

April 5, 2017

Representative Jim Knoblach
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Representative Sarah Anderson
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Representative Sheldon Johnson
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Dear Chairs and Members:

As the Omnibus State Government Finance bill moves toward floor consideration, I write to express deep concerns about the bill and its impact on Minnesota taxpayers and the State's fiscal health.

This bill as drafted represents about \$55 million less in funding than is needed for the Department of Revenue to simply maintain our current level of services provided to Minnesotans and meet the requirements of the bill. As explained in detail below, this reduction results from three failures in the bill. First, it fails to fund the Governor and Lt. Governor's recommended operating adjustment for the department's work of \$20.8 million. It fails to fund even our base budget, cutting it by \$12.4 million. Finally, failing to fund the requirement that the department provide a free filing system for income taxes by January 2018, which will cost the department approximately \$22.3 million, means that amount is unavailable to fund our existing services.

The bill represents an effective cut to current service funding of over 19 percent. It equates to a reduction of almost 200 employees who serve Minnesotans every day. The combination of the reduced funding levels, the riders that limit our ability to effectively and efficiently administer the tax system, and at least one significant new, unfunded program, will have a negative impact on the services we provide to Minnesotans and the revenue stream. The reductions in the bill could result in an estimated loss of at least \$80 million in general fund revenue.

Funding levels

Failing to fund the Governor's request for the operating adjustment for the department alone would mean a loss of 121 employees who work each day to serve Minnesotans. The bill further reduces base funding by over \$12 million in FY2018-19, resulting in an estimated reduction of an additional 82 FTE per year. The bill ignores the additional investment in the Governor's budget needed to address new demands, such as emerging patterns in fraud and the growing number of customer requests for guidance on complex tax questions.

Bill requirements are in conflict

In addition to the troubling, significant reduction to the amount of resources needed to maintain existing services, the bill language requires us to do exactly that – maintain those very services.

Section 14 of the bill specifically states that we can spend no less on tax compliance activities than we did in FY17. These activities include audit, enforcement, collection, appeal, legal support in audit, data analytics to find those furthest from compliance, education, information and outreach to help those who voluntarily comply, and support for the filing systems.

In addition, section 39 of the bill states that reductions must not be made to programs or services that are provided directly to members of the public. These include:

- education, information, and outreach services
- help for customers who walk-in, call, or email the department
- the ability to provide property tax education, guidance and assistance to county and municipal property tax administrators
- timely processing of tax returns and refunds
- protection of taxpayers from fraud

Sections 14 and 39 describe essentially all of our work at the department. The bill would have us perform all of our current services and yet cuts many of the resources needed to perform them. We cannot absorb the appropriation reduction and meet the requirements of the bill regarding services.

Impact on Revenue

Accordingly, the combination of the reduced funding levels and the riders will limit our ability to effectively and efficiently administer the tax system and will have a negative impact on the revenue in the state's general fund. Because we would not be able to meet both the required budget reductions in the bill and the mandated service levels, we would need to balance reductions across the agency.

The reductions in the bill could result in an estimated loss of at least \$80 million in general fund revenue. This estimate assumes an approximate 3:1 ratio – three dollars of revenue loss for every one dollar reduction to our tax system management program. This is a conservative estimate, especially in light of our already reduced staff and the well-publicized reduction in federal audit capacity – on which we depend for a significant portion of our state adjustments. It is also conservative when compared to historical compliance initiative ratios, which were often higher than the ratio used in this estimate.

Unfunded Free File program is unworkable and not cost effective

Although we share the goal of the bill's provision to encourage more Minnesotans to file electronically by offering additional free file solutions, the timeline and approach in the bill are unworkable and come with significant cost.

Currently 85 percent of Minnesotans file their individual income tax returns electronically. We know that some of our customers will always prefer paper and so we will continue to provide them with that option. We also know that some customers choose to file on paper for the sole reason that they do not want to pay their software vendor an additional fee for the state filing.

It is important to know that a number of software vendors already offer free electronic filing to those who qualify. Examples include:

- H&R Block
- OLT
- TaxAct
- FreeTaxUSA® Free File Edition
- TurboTax® Freedom Edition

Each vendor has a different set of qualifications to access the free filing options. For example, FreeTaxUSA's maximum adjusted gross income is \$51,000 and active duty military personnel qualify. TurboTax's qualifying income level is \$33,000.

Instead of building on these vendor provided options, the bill would require the department to replace those options with a government provided free file option for Minnesotans starting next year – just over nine months away. Even if the timeline was feasible, it is unlikely that we could gain the support and cooperation from those in the technology and vendor industry, who have expressed opposition to the provision, and who are so important for the success of such an effort.

I cannot express enough how challenging and fraught with problems it would be to create such a piece of technology within the bill's timeframe. Our partners at MNIT tell us that to build a quality product we should spend more time than is allowed in the bill for the final product to develop requirements, infrastructure, and architecture for such a complicated solution.

For example, to meet customer expectations and implement the pre-population requirement we would need to offer a wizard-like function, meaning the system would lead customers through a series of questions that determine tax liability. We estimate the system needing over 160 screens, each with four decision points and options. The development of just this customer interface will take significant time and resources.

The bill requires this solution to prepopulate information for taxpayers. We do receive some essential information from employers, but as you may know, the statute requires employers to file their W2s with us by the end of February and it would take until mid-March before that information would be available to be used in a system. This means the statutory date of having the system available on January 15 is simply unworkable.

Prepopulating sensitive data and ensuring we protect taxpayer information will mean this system will have to meet incredibly stringent security and customer verification requirements adding to development time and costs. There are many other impacts to this approach that we have previously shared. Ultimately, the bill requires us to offer a very robust service that few other software vendors do right now: a wizard function in addition to a prepopulated system from third party data.

Ultimately, the small cost savings through efficiency in processing would be outweighed by the cost to build this new system. If we were able to move additional people to electronic filing, it would reduce the processing costs compared to paper returns. However, as stated above, about 85 percent of returns are filed electronically now. Of the remaining 15 percent or 400,000 that file paper returns, we expect that, at best, we might have an additional 5 percent of the filing population, or 140,000, file electronically if we offered a free option. That would mean the department's costs for processing those returns would be reduced by about \$252,000. Of course,

many more than the additional 140,000 would use this system and stop using the existing software available in the market.

That \$252,000 in potential savings in processing would be overwhelmingly offset by the costs to build and maintain this system – over \$22 million in the first biennium. As you might imagine, building and maintaining a system that will meet the requirements of the bill, ensure appropriate security for taxpayer information, keep pace with changing laws, and appeal to customers will be very costly. After analyzing the bill requirements, the necessary technology, the impact on the private sector vendors existing free file programs, and our customers, we provided a fiscal note for HF2336, which is the standalone bill for this provision. That document identifies the work and resources associated with this program and the cost of over \$22 million in FY18-19.

Because the bill language now makes clear that the department must use existing funds for this work, it will reduce by the same amount our funds for serving Minnesotans and collecting revenue. Accordingly, there will be additional, significant reductions in service levels and could result in over \$45 million in lost revenue associated with this unfunded mandate.

The appropriate way to move forward with additional free file options is for the department to work with technology and software vendors in this industry to leverage their expertise through an RFI process and create a report for the legislature. This approach would seek a realistic solution that would build on the shared expertise of the industry and the department and not duplicate what is already available in the software vendors free file options. We urge the removal of the free file mandate in this bill and, instead, take the approach of HF433 to provide information about options available through private vendors and the costs and benefits of those options to the state and our taxpayers.

First time homebuyer credit

We appreciate the appropriation for the first time homebuyer credit. However, as we have been discussing with bill proponents, there are a number of issues that we need to continue to work on. In addition, there are many other provisions in the House omnibus tax bill that will have significant cost to implement and administer – student loan credit, the private letter ruling and assessment limitation provisions, and the reciprocity credit, among others. We have promised the House Tax Committee a full fiscal note as that bill moves forward.

Incidence Report changes

We are concerned with the language to add federal taxes to the incidence study. Federal tax incidence is not under the jurisdiction of Minnesota lawmakers and its inclusion in the report could confuse the policy conversation. This is the case because some federal taxes are not on the same tax base as Minnesota taxes. For example, the definition of income for federal tax would need to include the employer share of social security taxes – which is not included in the definition of income in past studies on Minnesota taxes. This would make it difficult to understand the effect of combining federal tax results and distort the effect of state and local tax results. We recommend retaining the current format of the incidence study, which gives the legislature information about taxes over which it has jurisdiction.

Pipeline Valuation Report

As we shared with you last week, a report of this scope, on the timeline specified in the bill, will take additional resources. We produced a similar report approximately 10 years ago, with the help

of an outside expert, and it cost about \$100,000. We would need additional resources to be able to complete this work.

Board of Assessors

We are very concerned that the bill fails to make the changes requested from the Board of Assessors. Current law requires the Board's fees to cover its cost to operate – not the general fund. The proposal in the Governor's budget reduces general fund expenditures for these costs and satisfies the Board's obligation under statute. By failing to provide the Board with the proposed fee schedule, and the revenue from those fees, the bill and the Board's governing statute remain in conflict.

Appropriation structure

Next, we have significant concerns with the structure of the appropriations in the bill, and appropriation riders and other bill requirements, which constrain the commissioner's budget management authority. For over 20 years, the department has received appropriations for each of its two programs– tax system and debt collection.

This structure has worked well for two decades and there is no reason to make this change now. The more detailed appropriations structure in the bill – combined with rider language that limits our ability to manage – will tie our hands and reduce our ability to respond in real-time to quickly changing needs. As circumstances change, such as cybersecurity threats that continue to grow, the department will lose the flexibility to quickly refocus resources.

Finally, it is important to note that appropriating at the budget activity level does nothing to improve transparency. Significant detail is available to the Legislature in the BPAS system and an even larger amount of information and detail is available at [TransparencyMN](https://www.transparencymn.gov/) website. Instead, this change to our appropriation structure is an unnecessary burden on how the agency does its business and serves customers, and interferes with the operational efficiency of the agency.

MN.IT cybersecurity funding

The bill's failure to fund MNIT – particularly its request on cyber security – as requested by the Governor's budget will put at risk the information Minnesotans trust all of us to protect. There are about 120 MNIT employees who work alongside us each day. Personnel cuts to MNIT will be translated into reduced use of technology by agencies or additional costs to agencies through rates. We cannot overstate the importance of ensuring that the data across the state is secure. For us, that means the tax data of millions of Minnesotans and financial information for over 400,000 businesses must be secured. This bill puts that security at risk.

Moving Forward

The department is eager to serve Minnesota taxpayers in the most efficient and effective way possible. To do that, we need your help in securing the appropriate level of financial resources. We welcome any opportunity to discuss how we can best do that on behalf of Minnesota.

Sincerely,


Cynthia Bauerly
Commissioner