



Montana Department of Revenue

Pass-Through Entities Compliance Program

Report to the Revenue and Transportation Interim Committee

April 30, 2010

Purpose of the Report

- Provide background information on pass-through entities
- Update on the compliance initiatives findings and results
- Summarize the department's experiences

Background

➤ Types of Pass-Through Entities:

- Partnerships
- S. corporations
- Trusts/Fiduciaries

➤ Tax Benefits:

- Limited owner liability
- Income taxed once

➤ Model Legislation:

- Montana was one of the first states to develop comprehensive laws for pass-through entities
- Montana's law became the model law that other states have adopted

Background

➤ Pass-through entities

➤ Pay no tax

- Except when entity makes an election to pay tax for non-resident partners
- Owners/Shareholders pay tax; can be S. corporation, C. corporation, partnership, trust or individual

➤ C. corporations

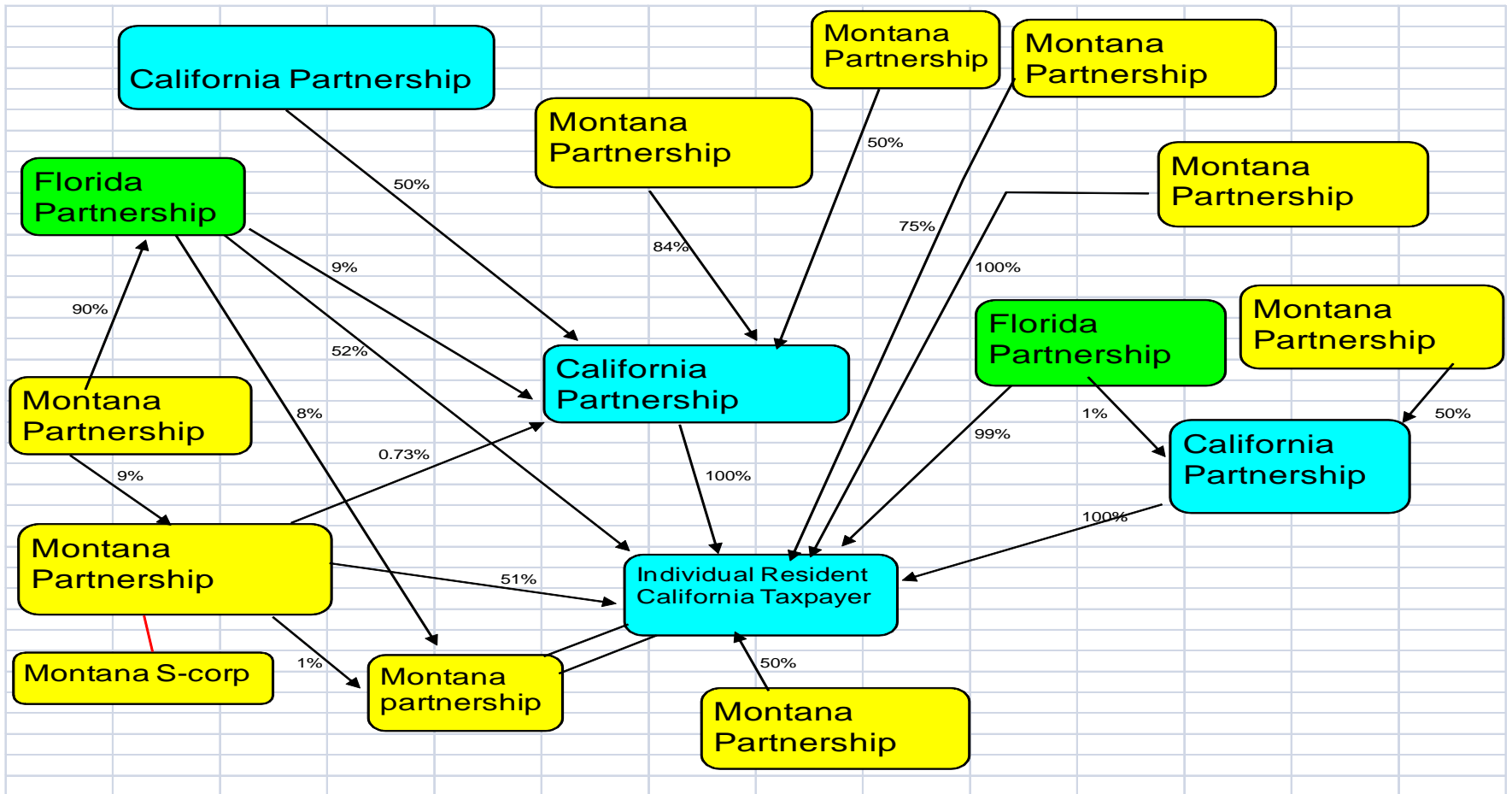
➤ Corporation pays tax

➤ Shareholders pay tax on dividends received

➤ Individuals

➤ Pay tax

Example of a Pass-Through Entity Operating in Montana



Montana Filing Numbers and Audit Coverage

- Number of Montana filers:
 - S. corporations – 25,000
 - Montana S. corps – 21,250
 - Non-Resident S. corps – 3,750
 - Partnerships – 19,000
 - Montana Partnerships – 14,500
 - Non-Resident Partnerships – 4,500
 - C. corporations – 17,000
 - Montana C. corps – 9,700
 - Non-Resident C. corps – 7,300
 - Trusts/Fiduciaries – 11,000

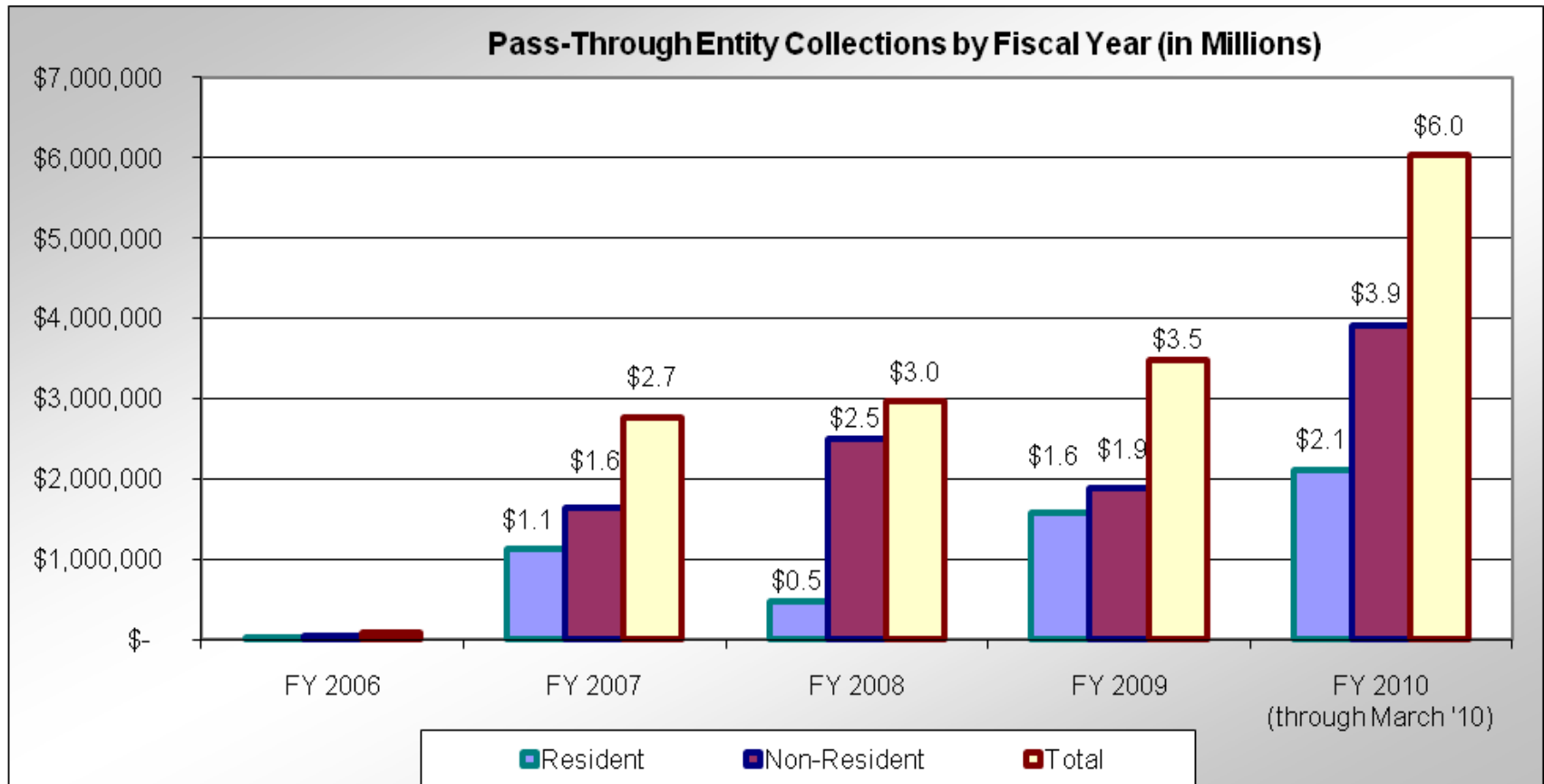
- Department audit coverage rates for pass-through entities (percent of returns audited):
 - FY2007 - 0.54%
 - FY2008 - 0.43%
 - FY2009 - 0.50%
 - FY2010 - 0.44%

IRS Filing Numbers and Audit Coverage

- IRS pass-through entity growth of tax returns filed from 2000 to 2009:
 - 59% increase in S. corporations
 - 70% increase in Partnerships
 - (12%) decrease in small C. corporations (Assets under \$10 million)
 - 16% increase in large C. corporations (Assets \$10 million and higher)
- IRS audit coverage rates (percent of returns audited):
 - 0.40% of S. corporations
 - 0.38% of Partnerships
 - 0.85% of Small C. corporations (Assets under \$10 million)
 - 14.55% of Large C. corporations (Assets \$10 million and higher)

Audit Collections

As of March 31, 2010



Summary

➤ Compliance Issues:

- Audits are very complicated
- Audits require an audit of the entity and owners/shareholders
- Difficult to track ownership and flow of income

➤ GAO Observations:

- “According to IRS data, about 68 percent of S corporation returns filed for tax years 2003 and 2004 (the years data were available) misreported at least one item. About 80 percent of the time, misreporting provided a tax advantage to the corporation and/or shareholder. The most frequent errors involved deducting ineligible expenses, which could decrease S corporation shareholder tax liabilities. Even though a majority of S. corporations used paid preparers, 71% of those that did were noncompliant.” *GAO Report to the Committee on Finance, U.S. Senate; December 2009; Tax Gap Actions Needed to Address Noncompliance with S Corporation Tax Rules; Cover Page.*

- The GAO report can be found at www.gao.gov/new.items/d10195.pdf