TENNESSEE'S FEDERAL/STATE TAX COMPARISON

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Background:

The Federal/State tax information exchange agreement has existed for many years with most states making relatively little use of the data until recently. Widespread revenue shortfalls, budget cuts, and Federal aid reduction coupled with the unpopularity of a tax increase have inspired and popularized many tax saving programs. This paper describes one of Tennessee's tax reporting comparison programs. It is a low-cost, high-yield program designed to quickly and efficiently locate misplaced tax dollars.

All processing (except reading the IMS database since SAS/IMS was not available at my site) was accomplished with SAS. SAS was chosen because it was the fastest and most economical method available for project workers. The programmer pool was not utilized because their time had already been allocated to other projects.

A State and Federal gross sales comparison was initially developed in Tennessee both to generate sales tax audit leads and to add independent variables for audit selection regression analysis. Federal 1040-C 1981 gross sales were compared to gross sales from Tennessee Sales Tax returns for the same period. Resultant independent variables assembled for use in the analysis and later used in audit selection and billings were:

- gross sales reported on Schedule C, form 1040
- difference between Federal and State gross sales reported
- wages reported on Schedule C
- profit or loss reported on Schedule C
- Standard Industry Classification (SIC) Code--a business type indicator

PROC's FREQ and SUMMARY were used to determine the degree of gross sales under-reporting. A suprisingly large number and dollar values of discrepancies were found. Since these constituted more audit leads than could be handled through normal field audit processes, the decision was made to take the comparison one step further. Under-reporting taxpayers were contacted by letter requesting them to call and make an appointment to explain any differences they felt were not subject to sales tax. Otherwise, the tax, penalty and interest were due and payable.

Program benefits:

Forty-two hundred 1981 comparison letters were mailed between July 1983 and February 1984. After all these letters are resolved and resultant audits completed, the 1981 program is projected to yield three million dollars at an estimated cost of $150,000. This charge includes the in-house costs of CPU time, a SAS programmer's time, an analyst's time, auditors' time spent handling taxpayer's appointments and questions, printing and postage cost. This leaves the only out-of-house cost being the purchase of data from the IRS.

In addition to the dollar return, audit coverage has increased. The audit budget allows a 13% audit coverage during each three-year audit cycle, whereas under the comparison program, taxpayers who would not ordinarily be contacted by sales tax field auditors will receive "audit" attention. This should improve voluntary compliance in the long run.

When possible auditor trainees were assigned to answer taxpayers' inquiries on the letters. This proved to be an excellent training tool since new personnel were exposed to simple audit situations, one-on-one taxpayer contact, and field audit paperwork early in their employ, while still under close supervision. This training advantage proves to be a drawback in areas where no auditor trainees are available.

State data used in the comparison:

Each month ninety thousand sales tax returns are filed with the Tennessee Department of Revenue. An additional thirty thousand quarterly and other filers submit returns throughout the year. All 53 amounts on each return are keyed, mathematically reviewed, corrected and stored on tape for future use. To assemble State data used for the Federal/State match, two June 30 fiscal year tapes containing detailed sales tax reporting information were used. The data was:

1. read selectively for account number, gross sales, exempt sales, use taxable, total tax paid, date filed and filing status fields;
2. placed in four SAS datasets using PROC COPY to facilitate processing the large files;
3. sorted, flagged, and resorted, allowing voided and amended returns to appropriately effect normal returns; and
4. summarized for the calendar year by account number.

About 120,000 accounts had some activity during 1981. All business structures (e.g., corporation, partnership) were included even though corporations were not considered in the comparison. Without the business structure code added from the database later, there was no clear way to remove corporations in early processing.

In addition to the above, taxpayer registration data such as name and address were also required. The Department of Revenue's IMS database was read, writing every individual owner or partner to a sequential tape file. One record was written for every Social Security number (SSN) so that all businesses in which a taxpayer had an interest would be included under one number. Of course, this method duplicated gross sales reported by partners under each partner's SSN. The duplication caused a reduction or exclusion from billing of a few taxpayers, a situation which was clearly more desirable than overbilling any taxpayers.

At this point, State data was set aside until Federal data was prepared.

Federal data used in the comparison:

Each year, 1.7 million Tennesseans file individual Federal income tax returns, ten percent of which contain sole proprietor business income reported on a Schedule C. Annually, after keying its returns, the IRS makes most of its data available to states at a nominal cost. In Tennessee, the Individual Return Transaction File (IRTF) --detailed information from 1040 schedules--and the Individual Master File (IMF) --general information for all filers--were purchased. In addition to other information, the IRTF provides several pieces of data from 1040 Schedule C. To separate needed fields, the file was SAS Macro processed in blocks of 100,000 records since the file contained one record for each Tennessee taxpayer. Gross sales, wages and profit/loss dollar figures were extracted along with SSNs and SIC codes. The new smaller file extracted from IRTF was matched with the IMF containing names and addresses of taxpayers as well as spouses' SSNs. Having the SSN of both spouses is essential since husbands and wives often own a business or businesses registered for sales tax under one or both SSNs.

Matching the files:

Matching the two files by SSNs was accomplished in several steps because of the immensity of the files. The first pass of the two found 46,000 matches on the primary SSN. Unmatched businesses were re-sorted by spouses' SSN and 14,000 additional matches were found. The two matched files were concatenated and sorted once again by the primary SSN. Duplicates arising because of married "partnerships" and married individuals each owning a business were removed. Matching and unmatching files were concatenated creating one file of 240,000 records, 54,000 IRS taxpayers remained unmatched with sales tax data. These were apparently not registered for sales tax but were reporting to the IRS as a business. Their treatment is discussed later.

Selecting and printing the letters:

Since taxpayers were unevenly distributed by dollar amount of tax owed and geographic location, taxpayers who represented a rough cross-section of the State were selected to receive letters. Only business types that should unquestionably have matched gross sales for sales tax and Federal tax purposes were included (e.g., grocery stores, used car dealers). Closed accounts and previously audited accounts were also excluded from the billing program; however, any accounts having a discrepancy could be selected for audit.

A spout file was created for printing the letters using a SAS "put/file" routine. A SAS format library for the letter printing program was built including addresses and phone numbers of regional offices as controlled by location zip codes. The library also contained a "picture" for the sales tax account number, a breakdown scheme for dollar discrepancies by size, and local sales tax rates which were controlled by county code and date. Interest and penalty were calculated from July 1, 1981 through the month the letter was sent using SAS functions INTCK and TODAY to calculate the number of months. The taxpayer's name and address appeared in the top third of the letter such that when folded, it showed through a window envelope. Also printed on the letter were SSN, date, sales tax account number, amounts of sales reported, tax, penalty, and interest due, and an address and phone number for responses. A laser printer began with blank paper, superimposed the State seal on each letter, and printed four trimmed and burst copies.

Similar print programming was used to produce "follow-up" letters. These short, undated letters referred to IRS comparison correspondence by date, name, SSN, and account number. As needed, letters could be dated and mailed acknowledging receipt of "sufficient information" to relieve taxpayers of additional sales tax shown in the IRS comparison letters.

The letter's date was written back to the master file to prevent a taxpayer from being selected twice. Several specialized reports also written using SAS "put/file" printing were utilized by auditors and administrators to solve taxpayer's problems in response to the letters. In addition to the billing letters and listings of letters, regional printouts were also provided for audit selection which showed a gross sales comparison of all businesses. The IRS requested and was provided with printouts of businesses reporting more to the State than to the Federal government. There has been indication as to how fruitful the data has been, other than a repeated request for the same data from the 1982 extract.

Non-registered taxpayers' questionnaires:

There were some 54,000 taxpayers filing a 1040 Schedule-C with the IRS who were not found on Tennessee's sales tax files. Many of these were businesses that were not subject to sales tax such as a janitorial service or a law firm. These were deleted based on the SIC code. Of the remaining 13,000 apparent non-filers, a sample of 100 were selected to receive letters requesting that they call one of two persons in the registration division and explain their reason for non-registration. Most of the taxpayers responded quickly; their reasons were noted by the registrars. When reviewed, some of the reasons were questionable but taxpayer re-contact solved the problems. To avoid this excessive taxpayer contact, a questionnaire was written and sent to a new list of taxpayers derived of the high-dollar non-registrants (not including the original 100). These 1000 taxpayers were sent questionnaires stating simply that no sales tax registration could be found for their business as reported to the IRS. They were asked to fill in the reason for the discrepancy, the name of their business, and their phone number. A return envelope addressed to the appropriate regional office was provided.

Taxpayer response to the questionnaires has been about 90%. There were four primary reasons for non-registration:

1. even though the taxpayer filed his 1040 in Tennessee, the business was located outside the State

2. date entry personnel for the IRS or Tennessee had incorrectly keyed the SSN

3. the SIC code was incorrect

4. sales shown on the return were those made by a manufacturer's representative; the manufacturer had taken care of the sales tax for him

Even though not subject to sales tax, taxpayers falling into the fourth category were referred for Business Tax (a separate gross receipts priviledge tax) audit.

The questionnaire method was more satisfactory since audit personnel reviewed responses and contacted taxpayers only if necessary. Roughly twenty audits, thirty-five registrations and $10,000 have resulted from the questionnaires thus far. Increased compliance rather than a high-dollar yield is the expected benefit of this program. Taxpayers appearing to be sales taxable but remaining unregistered simply cannot be ignored.

Plans for the future:

In late 1983, tapes were received from the IRS for tax year 1982. A process similiar to that described for 1981 was used to create a 1982 match file. Mailing will begin for 1982 extract letters in April 1984. Even better results than those achieved in the 1981 program are projected for 1982 because of the experience gained by all Sales Tax personnel involved in the program.

In addition to the data received for 1981, "cost of goods sold" for sole proprietors has also become available. This is seen as an excellent audit selection tool since norms for markups can be calculated leaving those outside the norm subject to review. Such a program is now being developed.

Corporate and partnership filers' data is captured on a Business Master File (BMF) and sold by the IRS. This file has also been purchased and is being matched in a similar manner to that for sole proprietors. This corporate matching program should be more productive than its counterpart since corporations and partnerships represent the majority of sales reported in Tennessee. In addition, a Business Returns Transaction File (BRTF) will be available for tax year 1983. It will also contain a "cost of goods sold" for use in markup and norm calculations.

Summary:

Some sales tax applications for data purchased under Federal/State Exchange Agreement are:

1. selecting for audit taxpayers under-reporting gross sales

2. writing under-reporters requesting they resolve discrepancies or pay the misplaced tax

3. sending questionnaires to unregistered tax payers to determine their reason for non-registration

Processing for this low-cost, high-yield project is accomplished quickly and efficiently through use of SAS.

Comparing State and Federal level data is a valuable project not only because of the welcomed dollars it contributes but also because of the policing action it provides on a broader base of taxpayers than field auditors can normally cover. This comparison should improve voluntary compliance in the future.

Please refer comments and questions to:

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