The Florida Senate

Interim Project Summary 98 - 64 *October 1998*

Committee on Ways and Means, Subcommittee E Senator Ostalkiewicz, Chairman

EFFECTS ON STATE REVENUES OF REDUCING THE STATUTE OF LIMITATIONS FOR TAXPAYER AUDITS

SUMMARY

A series of laws enacted in the late 1980's and early 1990's greatly strengthened Florida's tax enforcement statutes. Florida's statute of limitations on actions to collect taxes and the state's delinquency penalties and interest are among the highest in the nation. Over the last few years, a recurrent issue in the Legislature has been proposals to reduce both the statute of limitation and delinquency penalties and interest. In analyzing these proposals, especially those dealing with a reduction in the statute of limitation, it has been difficult to develop information for revenue impact estimates. The purpose of this interim project is to examine the issue of Florida's tax statute of limitations and the effect a reduction in the limitation would have on revenue collections.

This project conducted a survey of state auditors to gather data on the relationship between length of audit coverage and use of audit resources. The primary finding was that while reducing the statute of limitations from 5 to 3 years represents a 40% decrease in coverage, auditor resources to conduct those audits only declined by about 20%. This indicates that, assuming no increase in audit resources, a reduction in the statute of limitations should reduce audit recoveries. Applying the survey results, the study estimates that reducing Florida's statute of limitations from 5 to 3 years would reduce recurring revenues by $65.8 million, of which $53.7 million is General Revenue. The report discusses various legislative options for reducing the statute of limitations.

BACKGROUND

The term "statute of limitation" in the context of taxes refers to the time period after a tax is due in which the taxing authority must determine and assess any delinquent taxes, penalties, or interest that may be due. If action is not taken during this period, the taxing authority is barred from collecting those taxes. The statute is intended to provide the state with a reasonable period in which to discover tax delinquencies and provide taxpayers with a limit on the necessity of maintaining records necessary to justify their actions. The time limitation is commonly different for different types of delinquencies, often with no limit if a return was not filed or if fraud was involved.

Florida's tax enforcement statutes changed drastically over a six year period from the late 1980's to the early 1990's. During that period, three major pieces of legislation were enacted with the intent of increasing taxpayer compliance with a combination of stiffer penalties and increased enforcement capability on the part of the state. All three employed a "carrot and stick" approach, tying the increased enforcement provisions to a tax amnesty offering taxpayers the opportunity to come forward and declare delinquent taxes, thereby avoiding penalties. Taxes and interest still had to be paid. For those who failed to come forward and for those who made errors in the future, the "stick" was strengthened by increasing penalties and state enforcement powers.

As a result, Florida has a long statute of limitations compared to other states. Only two other states have a sales tax statute of limitation period equal to or longer than Florida's. The large majority, 32, have a limitation period of 3 years, one state has 3 ½ years, and 9 states have 4 years. Likewise, of the states which have a corporate income tax, only one state has a statute of limitation period equal to Florida's and no states have a longer period. Most states, 33, have a limitation period of 3 years, while one has 3 ½ years, one has 1 ½ years, and 8 have 4 years. Florida also has relatively strong tax enforcement provisions in the areas of delinquency penalties and interest.

Over the last few years, a recurrent issue in the Legislature has been proposals to reduce both the statute of limitation and penalties and interest. In analyzing these proposals, especially those dealing with a reduction in the statute of limitation, it has been difficult to develop information for revenue impact estimates. The purpose of this interim project is to examine the issue of Florida's tax statute of limitations and the effect a reduction in the limitation would have on revenue collections.

METHODOLOGY

A number of bills have been introduced in recent years to bring Florida's tax enforcement statutes more in line with those in most other states. Estimates of the revenue impact of these proposals have been difficult, especially for those reducing the statute of limitations. The most often proposed change is to reduce the statute of limitation from 5 to 3 years, meaning that individual audits could only cover a 3 year period instead of 5 years. Florida collects almost $200 million per year in audit assessments, penalties and interest so that relatively small changes to the audit program can have significant revenue impacts.

Reducing the period covered by a tax audit should reduce the time needed to conduct the audit, thus, assuming no increase in audit resources, freeing auditor time to conduct additional audits. At issue is the relationship between the reduction in the audit coverage period and the reduction in time needed to conduct the audit. On the one hand, if reducing the statute of limitation from 5 to 3 years reduced the time needed to conduct an audit by 40%, little or no revenue impact would be expected because the ability to increase audit coverage would counter the shorter time period of individual audits. On the other hand, if a 3 year audit takes the same amount of time to conduct as a 5 year audit the reduction could be expected to result in a 40% decrease in audit recoveries as the period subject to audit is reduced.

In an attempt to address this question, a survey of state auditors was conducted in conjunction with the Department of Revenue. Two samples were drawn from audits concluded in the six months ending August 1, 1998: 90 sales tax and 40 corporate tax audits. These were stratified by size of taxpayer and geographic area within the state. Together, sales and corporate tax audits account for 80% of all audit assessments.

Auditors were asked to allocate the hours actually spent on the audit into various components including audit preparation, pre-audit taxpayer contact, time spend analyzing various types of records, documentation of findings, exit interviews, and other post-audit taxpayer meetings. The auditor was then asked, with reference to the particular audit in question, to estimate the number of hours each task would have taken if the audit period covered had been 3 years instead of 5 years.

For sales tax audits, auditors estimated that a 3 year audit coverage would have reduced the average time required to conduct the audit from 62.6 hours to 51.1 hours, or 81.7% as long. A significant aspect of these findings is the extensive use of sampling in sales tax audits. Such samples, done either to save time or because of inadequate records, take the same time whether the audit period is 5 or 3 years. The survey found that samples are used in 86% of sales tax audits. For corporate income tax audits, the survey found that reducing the audit coverage period to 3 years would have reduced the average audit hours from 66.6 to 53.1, a proportion for the 3 year audit period of 79.7% of the actual.

FINDINGS

The purpose of this report is to assist in developing revenue estimates for legislative proposals reducing Florida's time limit on actions to collect taxes. As the limitation is reduced, audits should take less time thereby freeing auditor time to conduct additional audits. The key question is whether or not the freed-up auditor time is proportional to the time reduction in the limitation. This is the question the survey was intended to address. There are, however, many other factors which have an impact on the estimate and a number of assumptions which have to be made.

It is assumed for the purpose of making revenue estimates, that audit resources available to the Department of Revenue remain constant and that the relationship between direct audit resources and support services is the same under either a 5 year or 3 year limitation. The assumption about the relationship between direct audit and support services may be an oversimplification. Because more (but shorter) audits would be conducted, relatively more work would have to be done identifying taxpayers for audit, insuring assessments are collected and handling protests. However, no data is available to estimate this potential change and it was assumed to be small enough not to have a major impact on the results.

Within individual audits, it is assumed that the distribution of assessments is constant across the audit period. This assumption implies that interest payments, which make up over a quarter of all audit recoveries, are not evenly distributed. Interest on a delinquency in the first year of a 5 year audit period will be five times the interest on an equal delinquency in the most recent year of the audit.

Another important assumption is that the marginal revenue impact of conducting additional audits is the same with either a 5 year or a shorter limitation. As the limitation is shortened and auditor time freed-up, the additional taxpayers audited are assumed to be just as productive from a revenue standpoint as the audits already conducted. A primary purpose of audit activity is to encourage compliance with tax laws. To the extent that total time subject to audit is reduced, this deterrence might be reduced. On the other hand, as more audits are conducted due to the shortened audit coverage period, the deterrence affect on taxpayers might be increased. For purposes of this study, it is assumed that any reduction in the statute of limitation will not have an effect on overall taxpayer compliance.

In fiscal year 1997-98, the state collected $187.7 million. Based on Revenue Estimating Conference estimates, this is projected to grow to $200.8 million in fiscal year 1999-00. Applying the survey results and the assumptions discussed above, reducing the time limitation on actions to collect taxes from 5 to 3 years would have a recurring impact on all taxes collected by the state of negative $65.8 million. Of this amount $53.7 million would be from the General Revenue Fund, $2.4 million from state trust funds, and $9.7 million in dollars distributed to local governments. It is important to emphasize that this is the recurring impact. All bills introduced in the past few years would have acted only prospectively. That is, only audits of taxes due after the effective date of the change would have been affected. Thus, no impact would be encountered for the first 3 years after enactment. Because of the two year tolling period (assumed unchanged by these estimates) the full impact would not be felt until the 7th year.

RECOMMENDATIONS

During the late 1980's and early 1990's, the Legislature significantly expanded the state's tax enforcement tools in an effort to increase the fairness of the tax structure, close what was perceived at the time as the tax "gap" between taxes due and taxes collected, and to raise revenues. All of these changes were associated with tax amnesty programs in an effort to allow taxpayers time to bring themselves into compliance before being subject to the stricter enforcement provisions in a "carrot and stick" approach. While this approach probably changed some taxpayer behavior, it also had the effect of increasing audit recoveries and penalty revenue because, for many taxpayers, the main compliance problem is lack of knowledge about Florida's tax laws. The increased enforcement measures also put Florida considerably out of sync with other states and the federal government.

Reducing Florida's enforcement provisions will have an impact on revenues. This study investigated the revenue impact of reducing the tax statute of limitations. Because the use of audit resources is not proportional to the time under audit, reducing audit time coverage will result in overall lower audit coverage and therefore a reduction in audit recoveries.

The methodology put forward in this report results in a General Revenue Fund impact of negative $53.7 million for a reduction in the statute of limitation from 5 to 3 years. As discussed above, this is a recurring impact which, if the bill enacting the change only affects taxes due after its effective date, will only affect collections in the fourth year and thereafter. It would, however, affect the balance of recurring funds in the year enacted. While not directly estimated, it is probably reasonable to assume that the revenue impact of a reduction from 5 to 4 years would cut the estimate in half. The full effect of the legislation could be phased-in over a number of years, perhaps with an approach similar that used for Preservation 2000 funding and the repeal of accounts receivable intangibles taxation enacted last session. In these instances, a first step was taken in the initial legislation, with commitments made that further reductions would be legislatively enacted in coming years.

COMMITTEE(S) INVOLVED IN REPORT ***(Contact first committee for more information.)***
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MEMBER OVERSIGHT
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