generally expand their hours during filing season. We also conduct presentations at small business fairs for prospective new business owners, provide space for local Tax Aide volunteers in some field office lobbies, and collaborate with tribal jurisdictions to assist members with resolving tax issues. We work with tax preparers and tax preparation software companies to help them interpret and apply tax laws accurately.

We work hard to make tax forms and instructions as easy to understand as possible, given the complexity of the tax code and limited resources. We strive to design forms that are clear, accurate, and concise, and provide detailed instructions for accurate completion, while explaining topics that are very complicated. More information is available on our website, through the call center, from printed information, and by e-mail. Between July 2007 and June 2008 we helped more than 280,000 taxpayers either on the telephone or through the website, and responded to more than 15,000 e-mails from taxpayers.

Education can also be used to address intentional noncompliance, to some degree. Education can help change perceptions about where tax money goes, how noncompliance affects the tax burden on compliant taxpayers, and how services to communities, children, the elderly, etc. are affected by noncompliance. Education can also explain the consequences of being caught cheating on taxes.

We attribute the 81.5 percent level of voluntary compliance in Oregon in part to education and assistance. However, additional resources would help us better educate and assist the public by:

- Conducting regular taxpayer surveys to assess the public's understanding of the tax laws and gather data about the effectiveness of our customer service. (See recommendation C-6)
- Implementing a tax education program in the schools with the aim of creating future generations of responsible taxpayers, improving understanding about the benefits of paying taxes, and changing attitudes about the fairness of the tax system. (See initiative A-5)
- Educating those who choose to use a tax preparer that return preparers in Oregon must be licensed. Taxpayers should only use a licensed preparer when paying someone else to prepare their return. (See recommendation C-4)
- Enabling taxpayers to become more self-sufficient through an enhanced website and secure e-mail, allowing department staff to focus on other priorities. (See recommendation C-1 and initiative A-7)

Verification and audit

The Department of Revenue received about 1.8 million personal income tax returns for the 2007 tax year. Of those returns, 83 percent were filed on or before April 15, 2008 and the rest were filed on extension by October 15, 2008. All returns go through processing and high-level verification. Some returns will also go through a more detailed audit or examination.

After a return is filed, it goes through a process of checks to ensure accuracy. Simple things like addresses, names, and social security numbers are checked to match existing records. We perform math checks and make adjustments for obvious errors. A second check determines if values are reasonable in terms of statutory or other logical limits. For example, if a credit is limited to $500 and a return is claiming $5,000 for the credit, the return would then be manually reviewed in more detail. We manually review about 10 percent of returns.

After initial processing, we review or adjust returns further based on audit results or by comparing the return to external information (past returns, W-2s, 1099s, etc.). An auditor verifies information on the return by asking for documentation.

Auditors in field offices conduct most of the complex audits, as these typically require face-to-face contact with taxpayers or their representatives. Auditors in the main Salem office focus on audits that look at a single issue and are usually completed through mail and over the phone. A majority of other states surveyed about audit methods told us that both face-to-face and correspondence audits are effective, depending on the extent of the issue under audit.

For the year ending June 30, 2008, our audit enforcement programs identified over $60 million in tax, penalty, and interest owed to the state in 38,696 total cases. We collected about $9 million of that in the first 90 days before the accounts were turned over to revenue agents for collection.

The most cost-effective of these audits were in the CP2000 program, where the IRS matched third-party information (typically W-2 and 1099 forms) to taxpayer returns and made appropriate adjustments. The IRS shares the adjustment information with us and we use it to send notices to taxpayers explaining that the federal adjustment also created an Oregon adjustment. This is a good example of how compliance and collections are improved when agencies can share information and verify third-party information.

In 2007, the Oregon Legislature enacted legislation requiring all nonresident real estate sales to be reported to the department by intermediaries, such as title companies. Intermediaries are also required to withhold Oregon personal income tax from proceeds (some exceptions apply). We are creating processes to account for the withheld income tax we receive and are helping intermediaries comply with the new legislation. During the 2009 interim, we plan to research whether reporting and withholding on all real estate transactions (except for homeowners) would be beneficial. Because real estate transactions often involve large dollars

and all types of taxpayers—individuals, corporations, flow-through entities, etc.—much of this may be going unreported, especially with today's population being mobile and having flexibility to structure transactions to minimize or avoid tax. (See initiative A-9 and recommendation B-5)

During the 2009-2011 biennium our compliance program will focus on two areas:

1. Partnerships and limited liability companies (LLCs) filing as partnerships. Partnerships can have complicated transactions between partners, misstated income and expenses, and other means for misstating tax liability;

2. Auditing and pursuing filing enforcement of self-employed trades people (plumbers, landscapers, handymen, etc.), who are often engaged in cash-based businesses.

We share this information with tax preparers so they will be aware of our heightened scrutiny of these areas when preparing 2008 returns and can help their clients with proper reporting. Recently, our audit focus has shifted; rather than selecting personal returns with business activity (for example, Schedule Cs of all business types), we focus on specific segments that have higher probabilities of misreporting (for example, specific industries that accept cash payments), giving us a higher profile in these industries and alerting industry participants that we are actively auditing.

Ultimately, people who want to cheat will find a way. Auditor judgment alone cannot keep pace with those who evade paying taxes. A complex tax code, a few unethical tax preparers, and the sheer number of returns we receive enable some level of noncompliance. Keeping technology up-to-date and using sophisticated tools can improve our success in pursuing noncompliant individuals.

The challenge of building audit strength

For many years, we have had significant turnover in our audit positions. Experienced auditors spend less time auditing tax returns because they spend more and more time training and mentoring new employees. A number of our new auditors complete their training but find other opportunities before we realize a return on the training investment. Further, Department of Revenue auditors have a long training cycle due to the unique demands of the job. In the absence of good analytical tools for selecting audit issues, auditor judgment is acquired through experience. It takes three to five years of active auditing to become proficient in selecting and conducting an audit. This time may be reduced with effective case management software and better audit selection tools.

We are making some headway in retention, but we must do more. In 2006, 26 percent of tax auditors and 40 percent of senior tax auditors had more than five years of experience as tax auditors for the department. At the end of 2008, 41 percent of tax auditors and 96 percent of the senior tax auditors have more than five years of experience. Our progress could be largely due to the volatility of the current economy. In this economic climate, we expect to see lower turnover, but when the economy improves, it is likely some auditors will pursue higher income potential in public accounting and private industry.

We have strategic initiatives underway to address the problems of auditor turnover and expertise. For example, we have reduced initial classroom training for auditors from three months to six weeks and transferred some "processing" work to administrative assistants, allowing the auditors to more quickly hone their auditing skills. We also have improved the career path for skilled employees in the agency who do not have a formal accounting education, and who would like to become auditors.

But retention of auditors is only one challenge the audit and verification function faces. We rely heavily on outdated software to process and identify return issues, limiting effectiveness in identifying the most appropriate cases to audit. In early 2009, the department will implement a new software application that will help it improve audit case selection, the first step to acquiring better data matching and analytical tools. However, a more robust analytical tool to improve case selection would provide a larger return on investment than the less precise methods we currently use. Improving data sharing with other state agencies and removing disclosure barriers also will help us identify potentially high-yield audit cases. In the Recommendations portion of this report, we address these needs.

Retention and recruitment are essential to improving audit effectiveness, and we believe each of these measures would create a better environment for auditors and potentially result in lower turnover. In addition, we have to assign our resources to the cases that have the highest potential for affecting the compliance rate. According to best practices from other states, investing in analytical tools is the best way to do that.

Filing enforcement activity

Another area of noncompliance involves people who do not file a tax return. When taxpayers do not file returns as they should, we attempt to contact them and get them to file. Some do. During the year ended June 30, 2008, we contacted over 14,600 individuals regarding 20,400 past due returns. As a result of those contacts, 6,600 returns were filed.

For those taxpayers who did not file a return, we assessed their tax based on the best information available and issued a failure-to-file notice in place of a return. At any time after taxpayers have been issued a failure-to-file assessment, they can file an accurate return. Sometimes it can be difficult for taxpayers to gather the information needed to file past years' tax returns. In these cases, we will help them locate W-2s, 1099s, etc.

We have 32 positions that pursue tax returns from wage earners who fail to file. In addition, five auditors pursue tax returns from self-employed taxpayers who have not filed. One of the department's goals is to have taxpayers file their returns without being prompted, which will come as a result of increased education initiatives and for some taxpayers, increased enforcement action. We plan to devote more auditors and filing enforcement staff to pursuing returns from those who have not filed, based on what we've learned from our study of compliance over the past 11 months.

One method to improve compliance is to require applicants for state-issued licenses to show they have filed returns and paid their taxes before a license is issued or renewed. During the next two years we plan to pilot with one or two licensing boards to determine if verifying applicants' compliance status is an effective tool for bringing nonfilers into compliance. Based on the results of the pilot program, we may make a proposal to you in the 2011 session for any statutory changes or resources needed. See initiative A-3 and recommendation B-3.

Similarly, we plan to collaborate with contract-issuing state agencies to pilot a comparable program to determine if verifying a contractor's compliance status is an effective tool for bringing nonfilers into compliance. Based upon the results of our pilot, we may make a similar proposal to you in 2011. See initiative A-4 and recommendation B-4.

Another effective tool for filing enforcement would be the ability to suspend occupational and business licenses when a taxpayer refuses to work with us when they've been contacted about unfiled returns. Currently we are only able to ask a licensing agency to suspend or revoke a license after we have exhausted all other collection methods. This means we have to make an assessment of tax due based on best information available and multiple attempts to collect the tax before we can request that the licensing agency suspend the individual's license. We are recommending you expand our disclosure authority to allow us to notify state licensing boards and agencies of the taxpayer's noncompliance sooner in the filing enforcement and collection process. See recommendation B-1.

Transforming the collections process

A successful compliance effort depends as much on collections as it does on auditing and filing enforcement. We match our collection activity to the behaviors of the taxpayers. Taxpayers who are willing to work with us actually participate in determining how their debt gets paid. For example, Gary called our call center and explained that he filed his 2007 return without payment because he lost his job. He was able to set up a payment agreement giving him six months to resolve his debt. In another example, Nancy set up a payment agreement and failed to make three payments. When we contacted her, she agreed to pay and again failed to meet the terms of the agreement. We then garnished her wages.

If we cannot collect on a taxpayer's debt within a year, we must generally send the debt to a private collection agency. In the past, we typically sent the debt after the year expired; however, as a result of this compliance study and review of our collection practices by CGI, (an international consulting firm specializing in tax administration), we are re-evaluating our use of and relationship with private collection agencies. We believe that some accounts (out-of-state and small balance, among others) could be more effectively handled earlier in the collection process by private collection agencies, freeing our staff to address more difficult accounts. See initiative A-1.

In the past, the Oregon Legislature has given us some effective collection tools such as garnishing wages and bank accounts, filing liens against property, license suspensions, and advanced collection tools such as seizure of assets. We recently analyzed all collection processes and have embarked on a major re-engineering of those processes. We have developed initiatives to improve our effectiveness and included those in the Collections and Filing Enforcement Policy Option Package #152, which has been recommended by the Governor.

The major components of this package are to streamline account collection, provide tools to make taxpayers more self-sufficient, and increase our presence in the area of payroll tax enforcement. We expect an increase in tax compliance for taxpayers who have not filed returns and a reduction in accounts receivable for personal and payroll taxes. We will accomplish this by using additional staff and technology enhancements. The package is expected to generate $19.3 million in revenue with a cost of $6.5 million in the 2009-11 biennium. See initiative A-1 for more information about our plan to adopt collection best practices. See also recommendation C-1.

Obstacles to effective collections

Our two software programs, the Automated Collection Tracking (ACT) system and the Integrated Tax Accounting (ITA) system, track cases and outstanding debt. While these systems have functioned well for over fifteen years, they now are old, outdated, and expensive to maintain. They also do not easily adapt to best practices, and updating them requires the skills of a dwindling pool of technicians.. A new system would provide better case management, make training new revenue agents easier, and allow for greater accountability of the collection function (better management reports, account risk analysis and prioritization, performance management, etc.). We can improvise with and attempt to patch the two existing systems, but they will never be as good as a new system that has the capability to be integrated with other processes. (See initiative A-8 and recommendation C-2)

The collection rate also is affected by staffing levels. Volatility in the turnover of revenue agents impacts the effectiveness of the collection process. The current collection process is very labor-intensive so moving cases to different revenue agents disrupts the effectiveness of recovery efforts. Many of the same recruitment and retention issues arise with revenue agents as with auditors. Additional mid-level revenue agent positions are needed so that employees with the right skill levels are working the right kind of cases. See recommendation C-1.

Currently, we have 92 revenue agent 1s in the personal income tax division; additionally, 37 revenue agent 3s work the more difficult cases in the field. The number of revenue agent positions has remained fairly steady over the past three biennia, but turnover and vacancy in these positions disrupt the collection process. Improved technology in the form of better case management tools could improve collections by ensuring a more streamlined process. Such a system could also facilitate training new agents as it would be easier to learn and master.

In addition to systems and staffing challenges, other challenges exist:

- **Insufficient taxpayer knowledge of tax laws and taxpayer responsibilities.** Our experience is that the public is generally unaware of the consequences they face if they do not file or pay their taxes. As a result, some people decide to continue not filing and paying. By the time we contact them, they have incurred additional penalties and/or interest and may have an even harder time coming into compliance. We educate tax practitioners and the public by providing information in our publications and on our website. But we believe we should do more. We have an initiative to collaborate with the Education Department to add tax education to financial literacy courses throughout the state. See recommendation A-5.
- **Lack of resources to detect, prevent and prosecute income tax crimes.** We are currently prosecuting a criminal case with the Department of Justice. We would like to establish more expertise in this area or work more closely with that agency in the future to pursue criminal convictions for tax crimes. (See initiative A-6 and recommendation C-5)
- **Striking a balance between strong enforcement and fair treatment of taxpayers.** Whether we use strong enforcement tools or work with taxpayers to encourage voluntary compliance, we must be prepared to respond effectively to questions about our choices. We are also concerned about sending taxpayers the wrong message about stepping forward if they have not filed or paid. At times, our concern about public perception has affected how aggressively we pursue compliance.

Challenges to current compliance efforts

Although every effort is made to educate and assist the public, audit suspicious returns, and enforce penalties, our enforcement ability is limited. According to a 2007 report by the Congressional Research Service (which refers to national compliance, but also is applicable to Oregon compliance):

"Three factors are seen limiting the net revenue potential from increased enforcement. First, much of the gross tax gap for individual income tax filers is due to types of unreported income that are difficult to detect. Usually the income is not covered by third-party information returns (e.g. income earned by informal business proprietors who operate on a cash basis). Second, even when the unreported income is detected, some of the resulting tax liability cannot be easily collected, particularly from those taxpayers who are currently unable to pay. Third, many detected tax liabilities are so small relative to enforcement costs that it is not cost-effective to pursue collection."

Collection efforts are also limited because they impose direct or indirect costs on taxpayers and the economy. Some of those costs can actually be measured in time and money, but other issues, such as privacy concerns, are more difficult to quantify. The trade off between enforcement and privacy must be carefully balanced to "isolate and punish evaders without imposing a heavy-handedness or undue intrusion of tax authorities into the lives of most in order to reach a minority." (Mason, Robert, Oregon State University, 1983)

For example, Linda has broken her payment agreement again and we move to the next collection step, garnishment of her wages. The revenue agent sends a wage

garnishment to Linda's employer, directing them to garnish her wages. There is a cost to Linda's privacy because her employer now knows about her tax debt. The employer incurs direct costs, including the expense of writing an additional check to the department, reissuing Linda's paycheck, postage, and time and energy working with the employee. While garnishment is a very effective collection tool, it burdens the employer with additional work and expense.

Information sharing with other state agencies will improve taxpayer compliance. Taxpayer privacy is essential to encourage voluntary reporting and paying taxes. Sometimes, however, confidentiality laws hinder our ability to effectively collect tax and work with partner agencies. We could improve our compliance efforts further with the ability to disclose confidential taxpayer information to other agencies in limited situations (See recommendation B-1):

- **Licensing boards.** We work with taxpayers everyday who want to make payment arrangements and come into compliance; other taxpayers, however, are uncooperative and unwilling to file delinquent tax returns, resolve tax debts, or even return phone calls. Many of these uncooperative taxpayers must have licenses from the state to engage in their trade or business. We recommend that you change the law to allow us to disclose a taxpayer's compliance status to a licensing board earlier in the filing enforcement and collection processes. We also recommend that you change the law to allow us to disclose to licensing boards when a taxpayer has fallen out of compliance in between license renewal dates. This expansion would allow us to work closely with our Compliance Network partners to enforce income tax laws, as well as help identify employees who have been mislabeled and treated (for income tax, worker's compensation and unemployment purposes) as independent contractors.
- **Oregon Board of Tax Practitioners and Oregon Board of Accountancy.** By law, we disclose confidential information with these two boards when we have reason to believe a return was prepared by someone who does not comply with either board's regulations. We may disclose to the boards limited, specific items from a tax return to help them investigate licensees (or unlicensed return preparers). Often, the amount of information we can provide is insufficient for their needs and the boards must contact taxpayers to get more information. We recommend that you expand our ability to disclose tax return information to both boards. This will help them protect the public from unlicensed or incompetent tax return preparers. Compliance will improve if paid preparers are held to these licensing boards' knowledge and competency standards.
- **State law enforcement, district attorneys, and grand juries.** We have the authority to disclose information to state law enforcement, district attorneys, and grand juries for the investigation and prosecution of tax-related crimes. While working with the Department of Justice, we developed a process for releasing confidential information to these entities, but the process is cumbersome. District attorneys hesitate to ask for confidential information (and possibly investigate and prosecute tax related crimes) because of the obstacles to ask for, receive, and handle the information. For example, grand juries, who already swear an oath to keep information confidential, must also sign a department secrecy certificate before tax return information is disclosed to them. It is resource-intensive to account for secrecy certificates and provide instruction requiring grand jury members, state law enforcement, and district attorneys to sign the department's secrecy certificate.
- **Local law enforcement.** While Oregon law allows us to disclose confidential tax return information to state law enforcement, district attorneys, and grand juries, it does not allow us to disclose this information to local law enforcement, even if a local law enforcement agency is working alongside state law enforcement on the same cases. We recommend that you expand our ability to disclose confidential information to local law enforcement to enable them to help with the investigation and prosecution of tax-related crimes.

Best practices in compliance

To determine the best way to improve compliance in Oregon, we conducted a best practices review, incorporating information compiled from four sources: 1) an industry specialist's review of the department's collections processes; 2) an extensive survey conducted by Minnesota dealing with best practices in collections; 3) a Government Accountability Office (GAO) report on IRS practices for enforcement and collection of payroll tax debts; and 4) a survey of audit best practices in other states and the IRS.

Collections best practices

CGI Analysis

CGI is a consulting firm with over 25 years of experience advising governmental agencies on tax collection practices. They reviewed our internal processes regarding collections, interviewed staff and management, examined the technology systems currently in use, and compared us to other revenue agencies. They shared areas where they felt we were doing well and identified several strategies that have worked in other states.

CGI identified the following items as areas in which we are doing well:

- The collections area is a well run, professionally managed organization with a clear sense of purpose;
- The collections area has a clear focus on achieving its revenue goals;
- The collections area has achieved a significant reduction in overall level of receivables;
- The department is leveraging a variety of strategies to resolve tax debt, including:
  - — Federal Offset Program;
  - — Offset of tax rebates;
  - — Alternative payment options;
  - — Use of administrative levies/garnishments;
  - — Well-documented policies and administrative procedures

Their findings suggest that the department should focus on three areas which will provide additional efficiencies:

- **Upgrading collection case management and automated workflow tools**, which will increase the efficiency of collectors by assigning cases at the right time to the right collector.
  - — Our current case management tool for collections has served us well, but it is over fifteen years old and is reaching the end of its useful life. We recommend a new system in initiative A-8 and recommendation C-2.
- **Developing a business intelligence platform** that will improve business processes and automate data matching and analysis. With an enhanced intelligence tool, we can decide, within a certain degree of accuracy, how to assign accounts to maximize collection and minimize resources used for collection activity.
  - — We currently do not have a business intelligence platform. We are in the early stages of planning for an enterprise-wide business intelligence platform that can serve multiple programs with these capabilities. See recommendation C-2.
- **Automating self-service options.** Self-service initiatives would allow taxpayers to resolve their debts or conduct business without help from a department employee.
  - — Taxpayers have limited access to their tax information on our website. We want to expand our website and have included this initiative in Collections and Filing Enforcement Policy Option Package #152. This initiative will allow taxpayers to resolve collection issues online, including monitoring their account balance, submitting information for payment agreements, and making payments. See recommendation C-1.

Minnesota revenue collection survey

In 2007, the Minnesota Department of Revenue produced a study for its legislature on collection best practices. They received information from 44 states to draw their conclusions. The following information describes the best practices found by the Minnesota survey.

- **Wage, financial institution, and third-party garnishments** are the most effective collection tools for revenue departments. Some states have automated these tools. Many departments also stress that liens help them obtain full payments.
  - — We use wage and financial institution garnishments and property liens to collect tax debts. Our system for issuing garnishments is partially automated. State law requires that once we generate them, we must send the documents to employers and financial institutions by certified mail. This is an inefficient and expensive process because it means multiple sets of virtually identical 14-page documents are sent to each employer or financial institution. Property liens are also filed with each Oregon county by mail. We will explore ways to streamline these processes. If we need statutory changes or additional resources, we will bring you a detailed proposal next session. See initiative A-1.
- **Data matching with bank account information is now used by many states**.
  - — States said that they, either alone or working with industry, sought legislation that would allow them to match their accounts with bank account information at major financial institutions. We use wage and financial institution garnishments and property liens, but do not have an automated system to match them to financial institution account information. See recommendation B-2.
- **Adopting more stringent collection practices** such as blocking the renewal of vehicle license plates, conducting sheriff seizures, and posting signs announcing that businesses are closed for nonpayment of taxes can be useful for increasing compliance.

— We use certain advanced collection tools, such as occupational license suspensions and seizures, in egregious cases. We can make better use of these tools with expanded statutory authority to disclose information as described in Recommendation B-1.

- **Adopting a waiver of penalty for payment in full on the first contact**

— We don't waive penalties for payment in full, but we do work with taxpayers to resolve debts through use of other penalty waivers and settlement offers.

- **Timeliness of taxpayer contact.** The best results come from the earliest contact. The sooner action is taken on delinquent accounts, the more effective the collection tools are. The longer accounts age, the less effective the collection tools become.

— We agree. We strive to contact taxpayers as quickly as possible. We've incorporated this concept into our collection re-engineering efforts and in the Collections and Filing Enforcement Policy Option Package #152. Specifically, we plan to implement an automated call distributor tool and establish extended working hours. See initiative A-1 and recommendation C-1.

Government Accountability Office's collections recommendations to the IRS

- **Increased use of liens.** The GAO recommends the IRS file a Notice of Federal Tax Lien against property as soon as possible after payroll tax debt is identified and make sure liens are filed on both businesses with unpaid payroll taxes and identified owners/officers.

— We are also improving processes to file liens as soon as possible on payroll tax debts and reviewing the types and number of debts upon which liens are filed.

- **Data match for levy sources.** The GAO recommended the IRS work with states that have procedures for matching financial accounts to tax debts. The IRS would evaluate the potential to either develop similar measures or partner with states that have that tool to better assist revenue officers identify a business' assets that can be attached.

— Below we recommend legislation so that we may participate in a similar program.

- **Publishing tax debtor names.** An increasing number of states now publish the names of tax debtors on websites as a means of both collecting unpaid taxes and stopping the debts from growing. Currently, however, the IRS is prohibited by law from publicly disclosing names of tax debtors in this manner.

— Our research of collection best practices was inconclusive as to whether other states consider publishing tax debtor names a best practice.

- **Criminal enforcement.** The GAO recommended stronger action against payroll taxpayers who continue to accumulate payroll tax debts.

— We are working with the Department of Justice to prosecute one such case. We are planning a review of and possible need for resources as we explore stronger enforcement efforts. (See initiative A-6 and recommendation C-5)

Audit best practices from other states and the IRS

In the summer of 2008, we surveyed all 50 states and the District of Columbia to gather information about their compliance efforts and to determine auditing best practices. Staff also contacted the IRS liaison in Portland to discuss IRS best practices. Some of the best practices are discussed below. A detailed report is available in Appendix D.

Audit processes or methodology

- **Implementing secure e-mail.** Secure e-mail helps facilitate communication and information exchanges once an audit is underway.

— We don't have secure e-mail, but we recognize that secure e-mail is a necessary and expected tool in today's environment. We plan to implement this tool within existing resources, but may ask you for additional resources in the future, if necessary. See initiative A-7.

Audit/verification tools

- **Third-party information to verify taxpayer provided information.** Compliance increases any time third-party reporting exists.

— We use third-party reporting whenever possible, such as Form 1099 and W-2 information from the IRS, but we could always use more. We can increase our use of those and other resources through enhanced technology and analytical tools. See recommendation A-2.

- **Federal tax return data from the IRS.** States benefit from leveraging taxpayer data received through IRS exchange programs.

— We receive and use federal tax return information, and are acquiring tools for more robust data analysis. We could make better use of this

information when we acquire data analysis capability and case selection tools. See recommendation C-2.

- **Well-trained, knowledgeable, experienced auditors** are necessary for effective compliance.

  — We are redesigning training programs to match the knowledge level of incoming staff, and get people working audits as quickly as possible. We are pursuing use of video conferencing to more efficiently train staff and reduce travel expense.

- **Case management systems** allow agencies to assign, monitor and evaluate audit work, as well as capture and analyze audit program effectiveness.

  — We do not have a system for managing audit cases. However, we do use an aging system for creating and storing audit reports that is limited in its ability to capture and analyze overall program effectiveness. See recommendation C-2.

Audit case selection

- Audit cases should be selected by software or specialists. Managers or lead workers should perform further manual review before cases are assigned to auditors.

  — Our auditors select their audit cases based on predetermined focus areas. Better analytical tools will help us identify more productive cases and evaluate overall results. See recommendation C-2.

- When auditors self-select their audit cases, (rather than having software or specialists select them), additional controls should be in place to monitor case loads and to ensure auditors are choosing appropriate cases.

  — We agree with this concept and are pursuing better analytical tools and are redesigning the way we select cases. See recommendation C-2.

- Data analysis plays an important role in audit and filing enforcement case selection. Applying risk factors and analytics to multiple groups of data can determine the best returns and taxpayers to audit.

  — We agree with this practice and are pursuing better analytical tools and are redesigning the way we select cases. See recommendation C-2.

Return processing best practices

- Compare returns to a set of predetermined criteria that cause a return to "suspend" or be referred for manual review. Evaluate the criteria periodically and change them over time to incorporate new laws, changes in fraud schemes, etc.

  — We compare returns to a predetermined set of criteria during processing that is updated annually, with returns referred for manual review as needed.

- When possible, use multiple sources to authenticate taxpayer identity.

  — We authenticate taxpayer identity during return processing using historical information and, when needed, IRS databases. Additional databases would enhance our processes. See recommendation C-2.

Recommendations and Conclusions

The past 11 months of studying tax compliance in Oregon has been fascinating, frustrating, and overwhelmingly positive. While we regularly review and adjust our processes and procedures, this process has been an excellent opportunity for us to come together as a team and take a good look at the way we do our business. We have identified areas where we work well, where we could improve, and what we need to pay attention to in the future.

We developed the following initiatives and recommendations using what we learned in the best practices surveys along with initiatives proposed by the internal focus groups. Our initiatives and recommendations are divided into three categories a) things we can and will do within our current budget; b) things the legislature can do to help us increase compliance and c) things we could do, but require additional resources.

There is a caveat. The IRS points out that it can be difficult to determine the impact of any initiatives to improve compliance. While we can usually measure direct effects of certain activities such as changes to tax law affecting individual income and credit items, we cannot easily determine indirect effects of those same changes. It also can be difficult to measure the effects that changes in our processes will have on taxable behavior. Given those considerations, we purposely did not assign revenue impact figures to the recommendations, nor did we estimate how long improvement might take.

Immediate department initiatives (no budget increases necessary)

A-1. Improve collection methods to incorporate best practices such as:

- Identifying accounts that can be more effectively collected by private collection firms; providing streamlined processes to transfer, monitor, and resolve these accounts.
- Extending collection hours for contacting taxpayers to improve our chances of reaching a debtor on the phone.
- Protecting the infrastructure of the withholding program. This is a necessary step due to the tenuous economic and business climate. To make sure employers send in their payroll withholding taxes, we will increase our efforts to:
  - — Contact employers if they miss a quarterly payment.
  - — Visit employers earlier to make sure they understand the importance of paying withholding taxes accurately and on time.
  - — Add staff to pursue more timely filing enforcement actions. We can accomplish most of this initiative with existing resources, although we will be bringing on additional compliance specialists from the Collections and Filing Enforcement Policy Option Package #152 to help with the filing enforcement effort.
- Exploring options to streamline service of garnishments to employers and financial institutions and filing liens with Oregon counties.

A-2. Improve audit methods and increase training to incorporate audit best practices of other taxing agencies and the IRS. These best practices include:

- Checking for compliance in multiple programs simultaneously (for example, while auditing a small business, we would also make sure the taxpayer is in compliance with Workers' Compensation and Employment tax programs).
- Obtaining and using additional third-party information that will improve our ability to audit returns, such as data from title companies, Pay Pal accounts, credit card transactions, etc. This action will improve our ability to verify taxpayer data against third-party information. However, we need additional analytical tools and systems to fully use the data.

A-3. Work with Oregon licensing boards to establish tax compliance status before a license is issued or renewed. We will develop a proposal for the 2011 Legislature.

A-4. Collaborate with contract-issuing agencies to develop an efficient way to establish tax compliance status before a contract is approved or paid. Develop a proposal for the 2011 legislature. Current law requires some contractors to be in compliance and to self-certify that they are in compliance; there is no check by the Department of Revenue or the other agency. The department does not have authority to disclose compliance status to most other agencies.

A-5. Collaborate with the Education Department to develop tax education curriculum and encourage tax education in high school.

A-6. Explore a policy option package for the 2011 session that would provide increased capability for criminal prosecution with additional resources to detect, prevent, and prosecute income tax crimes.

A-7. Determine the feasibility of providing encrypted (secure) e-mail, which could enable both the taxpayers and agency employees to easily and quickly transmit secure information using the internet.

A-8. Evaluate our core systems as part of our long-term strategy. This strategy will provide a comprehensive plan for upgrading and integrating our legacy systems and is a key component to addressing our tax compliance rate. One of the obstacles to increasing the compliance rate is the age of our legacy systems and our inability to process and analyze large amounts of data to identify returns with the highest probability of noncompliance. This will allow us to focus resources more effectively, as well as provide increased tools for taxpayers.

A-9. Research whether withholding on real estate transactions should be expanded to include everyone except homeowners, not just nonresidents.

Suggested legislative action

2009 session provisions

B-1. Expand statutory authority to disclose confidential information in limited situations:

- Expand our disclosure authority to Oregon licensing boards to notify those boards of a taxpayer's noncompliance (either nonfiling or nonpayment) and ask for a license suspension earlier in the filing enforcement or collection process. Currently, we have disclosure authority when asking the licensing board to suspend a license, after we have exhausted all other collection methods.
- Expand disclosure ability to the Oregon Board of Tax Practitioners and Oregon Board of Accountancy to more easily identify and pursue unlicensed or incompetent preparers.
- Improve current disclosure provisions when working with state law enforcement, district attorneys, and grand juries to investigate and prosecute income tax crimes.
- Allow disclosure to local law enforcement, which would enable the department, the Department of Justice, and the Oregon State Police to partner with local law enforcement to investigate and prosecute income tax-related offenses.

B-2. Establish statutory authority for the department and the Oregon banking industry to participate in a data match of bank accounts to state tax and other debts, similar to the Department of Justice, Child Support Enforcement. This action should improve collections by matching delinquent tax accounts to bank records to identify and garnish available funds.

2011 session provisions

B-3. In conjunction with licensing boards, present the proposal developed during the 2009 interim that would require tax compliance for licensing.

B-4. In conjunction with state contracting agencies, present the proposal we developed during the 2009 interim to require tax compliance for people entering into contracts with the state.

B-5. Report on results of our research involving reporting and withholding on real estate transactions.

Initiatives requiring additional resources

2009 session provisions

C-1. Provide resources to enhance collection tools (the following three items are included in Collections and Filing Enforcement Policy Option Package #152):

- Create a website that allows taxpayers to resolve collection issues, including monitoring account balances, submitting information for payment agreements, and making payments online. In addition to enabling taxpayer self-sufficiency, this would allow our collections staff to focus on other issues.
- Install an Automated Call Distributor. This feature allows taxpayers to talk to an agency representative when trying to resolve their tax issues, even if their assigned agent is not available.
- Establish positions to more effectively manage collection cases (Revenue Agent 2s). These positions would increase our capability to collect more difficult accounts and increase the field calls to debtors.

2011 session provisions

C-2. Implement an enterprise-wide business intelligence platform that will help us manage information more efficiently, including case management and data analysis tools. These tools also will help us:

- Decide how to score debt for proper assignment to collectors and private collection agencies.
- Select the most productive audit and filing enforcement cases.

• Use more data while processing returns.

C-3. Create a partnership return processing system, as we capture very little information on partnership returns. This will give us more information to determine audit case selection, analysis, and to identify areas of noncompliance.

C-4. Provide resources to partner with practitioner boards to advertise that return preparers in Oregon must be licensed and that taxpayers should only use a licensed preparer when paying someone else to prepare their return.

C-5. Based on the outcome of our research, present a policy option package developed during the 2009 interim that would provide increased capability for criminal prosecution with additional resources to detect, prevent, and prosecute tax crimes.

C-6. Provide resources to conduct taxpayer surveys periodically to assess attitudes regarding compliance and our activities, direction, and message.

Summary

Intentional noncompliance. Complex tax laws. Outdated technology and processes. These are just a few challenges we face in performing our mission to "make revenue systems work…" Over the past 11 months as we have explored tax compliance in Oregon, we have learned that we have much in common with other states and the IRS, and in some cases, have much that makes us different. One thing we share with others: the belief that tax compliance is complicated and sometimes murky—and that implementing significant change will take time and commitment. By using best practices, implementing updated technology, and partnering with you, the Oregon legislature, we believe we can improve Oregon's tax compliance and achieve our mission to "make revenue systems work to fund the public services that preserve and enhance the quality of life for all citizens."

Appendix A
SB 1082, 2008 special session

74th OREGON LEGISLATIVE ASSEMBLY--2008 Special Session

Enrolled
Senate Bill 1082

Printed pursuant to Senate Interim Rule 213.28 by order of the President of the Senate in conformance with presession filing rules, indicating neither advocacy nor opposition on the part of the President (at the request of Senate Interim Committee on Finance and Revenue)

CHAPTER ....

AN ACT

Relating to individual taxpayer compliance; and prescribing an effective date.

Be It Enacted by the People of the State of Oregon:

SECTION 1. (1) No later than February 1, 2009, the Department of Revenue shall make a report on the level of individual taxpayer compliance in the State of Oregon to the Seventy-fifth Legislative Assembly. The department shall use all data available to the department to prepare the report, which shall:

(a) Estimate the level of taxpayer compliance among persons subject to individual income tax;

(b) Identify taxpayer behavior that affects taxpayer compliance; and

(c) Make recommendations to the Legislative Assembly about the following:

(A) Measures to improve the level of individual taxpayer compliance; and

(B) Processes and procedures for updating the department's taxpayer compliance estimates and for measuring the effects on compliance attributable to changes in taxpayer behavior.

(2) In developing the report, the Department of Revenue, in consultation with the Legislative Revenue Officer, shall:

(a) Consult with external resources as needed; and

(b) Identify through research the most effective tools used by other states and the Internal Revenue Service to increase taxpayer compliance.

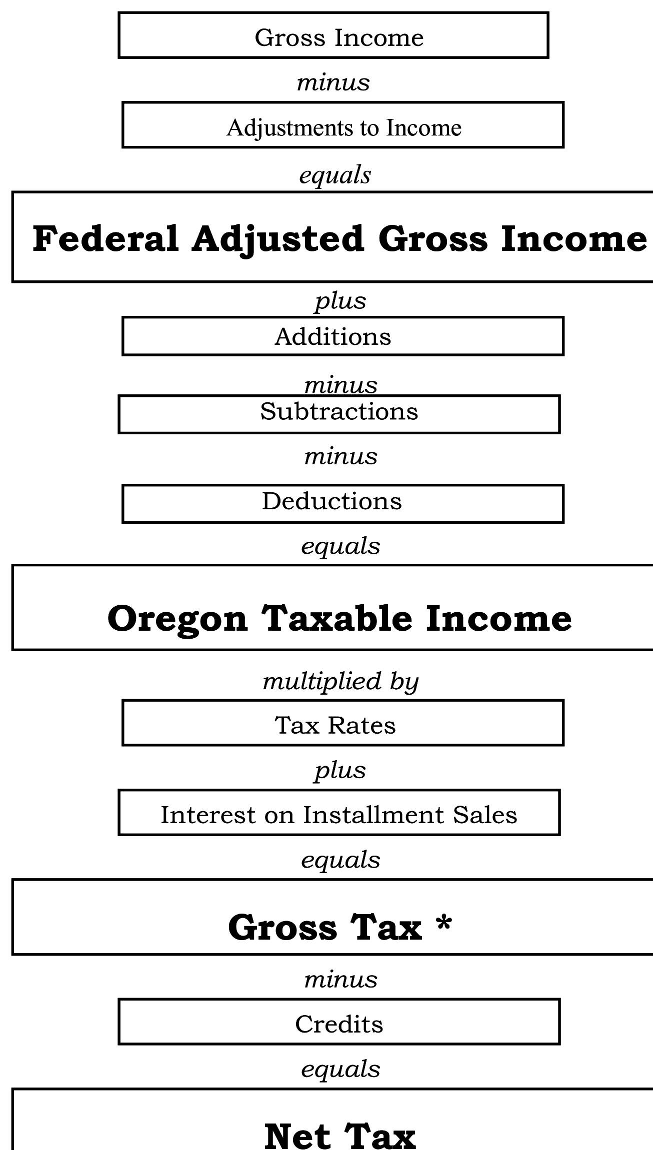
SECTION 2. This 2008 Act takes effect on the 91st day after the date on which the special session of the Seventy-fourth Legislative Assembly adjourns sine die.

Enrolled Senate Bill 1082 (SB 1082-INTRO) Page 1

Appendix B
How Oregon personal income tax is computed

Personal Income Tax Calculation

From 1997 to 2002, Oregon personal income tax law was continuously tied to the federal definition of taxable income. Oregon law automatically adopted changes made at the federal level that affected taxable income. The 2003 Legislature suspended this "rolling reconnect" for tax years 2003 through 2005. In 2005, the Legislature again established a rolling reconnect to the federal definition of taxable income (other definitions have subsequently been connected to federal law as of the end of 2007). The diagram below shows the full-year resident tax computation. See the next page for details about specific elements.



*For a small number of filers, Gross Tax includes interest on installment sales, farm capital gains taxed at five percent, or farm taxes calculated from income averaging.

The following examples are elements from the preceding diagram for tax year 2006:

Gross income includes:

- Salaries and wages
- Interest
- Dividends
- State income tax refunds (if deductions were itemized in the prior year)
- Alimony received
- Business income/loss
- Farm income/loss
- Capital gains/losses
- Rental income
- Royalties
- Partnership income/loss
- Estate and trust income
- S corporation income
- Unemployment compensation
- Social Security income taxed at the federal level
- Retirement plan distributions

Adjustments to income include:

- IRA, SIMPLE, and SEP contributions
- Self-employment health insurance
- Forfeited interest
- Moving expenses
- Alimony paid
- Self-employment tax
- Student loan interest
- Tuition and fees
- Educator expenses
- Qualified business expenses
- Health savings account contributions

Additions include:

- Interest on bonds from other states
- Federal deduction for long-term care insurance premiums
- Federal income tax refunds from an amended or audited return
- Federal deduction of unused business credits
- Lump-sum payment from a qualified retirement plan

Subtractions include:

- Oregon income tax refunds
- Social Security income
- Federal income tax (up to $5,000 or $2,500 if married filing separately)
- Federal pension income
- U.S. bond interest
- Military active duty pay
- Scholarship awards used for housing expenses

Deductions (standard or itemized):

- **Standard deduction:**
  - $3,685 if joint filer, or
  - $2,965 if head of household filer, or
  - $1,840 if single filer, or
  - $1,840 if married filing separately, or
  - One of the listed four amounts plus an additional $1,000 for each taxpayer age at least 65 or blind. The additional amount is $1,200 for single and head-of-household filers.

- **Itemized deductions include:**
  - Medical and dental expenses
  - Property taxes
  - Home mortgage interest
  - Investment interest
  - Charitable gifts
  - Casualty or theft losses
  - Special medical deduction

Tax credits include:

- Personal exemption of $159
- Earned income (refundable)
- Working family childcare (refundable)
- Child and dependent care
- Political contribution
- Elderly or permanently disabled
- Retirement income
- Income tax paid to other states

Appendix C
Tax gap elements and examples of noncompliance

Table C1. Oregon Tax Gap Estimate ($ millions), Tax Year 2006

	Oregon resident tax gap	Part-Year resident tax gap	Nonresident tax gap	Full gap
Income reporting				
Wages and salaries	36.8	1.0	2.0	**39.8**
Interest and dividends	8.4	0.1	0.4	**8.9**
Alimony income	0.4	0.0	0.0	**0.4**
Unemployment income	1.9	0.0	0.1	**2.0**
Retirement income	11.3	0.2	0.2	**11.7**
Business income (net)	293.0	3.6	16.4	**313.0**
Farm income (net)	95.5	0.8	3.1	**99.4**
Capital gain (net)	96.2	1.5	5.2	**102.9**
Other gain (net)	30.5	0.4	1.9	**32.8**
Rents, royalties, etc (net)	176.2	4.1	4.6	**184.9**
S-corps, partnerships, trust, etc (net)	199.0	1.6	33.5	**234.1**
Other income (net)	231.5	6.0	29.0	**266.5**
Total income reporting	**1,180.7**	**19.3**	**96.4**	**1,296.4**
Adjustments to income				
Federal adjustments	17.3	0.3	0.3	**17.9**
Oregon additions	1.2	0.0	0.0	**1.2**
Oregon subtractions	6.4	0.1	0.2	**6.7**
Deductions (itemized and standard)	32.9	0.5	1.2	**34.6**
Total adjustments to income	**57.8**	**0.9**	**1.7**	**60.4**
Adjust from national to Oregon misreporting *Based on GAO Report (GAO-08-781)*	**(98.8)**			**(98.8)**
Credits				
Oregon exemption credit	25.3	0.5	1.2	**27.0**
Oregon regular credits	35.5	1.1	13.9	**50.5**
Oregon refundable credits	13.9	0.3	0.4	**14.6**
Oregon withholding claimed	47.8	1.3	2.8	**51.9**
Total credits	**122.5**	**3.2**	**18.3**	**144.0**
Total misreporting gap	1,262.2	23.4	116.4	**1,402.0**
Nonfiling gap (IRS est = 12.7% of misreporting gap)	160.2	3.0	14.8	**178.0**
Underpayment gap	75.8	2.0	4.3	**82.1**
Estimated gross tax gap	**1,498.2**	**28.4**	**135.5**	**1,662.1**
Gross tax gap as % of true liability				**24.7%**
Voluntary withholding payments not claimed on timely returns				**(284.1)**
Other receipts beyond reported tax (est = 2.5% of reported liability)				**(130.3)**
Estimated net tax gap				**1,247.7**
Net tax gap as % of true liability				**18.5%**

Line item descriptions

In this portion of the appendix, each line item from the preceding table is broken down into the reported amount of each taxable item, as well as the ESTIMATE for the unreported amount and the subsequent missing tax. The description that follows gives examples of the most common types of noncompliance behaviors seen for each line item. Amounts were determined based upon federal misreporting percentages.

Note: Amounts included and number of returns are for full-year Oregon residents.

Table C2. Wages and Salaries

Wages and salaries		Number of Returns
Reported wages and salaries	$54,698,000,000	1,268,158
Unreported wages and salaries	$664,000,000	Misreporting %
Tax on unreported wages and salaries	$36,800,000	1.2%
Part-year and nonresident tax gap estimated at an additional $3,000,000		

Wages may be underreported intentionally or unintentionally. Since employers must report any wages for the prior year to employees (using a Form W-2) by January 31, unintentional underreporting is likely due to the employee not receiving a W-2 for a particular job. Most employees would know that they should have received a W-2, so unintentionally not reporting income for a missing W-2 would most likely be for a type of work they felt wasn't taxable, or for a job they felt was insignificant.

Complicating wage reporting, employers may incorrectly classify an employee as an independent contractor. This practice can give a business owner a competitive advantage in the market place. Employers are required to report payments in excess of $600 to independent contractors on a Form 1099-MISC. In addition to not reporting wages below $600, independent contractor status allows more favorable deductions than employee status and may be used to understate income intentionally.

Some businesses hire and pay employees "under the table" in cash and do not report or pay payroll taxes on these wages. As a result, they do not withhold any income tax from the employee's wages and do not file quarterly payroll returns or remit withheld funds to the state. Without income tax withheld (and without a Form W-2 – third-party withholding), the employee has little incentive to file and pay the income tax they are responsible for on the income.

Some workers also provide a false social security number to their employers; this may be to avoid taxes. The worker can understate income with a reduced chance of detection, since the IRS or the department will not be able to match the income automatically to the employee using the standard identifying number.

Further complicating matters, we do not know how much withholding was paid by employers for any specific individual. However, beginning in 2010 employers will begin reporting more specific withholding information by employee directly to DOR.

Table C3. Interest and Dividends

Interest and dividends		Number of Returns
Reported interest and dividends	$4,466,000,000	1,134,073
Unreported interest and dividends	$169,000,000	Misreporting %
Tax on unreported interest and dividends	$8,400,000	3.7%
Part-year and nonresident tax gap estimated at an additional $500,000		

Interest and dividends are reported to taxpayers on a Form 1099-INT if the total amount received in the tax year was at least $10. Obviously, some amounts below that are not reported.

Interest income may or may not be taxable, depending on the source. Some interest is not taxable at either the federal or the state level. Other interest is taxable at the federal level, but not at the state level or vice versa. This means it is relatively easy for a taxpayer to misclassify interest they received, and underpay their federal tax, their state tax, or both.

Some taxpayers will open investment accounts in the name of a different person in a lower income tax bracket (for example, a parent or child). This avoids taxation at a higher tax rate, and reduces the amount of tax collected.

Table C4. Alimony Income

Alimony income		Number of Returns
Reported alimony income	$114,000,000	**8,150**
Unreported alimony income	$9,000,000	**Misreporting %**
Tax on unreported alimony income	$400,000	**7.2%**
Part-year and nonresident tax gap estimated at less than an additional $100,000		

Taxpayers who receive alimony from a spouse or former spouse as the result of a divorce decree or separation agreement should report that amount as taxable income. The payer deducts the payments from their taxable income.

Because the payments are not subject to third-party information reporting, there is a lot of potential to misstate either the income amount (payee) or the deduction amount (payer). Ensuring compliance in this area requires an audit, and often involves looking at cancelled checks. One difficulty is that child support payments are treated differently from alimony, and it is often unclear which payments should be classified as alimony, and which should be classified as child support.

Table C5. Unemployment Income

Unemployment income		Number of Returns
Reported unemployment income	$359,000,000	**109,102**
Unreported unemployment income	$45,000,000	**Misreporting %**
Tax on unreported unemployment income	$1,900,000	**11.1%**
Part-year and nonresident tax gap estimated at an additional $100,000		

Unemployment compensation paid to Oregon residents is taxable and should be reported as taxable income. Taxpayers should receive a Form 1099-G showing the amount paid to them. Taxpayers have a choice about whether to have federal or state income tax withheld from their unemployment compensation. If they choose federal withholding, federal tax is withheld at 10 percent. If they choose state withholding, state tax is withheld at 6 percent.

Some taxpayers do not report unemployment compensation on their tax returns. If the agency that paid the unemployment compensation issued a Form 1099-G to the individual, the IRS will identify a mismatch between income reported on the individual's return and the unemployment compensation reported by the third-party on the Form 1099-G.

Because taxpayers receiving unemployment compensation usually need access to their full unemployment payments, and may not understand the tax implications, they will often choose to not have any income tax withheld. This might result in tax owed at the time they file their return. If they are still unemployed at that time, they may not be able to pay the tax that is due.

Table C6. Retirement Income

Retirement income		Number of Returns
Reported retirement income	$7,434,000,000	**421,323**
Unreported retirement income	$318,000,000	**Misreporting %**
Tax on unreported retirement income	$11,300,000	**4.1%**
Part-year and nonresident tax gap estimated at an additional $400,000		

Retirement income includes many different forms of distributions including: social security, railroad retirement, qualified pension plans, annuities, IRAs, 401(k) plans, deferred compensation plans, SEP accounts, SIMPLE accounts, etc. Each form of retirement income has its own set of taxation rules.

Because of the complexity, many taxpayers incorrectly report the portion of their retirement income that is taxable at the federal level or taxable to Oregon. Some merely exclude all of their retirement income because they are under the impression that it is not taxable. Others make computational errors and/or misreport various portions of their retirement income. These types of omissions are often identified during processing or through the IRS data matching.

One area of noncompliance that we identify periodically is a taxpayer who makes an attempt to move out of Oregon to escape taxation of their Oregon-sourced retirement income. For example, taxpayers buy a motor home and travel throughout the United States, but never acquire a permanent home elsewhere and never abandon their Oregon domicile. Alternatively, a taxpayer might change their address to a Washington post office box. They do not change any of their other connections to Oregon, such as their driver's license, vehicle registration, voter registration, etc. In these circumstances, they are considered an Oregon resident and their retirement income is still taxable to Oregon.

Some taxpayers invest privately in stocks and bonds, planning for future income to be used after retirement without investing through qualified retirement plans or individual retirement accounts. They incorrectly treat their investments as if they were in qualified plans or IRAs, and accordingly underpay their Oregon tax.

Table C7. Business Income (net)

Business income		Number of Returns
Reported business income	$3,175,000,000	**281,510**
Unreported business income	$6,622,000,000	**Misreporting %**
Tax on unreported business income	$293,000,000	**57.1%**
Part-year and nonresident tax gap estimated at an additional $20,000,000		

Business owners who operate their business as a sole proprietorship report their net business income on federal Schedule C of their personal income tax return. The net income is calculated as gross receipts minus expenses. Accurate reporting requires accurate record keeping, and businesses often lack or have inadequate bookkeeping and/or records.

Much business activity escapes third-party reporting, and many businesses operate solely in cash, so no records are created through their operations. Even with accurate and correct records, the location of the records may be different from the location of the business, or simply out of state. Since substantiation of the reported information usually requires a physical review of records, the information can be difficult to substantiate.

Cash based businesses can easily hide transactions, and some do not maintain bank accounts, avoiding transactions that would generate a paper trail or withholding. For example, we have seen business owners offer customers a discount if they pay in cash so that a paper trail is not created. Underreporting the income on tax returns can more easily go undetected. We have also seen business returns on which personal expenses are claimed as business expenses.

Detecting understated income requires some type of gross receipts test, a much more in-depth life-style or cash flow analysis audit. Identifying overstated expenses requires examining volumes of receipts (some may be falsified or missing), vouchers, cancelled checks, etc. These are the most time intensive audits that the department performs.

Taxable income for businesses also includes income in the form of bartered goods or services. For example, a taxpayer may provide child care services in exchange for appliance repair services. This type of bartering activity is taxable income which often goes unreported. In general, no cash changes hands, and no records are kept of the transaction, making it difficult to identify that the transaction occurred and even more difficult to determine the fair market value of the goods or services exchanged.

Frequently the department identifies activities undertaken by taxpayers without a profit motive, referred to as "hobby" or "not for profit" businesses. There are specific federal rules that govern when an activity constitutes a business and, if not, how to report any income and expenses from the activity. Determining if a loss is from an activity in which the taxpayer has a profit motive can be time consuming and encompass examination of many records.

Complexity often leads business taxpayers to make computational errors in determining the depreciation allowable for their assets. This type of error is difficult to detect without a thorough evaluation of all business property.

Another area of noncompliance is businesses that operate both inside and outside of Oregon. Often times out of state businesses operate within Oregon for short periods of time and do not properly register their business activities or correctly apportion and report their Oregon-source income.

Table C8. Farm Income (net)

Farm income		Number of Returns
Reported farm income	($271,000,000)	33,121
Unreported farm income	$2,042,000,000	Misreporting %
Tax on unreported farm income	$95,500,000	72.0%
Part-year and nonresident tax gap estimated at an additional $3,900,000		

Frequently, the department identifies farm activity undertaken by taxpayers without a profit motive. Often this type of activity has elements of pleasure, recreation, or personal interest. However, there are specific federal rules that govern when an activity constitutes a business and, if not, how to report any income and expenses.

Oregon counties allow attractive property tax rates for farm land. This can encourage taxpayers to conduct some type of farming activity to obtain the preferential property tax rate, but not necessarily with a profit motive.

Table C9. Capital Gain (net)

Capital gain		Number of Returns
Reported capital gain	$7,545,000,000	346,191
Unreported capital gain	$1,514,000,000	Misreporting %
Tax on unreported capital gain	$96,200,000	11.8%
Part-year and nonresident tax gap estimated at an additional $6,700,000		

When a capital asset (for example, stocks and bonds, machinery, or real property) is sold for a higher price than for which it was purchased, taxes may be due on the gain. In addition, if the item is sold at a loss, the loss may be tax deductible. Capital gains and losses are reported on federal Schedule D.

Capital gains and losses are short-term if the capital asset was held for less than one year. All others are long-term. Short-term losses must be netted against short-term gains; long-term losses must be netted against long-term gains.

Then, the net short-term gain/loss is netted against the net long-term gain/loss. A resulting net capital loss deduction is limited to $3,000, but taxpayers may carry forward any unused capital losses to future years.

Some third-party reporting happens on sales of capital assets (e.g., stock transactions that are handled by brokers, real property transactions, etc.), but many sales and exchanges do not involve third-party reporting. When third-party reporting does exist, however, it does not contain the taxpayer's basis information for determining gain or loss. Recent federal legislation has been adopted that requires basis to be included on Form 1099.

Table C10. Other Gain (net)

Other gain		Number of Returns
Reported other gain	$105,000,000	**28,719**
Unreported other gain	$648,000,000	**Misreporting %**
Tax on unreported other gain	$30,500,000	**64.4%**
Part-year and nonresident tax gap estimated at an additional $2,300,000		

Other gains include all other gain/loss activity except capital gains and losses and/or personal gains and losses (which are nondeductible).

One of the most common adjustments made to returns claiming other gains is for basis computations. Basis is determined and adjusted by a number of factors throughout the term of ownership, depending upon the asset, such as: purchase price, improvements, prior distributions from a pass-through entity, contributions to pass-through entities, mode of acquisition, etc. If taxpayers make errors in basis computations, it will cause a resulting error in the computation of other gains and losses at the time of disposition.

A popular method used to defer tax on property exchanges is to use the provisions of IRC Section 1031 (like-kind exchanges). Examples of noncompliance issues for like-kind exchanges include: taxpayers exchange nonqualifying property, do not meet time lines in which replacement property must be identified, and fail to report additional compensation received at the time of exchange.

Taxpayers outside of Oregon must notify the department when exchanging land within Oregon for land outside of Oregon, deferring gain to future years. These taxpayers must report the gain to Oregon in the future at the time they dispose of the property. However, some taxpayers defer the gain for many, many years, and never report the deferred gain to Oregon. Recently, a new form was developed for nonresidents to file (Form 24, Like-Kind Exchanges/Involuntary Conversions), notifying the department of nonresidents' deferred gain. However, not enough time has elapsed for the department to know if this is an effective tool for tracking these deferred gains.

Some taxpayers mistakenly deduct unallowable personal losses, such as a loss on the sale of a principal residence. In addition, taxpayers may attempt to convert a personal asset to a business asset so that they can deduct a loss as a business loss.

Table C11. Rents, Royalties, etc. (net)

Rents, royalties, etc.		Number of Returns
Reported rents, royalties, etc.	$475,000,000	**204,316***
Unreported rents, royalties, etc.	$2,701,000,000	**Misreporting %**
Tax on unreported rents, royalties, etc.	$176,200,000	**51.3%**
Part-year and nonresident tax gap estimated at an additional $8,700,000		

**Taxpayers use federal Schedule E to report income or losses from rents, royalties, etc. as well as from S-corporations, partnerships, and trusts. The number of returns displayed includes all full-year resident returns filed with Schedule E income, regardless of income type.*

Rental income can be for the use of personal property (such as equipment and vehicles) or real property (such as rental homes and leased commercial property). Royalty income arises from copyrights, patents, and oil, gas, and

mineral properties. Third-party reporting of rental income is typically nonexistent, and third-party reporting of royalty income is rare.

The details of reporting rental of personal property depend on whether or not the rental activity is a business, and whether or not the rental activity is conducted for profit. Taxpayers use federal Schedule E to report income and expenses associated with real property rental.

Rental activity is considered a passive activity, and losses from passive activities generally cannot be used to offset any other income than passive income.

Some taxpayers deduct the cost of items purchased for personal use as rental expense, or immediately expense certain types of repairs that should be depreciated over time. Some use rental income from relatives or others at below-market rates to increase the amount of rental loss claimed on a return.

There are complex rules that apply to rental property that is also the taxpayer's principal home or vacation home. It may be difficult for some taxpayers to compute the correct amount of income and expense they should be including in their income. Additionally, some taxpayers try to deduct expenses of a vacation home by labeling it as rental property.

Table C12. S Corps, Partnerships, Trusts, etc. (net)

S corps, partnerships, trusts, etc.		**Number of Returns**
Reported S-corps, partnerships, trusts, etc.	$4,928,000,000	**204,316***
Unreported S-corps, partnerships, trusts, etc.	$3,051,000,000	**Misreporting %**
Tax on unreported S-corps, partnerships, trusts, etc.	$199,000,000	**17.8%**
Part-year and nonresident tax gap estimated at an additional $35,100,000		

**Taxpayers use federal Schedule E to report income or losses from rents, royalties, etc. as well as from S-corporations, partnerships, and trusts. The number of returns displayed includes all full-year resident returns filed with Schedule E income, regardless of income type.*

Income earned by certain entities is not taxable at the entity level, but is passed through to shareholders or partners. These entities include S corporations, partnerships, trusts, limited liability companies and others, collectively known as pass-through entities.

Pass-through entities use federal Schedule K-1 to report items of income and expense to individual owners according to their ownership percentage. The taxpayer then uses the Schedule K-1 received from the entity when preparing their personal income tax return.

Pass-through entities have the same areas of noncompliance as sole proprietorships. See Business Income.

One of the most prevalent audit issues involving pass-through entities is calculating an individual's basis in their ownership of the entity. Owners are often unaware that a loss from the pass-through entity is limited to the amount of their ownership basis. Items affecting ownership basis include many factors, such as contributions to the entity (cash or property), distributions, guaranteeing loans for the entity, income and expenses, etc.

The complexity of basis calculations makes it difficult to determine the correct value of ownership interests and proper tax treatment of specific items, by both entity owners and department auditors.

Pass-through entities can be a vehicle for abusive tax avoidance transactions due to multi-layer ownership structures. Multi-layer ownership and structure can provide opportunities to disguise related-party transactions, taxpayer identities, and financial transactions.

The department has seen payments to owners improperly characterized as dividends or guaranteed payments, rather than as salaries or compensation in order to avoid withholding and payroll taxes.

Compliance auditors are working a project to audit partnerships and limited liability companies (LLCs). Auditors are also performing filing enforcement on partnerships as well as on the nonfiling partners of those entities. In the past, similar projects have been conducted on other pass-through entities, such as S-corporations and trusts.

Table C13. Other Income (net)

Other income		Number of Returns
Reported other income	($162,000,000)	**132,659**
Unreported other income	$4,570,000,000	**Misreporting %**
Tax on unreported other income	$231,500,000	**63.5%**
Part-year and nonresident tax gap estimated at an additional $35,000,000		

Examples of other income include:

- Gambling income;
- Prizes and awards;
- Jury duty pay;
- Canceled debt;
- Net operating loss deductions.

Taxpayers receive some third-party reporting for certain items that should be reported as other income, but not for others. For example, gambling winnings over $600 are reported to the taxpayer on a Form W-2G. Jury duty pay, on the other hand, is paid to the taxpayer after their time of service, but is usually such a minimal amount that third-party reporting is not required.

Taxpayers incorrectly calculate and/or deduct some net operating losses. For example, a taxpayer moving into Oregon with net operating loss carryforwards incurred from sources outside of Oregon may not deduct their loss on their Oregon return.

Table C14. Federal Adjustments

Federal adjustments		Number of Returns
Reported federal adjustments	$1,461,000,000	**546,866***
Over-reported federal adjustments	$388,000,000	**Misreporting %**
Tax on over-reported federal adjustments	$17,300,000	**21.0%**
Part-year and nonresident tax gap estimated at an additional $600,000		

**Taxpayers may claim more than one federal adjustment. This number represents the number of federal adjustments claimed on all Oregon full-year returns, not the number of returns claiming federal adjustments.*

Federal adjustments are deductions taken by the taxpayer on the front of Form 1040 that reduce total income to reach adjusted gross income (AGI). These deductions are also called "above the line" deductions. Some of these items have third-party reporting, but many do not.

Examples of federal adjustments include:

- Educator expenses;
- Moving expenses;
- IRA deductions;
- Student loan interest deductions.

These items reduce AGI, which flows to the Oregon return as the beginning amount for preparing the Oregon return.

If a teacher incurs unreimbursed expenses for classroom materials, they may claim up to a $250 deduction. Because tax on this amount is minimal, rarely is substantiation verified.

Many taxpayers claim moving expense items that used to be deductible but no longer are. For example, taxpayers deduct meals, house hunting trips, costs of selling a home, security deposits, etc.

Either in an attempt to reduce their AGI or because of a lack of understanding, some taxpayers will claim an IRA contribution deduction for a Roth IRA rather than a traditional IRA. Contributions to Roth IRAs are made with after-tax dollars and are not deductible. Other taxpayers claim an IRA contribution deduction on their tax returns, but do not make a contribution.

Table C15. Oregon Additions

Oregon additions		Number of Returns
Reported Oregon additions	$297,000,000	81,393*
Under-reported Oregon additions	$17,000,000	Misreporting %
Tax on under-reported Oregon additions	$1,200,000	5.4%
Part-year and nonresident tax gap estimated at less than an additional $100,000		

**Taxpayers may claim more than one Oregon addition. This number represents the number of Oregon additions claimed on all Oregon full-year returns, not the number of returns claiming an Oregon addition.*

These are items Oregon taxes but that are not included in federal AGI. To calculate Oregon taxable income, these items are added to federal AGI. One example is interest and dividends on bonds of other states or a political subdivision of another state. There are many other examples, but most Oregon additions apply to a very small group of individuals.

Some omissions or calculation errors can be identified and corrected in return processing. Others can only be detected by contacting a taxpayer for more information. If a taxpayer claims an Oregon credit relating to an item they deducted on their federal return, they must usually add back the amount deducted on the federal return.

Table C16. Oregon Subtractions

Oregon subtractions		Number of Returns
Reported Oregon subtractions	$3,932,000,000	1,930,309*
Over-reported Oregon subtractions	$224,000,000	Misreporting %
Tax on over-reported Oregon subtractions	$6,400,000	5.4%
Part-year and nonresident tax gap estimated at an additional $300,000		

**Taxpayers may claim more than one Oregon subtraction. This number represents the number of Oregon subtractions claimed on all Oregon full-year returns, not the number of returns claiming an Oregon subtraction.*

These are items Oregon does not tax but that are taxed at the federal level. To calculate Oregon taxable income, these items must be subtracted from federal AGI. A common subtraction is for the amount of a taxpayer's social security income taxed on their federal return. Another example is interest and dividends on U.S. government securities.

Another example of complexity relating to interest and dividends is that taxpayers must have received information from the payer about investments in order to know whether or how much of their interest and dividends is from U.S. government securities. If only a portion of their investment is in U.S. government securities, the taxpayer must make a calculation to arrive at their subtraction. The Forms 1099-INT and 1099-DIV filed with the federal government by the payer, however, do not include information about the percentage of interest and/or dividends earned on U.S. government securities. Therefore, the department does not receive this piece of information from the IRS and must rely on the taxpayer to provide it.

There are many other examples of Oregon subtractions that involve computations or special requirements.

Table C17. Itemized and Standard Deductions

Itemized and standard deductions		Number of Returns
Reported itemized and standard deductions	$15,021,000,000	**1,546,097**
Over-reported itemized and standard deductions	$857,000,000	**Misreporting %**
Tax on over-reported itemized and standard deductions	$32,900,000	**5.4%**
Part-year and nonresident tax gap estimated at an additional $1,700,000		

Taxpayers can claim the greater of their federal itemized deductions from Schedule A on their Oregon return, or the Oregon standard deduction. If itemizing deductions, total itemized deductions must be reduced by any Oregon income tax (or sales taxes paid in other states by nonresidents) included in federal itemized deductions.

Even if a taxpayer took the federal standard deduction on their federal return, they may itemize deductions for Oregon (only) if it is more beneficial for them than claiming the Oregon standard deduction. Oregon's standard deduction is indexed for inflation. An additional standard deduction amount is allowed for taxpayers 65 and over and/or blind.

Oregon also allows a special medical deduction for taxpayers age 62 and over. The deduction is equal to the amount of medical expenses that were not allowed on federal Schedule A because of the AGI limitation (7.5 percent).

Federal itemized deductions are limited for taxpayers with AGIs exceeding certain income thresholds.

Itemized deductions include:

- Medical, dental, prescriptions, etc. expenses if they are the taxpayer's own expenses or those incurred by a spouse or dependents included on the return.
- Mortgage interest and points, limited to certain qualifications, such as only for the taxpayer's principal residence and one other residence.
- Charitable contributions of cash or property if donated to a qualified organization. Common issues identified for adjustment include the value of property donated to charity.
- Many other miscellaneous deductions, which are deductible only to the extent they exceed 2 percent of the taxpayer's AGI. Examples include:

— Unreimbursed employee business expenses;
— Union dues;
— Job search expenses;
— Licenses and regulatory fees;
— Tax return preparation expenses;
— Investment fees and expenses (Safety deposit box, journals, clerical expenses, etc.).

Many taxpayers claim inappropriate deductions. For example, taxpayers often claim deductions that are business expenses on both Schedule A (personal deductions) and Schedule C (business expenses), improperly doubling the tax benefit of the deduction.

In addition, many individual deductions are claimed improperly. Deductions that taxpayers would be entitled to if they had proper documentation are not allowed if they cannot substantiate the expense or donation.

Table C18. Credits

Oregon exemption credits		Number of Returns
Reported Oregon exemption credits	$443,400,000	1,343,827
Over-reported Oregon exemption credits	$25,300,000	Misreporting %
Tax on over-reported Oregon exemption credits	$25,300,000	5.4%
Part-year and nonresident tax gap estimated at an additional $1,700,000		

Oregon regular credits		Number of Returns
Reported Oregon regular credits	$99,500,000	223,909*
Over-reported Oregon regular credits	$35,500,000	Misreporting %
Tax on over-reported Oregon regular credits	$35,500,000	26.3%
Part-year and nonresident tax gap estimated at an additional $15,000,000		

**Taxpayers may claim more than one Oregon regular credit. This number represents the number of Oregon regular credits claimed on all Oregon full-year returns, not the number of returns claiming an Oregon regular credit.*

Oregon refundable credits		Number of Returns
Reported Oregon refundable credits	$39,000,000	231,903*
Over-reported Oregon refundable credits	$13,900,000	Misreporting %
Tax on over-reported Oregon refundable credits	$13,900,000	26.3%
Part-year and nonresident tax gap estimated at an additional $700,000		

**Taxpayers may claim more than one Oregon refundable credit. This number represents the number of Oregon refundable credits claimed on all Oregon full-year returns, not the number of returns claiming an Oregon refundable credit.*

Oregon offers numerous tax credits. Some are available to a wide segment of the population, while others are very specialized and only a few taxpayers may claim them. Some of the credits are refundable; however, most are not.

Credits reduce tax dollar for dollar, therefore noncompliance can have a significant impact on the tax gap. Most Oregon credits do not require the taxpayer to attach documentation to the return.

Among the most common credits are:

- Business or residential energy credits are available for purchase of certain energy conservation devices. Eligibility is certified by the Department of Energy.
- Child and Dependent Care credit (CDCC) is a percentage of the taxpayer's federal CDCC.
- Income taxes paid to another state, which is based on a complex calculation of income taxed by Oregon and another state. This and several other credits require that if the taxpayer is claiming the expense as an itemized deduction, the taxpayer must make a required addition on the Oregon return for the amount included as an itemized deduction.
- Political contributions up to $50 for a single filer and $100 for joint filers.
- Earned Income Tax credit (EITC) is a refundable credit calculated as a percentage of the federal EITC.
- Working Family Childcare credit (WFC) is a refundable credit designed to recover some of the costs of childcare incurred while parents work or attend school. The WFC is calculated as a percentage of childcare expenses paid.

Some improperly claimed credits are caught in processing, due to edits in the processing system. Some improperly claimed credits are discovered through other enforcement actions.

Refundable credits are a particular compliance problem, and the department dedicates several employees to reviewing claims. For WFC, childcare is often provided by related parties and paid for in cash. It is difficult, if not impossible, to verify that cash exchanged hands or was done so in an arms-length transaction. One party will often testify (in writing or orally) that they received payment, but it appears no payment was made. Many falsified documents are supplied during audits.

Most other state agencies involved in personal income tax credits are cooperative and work well in providing information to taxpayers and the department. It can be difficult for them, though, to administer certain tax credits with limited resources or ambiguous legislation. Some legislation directs the department to administer certain credits; however, the department does not have the industry or topical knowledge to fully administer the program. For example, the Biomass Production/Collection credit was recently established. The department is not familiar with this industry, but must write administrative rules and provide assistance to taxpayers and preparers about the credit.

Table C19. Withholding Claimed

Withholding claimed		Number of Returns
Reported withholding claimed	$3,935,000,000	**1,301,930**
Over-reported withholding claimed	$47,800,000	**Misreporting %**
Tax on over-reported withholding claimed	$47,800,000	**1.2%**
Part-year and nonresident tax gap estimated at an additional $4,100,000		

Individual taxpayers use the amount of Oregon income tax withheld as reported to them on Forms W-2 and 1099 in preparing their Oregon personal income tax returns. The majority of filers are not required to submit W-2 or 1099 forms because they file their returns electronically. The minority of taxpayers—those who file paper returns—are required to attach substantiation for the amount of tax already paid through withholding claimed on their return. The part of the tax gap due to misreporting that comes from withholding is due to taxpayers claiming more Oregon tax withholding than was actually deducted from their paychecks.

A significant part of the tax gap due to underpayment is due to wage earners that intentionally minimize their withholding. Employers are required to remit to the department all Form W-4s in which employees have claimed 10 or more exemptions, or exempt status (employees must earn at least $200 per week). The department devotes two employees, half time, to investigate and determine if the proper amount of allowances has been claimed on the Form W-4. If the exemptions claimed are excessive, they instruct the employer to withhold tax from the employee's paycheck at an appropriate rate, based on their filing status, number of dependents, etc. If an employer does not implement the department's instructions by withholding at the instructed rate, the employer can be held liable for the difference between the amount that should have been withheld and the amount that was withheld. A $500 penalty can also be imposed on the employee for not complying with the department's instructions by resubmitting an incorrect W-4 to their employer.

Most employers do correctly pay their employees and do correctly withhold income taxes from their pay. However, due to cash flow shortages, some employers decide to use those trust funds for business or other purposes, rather than remitting them to the state. The business is liable for the withheld income tax and the department takes collection action against the employer.

With the advent of tax preparation software, taxpayers can more easily falsify W-2 forms, claiming nonexistent withholding or inflating amounts withheld.

Table C20. Estimated Net Tax Gap

Full-year residents		
Total misreporting gap	$1,262,200,000	
Nonfiling gap	$160,200,000	
Underpayment gap	$75,800,000	
Total		**$1,498,200,000**
Part-year and nonresidents		
Total misreporting gap	$139,800,000	
Nonfiling gap	$17,800,000	
Underpayment gap	$6,300,000	
Total		**$163,900,000**
Oregon residents, part-year & nonresidents total gap		**$1,662,100,000**
Voluntary withholding not claimed on returns		($284,100,000)
Other receipts beyond reported tax		($130,300,000)
Estimated net tax gap		**$1,247,700,000**

Appendix D
Audit/verification best practices survey

In conjunction with the 2008 Tax Compliance Report, the department conducted an audit/verification best practices survey that incorporates responses from other states' tax collection agencies. The survey was sent to all 50 states plus the District of Columbia. The department received 46 responses from 36 states (some states provided multiple responses). This summary also includes IRS auditing best practices as gleaned from IRS phone forum presentations and conversations with an IRS Territorial Exam Manager and an Exam Unit Manager in Portland, Oregon. They were not asked to participate in the actual survey.

Audit processes and methodology

Agencies use face-to-face audits (39 vs. 3) and correspondence audits (39 vs. 2) most frequently. Agencies use telephone (10 vs. 29) and e-mail (9 vs. 30) to conduct audits much less frequently.

States respond that face to face audits can be more effective, because:

- Taxpayers take the audit more seriously;
- Audits can be more comprehensive;
- Records are more readily available;
- It helps establish relationships with taxpayers;
- Auditors can better grasp the taxpayer's business;
- One response said face to face works best with large and cash-basis businesses; however, the same can be said for small businesses.

However, face-to-face audits are more costly than other audit methods.

Most stated that correspondence audits work best if trying to touch a large volume of taxpayers. Correspondence audits tend to have a ripple effect. Most states agree that either face to face or correspondence audits can be the most effective audit method, depending on the objective of the audit.

Auditors can encounter authentication and security of information exchange issues when using e-mail for auditing purposes. Some states only use e-mail during later stages of an audit to address small issues or to exchange limited bits of information.

Some states have their auditors examine for multiple programs whenever working with a taxpayer. Many of the survey responses were from sales/use tax programs. As long as their auditor is at a business location, they audit for not only sales/use taxes, but also for payroll tax, corporate tax, personal income tax, etc., depending on the state and/or taxpayer.

- Most states do not limit the scope of the audit to a single issue.
- Most states do audit the entire tax return.
- Most states do not perform life-style audits.
- Most states do verify both expenses and income when conducting an audit.

IRS audit processes and methodology

The IRS uses telephone contact to initiate an audit. This allows them to get directly to the right person needed to conduct the audit, and allows for scheduling, prioritizing, determining where records are located, etc. Their phone call is then followed up with a letter confirming arrangements agreed to during the call. The letter also serves to confirm the identity of the caller, as it contains the IRS logo, etc. The IRS reports that their time estimates for how long an audit will take is more accurate when initial contact is by telephone.

The IRS has also initiated a Mutual Commitment Date (MCD) process for resolving field audits. The MCD process addresses the taxpayer's concerns regarding the length of an audit, but also emphasizes the need for all parties to work together to complete the audit. The process:

- Involves discussing the roles and responsibilities of all parties to the audit,
- Covers the time needed to obtain, provide and review additional information, and
- Sets a tentative date for completion of the exam.

The IRS indicates the MCD process provides for better communication, allows everyone to understand the need to work together and to understand their roles and responsibilities, and completes the audit in a timely manner.

For field audits, a tour of a taxpayer's business is usually mandatory, allowing the auditor to gain a better

understanding of the business, location, processes, etc. The IRS also prefers that the taxpayer be present during a field audit, even if a representative is involved. At a minimum, the taxpayer must be available, if needed.

At the conclusion of a field audit, the IRS auditor will ask the taxpayer if they agree or disagree with any adjustments resulting from the audit. In agreed cases, the auditor will pursue payment or payment arrangements with the taxpayer at that time.

Audit/verification tools

Responders indicated their most effective audit/verification tools are:

- Third-party information to verify taxpayer provided information;
- Federal tax return data from the IRS;
- Creation of an "as expected" return (based on federal data) compared with the actual return filed;
- Well trained, knowledgeable, experienced auditors;
- Data warehouses;
- Pilot audits in targeted industries;
- Auditing new businesses for their first three years;
- Auditing software;
- Computer assisted auditing procedures.

Responders indicated their least effective audit/verification tools are:

- Desk audits;
- Taxpayer provided information/data and conversations with the taxpayer;
- Comparisons to federal return data (self-serving for taxpayer);
- Voter registration (too many inconsistencies);
- Random return selections;
- Estimation/indexing to other like-kind businesses in same industry.

For all responses, 28 indicated that they use data warehousing, while 13 indicated they did not. Several responded that their data warehouses are still in their infancy, or still being developed. The data most included in the warehouse was:

- IRS extracts (23);
- Employment Department (17);
- W-2 Data (15);
- DMV data (14);
- K-1 Matching (14);

To a lesser extent, some states include the following:

- Professional licenses (7);
- State lottery winners (5);
- Other tax programs administered by the responding agency;
- Collections information;
- City and county data;
- U.S. Customs data;
- I-Pass information on Toll-way Authority;
- Guaranteed student loan data;
- Mortgage and assessment data purchased from a private company.

Of those responders using data warehousing, most are using the warehouse for audit case selection (23), as well as filing enforcement selection (19); a few use the data warehouse during processing of returns (8). A few responders indicated that they were just in the process of setting up their data warehouses and had not started using it yet. One state is in the process of requesting funding to acquire a data warehousing system.

Of those states responding that do NOT use data warehousing, many said that certain types of data sets are available to them and are used for audit and filing enforcement purposes. Several of these states indicated, however, that the same data sets heavily used by those with data warehouses above are not available to them.

Case selection

Audit case selection practices include:

- Using both manual and automated processes to select cases;
- When using automated processes, initial selections are further reviewed and filtered by experienced staff/managers before being assigned;
- Using case selection specialists/technicians to identify cases or case selection criteria. Some prescreen returns and scope audits before assigning them to auditors;

- Identifying the largest taxpayers with known audit risks;
- Identifying specific industries or specific issues;
- Matching federal data, identifying differences as audit leads;
- Identifying return items specific to the individual state;
- Comparing taxpayers to industry averages, examining those outside the norm;
- Using data warehouse to select cases;
- Auditing referrals;
- Auditing taxpayers with a trend of filing late returns;
- Identifying certain risk factors;
- Evaluating past productive audits—initiating a three-year audit cycle to confirm taxpayer is staying in compliance;
- Reviewing new business list for potential audits;
- Self-selection by auditors;
- Eliminating audits of taxpayers who were recently audited or those that had "no change" audits.

In many agencies (24), auditors select audit cases. However, in a majority (33), managers are involved in audit case selection. Many agencies (19) use case management software. Other audit case selection methods include:

- Joint effort to select cases (auditors, managers and case selection section of program);
- Data warehouses;
- Auditors submit well-documented referrals, but managers make ultimate case selection decisions;
- Audit selection staff specialists;
- Legislatively recommended audits;

Filing enforcement case selection practices include:

- Federal information matching, especially when a federal return was filed, but no state return;
- Comparing returns filed to business licenses;
- Taxpayers with a history of noncompliance are moved up in priority;
- Compliance required for license or permit within the state;
- Using an information warehouse (assumed to be the equivalent of a data warehouse);
- Dollar tolerances considered (highest dollar amounts have priority).

Similar methods are used for selecting filing enforcement cases. Auditors select filing enforcement cases in 16 agencies; however, managers select filing enforcement cases in 25 agencies. Nineteen agencies use case management software. Other methods include:

- Collaboration;
- Warehouse;
- Referrals;
- Handled by Collection Division.

More often than not, collectibility of resulting deficiencies is NOT considered when selecting cases for audit (26) or filing enforcement (25).

Most agencies analyze statistics and data, evaluating audit case selection (32 vs. 7). Comments provided relating to analysis include:

- Determining if return on investment was achieved;
- Determining whether taxpayers were in bankruptcy or uncollectible;
- Reviewing auditor productivity to see if individual case selection techniques are effective;
- Using audit sampling to verify risk selection criteria;
- Analyzing industries and comparing to similar audits;
- Using software/spreadsheets to track results.

IRS case selection

The IRS selects audit cases through automation, comparing actual returns with "norms." Identified returns are then further reviewed by an experienced agent (in a different geographical area of the country than the taxpayer) for audit suitability. Returns are then forwarded to unit managers who also review the case before assigning it to an auditor. This process, involving multiple reviews and filters, is used for both office and field case selections.

Processing

Almost all agencies review every return for math accuracy during processing (37 vs. 1). Most agencies compare returns to a set of predetermined criteria that cause a return to "suspend" or "except out" of processing (30 vs. 7). Criteria used:

- Is developed over time from agency experience;
- Evolves over the years, as new exemptions and refundable items are created;
- Includes recent law changes;
- Includes aspects of the suspicious filer program and fraud measures (multiple refunds to same account, address, etc.);
- Includes identified areas of most risk;
- Includes maximum amounts allowed for credits.

Agencies provided the following ways they authenticate a taxpayer's identity:

- Comparing return data to historical data;
- Using an alternate number (seller's permit number);
- Comparing to Department of Labor information, W-2 database;
- Clearing through federal electronic filing program;
- Creating a "pre-validated list" (compared with other sources like DMV, Employment, etc.)—if not on the list, they must go through a refund fraud model;
- Comparing to Social Security Administration data;
- Requesting a copy of their social security card;
- Comparing to other state agency data (similar to Vital Statistics);
- Two agencies responded that they do not have any way to validate taxpayer identity.

Miscellaneous

Survey participants indicate that their biggest areas of noncompliance include:

- The number of nonfilers;
- Erroneous returns by paid preparers;
- Individual taxpayers not being aware of other tax programs to which they are subject;
- Flow-through entities that have nonresident members (nonfiling);
- Self-employed and independent contractors;
- Employer withholding tax;
- Underreporting of taxable income;
- Under reporters (Schedules C & E, EBE, cash economy);
- Fraudulent refund claims, including EIC and withholding;
- Nonresidents not filing;
- Individuals not reporting federal changes;
- Residency; taxpayers claiming to have moved domicile to "warmer" (read: nonincome) tax states (Texas and Florida);
- Construction industry.

Seven responders indicated they currently have pending legislation or projects relating to audit/verification techniques, including:

CA: Requesting approval/funding to replace compliance process/systems.

KY: Updating the Computer Assisted Audit Program and requesting overhaul of tax systems used by the department.

MD: Acquisition of data warehouse technology.

MN: Seeking legislation to require intermediaries to report Section 1031 exchanges to DOR on demand, eliminating the need for John Doe subpoenas.

NV: Considering a software contract for better audit case selection tools and to obtain additional data sources.

OR: Acquiring ACL Software; considering increasing compliance checks for licensees; reporting to Legislature on Oregon's tax gap.

WI: Seeking penalties for failure to provide records requested in an audit.

WI: Data warehouse projects and automating CP2000 audits.

Administering a personal income tax program

Thirty-three respondents are from agencies that administer a personal income tax.

Of those that impose a personal income tax, the percentage of their state's revenue stream attributable to the personal income tax is as follows:

1 percent–25 percent	5 states
26 percent–50 percent	13 states

51 percent–75 percent	6 states
76 percent–100 percent	2 states

Twenty-five agencies' personal income tax is tied to federal AGI or federal income.

Of those tied to federal AGI or federal income, 20 audit items from the federal return.

Agencies varied in the amount of federal information required to be attached to a state return. The following number of respondents indicated the attachments required for their state:

- No federal documentation required to be attached (9);
- Complete copy of the federal return (7);
- Copy of Form 1040, 1040A, or 1040EZ only (2);
- Other federal information (9):

  Examples of other federal information include:

  - Page 2 of federal return;
  - Only Schedule A;
  - Only some taxpayers must attach 1040;
  - Applicable federal schedules;
  - Part year and nonresidents must attach federal return;
  - Federal schedules if no comparable state schedules;
  - Federal schedules C, C-EZ, E, F and others.

Agencies indicated that the following items are compliance issues they face relating to nonresidents:

- Failure to file; nonresidents don't think they should have to pay;
- Income from flow-through entities/nonresident K-1s;
- Income sourcing;
- Complexity of tax laws as they pertain to sovereign nations;
- Non-income taxing bordering states;
- Out-of-state employers not withholding on employees who come into the state to work;
- Tax shelters;
- Calculating tax incorrectly (worksheet computations);
- Domicile—taxpayers claiming Florida, New Hampshire, etc. residency;
- False apportionment claims;
- Out of state preparer's lack of knowledge of state law;
- Reciprocity issues;
- Credit for taxes paid to another state;
- Failure to report sales of real estate.

The following additional general comments were provided:

- A national preparer program would be helpful.
- Secure e-mail facilitates communication between departments and taxpayers.
- E-file and direct deposit have provided new challenges with fraudulent preparers, especially with purchased software for home computers.
- It would be helpful to have legislation asserting the department's right to examine PIT returns (and make changes to the taxpayer's federal return).

Conclusions

Best practices (audit processes or methodology)

- Agencies benefit from a balance of face-to-face and correspondence audits. Both can be effective, depending upon the objective.
- Encrypted e-mail helps facilitate communication and information exchanges once an audit is underway.
- Auditors should maximize opportunity and minimize inconvenience to the taxpayer by examining for multiple programs simultaneously.
- Initial contact by telephone is an efficient method to make contact with the taxpayer, schedule the audit, determine the location of books and records, identify key personnel needed for the audit, etc.
- Establishing a mutual commitment date (MCD) process is beneficial for both taxpayer and agency; taxpayer concerns about the length of an audit are addressed, and the agency's request for specific follow-up information or documentation is communicated in a collaborative, mutually agreed-upon effort.

- Field audits should include a tour of the taxpayer's business whenever possible so the auditor can become familiar with the business, location, processes, etc.
- Taxpayers should be available during an audit, if needed, even if a representative is involved.
- At the conclusion of an audit, auditors should attempt to collect the amount due or to make payment arrangements while in the field.

Best practices (audit/verification tools)

- The most effective audit/verification tools include:
  - Third-party information to verify taxpayer provided information;
  - Federal tax return data from the IRS;
  - Well trained, knowledgeable, experienced auditors;
  - Data warehouses;
  - Auditing software/computer assisted auditing procedures;
- Some states employ a case management system (allows for monitoring of case loads, aging of cases, capture of results, etc.).

Best practices (case selection)

- Audit cases should be selected/determined by software and/or specialists. If identified for audit by software, further manual review should be performed by specialists/managers before cases are assigned to auditors.
- If auditors self-select audit cases, additional controls should be implemented to maintain controls over inventory, independence, audit program goals, etc.
- Data warehousing plays an important role in audit and filing enforcement case selection. Applying risk factors and analytics to multiple groups of data can determine the best returns and taxpayers to audit.
- When compliance is required for licenses or permits, filing enforcement cases are reduced/expedited.
- Audit and filing enforcement cases should be analyzed to evaluate effectiveness of case selection methods.

Best practices (processing)

- Most agencies review every return for math accuracy during processing.
- Most agencies compare returns to a set of predetermined criteria that cause a return to "suspend" or "except out" of processing. The criteria are evaluated periodically and evolve over time to incorporate new laws, changes in fraud schemes, etc.
- If possible, agencies use multiple sources to authenticate taxpayer identity.

Appendix E
OSU survey procedures and results

Full survey results available at www.oregon.gov/2009

The Oregon Department of Revenue Survey was conducted in the summer and fall of 2008. The objectives of the survey were to obtain opinions of Oregon residents on filing Oregon personal income taxes.

Although a telephone survey was initially discussed, the survey was conducted strictly by mail. There is increasing concern among survey researchers conducting telephone random probability surveys about the increasing use of mobile phone only users. Recently about one out of six Americans do not have a landline. In addition, the users of mobile phones only are not random. Many young rather than old are mobile phone only users. Therefore, the mobile phone only users are not representative of the U.S. population. The concern by survey researchers is obtaining a representative sample of households in the U.S. for a telephone survey. Mobile phone numbers are not routinely included in RDD samples. The reason for this is that it is slower and more expensive.

In order to obtain opinions throughout the state of Oregon, a sample of 500 addresses in each of eight regions were selected to complete this survey. A stratified random sample of Oregon addresses was selected using region as the stratifying variable.

Mailing addresses were obtained from the U.S. Postal Service (USPS) through the Genesys Sampling Company. The household addresses were obtained using the delivery sequence file (DSF) which is a computerized file that contains all delivery point addresses serviced by the USPS. A paper version of the questionnaire was sent to 4,000 household addresses. In order to improve response rates, a preletter was sent to alert the respondent to the upcoming survey. One week later, the initial mailing of the questionnaire was sent followed with a thank you reminder postcard another week after the initial mailing. A follow-up letter with another copy of the questionnaire was mailed to nonrespondents. This report provides results for responses obtained after these mailings. A final mailing to a subset of nonrespondents was sent priority about four weeks later. These results were combined with the other responses and presented in the final report.

In order to test the difference in response rates given the receipt of a preletter coming from the Department of Revenue versus one originating from the SRC, the sample of 4,000 was split and one-half received a DOR preletter while the other half received an SRC preletter. The preletter was mailed July 17 and on July 23 the first survey mailing was sent to the selected sample addresses. A follow-up postcard was mailed on September 30. About two weeks following the postcard reminder mailing (August 14) the follow-up survey mailing was sent to the individuals who had not yet responded.

In order to assure the respondents that their completed questionnaire could not be linked to their household, the questionnaire did not have the household ID number. Instead a postcard with the ID number printed on it was inserted into the survey packet. This separate postcard called the "postcard identifier" was mailed back separately to inform the OSU-SRC that the questionnaire was completed and mailed back to the OSU-SRC. Therefore no additional mailings of the questionnaire were sent to these households. This procedure was adopted to assure confidentially and hopefully improve response rates.

In order to improve response rates further and account for nonresponse, a double sample to adjust for nonresponse was used. A sample of 105 nonrespondents within each region was selected and a special priority mailing was sent to these households. The estimates for the overall state and regional estimates adjusted for this double sample.

Questionnaire design

The questionnaire was formatted and edited a number of times between the OSU-SRC and personnel from the Department of Revenue. Several questions were similar to the "An Estimate of Income Tax Evasion in Oregon" survey conducted in 1981.

Results

Response rates

Approximately 31 percent of eligible respondents across the state responded and returned the mail questionnaire. The disposition of response from the survey is presented in Table 1. Of the total completed surveys, 83 (6.8 percent) were completed from the priority mailing while the bulk of the completed questionnaires were obtained from the first set of mailings.

Frequency analyses

Since the sampling design was a stratified random sample, the statewide weighted analyses for these data incorporate the sampling weights to reflect the variable selection probabilities within each region. In addition,

Table E1. Disposition for the 2008 Oregon Department of Revenue survey

Outcome	Number	Percent
Completed	1,229	30.7%
Undeliverable	364	9.1%
Refused	127	3.2%
Deceased	4	0.1%
Other	16	0.4%
Not returned	2,260	56.5%
Total	**4,000**	

The adjusted response rate, which adjusts for undeliverable mailings, accounts for no living individuals living at the address, and businesses solicited was 34.0 percent.

the statewide and the regional estimates incorporate weights to account for the double sample design.

A summary of the results for the statewide summary follows. The coding for these frequency results is interpreted as follows. Each question is titled at the top of the page. For continuous questions, such as years living in Oregon, a frequency analysis and a summary computing the mean are both presented. For categorical questions, the response category first appears on the left column. The next column lists the response categories for the question. The column "frequency" represents the number of completed surveys that were obtained for the response to that question. The "percent" column represents the percentage of Oregon households expected to answer each category based on the responses.

Interpretation of statewide results

The sampling design was a stratified random sample. Double sampling was also used to make an adjustment for nonresponse. The statewide weighted analyses for these data incorporate the sampling weights to reflect the variable selection probabilities within each region and the double sample. This weighting adjusts for the differences in population in terms of households found in the regions of the state. The estimates in the frequency results are thus estimating the percent of Oregonian households expected to respond to the categories of response based on the survey sample results. The following statements refer to responses representing a household obtained from Appendix B (omitted). These are referred to as Oregonians in this summary.

Based on the results of the respondents, the average number of years that individuals who completed the questionnaire live in Oregon is 34.9 years (Question 1). Approximately 78 percent of Oregonians own or are buying a home, while 19.6 percent rent (Question 4). Nearly 45 percent of individuals living in Oregon households felt they receive fewer benefits from the services of state government than the average Oregonian, while 36.6 percent think they received about the same amount of benefits (Question 5).

Individuals were asked whether they feel the Oregon state income taxes paid are reasonable or unreasonable considering the benefits received. Approximately the same percentage of Oregonians (42 percent) felt that the state income taxes paid were reasonable or were unreasonable considering the benefits received (Question 6). Forty-nine percent of Oregonians were partially satisfied with the services and benefits obtained from the taxes paid to the state of Oregon (Question 7), while 28 percent were not satisfied. Approximately 51 percent felt they are paying too much for the services received, while nearly 33 percent felt they pay about the right amount for the services received (Question 8). Just under forty percent of Oregon households felt that the Oregon state tax system is fair, while 40.16 percent thought it was unfair (Question 9).

Participants to the survey were then asked to compare their life financially five years ago to today. Approximately 59 percent of Oregonians felt that they are worse off financially than in 2003, while 21.3 percent stated there was no difference, and 17.9 percent thought they were better off (Question 11).

Ten percent of Oregonians felt that the tax forms are very confusing while 9.2 percent stated they were not at all confusing (Question 12). However, approximately 53 percent of Oregon households that filed the 2007 Oregon state income tax return paid a tax professional to prepare the taxes, while 22 percent filled out the form themselves using preparation software (Question 16).

Sixty-one percent of Oregonians stated they knew a little about the Oregon tax system, 22.9 percent stated they knew quite a bit, 12.3 percent stated they knew

nothing at all, and just 2.4 percent stated they knew a lot (Question 13). Thirty-two percent of Oregonians stated that the statement "You have three years to file an amended Oregon state income tax return to correct errors" was true; 10.7 percent stated it was false; and 55.4 percent did not know (Question 14).

Eighty-seven percent of Oregon households filed an Oregon state income tax return by April 15, 2008 for the 2007 tax year (Question 15). Forty-two percent of those that did not file received an extension, while 53 percent did not file for some other reason (Question 15a).

Based on the respondent data, 56 percent of Oregonians were due a refund, while 37 percent owed tax (Question 17). Fifty-percent of respondents that worked in 2007 had all employers withhold some of their wages in 2007 for Oregon taxes (Question 18). Nearly 44 percent of the respondents were employed full time, 14.4 percent were part-time employed, and 22.9 percent were retired (Question 19).

Question 26 presented the respondent with a variety of statements about preparing income tax returns. The two statements that obtained the largest percent of individuals who either strongly or somewhat agreed to the statement were parts f and a. Sixty-seven percent of Oregonians either strongly or somewhat agreed that people cheat on their taxes because they want the extra money (Question 26f), while 56.8 percent either strongly or somewhat agreed that more people than ever are taking income payments in cash to avoid paying taxes on some of their income (Question 26a).

A list of different offenses was provided in Question 27 and respondents were asked their opinions about the seriousness of the offenses. Nearly 86 percent thought that beating up a spouse was very serious, while 85 percent thought driving while drunk was very serious (Question 27).

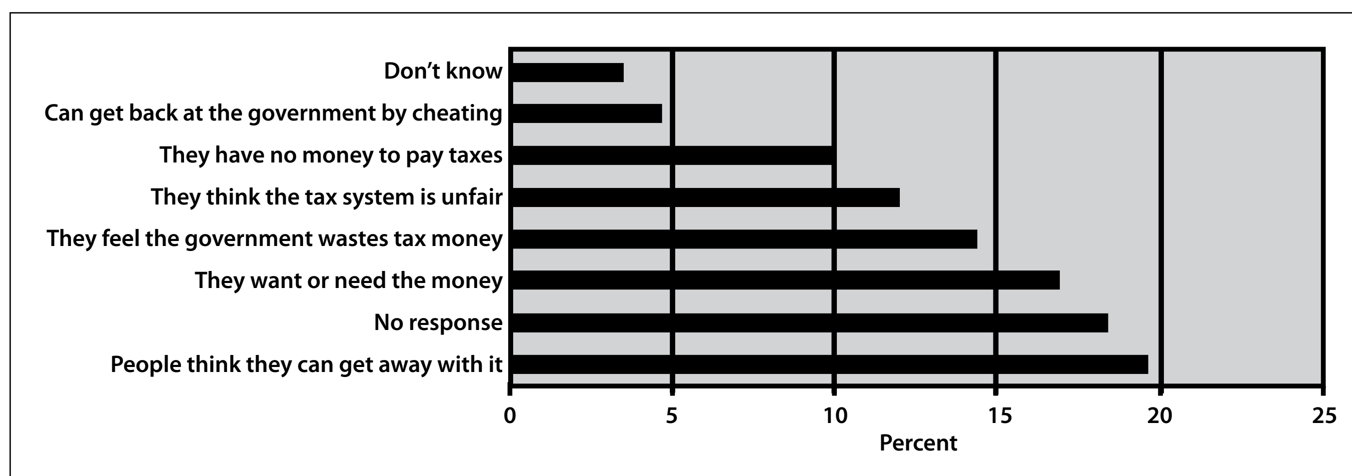
Forty-two percent thought that cheating on income taxes was very serious (Question 27d). When people cheat by small amounts on their income taxes, 9 percent state they are very likely to get caught, while 21.9 percent think it is quite likely they will get caught (Question 28). However, respondents were also asked about cheating by large amounts on their taxes. When people cheat by large amounts on their income taxes, 30.9 percent of Oregonians state it is very likely to get caught while 41.9 percent state it is quite likely they will get caught (Question 29).

In Question 30, respondents were asked to list the three main reasons they think people cheat on their income taxes. Approximately 19 percent of Oregonians selected "people think they can get away with it" (Figure 1).

Question 31 asked respondents how often they have claimed fewer deductions than they were entitled to on their income tax return. Approximately 29 percent stated they have sometimes done this, 24.2 percent stated never, while 22.9 percent stated seldom, and 9.0 percent stated often. However, 13.5 percent either don't know or couldn't answer, while 2.0 percent did not give a response (Question 31).

Respondents were asked about whether they have listed more deductions or travel or business expenses than he or she should have on their income taxes. Seventy-eight percent of the households stated that this was never done, 11.0 percent stated that this was seldom done, 3.2

Figure E1. Percent of Oregon Households Responding to Why People Cheat on Their Income Taxes



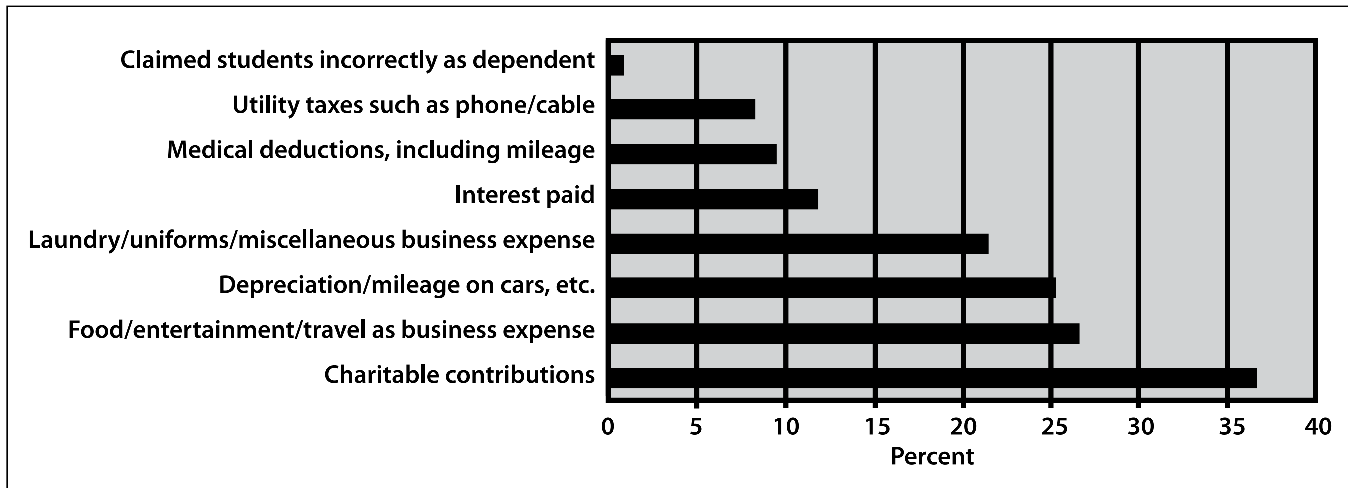
percent did this sometimes, and 0.3 percent stated this was done often (Question 32). A question followed that provided a list of things that may have been deducted. Respondents were asked to state whether or not he/she may have deducted each item but should not have. Charitable contributions were most frequently selected (36.4 percent stated yes) as an item that may have been deducted but should not have been deducted (Question 32a; Figure 2).

Ninety-two percent of Oregon households stated that they never claimed some tax credits that should not have, while 2.3 percent of Oregon households stated they either seldom, sometimes or often claimed some tax credits that probably shouldn't have been claimed (Question 33). There are too few respondents to Questions 33a and 34 to summarize conclusions with reasonable levels of confidence.

Approximately 15 percent of Oregon households seldom, sometimes, or often missed reporting some income on their income taxes (even just a minor amount) within the past five years (Question 35). The most frequently selected source of income that was not reported was cash payment for small jobs or jobs out of state which was selected by 49.5 percent of Oregon households (Question 35a).

Nearly 27 percent of Oregon households stated they happen to miss reporting some income on their 2007 income tax return while 57.8 percent stated they did not miss reporting some income (Question 36). Approximately 4 percent of Oregon households stated that in their adult life in Oregon they either seldom or sometimes did not file a state income tax return when they should have (Question 37). The reason most often selected as why he/she did not file an Oregon income tax return (selected by 45.1 percent of respondents) was due to a major life event (Question 37ai). These respondents then indicated that if they had filed in those cases, 35.2 percent thought he/she would have owed money (Question 37b).

Figure E2. Percent of Oregon Households Stating that They May Have Deducted Each Item but Should Not Have



Appendix F
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