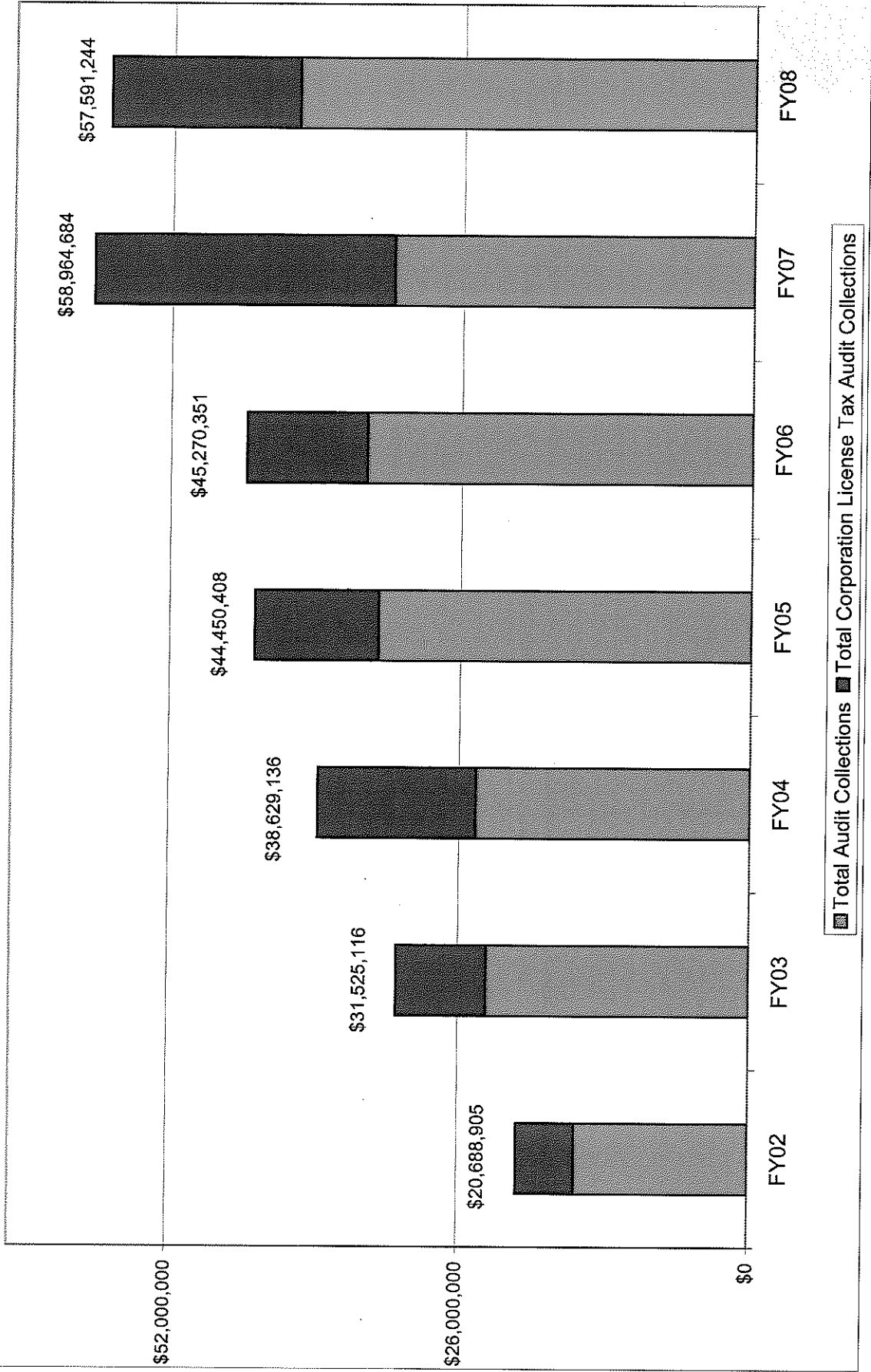


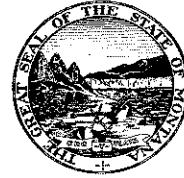
Business and Income Taxes: Total Audit Collections by Fiscal Year





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Montana Department of Revenue Pass-Through Entities Audit Program Report July 11, 2008

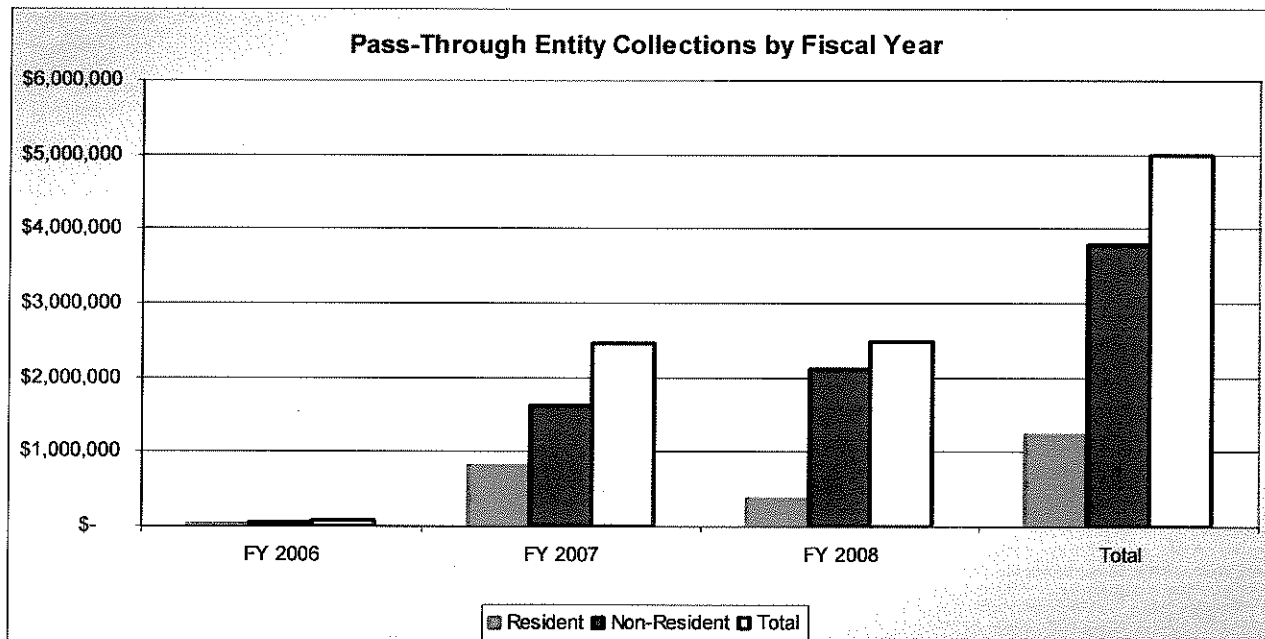
Over the last fiscal year, the department has been reporting on the progress of our pass-through entities audit program. This progress report focuses on some of the specific details related to our compliance program as well as a few observations based on the compliance results.

As we have reported in the past, pass-through entities are those entities where the income earned by the entity passes through or flows through to the respective shareholders or partners. In these cases, except where an entity has elected to file and pay on behalf of the owners through a composite return, the obligation for filing returns and paying taxes rests with the shareholders or partners, not the entity. S. corporations and partnerships are examples of pass-through entities. There are approximately 23,000 S. corporations and 17,000 partnerships that file tax returns annually. For comparison purposes there are roughly 17,000 C. corporations that file an annual Montana tax return.

Compliance Efforts:

The main method that the department uses to verify income reporting is by conducting an audit of the pass-through entity's tax return. The department has been conducting pass-through entity audits through field and office audits. A field audit consists of a department audit team conducting an audit at the taxpayer's place of business. The field audits can take place either in-state or out-of-state. Field audits are generally more encompassing in that more than a single issue will be reviewed. Office audits are conducted by auditors requesting information from the taxpayer by means of written correspondence. Based on the information supplied by the taxpayer the appropriate adjustment is made.

In prior reports, the department has provided the following graph of the overall audit collections for the last three fiscal years. The graph simply illustrates the total amount of audit collections from both field and office audit activity.



To provide additional detail of the audit program, the following two tables break out some of the audit results by the type of entity being assessed and the type of compliance issues that have been identified.

The following table breaks down the overall audit collections by entity type.

Entity Type	Non-Residents			Residents			Total		
	Taxpayers Assessed	Periods Assessed	Total Collections *	Taxpayers Assessed	Periods Assessed	Total Collections *	Taxpayers Assessed	Periods Assessed	Total Collections *
Fiduciary	1	1	\$ 389,500	0	0	\$ -	1	1	\$ 389,500
Individual	105	203	\$ 669,200	50	97	\$ 479,500	155	300	\$ 1,148,700
Partnership	56	74	\$ 1,513,700	98	130	\$ 345,900	154	204	\$ 1,859,600
S. corp	29	46	\$ 1,140,400	98	127	\$ 393,600	127	173	\$ 1,534,000
501c (3)	1	8	\$ 70,000	0	0	\$ -	1	8	\$ 70,000
Total	192	332	\$ 3,782,800	246	354	\$ 1,219,000	438	686	\$ 5,001,800

* The total collection columns have been rounded to avoid potential disclosure of taxpayers.

The entity type means the taxpayer that is responsible for paying the tax. Briefly, the entity types are defined as: "Fiduciary" can be either an estate or trust; "Individual" is simply an individual income taxpayer that is an owner or shareholder of the pass-through entity; "Partnership" and "S. corp" is a pass-through entity that has elected to pay the composite tax at the partnership or S. corp level; and "501c (3)" is a tax exempt entity.

The following table breaks out the collections into general compliance issues that have been identified. Office audits are typically focused on a single compliance issue, therefore, specific detail on each audit initiatives can be clearly identified. A similar breakdown is not provided for field audits because any one field audit may include a number of issues.

Pass-Through Entity Audit Collections FY07 and FY08			
Field Audit	Non-Resident	Resident	Total
	\$ 1,632,107		\$ 1,632,107
Office Audit:			
Gross Proceeds	\$ 33,880	\$ -	\$ 33,880
Interest Income	\$ -	\$ 244,416	\$ 244,416
Medical & Health Care Payments	\$ 5,897	\$ -	\$ 5,897
Mortgage Interest	\$ -	\$ 115,549	\$ 115,549
Nonemployee Compensation	\$ 1,407,437	\$ 182,179	\$ 1,589,616
Other Income	\$ -	\$ 21,069	\$ 21,069
Partner Non-filers	\$ 639,992	\$ 480,113	\$ 1,120,105
Property Sales	\$ 41,449	\$ 118,622	\$ 160,070
Rents	\$ 1,465	\$ 52,844	\$ 54,309
Royalties	\$ 20,677	\$ -	\$ 20,677
Substitute Payments in Lieu of Dividends of Interest	\$ -	\$ 4,176	\$ 4,176
Grand Total	\$ 3,782,904	\$ 1,218,968	\$ 5,001,871

General Observations

From a review of the material presented above, several general observations can be made:

Ratio of Audit Collections to Expenditures:

Over the last two fiscal years the department has collected approximately \$2,500,000 per year. Based on the annual collections and the expenditures related to the pass-through entity audit program the ratio of audit collections to expenditures is 24:1. For comparison, the department's general audit collections to expenditures ratio is 7.4:1.

Audit Coverage:

Pass-through entity compliance enforcement is an area where many states and the federal government have very limited or no audit program. For example, the IRS Oversight Board's 2007 Annual Report indicates that the IRS had audited only 12,200 of 3.1 million partnership returns in FY2007. This equates to an audit coverage rate of partnership returns of .39%. (The audit coverage rate is the number of audits conducted divided by the overall population.)

For comparison purposes, the department's relatively new compliance efforts have produced higher audit coverage rates than that of the IRS. In FY2007, the department conducted 217 pass-through entity audits for an audit coverage rate of .54%. In FY2008 the department conducted 170 pass-through entity audits for an audit penetration rate of .43%.

DEPARTMENT OF REVENUE ADMINISTRATION FEATURES

IDAHO v. MONTANA

	<u>Idaho</u>	<u>Montana</u>
# of employees ¹	526.50	313.18
# of taxes/functions administered	21	37
Employees per tax/function administered	25	8
Population	1,499,402	957,861
Population per employee	2,848	3,058

¹ Includes full-time, part-time year-round, full-time seasonal, temporary FTE and attorneys; does not include residential, commercial, and agricultural property appraisal and assessment, or liquor control functions.