

2018 Compliance Study

A Study of Compliance Rates for Taxpayers Registered
with the Washington Department of Revenue and
Reporting on the Combined Excise Tax Return

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INTRODUCTION AND METHODOLOGY

This study presents the results of the 2018 review of taxpayer compliance with reporting requirements and exclusively focuses on unreported tax by taxpayers registered with the Washington State Department of Revenue (Department).

This study does not include businesses that are unregistered, or are registered, but are not filing tax returns. Unregistered businesses could include those in the “underground economy” or businesses that are simply unaware of registration and reporting requirements. In addition, this study only estimates compliance for businesses and does not include individuals reporting use tax.

For the purposes of this study, the terms “unreported tax” and “noncompliance” are used interchangeably.

Using the results of a stratified random sample of audits selected from 2013 to 2016, this report estimates taxpayer noncompliance for state taxes included on the Department's combined excise tax return. To statistically represent the universe of registered Washington taxpayers, the Department stratified the sample data by firm size and industry.

Many of the smaller firms randomly selected for audits depict taxpayers generally excluded by the standard audit selection procedures. All of the noncompliance figures provided in this report equal the net of the estimated debit and credit assessments, unless labeled otherwise. A debit assessment represents taxpayer underpayment of tax liability and a credit assessment represents taxpayer overpayment of tax liability. Additionally, when referring to total tax liability, this represents the noncompliance amount plus the amount of voluntarily reported tax.

The state taxes discussed in this study include:

- ◆ Sales tax,
- ◆ Use tax,
- ◆ Business and occupation (B&O) tax,
- ◆ Public utility tax,
- ◆ Hazardous substance tax, and
- ◆ Other taxes such as litter tax, syrup tax, petroleum tax, spirits liter and sales tax, and enhanced 911 tax.

State taxes such as the property tax, real estate excise tax, timber excise tax, leasehold excise tax, litter tax, cigarette tax, and taxes not administered by the Department of Revenue are not included in this study. Collections of spirits taxes are recent and the Department has very few audits completed that cover this activity.

Audits usually cover a number of years, with four years being the most common. Drawing on multiple years of sample data necessitated annualizing the assessments and statistically

projecting the figures to a single mid-year to account for inflation factors and to create measurable and comparable information. For the 2018 study, the Department projected estimates to Calendar Year 2014.

When comparing to previous studies please note the following:

- ◆ The Department had a tax amnesty program that had an impact on assessment activity in 2014. Businesses that participated in the amnesty program produced \$345.8 million in collections, representing multiple years of tax activity. However, a majority of the collections would likely have been collected regardless of the amnesty program.
- ◆ Industry groupings have changed from previous studies, and noncompliance rates from previous studies by industry are not comparable to this study.
- ◆ A correction occurred in the underlying calculations of size groupings, and results should not be compared to historical reports prior to 2016.

All estimates represent the total population of registered taxpayers reporting at least one of the excise taxes listed above. In other words, these figures estimate the total noncompliance that the Department of Revenue would discover if the Department performed an audit on each combined excise tax return filed.

Major findings of the study include the following:

- ◆ For Calendar Year 2014, the Department estimated \$232.2 million in total annual excise tax noncompliance for registered taxpayers. This equals 1.8 percent of the total tax liability.
- ◆ Use tax had the highest rate of noncompliance by tax type at 14.9 percent, with nearly \$68.8 million in unreported tax. B&O tax had the largest dollar amount of noncompliance at \$82.0 million in unreported tax.
- ◆ The professional, finance, and real estate industries had the highest rate and largest dollar amount of noncompliance by industry at \$91.3 million with a rate of noncompliance of 5.6 percent.

Table 1. Comparison of 2018 to 2016 Compliance Study by Tax Type

Type of Tax	2018 Compliance Study		2016 Compliance Study	
	Estimated Annual Noncompliance	Noncompliance as a Percent of Total Liability	Estimated Annual Noncompliance	Noncompliance as a Percent of Total Liability
Sales	70,895,000	0.9%	124,515,000	1.8%
Use	68,842,000	14.9%	86,323,000	21.5%
Business & Occupation	82,027,000	2.3%	63,714,000	1.9%
Public Utility	9,944,000	2.3%	3,047,000	0.8%
Hazardous Substance	947,000	0.5%	4,705,000	2.2%
Other	(438,000)	-0.1%	877,000	0.9%
Total	232,217,000	1.8%	283,183,000	2.5%

TOTAL NONCOMPLIANCE

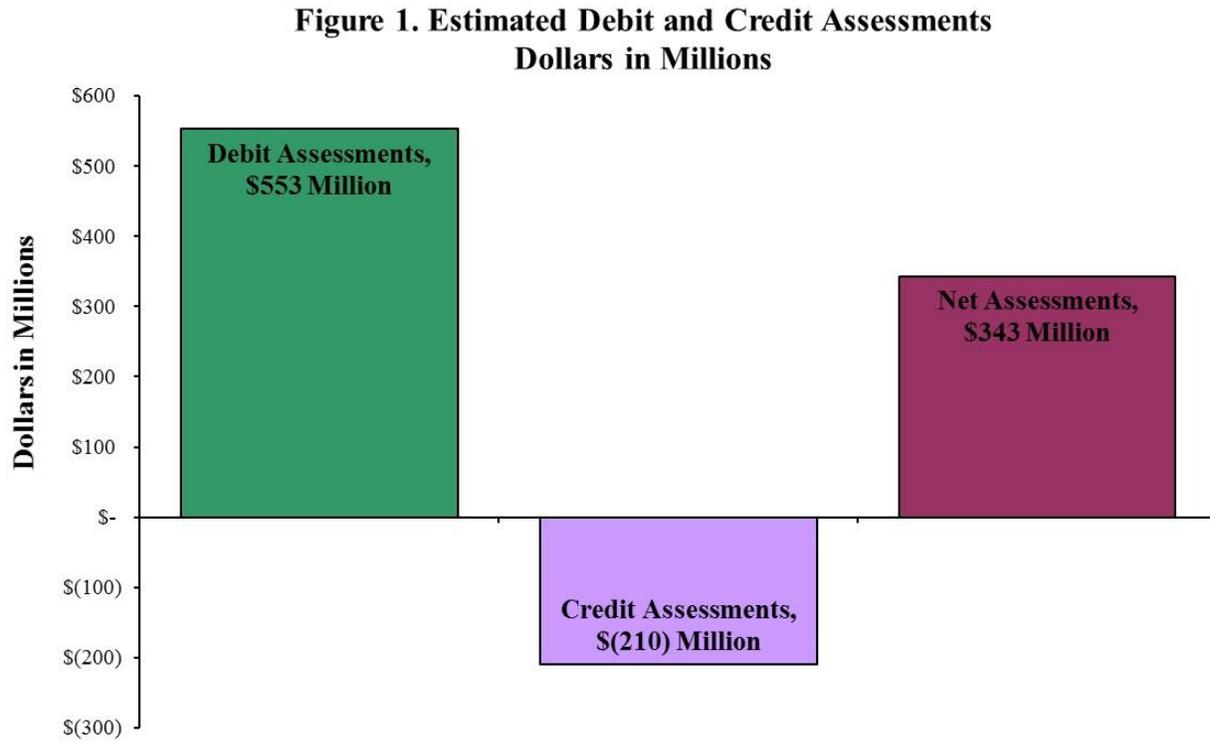
The Department estimated \$232.2 million in total annual excise tax noncompliance for registered taxpayers. This equals 1.8 percent of the total tax liability.

As shown in Table 2, use tax had the highest rate of noncompliance at 14.9 percent. B&O tax comprised the largest dollar value of unreported tax with \$82.0 million.

Table 2. Estimated Noncompliance by Tax Type

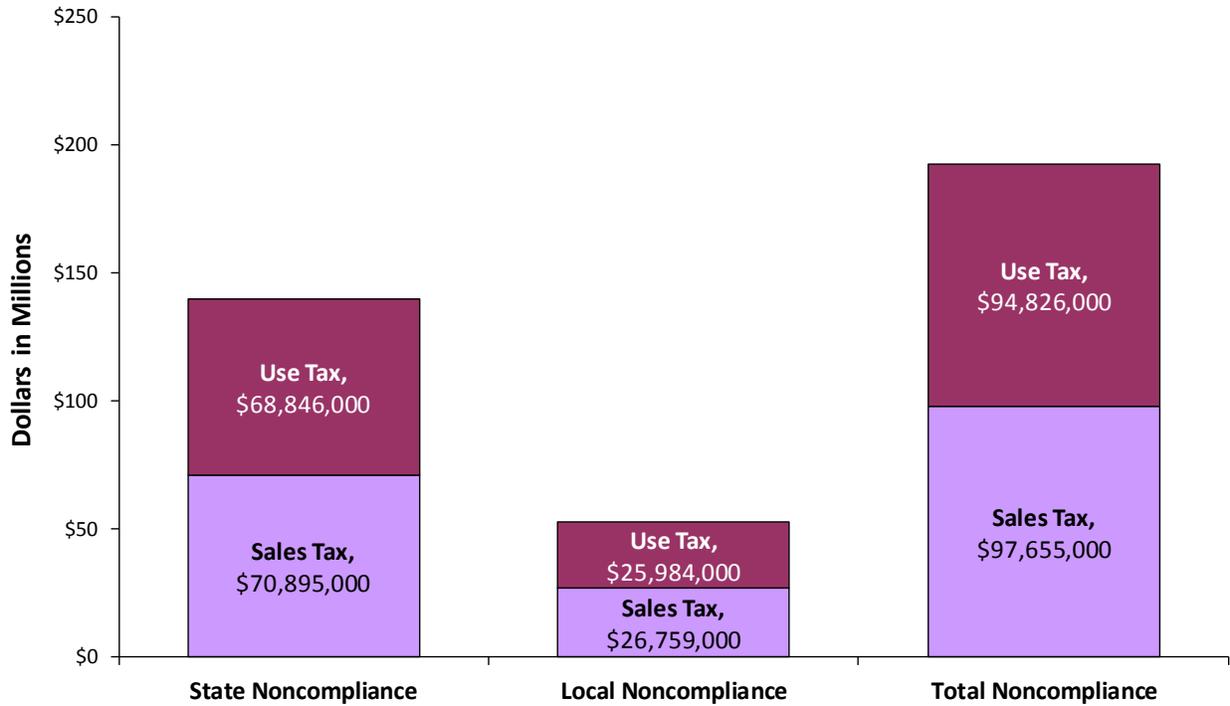
Type of Tax	Estimated Noncompliance	Voluntary Reported Tax	Noncompliance as a Percent of Total Liability
Sales	70,895,000	8,114,873,000	0.9%
Use	68,842,000	394,648,000	14.9%
Business & Occupation	82,027,000	3,514,196,000	2.3%
Public Utility	9,944,000	422,474,000	2.3%
Hazardous Substance	947,000	199,031,000	0.5%
Other	(438,000)	342,896,000	-0.1%
Total	232,217,000	12,988,118,000	1.8%

Figure 1 depicts the relative proportions of debit and credit assessments. Projections from the years sampled show \$553 million in annual underreported tax and \$210 million in over reported tax.



Although this report focuses on state excise taxes, sales and use tax noncompliance estimates are also subject to local taxation. As seen in Figure 2 below, the Department estimated the local share of noncompliance at \$52.8 million; \$26.0 million of this represents use tax and the remaining \$26.8 million represents unreported sales tax.

**Figure 2. State and Local Sales and Use Tax Noncompliance
Dollars in Millions**



NONCOMPLIANCE BY INDUSTRY

In Table 3, each industry grouping represents selected North American Industry Classification System (NAICS) codes. Note that the industry groupings have changed from previous studies, and rates of noncompliance from previous studies by industry are not comparable to this study. This is due to a NAICS update in 2012.

Table 3 details Calendar Year 2014's estimated noncompliance by industry and provides each industry's voluntarily reported tax liability. According to the percentages, the professional, finance, and real estate industries group had the highest rate of noncompliance at 5.6 percent. This group also had the highest dollar amount of noncompliance at \$91.3 million.

Table 3. Estimated Noncompliance by Industry

Industry	Estimated Annual Noncompliance	Percentage of Annual Noncompliance	Voluntarily Reported Tax Liability	Noncompliance as a Percent of Total Liability
Construction	16,597,000	7.1%	1,607,022,000	1.0%
Manufacturing	(2,597,000)	-1.1%	968,002,000	-0.3%
Professional, Finance, Real Estate	91,359,000	39.3%	1,553,651,000	5.6%
Retail	46,568,000	20.1%	5,575,558,000	0.8%
Transportation, Utilities, Telecom, Internet, Broadcasting	42,152,000	18.2%	1,088,168,000	3.7%
Wholesaling	31,850,000	13.7%	1,166,654,000	2.7%
Personal, Health	3,564,000	1.5%	918,060,000	0.4%
Agriculture, Mining, Public Administration, Other	2,724,000	1.2%	111,002,000	2.4%
Total	232,217,000	100%	12,988,118,000	1.8%

Noncompliance not only includes firms that purposefully avoid paying their full tax liability, but also firms that may underpay or overpay their tax liability for a variety of reasons including lack of understanding regarding reporting requirements, accounting errors and differences of opinion. Therefore, Tables 4 and 5 provide estimated noncompliance by tax type and industry based on debit assessments only.

Table 4. Estimated Noncompliance by Industry and Tax Type Debit Assessments Only

Industry	Sales	Use	B&O	Public Utility	Hazardous Substance	Other	Total Noncompliance
Construction	16,770,000	14,973,000	5,752,000	37,000	2,000	27,000	37,561,000
Manufacturing	1,883,000	11,879,000	7,958,000	-	1,130,000	444,000	23,293,000
Professional, Finance, Real Estate	26,092,000	16,999,000	115,634,000	-	-	3,000	158,729,000
Retail	34,462,000	13,535,000	17,103,000	129,000	498,000	212,000	65,940,000
Transportation, Utilities, Telecom, Internet, Broadcasting	18,641,000	15,123,000	17,447,000	17,953,000	3,000	218,000	69,384,000
Wholesaling	6,063,000	5,796,000	41,866,000	-	4,000	310,000	54,040,000
Personal, Health	3,386,000	10,594,000	6,040,000	-	-	-	20,020,000
Agriculture, Mining, Public Administration, Other	3,491,000	7,320,000	2,135,000	64,000	-	2,000	13,012,000
All Industries	110,787,000	96,220,000	213,934,000	18,183,000	1,637,000	1,216,000	441,979,000

Sales tax noncompliance occurs most frequently for construction at 44.6 percent or \$16.8 million and retailing at 52.3 percent or \$34.5 million. Overall noncompliance occurs most frequently for the B&O tax, with \$213.9 million in unreported tax. The professional, finance, and real estate industries group had the highest B&O tax noncompliance dollars.

Table 5. Percent of Estimated Industry Noncompliance by Tax Type Debit Assessments Only

Industry	Sales	Use	B&O	Public Utility	Hazardous Substance	Other	Total Noncompliance
Construction	45%	40%	15%	0%	0%	0%	100%
Manufacturing	8%	51%	34%	0%	5%	2%	100%
Professional, Finance, Real Estate	16%	11%	73%	0%	0%	0%	100%
Retail	52%	21%	26%	0%	1%	0%	100%
Transportation, Utilities, Telecom, Internet, Broadcasting	27%	22%	25%	26%	0%	0%	100%
Wholesaling	11%	11%	77%	0%	0%	1%	100%
Personal, Health	17%	53%	30%	0%	0%	0%	100%
Agriculture, Mining, Public Administration, Other	27%	56%	16%	0%	0%	0%	100%
All Industries	25%	22%	48%	4%	0%	0%	100%

NONCOMPLIANCE BY SIZE OF FIRM

Table 6 shows noncompliance by size of firm. Table 6 includes estimated noncompliance, voluntarily reported tax liability, and the average noncompliance amount per firm by size category. Note a correction occurred in the underlying analysis of noncompliance by size of firm, and results should not be compared to historical reports prior to the 2016 report.

Interestingly, noncompliance as a percent of total tax liability fluctuates depending on gross income, and businesses with gross income of less than \$100,000 had the lowest rate of noncompliance.

When comparing the average noncompliance per firm, the dollar amount generally increases as the firm size increases.

Table 6. Estimated Noncompliance by Size of Firm

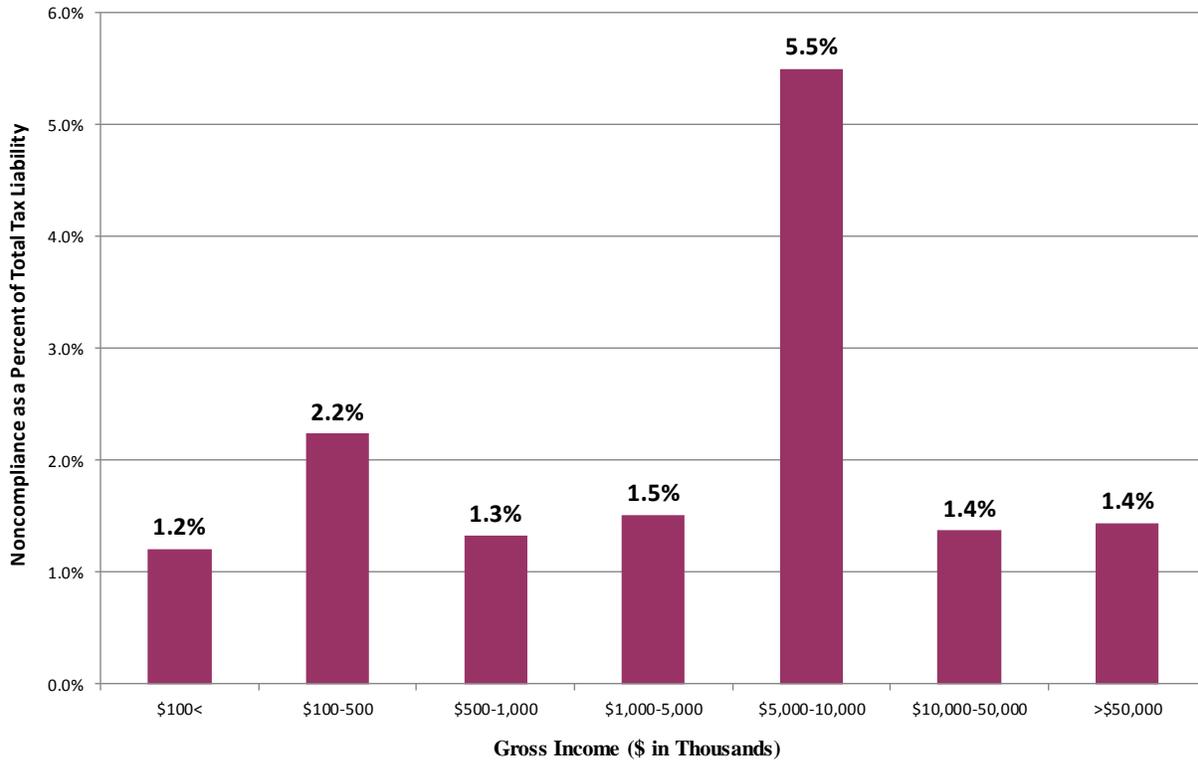
Gross Income (\$ in Thousands)	Estimated Noncompliance	Voluntarily Reported Tax	Noncompliance as a Percent of Total Tax Liability	Average Noncompliance Per Firm
\$100<	2,560,000	208,913,000	1.2%	400
\$100-500	15,277,000	667,974,000	2.2%	800
\$500-1,000	7,788,000	580,423,000	1.3%	1,900
\$1,000-5,000	27,640,000	1,797,606,000	1.5%	2,400
\$5,000-10,000	51,051,000	878,086,000	5.5%	6,700
\$10,000-50,000	34,325,000	2,459,496,000	1.4%	5,500
>\$50,000	93,576,000	6,395,619,000	1.4%	42,700
Total	232,217,000	12,988,118,000	1.8%	4,000

Table 7 and Figure 3 show noncompliance by size and tax type. Estimates are for debit assessments only. Firms with over \$50 million in gross income comprise the largest amount of debit assessments for sales tax, use tax, and the B&O tax.

Table 7. Estimated Noncompliance by Size of Firm and Tax Type Debit Assessments Only

Gross Income (\$ in Thousands)	Sales	Use	B & O	Public Utility	Hazardous Substance	Other	Total Noncompliance
\$100<	2,249,000	271,000	799,000	20,000	-	-	3,339,000
\$100-500	9,273,000	3,717,000	4,611,000	116,000	2,000	2,000	17,720,000
\$500-1,000	8,700,000	960,000	1,075,000	75,000	-	1,000	10,812,000
\$1,000-5,000	13,221,000	14,459,000	7,739,000	45,000	-	181,000	35,645,000
\$5,000-10,000	12,110,000	11,588,000	42,997,000	365,000	2,000	7,000	67,069,000
\$10,000-50,000	18,018,000	17,071,000	40,511,000	16,589,000	359,000	178,000	92,725,000
>\$50,000	47,216,000	48,154,000	116,203,000	972,000	1,275,000	848,000	214,669,000
Total	110,787,000	96,220,000	213,934,000	18,183,000	1,637,000	1,216,000	441,979,000

Figure 3. Noncompliance as a Percent of Total Tax Liability



NONCOMPLIANCE BY AGE OF FIRM

The Department has found that there is a correlation between a firm's age and its size. For the purposes of this study, the Department defined “newer firms” as firms that opened less than two years before the beginning of the sample audit tax reporting period. For example, if a firm was selected with an audit period start date of January 1, 2009, and an open date in July of 2007, then they would have been less than two years old at the start of their tax activity audit start date, and defined as a newer firm.

The Department found that new firms are generally small. While older firms may also be small, large firms usually have been established for a number of years. In this study, newer firms accounted for 26 percent of total noncompliance among registered taxpayers with older firms accounting for 74 percent.

Table 8. Estimated Noncompliance by Age of Firm

Age	Noncompliance	Total Voluntarily Reported Tax Liability	Noncompliance as a Percent of Total Tax Liability
Newer	61,358,000	1,068,409,000	5.4%
Older	170,859,000	11,919,708,000	1.4%
Total	232,217,000	12,988,118,000	1.8%

CONCLUSIONS

For this study, the Department estimated \$232.2 million in total net annual excise tax noncompliance for registered taxpayers, which equated to 1.8 percent of the total tax liability. This decreased in comparison to the 2016 study, at 2.5 percent.

As seen in Table 9, the noncompliance rates have been fairly consistent and range from a low of 1.8 percent to a high of 2.8 percent in the 1996 study.

Table 9. Historic Noncompliance Rates

Year of Study	Noncompliance Rate as a Percent of Total Liability
2018	1.8%
2016	2.5%
2010	2.1%
2008	2.5%
2006	1.8%
2005	2.2%
2003	2.5%
1996	2.8%

Business and occupation tax had the largest net dollar amount of noncompliance at \$82.0 million; however, this only represented 2.3 percent of the total tax liability. Use tax had the largest rate of noncompliance at 14.9 percent.

The professional, finance, real estate industries have the highest rate of noncompliance at 5.6 percent. This industry also had the largest dollar noncompliance at \$92.2 million.

Noncompliance as a percent of total tax liability fluctuated depending on gross income. The lowest rate of noncompliance occurred in businesses with gross income of less than \$100,000.

Newer firms in both the 2010, 2016, and 2018 studies underreport at a higher rate than the older firms. In the 2018 study, newer firms have a noncompliance rate of 5.4 percent, whereas older firms have a noncompliance rate of 1.4 percent.

For the local share of sales and use tax noncompliance, the Department estimates a total of \$52.8 million – \$26.0 million of this represents use tax and the remaining \$26.8 million represented unreported sales tax.