Tax Gap Plan mandated by Conn. Gen. Stat. § 12-7c(d)
Strategies for Addressing the State's Tax Gap

As required by Conn. Gen. Stat. § 12-7c, the Department of Revenue Services ("DRS") prepared and submitted to the Finance, Revenue and Bonding Committee of the Connecticut General Assembly a report wherein DRS estimated the state's tax gap ("Tax Gap Report"). Said Report, which was published on January 8, 2025, estimated the state's tax gap for the 2022 tax year. With regard thereto, Conn. Gen. Stat. § 12-7c further requires that DRS develops a plan for addressing the state's tax gap. More specifically, Conn. Gen. Stat. § 12-7c(d) requires DRS to "publish a plan that includes the department's measurable goals for closing the tax gap, specific strategies to achieve such goals and a timetable to measure progress towards closing the tax gap." In recognition of these requirements, DRS identified certain strategies and ideas for addressing the state's tax gap. As such, and as set forth more fully below, DRS identifies the steps it intends to take to implement such strategies and how it intends to measure the results thereof.

To that end, in the section of the Tax Gap Report entitled "Strategy to Promote Compliance and Discourage Tax Avoidance,"[1] DRS outlined certain strategies and ideas for addressing the state's tax gap. For purposes of this plan, DRS takes several of the strategies identified in the Tax Gap Report and identifies how it will implement such strategies and how it will measure the impact such strategies have on closing the tax gap. As set forth below, the strategies DRS intends to employ will be measured on a fiscal year basis and will commence with the fiscal year that starts on July 1, 2025.

<u>Summary of CT Gross and Net Tax Gap</u>

The [Tax Year 2022 Connecticut Tax Gap Report] estimated the overall gross tax gap for tax year 2022 to be $3.702 billion, with approximately $704 million expected to be collected through enforced and other late payments. This resulted in an estimated net tax gap of $2.998 billion for tax year 2022.

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[1] As set forth in the Tax Gap Report, DRS identified several strategies to encourage voluntary compliance and reduce tax avoidance. Included among these strategies were several aimed at tax policy, which DRS recognized would require legislative action. As several of these tax policy initiatives have proven successful in other states, DRS refers the Finance, Revenue, and Bonding Committee to these initiatives and encourages said Committee to consider such concepts during future legislative sessions.

	Non-filing	$ 240,000,000
+	Underpayment	$ 518,000,000
+	Underreporting	$ 2,944,000,000
=	Gross Tax Gap	$ 3,702,000,000
-	*Enforced & Late Payments*	$ 704,000,000
=	**Net Tax Gap**	$ 2,998,000,000

Specific Strategies

In the Tax Gap Report, DRS explained that the gap identified therein was comprised of three primary sources – underpayment, non-filers, and nonpayment of amounts owed. In order to address the tax gap, DRS must address each of these three components. The strategies identified below do just that.

Identification of non-filers: Formation of New Discovery Unit

As noted above, one of the three main components of the tax gap is non-filers. Stated simply, this component is comprised of persons and entities that are subject to and/or required to collect and remit taxes but do not. From DRS' perspective, this is one of the most significant components of the tax gap, and it is also the most difficult to address. That said, DRS has identified a strategy for identifying non-filers and bringing them into compliance. To this end, and as explained below, DRS will address this component of the tax gap through the formation of a new unit.

As part of its efforts to address the tax gap, DRS is in the process of forming a Discovery Unit. The unit will be staffed with current DRS employees and will be charged with identifying persons and entities that are working or otherwise conducting business in Connecticut, yet they are not reporting the tax consequences of these activities to DRS. Although DRS is precluded by state confidentiality statutes from disclosing the specific standards or data this new unit will use, said unit will have access to and utilize a variety of sources to identify such persons and entities. Moreover, the unit will be staffed with employees with experience in various disciplines, including those with backgrounds in accounting, collections, and data analytics. Combining both in-house and field activities, the Discovery Unit will be charged with identifying and registering persons and entities that have Connecticut tax obligations that are currently not being reported to DRS.

Consistent with the above, DRS has established a set of metrics for the Discovery Unit. As noted above, one such metric will be the number of persons and entities the Discovery Unit identifies and registers. Another metric will be the amount of taxes collected from these persons and entities. For the first fiscal year of operation, DRS' goal is to collect ten percent (10%) of this component of the tax gap or $7.3 million from the persons and entities identified by the Discovery Unit.

Identification of underreporting: Increase in Audit Coverage Rates

Another of the three main components of the tax gap is underreporting. As explained in the Tax Gap Report, underreporting results from returns filed by taxpayers that do not properly or fully reflect the actual facts and circumstances surrounding the taxpayers in a given year or period. For example, taxpayers may not report the total amount of income or gross receipts or may overstate expenses or deductions. Underreporting is not unique to Connecticut. Rather, it is an inherent weakness in a tax system that is based on voluntary compliance. That said, there are steps DRS can take to address underreporting of the taxes it administers on behalf of the State. The most effective way for DRS to address this component of the tax gap is to increase the number of taxpayers it audits. As such, and as explained more fully below, to address the underreporting component of the tax gap, DRS will increase its audit coverage rate.

In the Tax Gap Report, DRS identified its current audit coverage rates. The following is taken directly from said Report:

Table 5: Audit Coverage Rates

Tax Type	FY 2023	FY 2024
Sales Tax	0.87%	0.69%
Personal Income Tax	0.43%	0.39%
Corporation Business Tax	0.28%	0.24%
Pass-Through Entity Tax	0.25%	0.27%

DRS' goal is to increase the "FY 2024" coverages rates by ten percent (10%) over the next fiscal year. As noted above, DRS intends to accomplish this through the implementation of a targeted audit program. To that end, and by way of context, most audits conducted by DRS cover a multi-year period. These audits can be time consuming. Rather than continuing to solely conduct such traditional audits, DRS will begin to conduct audits that are more focused and cover shorter periods.[2] With regard to sales and use taxes, DRS will implement an audit program that focuses on a singular issue. Again, without disclosing standards DRS will employ or specific criteria that DRS will focus on in the conduct of such audits, these audits will focus on identified areas of abuse and underreporting.

Consistent with the above, the primary metric that will be utilized to determine if DRS' efforts in this area are successful is the audit rates themselves. To determine the effectiveness of this strategy, DRS will compare the "FY 2024" audit rates to the audit rates for the fiscal year ending June 30, 2026. Additionally, if DRS is successful in increasing these rates, the results of these audits will be another

[2] It must also be noted that DRS has already begun conducting more targeted audits. As set forth in the Tax Gap Report, cash businesses are a major source of noncompliance and underreporting. To address the issues presented by these types of businesses, which extend across numerous industries, DRS formed a Small Business Self-Employment Unit that is responsible for auditing these types of businesses. The continued growth and expansion of this Unit will also contribute to addressing the underreporting component of the tax gap.

way to measure the effectiveness of this strategy. If these audits do not yield significant dollars in assessments, this may suggest that the underreporting component of the tax gap may not be as significant as initially perceived. If, however, there are significant assessments from these targeted audits, DRS will not only reduce the underreporting component of the tax gap through the issuance and collection of such assessments but will have established a solid foundation on which to build on for expanding the scope and application of targeted audits.

Identification of Underpayments: Targeted collection actions and initiatives

The third of the three main components of the tax gap is nonpayment of known liabilities, also known as underpayments. As explained in the Tax Gap Report, this component is comprised of liabilities that are legally due and owing to the state that taxpayers who owe said liabilities have yet to make arrangements to pay. Responsibility for collection of these liabilities rests within the Collection/A&R Management Division within DRS. While DRS has many tools to collect these liabilities, it has identified a new strategy for addressing a segment of this component of the tax gap. To that end, and as explained below, DRS will implement a targeted collection initiative.

Under the law, DRS has the ability to compromise liabilities and enter into agreements with taxpayers.[3] The combination of these authorities will serve as the basis for DRS to administer a collection initiative. The initiative will be limited to certain taxpayers and certain liabilities. As a first step, DRS will segment its current accounts receivables and exclude those liabilities that are trust taxes.[4] DRS will then review the remaining accounts receivables to evaluate the compliance history of those taxpayers who owe said liabilities. Those taxpayers who are determined to have a satisfactory compliance history with DRS will be contacted by DRS and provided with a proposal to resolve said liability.

Consistent with the above, the goal of this initiative is to reduce the accounts receivable by ten percent (10%). As such, DRS expects to collect $77 million by June 30, 2026. In addition to, and perhaps as important as the collection of the taxes that are owed to the state, the initiative is also designed to bring those taxpayers who owe liabilities into compliance moving forward. Thus, not only will DRS reduce the current tax gap, but this strategy will also help ensure that this component of the tax gap does not continue to grow.

Conclusion

DRS is of the position that this plan satisfies it obligations under Conn. Gen. Stat. § 12-7d(c). Moreover, and consistent with Conn. Gen. Stat. § 12-7d(c), DRS will post this plan to its website on or before July 1, 2025.

[3] See Conn. Gen. Stat. §§ 12-2d and 12-2e.

[4] Trust taxes include those taxes that are collected or withheld by one person from or on behalf of another and the person who collects or withholds said tax is required to remit said tax to the state. Examples of trust taxes include sales and use taxes and withholding taxes.