Approved Thomas F. Walker
Date

MINUTES OF THE HOUSE COMMITTEE ON GOVERNMENTAL ORGANIZATION.

The meeting was called to order by REPRESENTATIVE THOMAS F. WALKER at
Chairperson

9:00 a.m./~~p.m.~~ on THURSDAY, JANUARY 26, 1989 in room 522-S of the Capitol.

All members were present except:

Committee staff present:

Avis Swartzman - Revisor
Carolyn Rampey - Legislative Research
Jackie Breymeyer - Committee Secretary

Conferees appearing before the committee:

Duane Johnson - State Librarian
Julian Efird - Legislative Research

Chairman Walker called the meeting to order. The minutes will stand approved at the end of the meeting if there are no corrections or additions. Chairman Walker stated there was proposed legislation to be introduced concerning plumbers, electricians, and contractors. He gave a short history of this proposed legislation and then entertained a motion.

Representative Gjerstad moved the proposed legislation be introduced. Representative Turnbaugh gave a second to the motion. The motion carried.

Duane Johnson, State Librarian, was present to clarify several points with regard to HB 2017. He went through the document disposal process and how the state documents depository network operates. These libraries that form the system are geographically located across the state with a representative collection of documentation acquired from state agencies. Adults and students can greatly benefit from these thirty libraries. Mr. Johnson spoke of the difficulty in obtaining session laws. This is the reason for not taking the initiative to notify school districts. If the session laws are not readily available, the districts' expectations could not be fulfilled. Mr. Johnson said he would provide a list to the committee on libraries of the state depository system.

The Chairman thanked Mr. Johnson for appearing and called on Julian Efird, Legislative Research, to begin his presentation on the Department of Revenue.

Mr. Efird had four attachments for the committee's information. The first attachment was a memorandum entitled "Sunset Review for the Department of Revenue and Office of Secretary of Revenue" (Attachment 1) The other three attachments were entitled, "Improving Collections on Closed Sales Tax Accounts" (Attachment 2), "Problems Implementing the Kansas Business Integrated Tax System" (Attachment 3), and "Department of Revenue Division of Taxation" (Attachment 4).

The Sunset Law provides for the abolition of the Office of Secretary and the Department of REvenue on July 1, 1989. If no bill is passed this session to continue the Department and Secretary, a one-year phaseout period would begin. Sunset Law requires that hearings be held on this proposed abolition.

Mr. Efird gave a capsule history of the highlights of the Sunset review of the Department and Secretary. The task that falls to the committee this year will entail the Division of Collections, Computer Assisted Mass Appraisal System (CAMA) and the Vehicle Information Processing System (VIPS). Also included will be the Department's delinquent tax collection process and whether recent changes are sufficient to address its tax collection problems.

The Governor's 1990 Budget include funding for a new Automated Collections System (ACS). This would be used by the Division of Collections. Multiyear costs for hardware and software are estimated to be $1.5 million. Also included in the 1990 Budget recommendations is funding for the continued development of BTIMS. Secretary Rolfs will appear before the Committee on the 1st of February. After Mr. Efird answered several questions, the Chairman thanked him for appearing and adjourned the meeting.

# GUEST LIST

COMMITTEE: GOVERNMENTAL ORGANIZATION DATE: JANUARY 26, 1989

| NAME | ADDRESS | COMPANY/ORGANIZATION |
|---|---|---|
| Duane Johnson | Topeka | State Library |
| Susan Duffy | Revenue DSOB | |
| Jacque Baker | Topeka | NECA. |
| Tom Slattery | Topeka | AGC of Ks. |
| Sherm Holliday | " | Budget |
| Neil Hermanson | Revenue DSOB | |
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# MEMORANDUM

January 25, 1989

TO: House Committee on Governmental Organization

FROM: Kansas Legislative Research Department

RE: Sunset Review for the Department of Revenue and Office of Secretary of Revenue

The Kansas Sunset Law provides for the abolition of the Office of Secretary and the Department of Revenue on July 1, 1989, unless continued in existence by an act of the Legislature. If no bill passes during the 1989 Session to continue these entities, both would enter a statutorily authorized one-year phaseout period before ceasing to exist on June 30, 1990. The Sunset Law requires that public hearings be held on the proposed abolition, continuation, or reestablishment of agencies and offices scheduled for sunset. Traditionally, the House Committee on Governmental Organization has conducted most of those hearings since 1979.

1983 Sunset Review

The Department of Revenue was scheduled for its first sunset review when the Sunset Law was reestablished by the 1981 Legislature. The Department and Office of Secretary were scheduled for abolition on July 1, 1983. The first sunset review took place during the 1983 Legislature.

Three performance audits were available to guide legislators during the 1983 sunset review of the Department of Revenue. These audits focused on certain aspects of the agency's operations: taxation, alcoholic beverage control, and dealer licensing and titles. A fourth audit of the driver control regulatory program was received too late in the 1983 Session to be considered and was recommended for interim study.

Several recommendations which were made during the 1983 sunset review either were enacted through legislation or were implemented by the agency with financing approved by the Legislature: eliminated in S.B. 309 licensing of vehicle salesmen (licensure was reestablished in S.B. 618 by the 1984 Legislature); endorsed the development of the Vehicle Information Processing System (VIPS) with funding provided in H.B. 2086; established in 1985 S.B. 340 (first introduced as 1983 H.B. 2562) three classified attorney positions; and recommended three additional positions be added to the Internal Audit unit with funding provided in H.B. 2086.

The 1983 Legislature enacted S.B. 43 which reestablished the Department of Revenue until July 1, 1987, at which time the agency was subject to another sunset review. The four year extension, rather than an eight year maximum extension allowed by the Sunset Law, was recommended because of several legislative concerns about the collection of taxes and monies owed to the state. Many of the proposed solutions to problems identified by the performance audit report concerning the tax collection system were supposed to be solved with implementation of Kansas Business Integrated Tax System (K-BITS). In a March

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Attach #1
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1983 status report about K-BITS, the agency indicated that the sales tax modules and transient guest tax modules would be completed in FY 1984, while the modules for other taxes would be completed in FY 1985.

It was requested that the Department of Revenue make a report to the 1984 Legislature concerning changes and improvements in departmental tax collection procedures as the result of the implementing K-BITS. The Department's 1984 report to the Legislature about K-BITS indicated that implementation had been delayed. Another report to the 1985 Legislature was requested. The 1985 report from the Department of Revenue indicated that K-BITS had been further delayed.

In 1985, an audit concerning taxes owed to the state was requested. The resulting audit, "Improving Collections on Closed Sales Tax Accounts," found that the Department of Revenue's procedures were generally ineffective for collecting outstanding accounts from retailers who had gone out of business.

In 1986, an audit was requested concerning the Department of Revenue's K-BITS project. The resulting audit, "Problems Implementing the Kansas Business Integrated Tax System," recommended that the Department continue to implement the transient guest tax but halt work on the rest of K-BITS and to reassess its business tax processing objectives and the ability of K-BITS to meet those objectives.

1987 Sunset Review

Two audit reports were available for review during the 1987 Session, one focusing on taxes owed to the state and one on K-BITS. The House Committee on Governmental Organization concluded that there were ongoing and unresolved issues and concerns relating to data processing and the collection of taxes. The 1982 and 1986 performance audits had revealed a number of problem areas which the agency indicated would be remedied when a new computer program, K-BITS, was brought on-line. The 1987 audit raised questions about whether K-BITS could meet the Department's business tax processing objectives.

The House Committee felt that additional legislative oversight and review was necessary in light of several developments, including the audit recommendations relative to K-BITS, a proposed new departmental reorganization, and implementation of new computer systems -- the Vehicle Information Processing System (VIPS) and the Computer Assisted Mass Appraisal (CAMA) project for statewide reappraisal. To facilitate such review, a two-year extension of the Department of Revenue was recommended, with the next sunset scheduled for July 1, 1989. The House Committee was concerned primarily with several areas, including a proposed new Division of Collections, the handling of business taxes, and the agency's failure to implement K-BITS. The 1987 Legislature enacted H.B. 2060 which extended the Department of Revenue for two years.

The House Committee in 1987 adopted several recommendations which suggested what should be examined during the 1989 sunset review:

1. that the Division of Alcoholic Beverage Control and the Division of Property Valuation be subjects of the 1989 sunset review;

2. that the Division of Taxation be thoroughly reviewed during the sunset audit of 1989; and

3. that the 1989 sunset review include a study of the proposed Division of Collections.

1989 Sunset Review

The Department stopped all work on K-BITS in June 1987 and in its FY 1989 budget submitted to the 1988 Legislature requested funding to undertake the Business Tax Information Management System (BTIMS), a computer project addressing only sales tax rather than all business taxes which K-BITS had addressed. The Governor recommended BTIMS funding and the 1988 Legislature concurred. The Secretary of Revenue under statutory authority reorganized the Department in Fall 1987 and established a Division of Collections. The Governor's recommendations include funding for the new division in the FY 1989 budget and the Legislature concurred with funding a Division of Collections.

In 1988, two audits were requested, one dealing with Department of Revenue computer operations and another with collection of taxes. The first audit reviews two of the Department's major computer applications, the Computer Assisted Mass Appraisal System (CAMA) and the Vehicle Information Processing System (VIPS). The second audit reviews the Department's delinquent tax collection process and whether recent changes within the agency would be sufficient to address its tax collection problems.

The Governor's budget recommendations for FY 1990 include funding for a new Automated Collections System (ACS) for the Division of Collections to use in collecting delinquent taxes owed to the state. Multiyear costs are estimated to be $1.5 million for the hardware and software. Also included in the Governor's recommendations for FY 1990 is funding to continue development of BTIMS, with implementation scheduled for the end of FY 1990.

89-28/je

# PERFORMANCE AUDIT REPORT

## Improving Collections On Closed Sales Tax Accounts

## OBTAINING AUDIT INFORMATION

This audit was conducted by Mary Beth Green, Senior Auditor, and Jim Davis and Cindy Lash, Auditors, of the Division's staff. If you need any additional information about the audit's findings, please contact Ms. Green at the Division's offices.

G. O. Comm.
1/26/89
Att. 2

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# IMPROVING COLLECTIONS ON CLOSED SALES TAX ACCOUNTS

## Summary of Legislative Post Audit's Findings

Sales taxes are paid by consumers but collected by retailers and remitted periodically to the Department of Revenue. In some cases, retailers go out of business before remitting all the taxes they have collected. This audit was conducted to address legislative concerns about the Department of Revenue's procedures for collecting delinquent sales taxes from such retailers.

**What is the sales tax liability of retailers who have gone out of business before remitting the sales tax receipts they owe?** As of September 30, 1985, the Department of Revenue's accounts receivable records indicated that retailers who have gone out of business before remitting all sales tax receipts may owe the State as much as $11.5 million. Also, these retailers owe up to $1.1 million to the counties and another $1.1 million to the cities. Automobile- and food-related businesses account for more than half of the outstanding liability.

**What efforts are made to recover or minimize these outstanding sales tax liabilities, and how successful have those efforts been?** The Kansas Retailers' Sales Tax Act provides several remedies for collecting delinquent sales taxes, but none apply specifically to retailers who have gone out of business. These remedies include penalty and interest charges, bonding, tax warrants, revocations of registration certificates, and injunctions. State law also provides for the imposition of liability on purchasers of businesses with delinquent sales taxes, and for fines and jail terms for delinquent retailers.

Once retailers have gone out of business, the State's collection procedures are generally ineffective. In a sample of 50 delinquent, closed businesses, the auditors found that the Department of Revenue collected only about $49,000 of the $545,000 owed to the State, or about nine percent. Most of the amount collected--$43,450--was recovered from bonds. However, few retailers had bonds when they closed, and the available bonds were not even sufficient to cover the outstanding taxes. In addition, 38 of the closed businesses sampled had some history of payment problems while they were operating. In those cases, the Department was often lenient with the retailers while they were still in business.

**Can the State improve its ability to collect outstanding sales tax receipts from retailers who are going or have gone out of business?** The Department of Revenue should attempt to maximize collections before businesses close. If collections cannot be made on delinquent accounts, the Department should attempt to have businesses closed before further obligations are incurred. The audit recommends that the Department of Revenue develop and follow standard procedures for more aggressive and uniform enforcement of the Retailers' Sales Tax Act. Changes in State law and administrative procedures could also improve collections.

# IMPROVING COLLECTIONS ON CLOSED SALES TAX ACCOUNTS

The Kansas Retailers' Sales Tax Act requires all businesses selling tangible personal property for final use or consumption to register with the Department of Revenue and collect sales tax. Sales tax is imposed on and paid by consumers, but retailers are responsible for collecting the tax and remitting it to the Department. Legislative concerns have been raised about the Department's procedures for collecting outstanding sales tax receipts from retailers who have gone out of business before remitting the taxes they collected to the Department of Revenue. To address these concerns, the Legislative Post Audit Committee directed the Legislative Division of Post Audit to conduct a performance audit in this area. The audit addresses three questions:

1. **What is the sales tax liability of retailers who have gone out of business before remitting the sales tax receipts they owe?**

2. **What efforts are made to recover or minimize these outstanding sales tax liabilities, and how successful have those efforts been?**

3. **Can the State improve its ability to collect outstanding sales tax receipts from retailers who are going or have gone out of business?**

To answer these questions, the auditors reviewed State laws and regulations and interviewed Department of Revenue officials. They also reviewed information provided by the Department concerning the number and type of retailers that discontinued operations without remitting all sales tax collected. They examined a sample of case files for closed sales tax accounts. They also contacted other states to identify ways to improve the State's sales tax collection procedures.

In general, the auditors found that retailers who have gone out of business without remitting all sales tax receipts may owe the State up to $11.5 million. Once these retailers have discontinued operations, the Department of Revenue generally does not collect the outstanding amounts. In some cases these liabilities cannot be avoided. But in many instances, the Department could enhance the collections made before these retailers go out of business through more stringent enforcement of current laws and regulations. Changes in administrative practices and State law could also help maximize the collections made on delinquent sales tax accounts. These findings are discussed following a brief overview of the sales tax program.

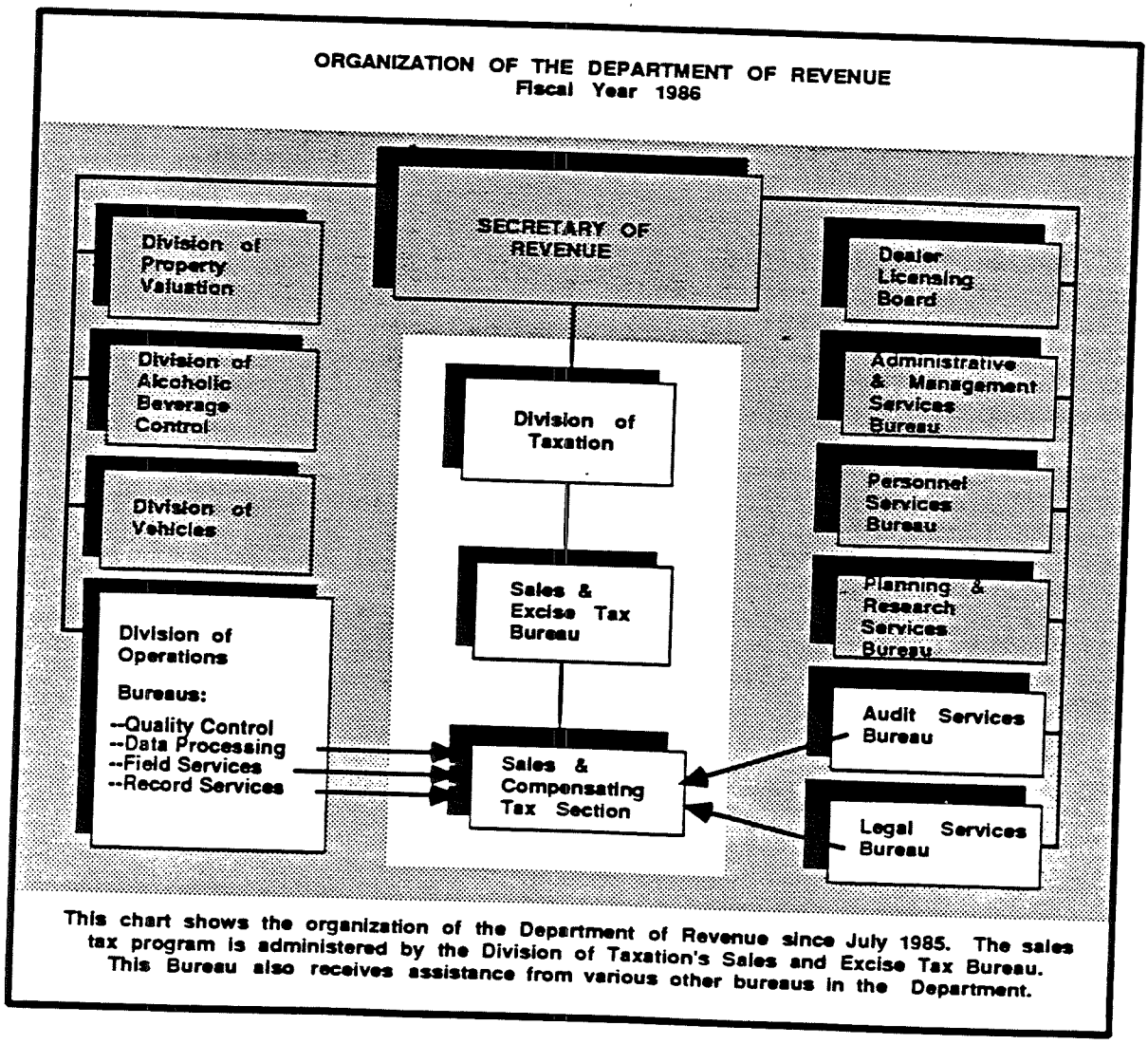
## An Overview of the Sales Tax Collection Program in Kansas

Sales taxes were originally enacted in 1937 by the Kansas Retailers' Sales Tax Act, K.S.A. 79-3601 et seq. Current State law levies a sales tax of three percent on retail sales. Counties and cities are allowed to impose additional sales taxes of up to one percent on retail sales. Effective January 1, 1986, 58 counties and 106 cities in Kansas had local sales taxes.

## Within the Department of Revenue, the Division of Taxation's Sales and Excise Tax Bureau Administers the Sales Tax Program

By law, counties and cities are prohibited from administering their portions of sales taxes. As a result, the Department of Revenue's Sales and Excise Tax Bureau administers all State, county, and city sales taxes. Sales tax receipts remitted to the State are deposited in the State treasury. Periodically, the State Treasurer's Office transfers money to the localities. In fiscal year 1985, retailers remitted approximately $480 million in State sales tax, and an additional $133 million in local sales taxes.

The Sales and Excise Tax Bureau has the primary responsibility for administering the sales tax program, but several other bureaus within the Department provide assistance. The Records Services Bureau handles return processing and money. The Audit Services Bureau reviews taxpayer records to ensure that the proper amounts of tax have been paid. The Field Services Bureau acts as the agency's collection arm. The Legal Services Bureau handles litigation and court actions. Finally, the Data Processing Services Bureau maintains computerized records of taxpayer account information. The organization chart below shows the bureaus involved in administering the sales tax program.




This chart shows the organization of the Department of Revenue since July 1985. The sales tax program is administered by the Division of Taxation's Sales and Excise Tax Bureau. This Bureau also receives assistance from various other bureaus in the Department.

2-B

In fiscal year 1985, the Sales and Excise Tax Bureau spent about $1.7 million on operations. Of that amount, $1.2 million, or 70.6 percent, was spent on salaries and wages. Budgeted expenditures for fiscal year 1986 are more than $1.9 million. The Bureau has 66 authorized positions, 23 of which are assigned to the sales and compensating tax section. The Bureau's sales tax activities include registering retailers, processing returns, maintaining payment records, and closing out accounts of taxpayers no longer in operation. In addition to sales tax, the Bureau is responsible for compensating, excise, motor fuel, and bingo taxes.

## What Is the Sales Tax Liability of Retailers Who Have Gone Out of Business Before Remitting the Sales Tax Receipts They Owe?

To answer this question, the auditors reviewed sales tax information provided by the Department of Revenue. Because retailers who have gone out of business often fail to file the required returns, the Department's figures include many estimated account balances. When a business does not file a sales tax return, the Department estimates the amount of tax owed, together with penalties and interest, and bills the taxpayer for that amount. This process is called a jeopardy assessment. Thus, the information presented here includes figures provided by jeopardy assessments. The information does not include all penalty and interest charges for businesses that filed returns without remitting taxes. In those cases, the Department knows the exact amount of tax owed by the retailer.

## Retailers Who Have Gone Out of Business Without Remitting Sales Tax Receipts May Owe the State Up to $11.5 Million

As of September 30, 1985, the Department's accounts receivable records indicated retailers who have gone out of business without remitting all sales tax receipts may owe the State up to $11.5 million. In addition, these retailers owe up to $1.1 million to the counties and another $1.1 million to the cities. Although $11.5 million is a significant amount, this figure represents less than three percent of the State's annual sales tax receipts.

## Retailers Classified as Automobile- and Food-Related Businesses Account for More Than Half of the Outstanding Liability

The Department of Revenue classifies retailers into 11 major groups for registration purposes. As shown in the table at the top of the next page, two of these major groups--the automotive group and the food group--account for 52.5 percent of the $11.5 million outstanding. However, these business classifications are not entirely accurate because they are not updated. Retailers who obtain a sales tax registration may change their line of business without contacting the Department. As a result, when a retailer goes out of business, the classification may not always reflect its final line of operations.

Each major classification contains numerous subgroups. For example, the automotive group includes auto, aircraft, and bicycle dealers, service stations, and garage/repair shops. The food group includes grocery stores, restaurants, bakeries, and vegetable markets. A detailed listing of the subgroups for all classifications, along with the number of accounts and amounts outstanding in each subgroup, can be found in Appendix A.

OUTSTANDING STATE SALES TAX FOR CLOSED ACCOUNTS
By Business Classification
As of September 30, 1985

| Business Classification | Number of Accounts | Average Account Balance | Balance Due | Percent of Total |
|---|---|---|---|---|
| Apparel | 293 | $ 651 | $ 190,864 | 1.7% |
| Automotive | 1,682 | 1,317 | 2,214,510 | 19.3 |
| Food | 3,288 | 1,161 | 3,816,847 | 33.2 |
| Furniture | 863 | 1,660 | 1,432,467 | 12.5 |
| General Merchandise | 858 | 512 | 439,359 | 3.8 |
| Lumber & Building | 650 | 1,694 | 1,101,087 | 9.6 |
| Professional & Personal Services | 1,064 | 776 | 826,192 | 7.2 |
| Public Utilities | 8 | 1,512 | 12,099 | .1 |
| Farm & Garden Produce | 84 | 389 | 32,669 | .3 |
| Manufacturing & Trading | 476 | 1,559 | 741,890 | 6.4 |
| Unclassfied | 783 | 874 | 684,242 | 5.9 |
| Totals | 10,049 | $1,144 | $11,492,226 | 100.0% |

## Many Closed Sales Tax Accounts Have Insignificant Balances

The Department of Revenue currently maintains computerized records for more than 10,000 closed sales tax accounts. Many of these accounts have small balances such as $1.02, $7.16, and $20.06. According to Department officials, many of these small balances are the residual amounts due after the retailers make final payments. The auditors did not count the total number of accounts with insignificant balances, but of a total of about 300 closed grocery store accounts, 63 accounts had balances of $50 or less. The Department's current policy for writing off accounts receivable, including closed sales tax accounts, is to write off any account after seven years have passed without any transactions.

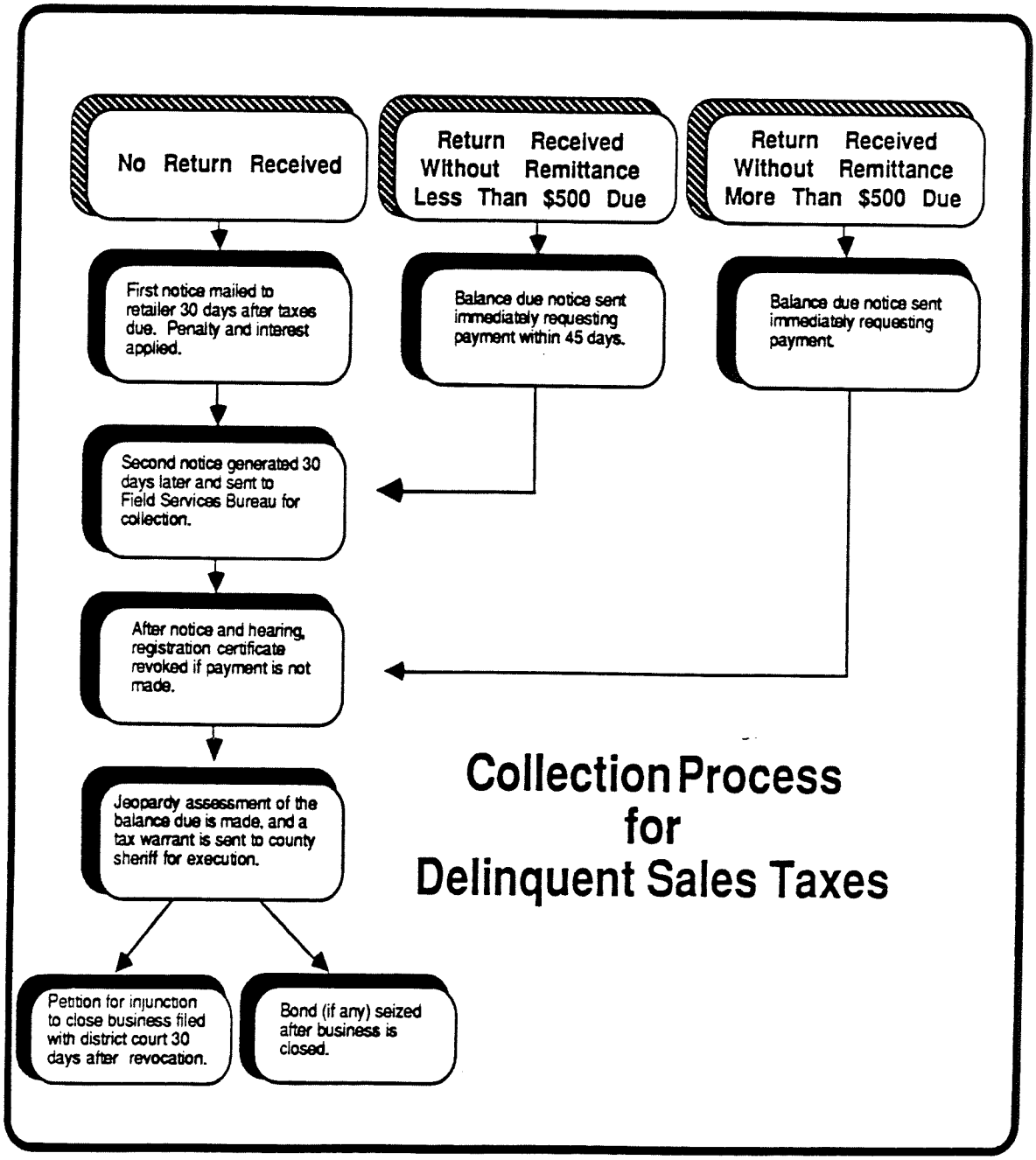
## What Efforts Are Made to Recover or Minimize These Outstanding Sales Tax Liabilities, and How Successful Have Those Efforts Been?

To answer this question, the auditors reviewed State laws and regulations, as well as the Department of Revenue's procedures for collecting sales taxes. A sample of closed sales tax accounts was examined to determine what efforts the Department made to recover the outstanding amounts. The auditors evaluated the effectiveness of those collection procedures after firms had gone out of business.

In general, they found that State law provides several remedies for collecting outstanding sales taxes, but that it has no special provisions for collecting delinquent sales taxes from closed businesses. Once retailers go out of business, it appears that the State's collection procedures are generally ineffective. However, the auditors determined that many businesses that close before remitting all taxes have historically been problem accounts. In such cases, the Department is often lenient with the businesses before they discontinue operations.

## The Retailers' Sales Tax Act Provides a Number of Remedies For Collecting Outstanding Sales Taxes

Retailers are required to remit sales tax receipts to the Department semi-monthly, monthly, quarterly, or annually. Individual remittance cycles depend on the retailer's annual tax collections. When a retailer does not file a sales tax return by the due date, the Department uses its standard procedures to collect the outstanding amount. These procedures include mail notices, personal contacts, penalties and interest charges, hearings, revocations of sales tax registrations, tax warrants, bond seizures, and court proceedings. The main procedures used by the Department to collect delinquent amounts are shown in the figure below.



As the figure shows, the Department uses numerous administrative procedures when attempting to collect from delinquent retailers. After this process is exhausted, it must rely on the district courts for additional actions. The State's major remedies for collecting outstanding amounts include:

**Penalties and interest charges.** Retailers who fail to remit taxes on time may be charged interest on the balance due, at the rate of 18 percent annually. Penalties can range from 10 percent to 50 percent of the amount due.

**Bonding.** All corporations applying for a sales tax certificate of registration must file a cash, escrow, or surety bond. The bond amount is equal to three months' average tax liability. Under certain circumstances, the bond requirement for corporations may be waived. The Department may also require bonds from any type of business--sole proprietorship, partnership, or corporation--with a poor payment record.

**Revocation of registration certificates.** After reasonable notice and a hearing, the Director of Taxation may revoke an entity's registration certificate. It is unlawful for any person to engage in the business of selling tangible personal property at retail without a valid registration certificate.

**Tax warrants.** After determining the amount due from a retailer, the Department can issue a tax warrant. Tax warrants are legal notices authorizing officials to seize and sell real and personal property of retailers to satisfy delinquencies. Warrants are generally sent to county sheriffs for execution. Warrants are filed with the clerk of the district court and become judgments against retailers and liens upon real property.

**Injunction proceedings.** For any retailer making sales without a valid registration certificate, the Department may file a petition for an injunction prohibiting the business from making retail sales. Injunction petitions are filed with the district courts.

**Imposing successor liability.** According to K.S.A. 79-3612, the purchaser of a business shall be personally liable for the payment of any unpaid sales taxes of the seller, up to the value of the property received.

**Jail terms and fines:** Upon conviction, retailers may be fined $100 to $1,000 or may be imprisoned in the county jail for one month to six months for violating the Retailers' Sales Tax Act.

**Some of the actions the Department may take when collecting delinquent sales taxes are punitive, but they will not directly produce monetary results.** For example, assessing penalties and interest will not necessarily result in the retailer remitting the taxes due, particularly if the retailer has used those sales tax receipts for other purposes. After retailers have gone out of business, many of these remedies for collecting delinquent sales taxes are inherently ineffective. For example, revocation of a sales tax registration certificate is meaningless once the retailer has gone out of business. Likewise, there is no point in seeking an injunction to have a business closed if operations have already ceased.

Theoretically, the methods that should be most effective when collecting from closed businesses include seizing bonds, issuing tax warrants, holding purchasers responsible for liabilities, and imposing jail sentences or fines. After businesses close, the Department generally seizes available bonds, issues tax warrants for the amount due, and files claims in bankruptcy courts.



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The auditors found that the procedures involving bonds and tax warrants generally are ineffective, as discussed in the section below. Department officials also indicated that they have not historically held purchasers of businesses responsible for the sales tax liabilities of the sellers, and recent attempts to do so have not been successful. Further, the Department does not generally initiate the legal actions that could result in jail terms or fines.

## The Department's Collection Procedures Are Generally Ineffective After Retailers Have Gone Out of Business

To determine what actions the Department actually takes to recover outstanding amounts from closed businesses, the auditors examined 50 accounts of retailers who went out of business before remitting all sales taxes. The 50 accounts reviewed included 25 automobile dealers and 25 grocery stores that owed the State at least $1,000 at the time they closed. Automobile dealers and grocery stores were selected for review because those subgroups belong to the two business classifications responsible for more than half the outstanding liability for closed sales tax accounts. In total, the 50 accounts owed the State more than $545,000 and owed cities and counties approximately $103,000.

The auditors found that the Department has collected delinquent sales taxes from only 12 of the 50 closed businesses sampled. It has collected approximately $49,000 of the $545,000 owed to the State by the 50 accounts, or about nine percent. The Department generally collected from businesses with bonds, but few businesses had them. For those that did, the bond amount covered only about one-fifth of the tax liability. The Department generally does not collect on tax warrants it files against closed businesses. These areas are discussed in more detail below.

**The Department usually collected from businesses with bonds, but few businesses had them.** According to the Department's administrative regulations, bonding requirements are only mandatory for corporations. Any bond requirement can be waived, at the retailer's request, after the firm establishes a satisfactory payment record for 12 consecutive months. The Department's bonding policies are discussued in more detail in the box on page eight.

Only 11 of the 50 cases reviewed had bonds posted at the time the business closed, and the Department collected the bonded amount in all 11 cases. The bonded businesses included five corporations, five proprietorships, and one partnership.

**Bond amounts were not sufficient to cover the taxes owed.** For the 11 cases with bonds, the accounts had total outstanding balances of $204,159, and the total amount recovered from bonds was only $43,450. Thus, the bonds represented only 21.3 percent of the total amount due, ranging from 1.2 percent to 44.6 percent. Individually, the amounts due ranged from $2,900 to more than $133,000. Bond amounts ranged from $50 to $35,000.

**The Department waited an average of seven months after businesses closed to seize available bonds.** For the 11 bonds in the auditors' sample, an average of more than seven months elapsed between the time the business closed and the actual date of the bond seizure. Department officials explained that such time lapses occur because of the time required to perform the internal, final audit of the account and arrive at the final balance due. For surety bonds, the Department does not request payment from the surety company until six weeks after the final audit is performed. Although this time lapse does not affect the amount collected on the bonds, it delays the State's ability to use these funds.



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## SALES TAX BONDING REQUIREMENTS

The Director of Taxation has statutory authority to require a bond from any retail seller. Such bonds help protect the State against the loss of tax revenues when businesses fail to remit sales tax receipts. According to the Department of Revenue's administrative regulations, this requirement is mandatory only for corporations, because corporate officials are not personally liable for unremitted sales tax.

To qualify for a sales tax registration certificate, a corporation must post bond in an amount equal to three months' average tax liability. Any bond requirement may be waived if a corporation provides a certified financial statement showing net worth in excess of one year's liability, or establishes a satisfactory payment record for 12 consecutive months. (The Department has proposed some changes to these regulations. The new rules would require all corporations to post bond in an amount equal to six months' average tax liability, or $1,000, whichever is greater. The proposed changes would not allow for any exemptions to bonding requirements. If adopted, these changes would become effective May 1, 1986.)

Businesses can obtain three types of bonds to satisfy Department regulations. A **surety bond** works much like an insurance policy, with the surety company paying the taxpayer's delinquent tax up to the face amount of the bond. An **escrow bond** is a deposit of cash held by a third party, usually a bank or an escrow company. A **cash bond** is a deposit of cash held by the Department of Revenue.

The Surety Association of America's suggested rate schedule sets the annual cost of a sales tax surety bond at $20 per $1,000 of coverage, with a $30 minimum annual premium. The following are examples of the annual cost to retailers of a surety bond using these rates.

| Monthly Retail Sales | Monthly Sales Tax Collections | Bond Currently Required | Annual Bond Premium | Monthly Bond Premium |
|---|---|---|---|---|
| $ 10,000 | $ 300 | $ 900 | $ 30 | $ 2.50 |
| 50,000 | 1,500 | 4,500 | 90 | 7.50 |
| 100,000 | 3,000 | 9,000 | 180 | 15.00 |
| 250,000 | 7,500 | 22,500 | 450 | 37.50 |

**The Department generally does not collect on tax warrants once they are filed.** Tax warrants are legal notices authorizing officials to seize and sell a retailer's property to satisfy delinquencies. Sales tax warrants are sent to county sheriffs for execution and are filed with the clerk of the district court, where they become liens against real property. In the 33 cases where warrants were filed after the business closed, the Department collected on the warrant in only two cases. A total of $5,815 was recovered, out of warrants filed for approximately $464,000. In the 17 cases where no warrants were filed after the business closed, 13 cases involved bankruptcy proceedings. In 10 of those 13 cases, the Department filed claims with the bankruptcy court. It has not received payment on any of those claims.

According to Department officials, one factor that contributes to the Department's inability to collect on warrants is its reliance on county sheriffs to identify and sell the retailer's available property. Under the current system, there is little incentive for sheriffs to make a serious effort to identify and sell property. Finally, warrants may not be satisfied in cases when the retailer leases property, or liens of higher priority are already attached to the property.

**The Department often does not file warrants until months after businesses close.** For the 33 cases where warrants were filed after the retailer went out of business, the Department filed the warrants an average of four and one-half months after the business closed. Although tax warrants become liens on property, the more time that elapses between the business closing and the warrant filing date, the less likely it is that assets will be available to satisfy the delinquency.

## For Many Closed Accounts, the Department Was Lenient With the Retailers While They Were Still In Business

Because the Department is so unsuccessful at collecting outstanding amounts once retailers have gone out of business, the auditors examined the history of the 50 sampled accounts prior to the business closings. They found that 12 of the 50 retailers had no history of delinquencies or other remittance problems prior to the date the business closed. In those cases, the Department could not be expected to foresee collection problems. However, each of the remaining 38 cases, or 76 percent of the sample, had some history of payment problems. Because most of these businesses were problem accounts, the circumstances encountered and the Department's actions often varied from account to account. However, typical problems included chronic instances of one or more of the following:

--failure to file timely returns
--failure to remit taxes collected
--failure to promptly obtain bonding
--paying with insufficient funds checks

**A Business Was Allowed to Operate Without a Sales Tax Certificate For More Than Three Years**

A grocery store opened in May 1975 and closed when the owner died in November 1982. Between March 1976 and October 1978, the retailer wrote 13 insufficient funds checks to the Department of Revenue totaling more than $3,400. In October 1978, the Department filed its first complaint against the retailer. At that time, the Department requested and received an additional $200 cash bond. The next month the retailer paid the balance due and the complaint was dismissed.

In February 1979, the Department filed a second complaint against the business. This second complaint cited six months of delinquency--three of these months had been cited in the prior complaint and were noted in November as having been paid. The next month, March 1979, the Department revoked the business' tax registration and stated that the retailer must pay the balance due and post an $800 bond to be reinstated.

Despite the revocation, the business continued to make retail sales--in violation of State law--until the owner died in November 1982. The Department apparently did not file a petition for an injunction to prohibit the retailer from operating at any time between March 1979 and November 1982. In April 1983, the Department sent the deceased retailer notice of an estimated balance due of over $17,000. A tax warrant for $16,600 was also filed in April. In May 1983, four bonds totaling just $800 were seized. No further action has been taken. Department officials stated there was no apparent reason why the business was allowed to continue operating for more than three years without a valid registration certificate.

While a delinquent retailer is still operating, the Department can effectively charge penalties and interest, require bonds, revoke registration certificates, issue tax warrants, and initiate injunction proceedings. For the 38 accounts with histories of payment problems, the auditors examined the actions taken by the Department on the accounts prior to the closings. They found that the Department generally did assess penalties and interest on the accounts, and in many cases did revoke registration certificates. However, the Department did not always take disciplinary actions promptly and did not act aggressively to collect the sales tax owed. Further, many of the problem accounts were not required to post bonds. For the businesses with bonds, the Department has adopted a policy not to seize the bonds to satisfy delinquencies while retailers are still operating. These areas are described in the following sections.

**A Retailer's Failure to Remit Sales Taxes Over a 31-Month Period**

A grocery store that opened in June 1970 went out of business in August 1974. At that time, the Department of Revenue noticed that the business had not remitted any sales tax since January 1972. In December 1974, the Department made a $15,000 assessment for the 31-month period and issued a tax warrant. The Department abated $5,700 of the assessment in January 1975 because returns were filed for February through December 1972. However, no actual payments were made for that period. Because this delinquency occurred more than 10 years ago, Department of Revenue officials could not explain why the account was allowed to operate for 31 months without remitting any sales tax receipts.

The retailer made nominal payments on the account in June and August 1975. In April 1976, the Department sent a letter to the retailer's attorney regarding a garnishment the Department had filed. This letter stated that several garnishments had been filed and that more would be filed until the balance due was remitted. From January 1976 to May 1979 the retailer paid approximately $2,975 of the outstanding balance. The Department has not received any payments on this account since May 1979, and the State balance due on September 30, 1985 was about $10,000.

**In many cases, the Department did not take prompt action against retailers who were delinquent in remitting sales taxes.** For example, the Department filed a complaint and scheduled a revocation hearing for a grocery store in February 1983. The complaint indicated the business had been delinquent for 10 of the 14 months it had been operating. When the retailer's registration certificate was revoked in March 1983, the retailer was delinquent for December 1981, March through December 1982, and January 1983.

The auditors found that 15 of the 38 problem accounts did not have valid registration certificates when the retailer went out of business. Seven of these retailers went out of business within about three months of the Department's revocation order. The remaining eight retailers operated an average of more than 18 months after revocation. The Department filed petitions for injunctions against five of these retailers, but an average of eight months elapsed between the revocation orders and the filings. The Department issued four additional revocations after the associated retailers had already gone out of business.

**When the Department did take remedial actions, those actions were often not aggressive.** For example, the Department revoked a grocery store's registration certificate in September 1983, following chronic tax delinquencies. At the time, the Department indicated the retailer would have to remit past taxes due and submit a $1,500 bond before being reinstated. The business continued operating after the revocation, in violation of State law. In October 1983, an employee of the Field Services Bureau requested that injunction proceedings be initiated. The Department did not file an injunction petition until almost one year later, in September 1984. The retailer then posted a $750 bond. The Department had the injunction action dismissed in November, because the field representative had provided the Legal Services Bureau with an incorrect name under which to file the action. A second injunction petition was filed in December under the correct name. The Department never received the remaining $750 bond. By April 1985, the business was closed and the retailer had declared bankruptcy. The final amount due on this account was $19,600.

**The Department did not require many problem accounts to post bonds.** According to the Department's administrative regulations, bonding requirements are only mandatory for corporations. Unlike owners of proprietorships and partnerships, corporate officials are not currently liable for unremitted sales tax. In some cases, the Department also requires firms with poor payment records to post bonds. Of the 38 problem accounts reviewed by the auditors, only 10 accounts had bonds at the time the business closed. If more of the remaining 28 accounts had been bonded, the Department could have collected on more closed accounts.

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**A Retailer Was Allowed to Operate Despite A Poor Payment Record**

A grocery store opened in November 1981 and closed in Jaunuary 1985. The owner apparently had problems remitting sales tax from the outset. In November 1982, the Department filed a complaint against the business and requested a $750 bond. The next month, the Department revoked the retailer's sales tax registration certificate and issued a tax warrant for the balance due of $3,300. For reinstatement, the retailer was required to pay the balance due and post a $750 bond.

In February 1983, the retailer sent a check (that later proved to be insufficient) for part of the delinquency. That same month, a representative of the Field Services Bureau recommended that the business be shut down. In March 1983, the Department sent the retailer a letter advising him that if he did not pay off the balance and post the $750 bond, it would seek an injunction to close the business. In April 1983, the field representative sent a memo to the Topeka office stating that the taxpayer had made a payment of more than $800 with an insufficient funds check, had not filed returns for several months, had not applied for a payment plan, and had not posted the $750 bond. The field representative again requested an injunction to close the business. He requested one again in July 1983.

In September 1983 the pattern changed. The retailer appeared and filed all delinquent returns. The retailer explained that he was currently involved in litigation that was about to net him enough money to pay off his balance due, and he would be back the next month to do just that. In the meantime, he paid $500 on his account. A November memo from the field representative stated that the retailer came back in October, but only paid $200 because the lawsuit was not yet settled. The field representative went on to say that the retailer was supposed to make a "substantial" payment in November. In December 1983, the Department dismissed its complaint against the business. A memo from the field representative in March 1984 said that the retailer had remitted the tax for January, but nothing on the balance. Lawsuit proceeds were expected in 30 to 60 days.

In June 1984, the field representative sent another memo stating that the owner had paid his taxes for February through April (with a check that was later returned for insufficient funds), but still had not received the proceeds from the lawsuit. The field representative told the retailer that he should provide some proof of the forthcoming proceeds from the lawsuit, such as a copy of the most recent journal entry in the case, or the Department would close him down. In August 1984, the retailer remitted his May tax in cash. In January 1985, a memo from the field representative stated that the retailer still had not brought in the journal entry and he had canceled several appointments.

The retailer closed the business in January 1985. In March 1985 he filed all the delinquent returns (without remittance) and stated that he was going to file bankruptcy. The final balance due on the account was about $5400. The Department did not file a bankruptcy claim against the retailer because he had no assets subject to the bankruptcy proceeding.

**The Department will not seize a bond from a delinquent retailer as long as the firm is making retail sales.** According to Department officials, this policy was adopted because if a bond was seized before the business closed, the retailer would have to obtain another bond. If the retailer failed to do so, the Department would be forced to initiate revocation proceedings. Because the Department will not seize a bond from a retailer until the business is closed, retailers can incur liabilities and even violate State law without having their performance bonds seized. For example, the Department revoked an auto dealer's registration certificate in July 1983, but the retailer continued to operate until February 1984. By that time, the retailer owed the State approximately $5,000 in delinquent sales taxes. Yet, the Department did not seize the retailer's $300 bond until September 1984.

### Businesses That Incurred Large Liabilities In a Short Time

An automobile dealership made its first sales in January 1983 and closed in December 1983. The dealer never filed a sales tax return and never remitted any sales tax. The Department made a jeopardy assessment against the dealer in early October 1983 covering the entire period the business had been open. The amount of sales tax due was in excess of $1,100. Later that month, the Department filed a complaint against the dealer. The complaint identified the period of delinquency and stated that, to avoid revocation, the dealer must post a bond of $150. The complaint was sent by certified mail, but the dealer never claimed it. In November 1983, the Department revoked the dealer's sales tax registration. In December, the field representative reported that the business was closed and the owner's whereabouts were unknown. The final balance due from this dealer was approximately $1,400. The Department has never been able to locate the owner.

Another automobile dealership operated only nine months--March to November 1979--before it closed. The Department sent notices asking for payment in August, October, and November, the month the business closed. The Department filed a complaint in January 1980 and, that same month, learned that a local auction company had held a liquidation sale for the business in November. The State received none of the proceeds from that sale. When the final jeopardy assessments were made, the balance due to the State was nearly $22,000. In September 1980, a notation was made in the file that the business had filed bankruptcy, and the Department filed a claim with the bankruptcy court later that month. The State has received nothing more on the account from the bankruptcy action or otherwise.

### A Retailer With Chronic Delinquencies

An automobile dealership began operating in February 1972 with a $500 surety bond. This level of bond coverage was continued until November 1975, when the requirement was increased to $1,500. The Department's field representative cited the retailer's "chronic delinquency" as justification for the increase. During the next year, the retailer was assessed penalty and interest on five delinquent returns, and in November 1976 its bond requirement was raised to $2,500. In July 1977, the Department filed a complaint asserting that the retailer had been delinquent for 15 of the past 18 months. The sales tax registration was revoked in early August, but by mid-month the retailer brought the account up to date, and at the end of August the registration was reinstated.

This scenario was repeated several times before the business closed on September 30, 1980. In the three-year period from July 1977 to September 1980, the Department filed five complaints against the retailer for continuous delinquency. Two of the complaints resulted in revocation, followed by payment from the retailer and reinstatement. The final revocation occurred in August 1980 after the $3,500 surety bond was canceled, and the retailer was unable to secure another. On September 25, an employee of the Department's Field Services Bureau recommended that the Department begin injunction proceedings to have the business closed. Five days later the retailer went out of business.

The Department made a jeopardy assessment of taxes due and filed a tax warrant in January 1981. In March, the jeopardy assessment was abated in lieu of returns filed for May and July-September 1980. The final audit of the account, completed in April 1981, showed a balance due of $9,400.

## Can the State Improve Its Ability to Collect Outstanding Sales Tax Receipts from Retailers Who Are Going or Have Gone Out of Business?

Collecting outstanding sales tax from retailers who are going or have gone out of business is complex and time-consuming. The Department has numerous administrative remedies available for collecting from delinquent retailers, but some of these remedies are

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not effective for closed businesses. Further, once the administrative remedies are exhausted, the Department of Revenue must rely on the district court system for additional remedies.

The auditors reviewed State law, regulations, and procedures for collecting outstanding sales tax receipts. They also contacted nine other states regarding their collection procedures. Other states' procedures are similar to the ones used in Kansas. There are, however, some provisions and policies that Kansas does not have or does not use. These include holding corporate officials personally liable for delinquencies, having State enforcement officials, and imposing criminal sanctions against offenders. The other states' procedures are summarized in the box on page 14.

**A Retailer That Closed With No History of Payment Problems**

A grocery store made its first sales in June 1976 and closed six years later in August 1982. The Department of Revenue's files show no sign of the business having any history of payment problems. In September 1982, the Department sent the retailer notice that no sales tax return had been filed for July 1982. In November, the Department contacted the retailer by telephone asking about returns for July and August. The retailer said that those returns had been mailed the previous week without the tax remittance. In December, the returns still had not been received, and a field representative requested a jeopardy assessment. In January 1983, the Department closed the account with a balance due of more than $6,000 in tax, penalty, and interest for July and August 1982. A tax warrant for $6,100 was filed on this account in May 1983. The files show no payments having been received and no further contact with the retailer.

In general, the State's procedures for collecting outstanding sales taxes are ineffective once retailers go out of business. The auditors concluded that for businesses with no history of payment problems, the Department of Revenue cannot be expected to foresee collection problems. However, with many other retailers, the Department should be aware that problems exist. In those cases, the Department should attempt to maximize the collections made before the firms go out of business. Such actions would include imposing penalties, filing tax warrants, and seizing bonds.

If collections cannot be made on delinquent accounts, the Department should attempt to have those businesses closed before further obligations are incurred. This would require the Department to promptly revoke registration certificates and seek injunctions prohibiting retailers from operating. Finally, after delinquent retailers go out of business, the Department could enhance collections by strengthening its bonding policies and tax warrant procedures. Some collections are currently made on bonded accounts, but the bond amounts are not sufficient to cover outstanding liabilities and many firms do not even have bonds. Once businesses are closed, the Department generally does not collect at all on tax warrants.

## COLLECTING DELINQUENT SALES TAXES IN OTHER STATES

The auditors contacted nine other states, including the four surrounding states, to determine how those states collected delinquent sales tax receipts. Most have procedures similar to Kansas', with Iowa's and Oklahoma's being virtually indentical. The following is a summary of the responses that were different.

**Colorado**--Colorado has an automated collection system that identifies sales tax delinquencies immediately. If the retailer does not pay the delinquent tax after proper notification, Colorado issues a distraint warrant authorizing tax compliance agents to seize and sell the retailer's property. The retailer's sales tax permit may be revoked, but the state usually does not do so. Colorado does not require retailers to be bonded.

**Indiana**--If a retailer in Indiana does not remit the tax owed, the state sends a warrant to the local sheriff. The sheriff can then file a lien against the retailer's property. If the sheriff cannot or does not collect, state collection attorneys file suit against the business. Private collection agencies are often used for firms headquartered outside Indiana. The state can revoke sales tax permits and can collect from corporation officials.

**Massachusetts**--Revenue officials in Massachusetts say the state has taken an aggressive, high-profile collection stance in recent years. Massachusetts turns delinquent accounts over to a state collection agent. The agent records a tax lien and looks for specific property to levy against. Massachusetts has an active seizure program, giving agents the power to seize property after 10 days' notice. Failure to file returns and remit sales tax is a felony, and the state is now sending violators to prison. Revenue officials believe this has increased voluntary compliance by several million dollars. Massachusetts has no bonding requirement.

**Minnesota**--If a retailer does not pay delinquent taxes after three months, the state tax commissioner may levy against any of that retailer's assets by issuing a distraint warrant. If no assets are discovered, Minnesota has other means to collect. It can hold corporation officials personally liable, seize income tax refunds, offset payments to retailers that sell to the state, and hire private collection agencies for retailers that have left the state. Minnesota also can require a bond and can revoke sales tax permits. It refuses to grant a permit to anyone who already owes $1,000 or more in delinquent sales taxes.

**Missouri**--Missouri files a lien against the assets of a retailer who has a delinquent sales tax account. It seizes the retailer's bond (all are required to have a bond) and revokes the retailer's sales tax permit. The account is then given to the county prosecutor who retains locally 20 percent of whatever can be collected. Missouri imposes successor liability on purchasers of businesses having outstanding sales tax receipts. Also, sales taxes for motor vehicles are paid directly to the state rather than to dealers.

**Nebraska**--If a retailer fails to remit sales taxes owed, Nebraska seizes any bond. However, retailers headquartered out-of-state are generally the only ones required to obtain a bond. Nebraska imposes personal liability on corporate officials. If a delinquent retailer continues to operate, the state may obtain a court order to take delinquent taxes from its profits.

**Wisconsin**--Wisconsin issues a delinquent warrant for outstanding sales tax accounts. The warrant is both a personal judgment against the retailer and a lien against the retailer's property. If retailers refuse to remit the taxes owed, they may be taken to court on the basis of the warrants. Personal judgments follow individuals and can lead to later garnishments of wages. Wisconsin may revoke sales tax permits. Bonds may also be required, but for a maximum of $15,000. The state can pursue corporation officials, but must initiate a separate assessment process.

## Recommendations

1. To maximize the collections made on both delinquent and closed sales tax accounts, the Department of Revenue should:

   a. Establish and follow standard procedures for more aggressive, consistent enforcement of the Retailers' Sales Tax Act against delinquent retailers. Such procedures could include:

      --seizing bonds before retailers go out of business
      --revoking registration certificates promptly
      --seeking injunctions promptly

   b. Strengthen its bonding policies. All retailers should be required to secure and maintain bonds, bond amounts should be increased, and bonds should be seized to satisfy delinquencies before businesses close. Legislative Post Audit made similar recommendations in its 1982 performance audit of the Division of Taxation.

   c. Systematically pursue enforcement of successor liability. State law currently requires the Department to hold purchasers of businesses liable for outstanding sales tax of sellers, up to the value of the property received.

   d. Seek legislation authorizing the imposition of personal liability for delinquent sales tax on corporate officials.

   e. Develop procedures for writing off closed sales tax accounts with insignificant balances. In many cases, it is not feasible or cost effective to collect these accounts, and writing them off would reduce the number of closed sales tax accounts managed by the Department.

2. To minimize delinquencies and enhance the sales tax collections made after delinquent retailers go out of business, the Department should explore these options:

   a. Developing procedures at the State level for identifying assets owned by delinquent retailers and providing county sheriffs with lists of those assets when warrants are filed.

   b. Providing financial incentives to county officials for collecting on tax warrants. A penalty could be added to the warrant amount and earmarked for the locality.

   c. Requiring purchasers to pay sales tax on large purchases directly to county treasurers or the Department of Revenue. State law currently requires sales tax on isolated purchases of motor vehicles to be paid in this manner.

## APPENDIX A

### Outstanding State Sales Tax for Closed Accounts
### By Business Classification
### As of September 30, 1985

| Business Classification | Number of Accounts | Balance Due | Average Balance |
|---|---|---|---|
| **Apparel** | | | |
| Boot and Shoe Stores | 31 | $ 22,142 | $ 714 |
| Clothing Stores - Men | 26 | 25,310 | 973 |
| Clothing Stores - Women | 70 | 56,533 | 808 |
| Shoe Repair Shops | 19 | 2,793 | 147 |
| Other Apparel Stores | 147 | 84,086 | 572 |
| **Subtotal - Apparel** | 293 | 190,864 | 651 |
| **Automotive** | | | |
| Accessories, Tires, Batteries | 182 | 256,270 | 1,408 |
| Auto, Aircraft, Bicycle Dealers | 324 | 1,108,124 | 3,420 |
| Filling and Service Stations | 399 | 210,698 | 528 |
| Garages & Repair Shops | 720 | 509,402 | 708 |
| Other Automotive Stores | 25 | 8,207 | 328 |
| Aircraft and Allied | 26 | 40,369 | 1,553 |
| Occasional Auto Sales | 6 | 81,440 | 13,573 |
| **Subtotal - Automotive** | 1,682 | 2,214,510 | 1,317 |
| **Food** | | | |
| Bakeries | 162 | 150,810 | 931 |
| Candy & Confectionery | 102 | 35,842 | 351 |
| Fruit & Vegetable Markets | 9 | 3,173 | 353 |
| Grocery Stores & Meat Markets | 292 | 662,400 | 2,268 |
| Lunch Rooms & Roadside Sales | 1,129 | 840,864 | 745 |
| Restaurants & Cafeterias | 1,466 | 2,068,445 | 1,411 |
| Other Food Stores | 128 | 55,313 | 432 |
| **Subtotal - Food** | 3,288 | 3,816,847 | 1,161 |
| **Furniture** | | | |
| Furniture Stores | 473 | 937,107 | 1,981 |
| Household Appliances | 106 | 92,294 | 871 |
| Radios & Musical Instruments | 271 | 394,289 | 1,455 |
| Other Furniture & Appliances | 13 | 8,777 | 675 |
| **Subtotal - Furniture** | 863 | 1,432,467 | 1,660 |

| Business Classification | Number of Accounts | Balance Due | Average Balance |
|---|---|---|---|
| **General Merchandise** | | | |
| Department Stores | 31 | $ 31,633 | $ 1,020 |
| Drug Stores | 39 | 22,033 | 565 |
| Dry Goods Stores | 36 | 15,895 | 442 |
| General Stores | 13 | 6,134 | 472 |
| Hardware Stores | 51 | 35,312 | 692 |
| Jewelry Stores | 51 | 26,727 | 524 |
| Luggage & Leather Goods | 7 | 14,996 | 2,142 |
| Secondhand Stores | 86 | 24,928 | 290 |
| Sporting Goods | 156 | 114,567 | 734 |
| Variety & Specialty Stores | 371 | 125,829 | 339 |
| Other General Merchandise Stores | 16 | 21,169 | 1,323 |
| Plastics - Retail | 1 | 136 | 136 |
| **Subtotal - General Merchandise** | 858 | 439,359 | 512 |
| **Lumber & Building** | | | |
| Building & Construction Contractor | 270 | 415,261 | 1,538 |
| Building, Hardware, & Machinery | 3 | 1,591 | 530 |
| Building Material Dealers | 33 | 132,593 | 4,018 |
| Electrical Equipment Supplies | 61 | 46,027 | 755 |
| Paint, Glass, & Wallpaper | 39 | 27,157 | 696 |
| Plumbing, Heating, & Air Cond | 237 | 407,157 | 1,718 |
| Other Lumber & Building Supplies | 7 | 71,301 | 10,186 |
| **Subtotal - Lumber & Building** | 650 | 1,101,087 | 1,694 |
| **Professional & Personal Services** | | | |
| Auctioneers | 32 | 17,767 | 555 |
| Barber & Beauty Shops | 113 | 14,766 | 131 |
| Optician Sales | 14 | 3,774 | 270 |
| Photographers | 78 | 48,319 | 619 |
| Other Professional Sales | 27 | 11,436 | 424 |
| Hotels & Motels | 90 | 133,777 | 1,486 |
| Laundry | 79 | 71,063 | 900 |
| Carwash | 19 | 4,386 | 231 |
| Cable Television & Radio Services | 9 | 2,393 | 266 |
| Carpenter & Janitorial Services | 603 | 518,511 | 860 |
| **Subtotal - Prof & Pers Services** | 1,064 | 826,192 | 776 |
| **Public Utilities** | | | |
| Telephone Companies | 6 | 12,052 | 2,009 |
| Water Companies | 1 | 4 | 4 |
| Electricity & Water Companies | 1 | 43 | 43 |
| **Subtotal - Public Utilities** | 8 | 12,099 | 1,512 |

| Business Classification | Number of Accounts | Balance Due | Average Balance |
|---|---|---|---|
| **Farm & Garden Produce** | | | |
| Hatcheries & Supplies | 5 | $ 1,583 | $ 317 |
| Livestock | 69 | 26,693 | 387 |
| Other Farm & Garden Produce | 10 | 4,393 | 439 |
| **Subtotal - Farm & Garden** | 84 | 32,669 | 389 |
| **Manufacturing & Trading** | | | |
| Beverages | 5 | 5,246 | 1,049 |
| Chemicals & Products | 75 | 18,143 | 242 |
| Food & Food Preparations | 7 | 5,310 | 759 |
| Leather & Leather Products | 11 | 3,311 | 301 |
| Lumber & Wood Products | 14 | 10,031 | 717 |
| Metal & Metal Products | 26 | 71,916 | 2,766 |
| Paper & Pulp Products | 3 | 1,211 | 404 |
| Machinery & Equipment | 172 | 393,329 | 2,287 |
| Printing & Publishing | 81 | 118,119 | 1,458 |
| Stone, Sand, & Gravel Products | 46 | 104,032 | 2,262 |
| Textiles | 1 | 521 | 521 |
| Other Manufacturing & Trading | 31 | 9,251 | 298 |
| Plastics - Wholesale | 4 | 1,470 | 368 |
| **Subtotal - Mfr & Trading** | 476 | 741,890 | 1,559 |
| **Unclassified Retail** | | | |
| Amusement Parks & Theatres | 40 | 58,256 | 1,456 |
| Athletic Games & Tournaments | 149 | 78,014 | 524 |
| Blacksmiths & Machine Shops | 42 | 9,121 | 217 |
| Cigar Stores & Smoking Supplies | 6 | 835 | 139 |
| Coal, Wood, Fuel, & Ice Dealers | 11 | 10,215 | 929 |
| Farm Implements & Machinery | 25 | 78,492 | 3,140 |
| Seed, Feed, Grain, & Fertilizer | 33 | 33,043 | 1,001 |
| Plants & Nursery Stock | 125 | 48,441 | 388 |
| Magazines & Newspapers | 74 | 18,114 | 245 |
| Monuments & Tombstones | 4 | 1,354 | 339 |
| Office Equipment & Supplies | 98 | 175,659 | 1,792 |
| Undertakers & Funeral Parlors | 2 | 2,943 | 1,472 |
| Other Unclassified | 88 | 58,564 | 666 |
| Rentals & Leasing | 86 | 111,191 | 1,293 |
| **Subtotal - Unclassified Retail** | 783 | 684,242 | 874 |
| **TOTALS** | 10,049 | $11,492,226 | $ 1,144 |

## APPENDIX B

## Agency Response



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KANSAS DEPARTMENT OF REVENUE
*Office of the Secretary*
State Office Building · Topeka, Kansas 66612-1588

January 17, 1986


Mr. Meredith Williams
Legislative Post Audit
301 Mills Building
109 SW Ninth Street
Topeka, Kansas 66612

Re: Audit of Department of Revenue's Collection of Outstanding Liabilities on Closed Sales Tax Accounts

Dear Meredith:

As requested by Legislative Division of Post Audit, the Department of Revenue hereby submits its response to the above-referenced Post Audit draft report. The Department expresses its appreciation for the courteous manner in which the audit was conducted and compliments the staff members of the Post Audit Division for their efforts in compiling the recommendations designed to improve the collection of outstanding sales tax liabilities for closed accounts.

Prior to specifically addressing the Department's response to each Post Audit recommendation, however, the Department wishes to clear upon a couple of factual misstatements contained in the audit report itself.

The chart on page 5 is somewhat misleading as to the actions the Department takes with respect to returns received without remittance and which have a liability of more than $500. The chart suggests that the Department proceeds immediately with revocation hearings on such accounts. Such is not the case, as the taxpayer is first mailed a balance due notice and if payment is not received, the revocation hearing is then scheduled.

On page 10, approximately in the middle of the page, Post Audit describes a grocery store account and would have the Legislature believe that the Department dismissed the injunction action since the account posted a $750 bond. In reality, the injunction action was dismissed due to the fact the Department's Field Representative had provided Legal Services Bureau with the wrong name under which to file the action. Therefore, the first injunction action had to be dismissed and a second one filed under the correct name.

As for the Department accepting the $750 bond, this bond was accepted in lieu of returning it and not receiving another bond back for the full $1,500. The bond requirement was never reduced to $750; the Department was still seeking the remaining $750 when the business closed.

*General Information (913) 296-3909*
*Office of the Secretary (913) 296-3041 · Legal Services Bureau (913) 296-2381*
*Audit Services Bureau (913) 296-7719 · Planning & Research Services Bureau (913) 296-3081*
*Administrative Services Bureau (913) 296-2331 · Personnel Services Bureau (913) 296-3077*

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Post Audit Recommendation

Page 15 -- 1. To maximize the collections made on both delinquent and closed sales tax accounts, the Department of Revenue should:

a. Establish and follow standard procedures for more aggressive, consistent enforcement of the Retailers' Sales Tax Act against delinquent retailers. Such procedures should include:

---seizing bonds before retailers go out of business.
---revoking registration certificates promptly.
---seeking injunctions promptly.

Agency Response

The Department of Revenue makes every effort to streamline the collection and enforcement of the Kansas Retailers' Sales Tax Act (hereinafter referred to as "Act"). In our endeavor to streamline these collection efforts, the Department has considered the procedures suggested by Legislative Post Audit as being helpful but believe each would be ineffective due to the following reasons.

Seizing bonds before retailers go out of business would result in the State being able to use these funds sooner than under the current procedure; however, the benefit derived from making earlier demand is outweighed by the consequences which would occur. Specifically, the Department foresees the following consequences:

1. The Department would require the retailer to post another bond. This sounds easy, but since the retailer is already delinquent, there is a problem of where the money for a bond would come from. Cash flow is already a problem with the retailer, therefore, a cash bond or escrow bond would probably be impossible for the retailer to post. In addition, there are fewer and fewer insurance companies willing to write surety bonds for retailers with a good history of reporting sales tax, let alone for delinquent retailers.

2. Assuming the retailer is unable to post the bond, the sales tax registration certificate would be revoked and the account referred to the

> Department's Legal Services Bureau for injunctive action. Courts have been historically reluctant to issue injunctions prohibiting retailers to operate their businesses where the only impediment to the retailer lawfully operating under the Act is the posting of a bond. What has been gained by seizing the bond?

Revoking registration certificates more promptly and seeking injunctions more promptly would require additional staff for not only the Sales and Excise Tax Bureau but also for Legal Services Bureau. In addition, the fact that an injunctive action is filed does not guarantee the business will actually close. The Court must first issue a permanent injunction order and if the retailer continues to operate, the Department must then obtain a contempt of court citation.

The Sales and Excise Tax Bureau has recently started reviewing sales tax accounts in the larger counties throughout the state to determine those accounts which remit $500 or more per month and which are delinquent five or more months. These accounts are then being set up for revocation hearings immediately. In addition, the Director of Taxation is contemplating eliminating the thirty (30) day referral to Field Services after a sales tax account has been revoked. The Director is considering referring the account to Legal Services Bureau immediately after the revocation letter is mailed. The main obstacle to such a procedure, however, is the increased number of accounts which Legal Services would have to handle with the present level of personnel.

Further, the Department is working on implementing a procedure for car dealerships whereby the sales tax certificate of registration and the dealer's license can be revoked at the same hearing. Of course, the Department would have to file a court action to enforce either revocation.

One further procedure in the endeavor to collect delinquent sales taxes which has recently been implemented by the Department is the simultaneous notification to the taxpayer (retailer) and the Department's Field Services Bureau on those accounts which have outstanding liabilities of $1,000 or more. It is anticipated that this procedure will accelerate the collection of delinquent sales tax liabilities with this earlier involvement of Field Services Bureau.

Post Audit Recommendation

Page 15 -- 1.b. Strengthen its bonding policies. All retailers should be required to secure and maintain bonds, bond amounts should be increased, and bonds should be seized to satisfy delinquencies before businesses close. Legislative Post Audit made similar recommendations in its 1982 performance



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audit of the Division of Taxation.

Agency Response

The Department has proposed an amendment to K.A.R. 92-19-35 (see copy attached). Under the proposed K.A.R. 92-19-35, each corporation applying for a certificate of registration would have to post a bond in an amount equal to its six months' average tax liability or $1,000, whichever is greater. There would be no provisions for waiver of this bond requirement and the bond would have to remain posted to the account until the business closed.

As for requiring sole proprietorships and partnerships to secure and maintain bonds, the Department believes its present policy of requiring bonds only after such businesses have become delinquent is a much better procedure to follow. Assets owned by each individual owner may be made available to satisfy sales tax liabilities of the business whereas corporate officers at the present time cannot be held personally liable for sales tax liabilities incurred by the corporate business.

Further, strengthening the bonding policies would only make it harder for businesses to begin operations which sheds a poor light on any attempt at advancing the economic development within the state of Kansas. And finally, businesses would open up anyway without posting the required bond.

Post Audit Recommendation

Page 15 -- 1.c. Systematically pursue enforcement of successor liability. State law currently requires the Department to hold purchasers of businesses liable for outstanding sales tax of sellers, up to the value of the property received.

Agency Response

K.S.A. 79-3612 provides that:

> "The tax imposed by this act shall be a lien upon the property of any person who shall sell his or her business consisting of tangible personal property....The purchaser shall be personally liable for the payment of any unpaid taxes of the seller, to the extent of the value of the property received by the purchaser."

In order for liability for unpaid sales taxes to become the obligation of a subsequent purchaser, the two requirements under K.S.A. 79-3612 must be met: 1) there must be a sale of the business, and 2) personal property must be conveyed with the purchase. In many instances, these two conditions can not

be met. Many delinquent taxpayers, when they are about to close their doors, are unable to "sell their business" because there is no goodwill which is salable. Moreover, even if the business concept is one which could be sold, the second requirement of "sale of tangible personal property" is often impossible to meet since these same taxpayers often lease their property or buy it on credit. The seller often has no interest in the tangible personal property transferred since it is financed and subject to prior security interests. Often the financial institutions are the real owners in interest, their transfer of property would not give rise to a duty on behalf of the purchaser to remit the tax.

It is difficult for the Department of Revenue to determine when there is, in fact, a successor that has purchased tangible personal property since these individuals may not locate at the same business location or use the same business name as the seller used in conducting his/her business.

It is the recommendation of the Department of Revenue that the sellers be made personally liable for unpaid sales taxes. Such a recommendation would make the persons who failed to remit the tax responsible and would not involve satisfying the requirements of K.S.A. 79-3612.

Post Audit Recommendation

Page 15 -- 1.d. Seek legislation authorizing the imposition of personal liability for delinquent sales tax on corporate officials.

Agency Response

The Department has and will seek legislation during this Legislative Session authorizing the imposition of personal liability for delinquent sales tax on corporate officials. (See recommendation #1 on page 2 of the Department's proposed legislation).

Post Audit Recommendation

Page 15 -- 1.e. Develop procedures for writing off closed sales tax accounts with insignificant balances. In many cases, it is not feasible or cost effective to collect these accounts, and writing them off would reduce the number of closed sales tax accounts managed by the Department.

Agency Response

The Department does have a written procedure for writing off sales tax accounts and the cost of "managing" these accounts is negligible. Incurring any significant costs, either personnel or computer-related, to write-off the account any sooner than the present seven years would not be cost-effective.

The Department would agree that a tolerance level should be established for sales tax liabilities. When a business closes and the liability is below the tolerance level, the tax examiner working the close-out of the account can simply abate the liability and not have to spend time auditing the account to determine if the liability is accurate. Any type of such tolerance level would appear to need legislative approval, however. The Department would recommend that the tolerance level be the same amount which is presently used as a minimum balance due before a tax warrant will be filed.

Post Audit Recommendation

Page 15 -- 2. To minimize delinquencies and enhance the sales tax collections made after delinquent retailers go out of business, the Department should explore these options:

a. Developing procedures at the State level for identifying assets owned by delinquent retailers and providing county sheriffs with lists of those assets when warrants are filed.

b. Providing financial incentives to county officials for collection on tax warrants. A penalty could be added to the warrant amount and earmarked for the locality.

Agency Response

The Department has and will continue to attempt to identify vehicles owned by delinquent taxpayers which are free and clear of all liens and issue a special execution to the Sheriff for such vehicles. In addition, the Department has been successful at times at requesting a special execution for the Sheriff to seize a delinquent taxpayer's cash register. Both of these procedures, however, can only be successful if the Sheriff is willing and able to act upon the special executions.

The Department believes that a better avenue to pursue, and one which would produce better results, would be to establish an internal unit within the Department of Revenue for criminal investigation purposes. Such a unit would be responsible for gathering and obtaining evidence which would enable the state to institute criminal actions against delinquent taxpayers. For example, file embezzlement charges against taxpayers who have "converted" sales tax monies to their own personal use.

Post Audit Recommendation

Page 15 -- 2.c. Requiring purchaser to pay sales tax on large purchases directly to county treasurers or the Department of Revenue. State law currently requires sales tax on isolated purchases of motor vehicles to be

paid in this manner.

Agency Response

This recommendation can only be applied to automobiles or other vehicle purchases. To apply it to other types of purchases would seem to place a significant amount of sales tax in jeopardy.

The Department, however, has opposed this approach for motor vehicle sales. The Department believes this approach may lead to sales tax evasion through failure to register and increase delinquencies because of insufficient fund checks. Moreover, these delinquencies will be relatively small and expensive to collect. The Department sees no need to treat vehicle purchases differently than other transactions.

Respectfully submitted,

Harley T. Duncan
Secretary of Revenue

HTD:do

92-19-35. Application for certificate of registration; bond requirements. (a) ~~Every~~ Each corporation applying for a certificate of registration shall be required to post a bond with the department in an amount equal to their ~~three (3)~~ six months' average tax liability, or $1,000, whichever is greater. New businesses applying for sales tax certificates of registration, who have no previous tax experience, may estimate their expected sales tax liability projected over a ~~twelve (12)~~ 12 month period and submit a bond in an amount equal to ~~twenty-five~~ 50 percent ~~(25%)~~ of the projected tax liability or $1,000, whichever is greater.

(b) Certificates of registration ~~will~~ shall not be issued until the bond requirements are met. Bond requirements may be satisfied through surety bonds purchased from a corporate surety, escrow bond agreement or through the posting of a cash bond with the department.

~~Bond requirements may be waived by the director of taxation under the following conditions only: (a) the corporation may submit a certified financial statement showing net worth in excess of its one (1) year's average sales tax liability, or (b) the bond requirement may be waived in consideration of a satisfactory prior continuous compliance record. A satisfactory prior continuance compliance record is defined as a twelve (12) month period in which sales tax returns were filed and in which there were no delinquencies in payment of sales tax liabilities or returned checks.~~

(c) Sales tax bonds, ~~and certified financial statements accepted in lieu of bonds will~~ may be reviewed on a periodic basis by the department, and the director may at any time require an additional bond or a current certified financial statement if the existing bond or financial statement is not sufficient to meet the current average ~~three (3)~~ six months' sales tax liability. The director may reduce the required bond to an amount equal to three months' average tax liability, but not less than $1,000, in

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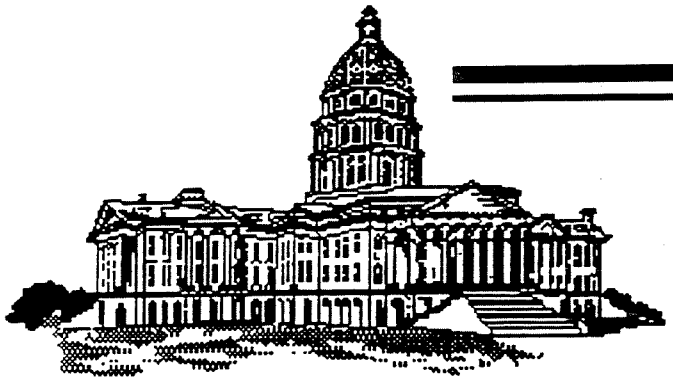
consideration of a satisfactory reporting history consisting of the prior 12 months in which there were no delinquencies or returned checks. (Authorized by K.S.A. ~~79-3616,~~ ~~79-3707~~ 79-3618; implementing K.S.A. 79-3616; effective May 1, 1979; amended May 1, 1986.)



# PERFORMANCE AUDIT REPORT

## Problems Implementing the Kansas Business Integrated Tax System

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
March 1987

87-47

# PERFORMANCE AUDIT REPORT

# PROBLEMS IMPLEMENTING THE KANSAS BUSINESS INTEGRATED TAX SYSTEM

## OBTAINING AUDIT INFORMATION

This audit was conducted by Ellyn Rullestad, Senior Auditor, and Allan Foster and Tom Vittitow, Auditors, of the Division's staff. If you need any additional information about the audit's findings, please contact Ms. Rullestad at the Division's offices.

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# PROBLEMS IMPLEMENTING THE KANSAS BUSINESS INTEGRATED TAX SYSTEM

## Summary of Legislative Post Audit's Findings

Since the end of fiscal year 1980, the Department of Revenue has been in the process of developing the Kansas Business Integrated Tax System to improve the Department's business tax processing, collections, and auditing functions. Legislative concerns have been raised about the delays in the implementation of the integrated tax system and about the costs of the system.

**How do the initial cost and time estimates for the development of the Kansas Business Integrated Tax System compare with actual costs and time?** The Department initially estimated that the integrated tax sytem could be completed by the end of fiscal year 1983 at a cost of $1.6 million. In March 1983, the Department revised its initial estimates and stated that the sales tax and transient guest tax portions of the system would be completed in fiscal year 1984 and that the rest of the system would be completed in fiscal year 1985. The total cost estimates at that time were $2.7 million. To date, the system has cost $2.8 million and it is still far from complete.

**Why has the implementation of the Integrated Tax System been delayed for so long?** The first consultant took longer than anticipated to prepare the detailed design, and it was initially full of errors and inconsistencies that had to be corrected. The Department's review of the detailed design was ineffective and incomplete. In addition, the Department paid for the detailed design and let bids for the next phase of the project before all the problems with the detailed design had been resolved. A second consultant was awarded the contract to complete the development of the system. Within a week of beginning work, that consultant determined that the specifications from the earlier phase were not detailed enough for coding. As a result, fixing and rewriting the detailed design specifications consumed much of the time during this phase. The consultant was able to have its contract modified so that it did not have to complete the system before it left. Since the consultant left, the Department has spent about 24,000 hours working on the system. It has not yet been completed for several reasons. The Department has not assigned a full-time manager to run the project, and it has reduced the resources available to the project.

**What is the business integrated tax system currently expected to be able to provide, when, and at what cost?** The Department is testing the transient guest tax on the integrated tax system. It expects to be running transient guest taxes using current data within the month. Sales tax programs are generally written, but are not fully tested. Estimates of when sales tax will be implemented on the system range from one year to eight years. Department staff indicated that additional business taxes will be incorporated after sales tax, but no agreement exists on which taxes will be included when the system is completed. In addition, Department staff support the concept of the integrated tax system, but some expressed concern that parts of the system's current design could make it inefficient and unmanageable.

The audit recommends that the Department continue to implement the transient guest tax but halt work on the rest of the system. The audit also recommends that the Department reassess its business tax processing objectives and develop a realistic long-range plan for upgrading the State's tax processing capabilities, including such things as cost estimates, deadlines, provisions for a full-time project manager, adequate resources, and continuity in personnel.

# PROBLEMS IMPLEMENTING THE KANSAS BUSINESS INTEGRATED TAX SYSTEM (K-BITS)

Since the end of fiscal year 1980, the Department of Revenue has been in the process of developing and implementing the Kansas Business Integrated Tax System (commonly referred to as K-BITS). The system, which is designed to improve the Department's business tax processing, collections, and auditing functions, was initially expected to be in operation by the end of fiscal year 1983. That timetable has been pushed back each year. Currently, the Department estimates that only one of the State's 25 business taxes will be operating under the system during 1987. That tax--transient guest tax--covers only 425 business tax accounts out of a total of about 233,000 accounts.

Legislative concerns have been raised about the delays in the implementation of the integrated tax system. Concerns have also been raised about the costs of the system and whether it will work as intended.

To address these concerns, the Legislative Post Audit Committee directed the Legislative Division of Post Audit to conduct an audit examining the development and implementation of the Kansas Business Integrated Tax System. The audit addresses the following specific questions:

1. **How do the initial cost and time estimates for the development of the Kansas Business Integrated Tax System system compare with actual costs and time?**

2. **Why has the implementation of the business integrated tax system been delayed for so long?**

3. **What is the integrated tax system currently expected to be able to provide, when, and at what cost?**

To answer these questions, the auditors interviewed officials of the Department of Revenue who have been involved in the system's development. They reviewed budget documents and other related financial data. They also reviewed pertinent reports from each phase of the development process and interviewed some of the consultants responsible for preparing those products. In addition, they interviewed officials of other State agencies as well as other states to determine their experiences in developing large-scale computer application systems.

In general, the auditors found that the Department has vastly underestimated the magnitude, time, and cost of developing and implementing the integrated tax system. The system has been delayed for so long because each step in its development has been plagued with problems. Although Department officials indicate the system is about 70-80 percent complete, they could not say when the system would be operating for just two business taxes. The system's design also includes inefficiencies that could make it unmanageable and difficult to use. The Department apparently continues to underestimate the time and resources needed to bring two taxes onto the system, and the auditors questioned whether it would ever be able to implement a fully integrated tax system. It appears that serious consideration should be given to stopping the development of the current integrated tax system and realistically assessing the steps that need to be taken to fix or replace that system.

Following a brief overview of the Kansas Business Integrated Tax System, these and other findings are discussed fully in the remainder of the audit.

## Overview of the Kansas Business Integrated Tax System

In an issue paper prepared in the late 1970s as part of the budget process, the Department of Revenue stated that its information processing systems were inadequate to meet its growing needs. Among other problems, the Department used two different computer systems to carry out its varied responsibilities. Most of its tax programs were on a UNIVAC computer system, while its vehicle information programs were on an IBM computer.

Other, more specific problems were also apparent. The Department's business tax systems were developed during the 1950s in response to legislative changes, and each system was set up differently. For example, transient guest tax accounts are essentially processed manually, while the system for processing sales taxes is fully automated.

Because the State's business taxes were developed separately and over time, no common database of business tax information exists to provide complete tax information about a particular taxpayer. And because each taxpayer had a different identification number for each business tax, the Department could not cross-check between taxes to see if a taxpayer who was owed a refund for one business tax had a liability for another.

Other inefficiencies existed as well. Many of the steps involved in processing business tax returns were handled manually, resulting in excessive errors. An excessive amount of duplicate data was maintained for each business. When changes were made, they had to be made for all duplicate sets of data, further increasing the chances for errors or inaccuracies.

In fiscal year 1980, the Department developed an Information Systems Plan in conjunction with IBM that addressed its overall information needs. IBM provided its assistance at no cost to the State. Among other things, that plan identified several problems specifically related to business taxes. In addition to those listed above, that plan noted that it took far too long to update new tax information on the computer, no effective collection follow-up system had been established, document control was lacking, no automated procedure existed to initiate or monitor legal action that should be taken on delinquent accounts, and the field staff received inadequate information.

The plan recommended that the Department make improved business tax processing its highest priority, and served as a catalyst in the Department's decision to develop the business integrated tax system.

## As Conceived, the Business Integrated Tax System Would Make Business Tax Processing More Efficient And Would Consolidate All Business Tax Information

The system itself was to be a non-tax-specific, computerized system that would integrate the processing of all 25 business taxes. It would address the problems identified above. The accompanying table lists the taxes that the system would eventually process, and presents some current information about those taxes.

## Business Taxes Originally Included in the Kansas Business Integrated Tax System

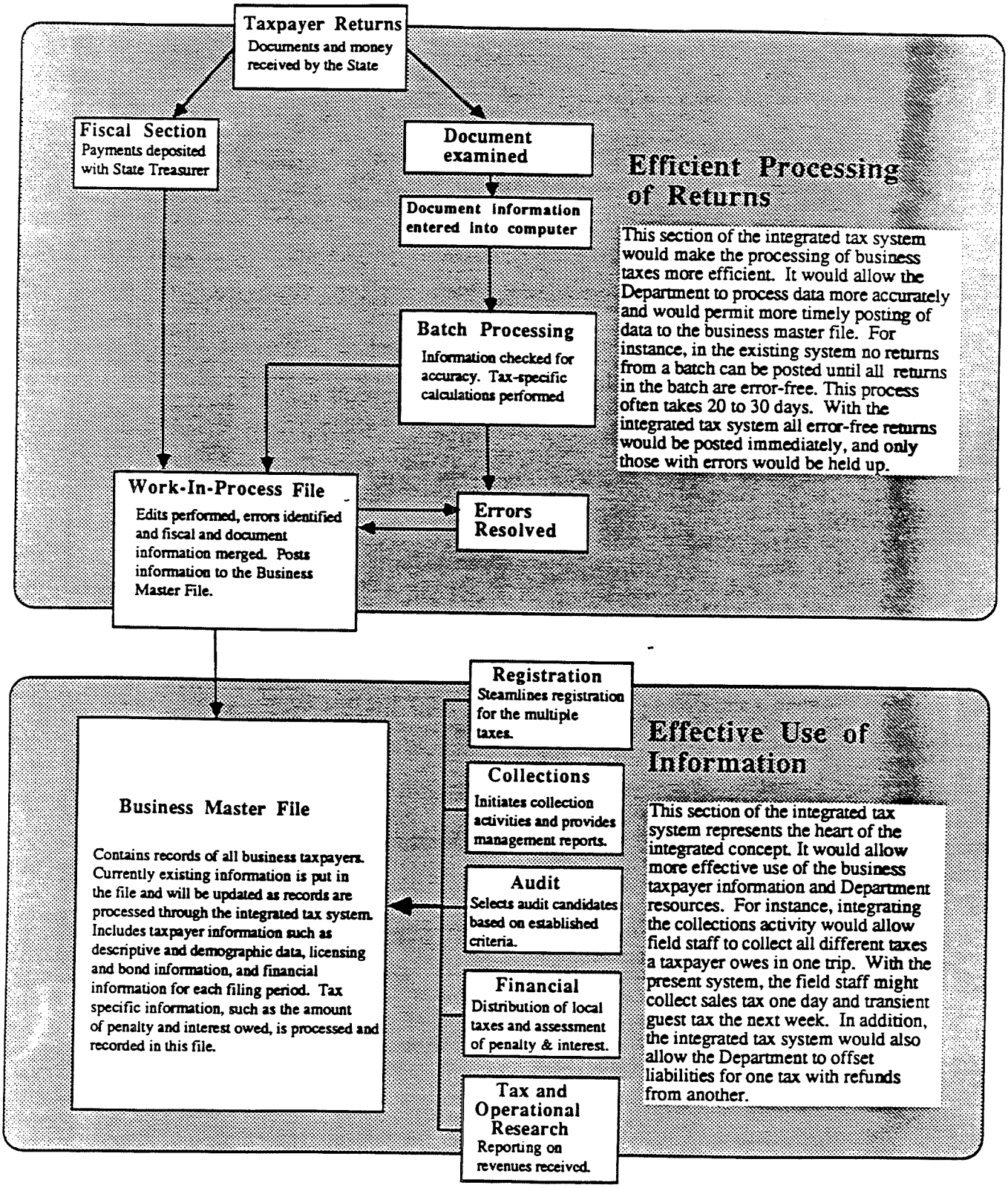
| Tax | Number of Accounts | Fiscal Year 1986 Revenues |
|---|---|---|
| Retailers' sales | 80,000 | $ 491,433,177 |
| Compensating use | 6,300 | 71,551,991 |
| Liquor excise | 1,400 | 10,485,968 |
| Liquor Enforcement | 1,200 | 17,743,451 |
| Cigarette | 118 | 58,725,680 |
| Tobacco products | 94 | 1,291,089 |
| Transient guest | 425 | 4,264,972 |
| Bingo enforcement | 700 | 743,979 |
| Motor vehicle fuel | 1,200 | 124,449,817 |
| Special fuel | 2,100 | 27,418,485 |
| Liquid petroleum fuel | 300 | 659,980 |
| Liquid fuel carrier's license fee | 1,000 | 10,910 |
| Interstate motor fuel user | 16,500 | 6,429,589 |
| Non-resident contractors fee | 100 | 1,900 |
| Gallonage tax | 85 | 11,981,983 |
| Cereal malt beverage | 56 | 4,654,504 |
| Corporation income | 36,000 | 81,252,620 |
| Privilege | 750 | 20,205,359 |
| Corporate estimated | 20,000 | 88,012,657 |
| Withholding | 65,000 | 555,978,173 |
| Sand and gravel | 21 | 1,069,350 |
| Gas and oil royalty | 33 | 208,858 |
| Oil inspection | 45 | 149,590 |
| Car line | 11 | 838,440 |
| Express company | 0 | 0 |
| TOTAL | 233,438 | $ 1,579,562,522 |

A fully integrated business tax system would be very complex. It would process business tax information through some 500 interrelated computer programs. The figure on the next page provides a simplified version of how the system would work.

As the figure shows, the integrated tax system was designed to process business taxpayers' returns more efficiently. Information from a return would be entered into the computer to be processed and checked for accuracy. Any tax-specific calculations--such as calculating the penalty and interest owed on an overdue sales tax account--would be performed at this stage as well. After additional checks, edits, and corrections were performed in the "work-in-process" file, the business tax information would be entered into a "master" file database of all business tax accounts.

This file would contain the records of all business taxpayers, and currently existing information would be automatically updated as records were processed through the system. The specific tax being paid would be automatically "posted" to the taxpayer's coded account. Thus, the integrated tax system would automate

# OVERVIEW OF KANSAS BUSINESS INTEGRATED TAX SYSTEM

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routine clerical tasks, minimize data duplication, and reduce the time required to post tax information. It would also provide a way to track taxpayer documents through the system, improving the Department's ability to provide taxpayer assistance.

The figure also shows that other major functions would be "run against" the information contained in the business tax master file. The collections function would use the information to determine what moneys a taxpayer owes the Department. The registration activity would use the information in the master file to identify all the taxes a business should be registered for, and would streamline the registration process by providing a common taxpayer identification number for all business taxes. The audit activity would use the information in the master file to identify businesses that had not filed taxes. By consolidating these functions into one large system for all business taxes, the integrated tax system would allow the Department to identify all the taxes a taxpayer is liable for, coordinate delinquency notices and collections, and simplify taxpayer registration and licensing.

The concept of an integrated tax system was not unique. A number of other states the auditors contacted have tax systems in operation or under development that they integrated to varying degrees. However, none of those states' systems is more comprehensive or more fully integrated than the system proposed for Kansas.

## How Do the Initial Cost and Time Estimates for the Development of the Business Integrated Tax System Compare With Actual Costs and Time?

In an issue paper prepared for the 1981 Legislature, the Department of Revenue estimated that the integrated tax system could be completed by the end of fiscal year 1983 at a cost of $1.6 million. Those estimates assumed that consulting resources would be used throughout the rest of the project. However, the estimates were made before the conceptual design of the project was finished.

The Department revised those estimates as it became more aware of the magnitude of the project. In a March 1983 status report prepared in response to a legislative request, the Department estimated that the portions of the business integrated tax system needed to operate just the sales tax and transient guest tax on that system would be completed in fiscal year 1984. The Department also indicated that completing these portions of the system would represent about 80 percent of the total effort required to process all business taxes under the integrated tax system. The report further anticipated that the rest of the system would be completed in fiscal year 1985.

According to that status report, total development costs through fiscal year 1985 were estimated to be just under $2.7 million. These cost estimates included computer processing expenditures, Department staff salaries, and consultant fees.

Although the Department has not updated its estimate of the system's overall cost since that status report, it has revised its time estimates several times since then, primarily in budget documents. For example, as recently as in its fiscal year 1987 budget request, the Department estimated it would be able to operate both transient guest taxes and sales taxes on the integrated tax system by the end of fiscal year 1986.

## The Department's Time Estimates Have Not Been Realistic, And Its Cost Estimates Have Already Been Exceeded

To date, development of the integrated tax system has cost $2.8 million. As the table on page six shows, $1.7 million of that amount was spent on Department of Revenue staff and data processing. The remaining $1.1 million was spent on consultants.

### Actual Expenditures for the Kansas Business Integrated Tax System

| | Conceptual Design Phase | Detailed Design Phase | Coding & Implementation Phase | Post-Consultant Work | Total Spent To-Date |
|---|---|---|---|---|---|
| Consultant Fees | $155,000 | $429,845 | $483,592 | $0 | $1,068,437 |
| Revenue Staff | 39,406 | 262,559 | 612,927 | 382,522 | 1,297,414 |
| Data Processing | 0 | 194,754 | 164,792 | 97,093 | 456,639 |
| TOTALS | $194,406 | $887,158 | $1,261,311 | $479,615 | $2,822,490 |

Although the total cost to date of $2.8 million is only slightly more than the amount the Department originally estimated a completely integrated business tax system would cost, the system is far from complete. At the time of the audit, Department officials estimated that only transient guest tax would be operating under the integrated tax system during 1987. No one within the Department could say with any certainty when the system would be completed, or what the completed cost of the project would be.

## Why Has the Implementation of the Integrated Tax System Been Delayed For So Long?

Clearly, the business integrated tax system has taken much longer to develop than the Department of Revenue originally estimated, and it has already cost more than planned. Department officials now readily admit that they had vastly underestimated what it would take to design, develop, and implement a system the scope and size of the integrated tax system.

Because of the system's size and the Department's inexperience managing large-scale projects, the Department decided to contract out the management and development of the business integrated tax system. The project was divided into three distinct phases--conceptual design, detailed design, and coding, testing, and implementation. Separate contracts were let for each phase, but Department staff were to perform some of the work as well.

The auditors interviewed key staff members who participated in the system's development. They also reviewed Department memoranda and other related documents that, taken together, describe the project's history to date. In general, they found that the design, development, and management of the business integrated tax system project has been plagued with problems. It appears that many of these problems could have been prevented.



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- The first major delay occurred during the detailed design phase. More importantly, the design specifications the consultant produced during this phase were flawed and incomplete, and could not be used as intended in the final stage of the system's development as the basis for coding computer programs. The Department's ineffective reviews and oversight of the detailed design phase neither prevented these problems nor identified most of them until after the consultant who had done the work had already been paid.

- The Department let bids for the final phase of the project--programming the computer, testing those programs, and putting the integrated tax system into operation--before it realized the magnitude of the problems with the design specifications. Because a different consulting firm won the contract bid for this final phase, the first consulting firm could not be held responsible for the major corrections and rewriting that followed.

- Fixing and rewriting the detailed design specifications consumed most of the scheduled time for the final phase of the project. Because of these design problems and because the Department had modified some elements of the tax system after the final contract had been let, the Department allowed the second consultant to quit working on the project on the scheduled completion date, even though the phase was far from complete. The Department modified the contract to relieve the second consultant of any legal liability for not meeting the original contract terms.

- Since July 1985, the Department has assumed responsibility for completing the integrated tax system. It is still working on the two taxes--transient guest tax and retail sales tax--currently scheduled for incorporation into the system. The development of even this much of the system has been hindered by the Department's failure to assign a full-time manager to the project and its decision to cut back on the staff and computer resources available for the project.

These problems are explained in some detail in the sections that follow.

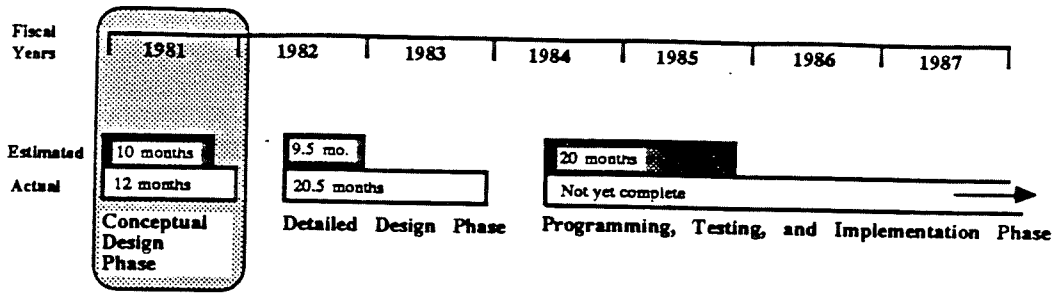
## The Conceptual Design Phase Was Completed Two Months Late, But the Final Product Was Apparently Satisfactory

The conceptual design phase was intended to develop the general framework that would serve as the basis for the eventual implementation of an integrated tax system. In addition, the contract for this phase called for reports to be prepared on the Department's information needs, the adequacy of the existing data processing systems, the relationships among the various revenue collection functions, the costs and benefits of the project, and a management plan for the next phase of the project.

Although the consultant was to be primarily responsible for the completion of this phase, the Department anticipated that State personnel would assist the consultant in gathering information, conducting interviews, and the like.

In June 1980, the firm of Deloitte, Haskins, and Sells was awarded the contract for $155,000, or about $45,000 less than the Department had estimated. Work on the contract began in September 1980 and was completed in late June 1981, or about two months later than specified in the contract.

## Development of the Kansas Business Integrated Tax System




According to the Department, the primary reason for the delay was that the consultant did not devote enough time to on-site supervision. According to Department staff, however, the consultant provided a general design as required, and the final reports from this phase were quite acceptable. They described how the Department operated and the problems that the new system would correct.

### The Detailed Design Phase Was Plagued With Problems That Adversely Affected the Development of the Rest of the Integrated Tax System

The detailed design phase, the next step in the project, in many ways was the most important step in the project's development. The design specifications needed to make the system work were to be developed during this phase, as would the logic that described how all the programs fit together. The reports that the system needed to produce for people using it would also be developed. The objective of this phase was to make the information from the conceptual design specific enough so that it could be coded by computer programmers.

The detailed design phase was to be a joint effort between the consultant and the Department of Revenue. The consultant would provide overall management for the phase and other personnel as needed. The State would provide a project director, three systems analysts, a database administrator, and two revenue analysts. As specified in the contract, these Department staff would provide at least 9,000 hours to the consultant in the project. Other Department staff would be used as needed to review the final products.

7.0 FTE

The detailed design phase contract was awarded to Deloitte, Haskins, and Sells, the same firm that had done the conceptual design. The total cost of the contract was $429,845, about what the Department had estimated. It was scheduled to begin in October 1981 and be completed by the end of July 1982. In fact, this phase of the project ran over schedule by about a year, and the consultant continued to make changes to the final product for about five months after receiving the final contract payment.

The delay itself can be attributed to several factors. First, Deloitte, Haskins, and Sells' development of the detailed design took longer than expected. Some of its early work was full of errors and inconsistencies and had to be redone. Second, the Department's review of the detailed design took much longer than expected. In all, Department staff clocked nearly 22,000 hours during this phase.



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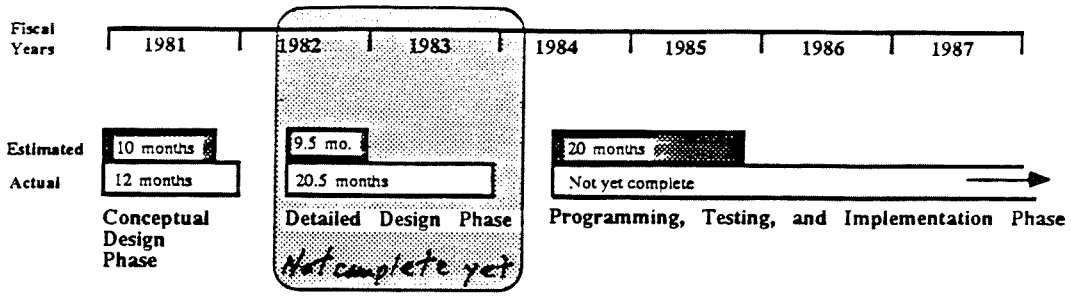
## Development of the Kansas Business Integrated Tax System




But the real problem with the detailed design phase was that the design specifications the consultant produced were later found to be flawed and incomplete. The Department's review and oversight of the detailed design phase neither prevented these problems nor identified most of them until after the final contract payment had been made. These findings are discussed in the sections that follow.

**The Department's management and oversight of the detailed design phase was ineffective and incomplete.** Although it hired consultants to manage and develop much of the integrated tax system, the Department was still responsible for a number of management tasks during each phase--writing contract specifications telling the consultant what it wanted done, reviewing the consultant's work, and ultimately decided whether that work met the terms of the contract and would do what it was supposed to do. In the detailed design phase, the consultant was supposed to produce design specifications that could be "translated" or programmed directly into computer language in the next phase of the project.

The auditors found that the Department failed to adequately carry out its responsibilities over the contract process during the development of the system's detailed design. For example, the Department's contract specifications for the detailed design phase did not specify such things as the level of detail the consultant needed to provide so that the rest of the project could be effectively carried out. Especially toward the end of this phase, the Department became concerned that some of the design specifications that Deloitte, Haskins, and Sells was providing were not written in sufficient detail so that a computer programmer could follow them. In many instances, the firm said it was providing sufficient detail, and that the Department's concerns were not substantive but were simply a matter of preference. The Department generally accepted the consultant's final decision.

During and after the consultant's development of the detailed program instructions, the Department was responsible for reviewing the work to ensure it was technically sound and would work as intended. However, the Department's reviews of the consultant's work during the detailed design phase failed to correct or even identify many of the problems with the design specifications that were later discovered.

The reasons why the Department's reviews were incomplete and inadequate varied. First, the Department staff members assigned to the project apparently had

no experience working on such a large and complex computer system. Further, although these staff members were skilled computer technicians, Deloitte, Haskins, and Sells assigned them to perform the less complex tasks of the detailed design. As a result, the Department's skilled technicians did not become familiar with the more complex parts of the design or how they fit into the overall system design.

Second, the quality assurance team the Department named to review the project was unable to conduct its reviews until very late in the detailed design phase. This quality assurance team was not involved in the actual development of the system's detailed design, but was going to be involved with the next phase--actually using the consultant's design specifications to code computer programs. Thus, its review would have been an important check on the adequacy of the consultant's work. The quality assurance team was unable to conduct its reviews because the staff members on that team had other full-time responsibilities within the Department.

Finally, because of the large volume of documentation and instructions the consultant produced, the Department's staff could not conduct as complete a review as was needed. The consultant's documentation, diagrams, instructions, and coding directions specifying how the system should work filled a total of more than 50 four-inch notebooks. This finished product was so voluminous because the consultant had adhered to the State's newly acquired standardized methodology for designing and developing large-scale projects. That methodology, called the Systems Development Methodology, required reviews, assessments, and decisions to be made at every step of a project, and required thorough documentation of every step.

Because the Department had so much material to review, it divided the review responsibilities among several technical staff and users. The reviews did identify a number of continuing problem areas, such as typing errors, incomplete specifications, and errors in logic, which were sent back to the consultant for corrections. However, the Department could not completely review all the documentation provided.

**The Department approved the consultant's work for the detailed design phase and paid the contract off before the problems being discovered with the design specifications were resolved.** As the detailed design phase was coming to an end, and shortly before the final payment was made to the consultant, some staff members involved in the project began to express serious concerns about the adequacy of the consultant's final products. These included members of the quality assurance team that was originally to have been part of the review process. They indicated to Department officials that the design specifications the consultant had developed were not sufficiently detailed to allow a computer programmer to code from them. One Department employee told the auditors that the the level of detail provided in some of the specifications was comparable to saying "build a car," without providing detailed instructions on actually how to build a car.

In addition, before appropriating funds for the final contract phase (programming, testing, and implementing the integrated tax system), the Legislature asked both the Department and the Division of Information Systems and Communications to review the project management to date to ensure that the detailed design was satisfactory.



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### Large Systems in Other State Agencies

Other State agencies also have large computer application systems in place or under development.

**Transportation:** This agency has a resource management system that is comparable in size to the Kansas Business Integrated Tax System, according to Department officials. The system provides financial, scheduling, and project inventory information for the entire Department. The system was developed in the late 1970s using consulting resources and in-house staff.

The system is integrated, but was developed in discrete pieces that could be implemented quickly. As resources become available, additional pieces, such as personnel and skill information, can be added. Department officials indicated to the auditors that they used the State's standardized development methodology in developing the resource management system's detailed design, but that they modified it to some extent to reduce the volumes of paperwork.

**Social and Rehabilitation Services:** The agency has hired a consultant to work with Department staff to complete the automated eligibility and child support enforcement system (CAECSES). The consultant has designed similar systems for a number of other states, and those designs are being adapted for use in Kansas. Because there are many federal requirements in such a system, common elements exists among all states, making the design of the program somewhat easier than if the agency had to design it from scratch.

**Department of Administration:** This Department has the Kansas Integrated Personnel and Payroll System (KIPPS). This system, maintained on the State's UNIVAC computer system, is quite large. it was primarily developed in-house. It contains millions of pieces of information. According to Department officials, like the Department of Transportation, staff of the Division of Information Systems and Communications, also use the State's standardized methodology in developing their systems.

The Department's status report on the integrated tax system's progress to date was issued in March 1983. That report cited a number of reasons why the system's development had been delayed, including the fact that the Department and the consultant had both underestimated the scope and magnitude of the project, the quality of some of the consultant's written documentation was not up to standards and had to be reworked, and the volumes of materials the consultant produced took longer than expected to review. Nonetheless, the Department anticipated that it could complete its review of the documentation and design specifications by the end of April 1983.

In its formal report on the project, issued in April 1983, the Division of Information Systems and Communications' assessment was generally favorable. Although the Division did not review any of the volumes of documentation and detailed instructions Deloitte, Haskins, and Sells had produced, the report noted that the project was being well-managed and that the use of the new methodology minimized the risks associated with the project. The report did note that some problems existed with the quality of the consultant's work, especially in the area of insufficient documentation, but said these problems were being addressed. In addition, the Division stated that the delays that had occurred in the project were not

excessive for a project the size of the integrated tax system, but it noted that the Department's estimates for the final phase may be too low.

In subsequent informal discussions with Department staff, however, some of the Division's staff apparently pointed out problems. For example, Division staff members indicated to the auditors that they had expressed their concerns about the volumes of materials Deloitte, Haskins, and Sells had produced. They said that because the volumes of documentation and instructions were not well indexed, those materials could not be easily used and did not look like a phase-end document.

Despite these concerns, Department officials were apparently convinced that the problems were not insurmountable, and the consultant was paid. The final payment for the detailed design phase was made in June 1983, even though the Department's review of the consultant's work was not complete. Deloitte, Haskins, and Sells continued to correct and revise various parts of the design specifications through November 1983, five months after it had been paid by the State.

## The Department Let Bids for the Programming, Testing, And Implementation Phase of the Tax System Before Fully Realizing the Magnitude of the Problems With the Design Specifications

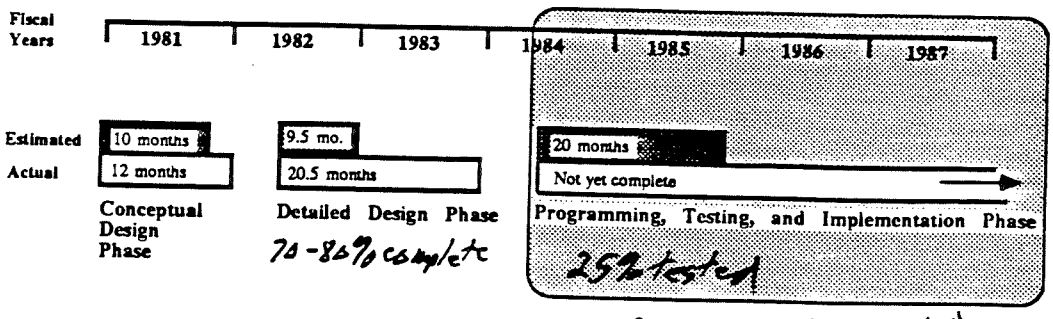
The contract for the final phase of the project called for the recipient to use the design specifications developed by Deloitte, Haskins, and Sells as building blocks to write and test the programs and implement the integrated tax system for two taxes--transient guest tax and sales tax. The outcome of this phase was to be a completed system that would be ready to process the two taxes.

12.0 FTE

This phase was to be a joint effort of the contractor and the Department. The contractor was to provide management and technical assistance and the Department was to provide a project director, a quality assurance group made up of three technicians, and eight full-time programmers who would work under the supervision of the contractor for at least 9,500 man-hours. The phase was to start in November 1983 and was to be completed in June 1985.

The final contract was awarded to Alexander Grant and Company. The firm submitted a bid of $483,592, almost $200,000 under both the bid submitted by Deloitte, Haskins, and Sells and the amount the Department had estimated the phase

**Development of the Kansas Business Integrated Tax System**




coding existing data "big task"

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would cost to complete. In its proposal, the firm stated that its bid was 30 percent below normal rates because it wanted to gain experience doing government work.

Alexander Grant and Company quit working on the contract for this final phase on or near the scheduled completion date. But the system was far from complete. Almost immediately after starting the contract, the firm indicated it could not use the design specifications to code computer programs because those specifications were flawed and incomplete. Fixing and rewriting the design specifications ultimately consumed much of the scheduled time for this contract. For these and other reasons, the Department modified the contract, allowing the firm to quit on schedule and relieving it of any legal liability for fulfilling the contract terms. These findings are discussed in detail in the sections that follow.

**Within a week after beginning the final phase of the project, Alexander Grant and Company indicated that its programmers could not use the design specifications produced by Deloitte, Haskins, and Sells because they were flawed and incomplete.** According to both the Alexander Grant and Company and Department employees, the design specifications were not written in sufficient detail to allow the programmers to program directly from them. A Department employee told the auditors that a one-page specification sheet he reviewed became 10 pages long by the time he had brought it up to the necessary level of detail.

In addition to the lack of detail, Alexander Grant and Company indicated that the detailed instructions it had to work with were often unclear and incomplete, and sometimes incorrect. It cited such problems as a lack of documentation of the system's logic and unclear definitions.

It appears that the switch in consulting firms midway through the project compounded the problems being identified with the design specifications. At a minimum it resulted in a tremendous loss of continuity and understanding of how the integrated tax system would actually work. The auditors were not able to determine whether the programming could have been done with fewer problems if Deloitte, Haskins, and Sells had won the contract and had been on-hand to manage it.

**Fixing and rewriting the detailed design specifications consumed much of the calendar time scheduled for this contract.** Had Deloitte, Haskins, and Sells won the contract, the Department could have required it to correct the errors and inconsistencies that were found in the design specifications. Given the change in consultants, fixing and rewriting the detailed design specifications became the Department's responsibility, and the project could not go forward until the problems and errors were resolved. Alexander Grant and Company agreed to assist the Department in this task.

Well into the contract period, Alexander Grant and Company expressed concern that it was using all its scheduled time and resources to help the Department correct the design specifications. It established a deadline of May 1984 for all corrections to be made so that it would have sufficient time to complete the rest of its contractual obligations.

The Department could not meet that deadline for several reasons. The process of correcting the detailed design specifications was difficult without the assistance of the Deloitte, Haskins, and Sells staff who had designed the system

and understood its details and complexities. None of the Department's staff members working on the project had a good understanding of how the overall system worked. Also, some key members of the staff, who had worked on the system's development and understood at least parts of it, had resigned.

Trying to meet the consultant's deadline for correcting the detailed design specifications, the Department reassigned responsibilities for some of its staff members working on the project. As a result, other important tasks that they were responsible for completing during this final phase of the system's development--such as converting, coding, and entering existing data for business taxpayers onto the master file--were not completed as planned. But in all, Department staff spent a total of nearly 43,000 hours working on this phase of the system.

**The Department agreed to modify its contract with Alexander Grant and Company because it had not fulfilled all its contractual obligations and had changed the design of the system after awarding the contract.** In August 1984, the contractor asked the Department to modify its contract based on the delays caused by the need to correct or rewrite most of the detailed design specifications.

It also cited the fact that the Department was continuing to make modifications to the system design. Throughout the final phase of the project, the Department modified some of the key elements in the basic design of the tax system. While working with the design specifications, Department staff began finding ways that the system needed to be changed or could be improved. By the end of the second month of the contract, the Department had added more than 70 programs to those listed in the contract. When it bid on the contract, the consultant indicated, the contract had consisted of fewer programs.

The Department's project manager objected to the proposed modification because Alexander Grant and Company had inspected the design specifications before bidding on the contract and had attended the pre-bid conference held to answer bidders' questions. However, Department officials apparently decided they could not hold Alexander Grant and Company to the original contract, and agreed to modify the contract.

Those modifications relieved the contractor of the commitment to provide any additional staff to the project and allowed it to quit working on the project on June 30, 1985, the originally scheduled completion date. If the project was not complete at that time, the consultant would be required to provide 20 additional staff-days from one staff member. At the end of this 20 staff-day period, the contractor would be relieved of any responsibility for correcting errors in any programs it had completed. The Department agreed to pay the contractor in full for the contract.

**At the conclusion of the contract, the business integrated tax system was far from complete.** Alexander Grant and Company quit working on the project on June 30, 1985. At the Department's request, the consultant supplied 20 days of one of its staff member's time over the following six weeks for no additional money. When the consultant left, three of nine groups of programs had been completed, tested, and accepted by the Department. In addition, some of the programs in the other groups were in varying stages of completion and testing. Many of the remaining design specifications still had not been reviewed and



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22,100 + 43,000 + 24,000 = 99,000 hrs.

corrected. Nevertheless, Department officials told the auditors that they felt the Department had "gotten its money's worth" for this phase of the project.

## Since June 1985, the Department Has Been Working To Complete Parts of the Integrated Tax System Using Its Own Staff, But It Apparently Has Not Placed a High Priority on the Project

After the contractor left, the Department decided to concentrate only on those programs necessary to operate transient guest tax. Department staff have also had to continue reviewing and correcting design specifications that were incomplete. Since July 1985, they have spent nearly 24,000 hours working on the tax system. 7 FTE

During their review of the system's development since July 1985, the auditors identified several problems that led them to conclude the Department had not placed a high priority on completing the business integrated tax system. Specifically, the Department has not assigned a full-time manager to the project and it has reduced the other staff resources devoted to the project. These and other problems are explained more fully in the sections that follow.

**The Department of Revenue has not assigned a full-time manager to the project since assuming full responsibility.** Throughout the contractual phases of the integrated tax system, the Department required the consultant to provide direct management for the project. Since then, no full-time manager has been assigned to the project. The current project manager has other duties and has been able to devote only about 15 percent of his time to the integrated tax system's development. As a result, the lead analyst, who also has other duties, has had to assume some of the management duties. Recently, however, the Department assigned another person to manage the development of the sales tax. That staff member will devote approximately 30 percent of his time to the project.

**The Department has reduced the other staff resources devoted to completing the integrated tax system.** Within six months after the last consultant left, the project team was reduced by seven programmers and one data processing person. Many of these employees were transferred to other systems that were being developed within the Department. Others quit their jobs and were not replaced. Currently, two full-time analysts, four full-time programmers, and a part-time analyst/programmer are assigned to the project. This reduction in staffing levels has slowed down completion of the programming and testing for the project. (8.0) FTE 6.0 FTE

## What is the Business Integrated Tax System Currently Expected to be Able to Provide, When, and at What Cost?

The Department of Revenue initially estimated that a fully integrated business tax system could be developed and in place by the end of fiscal year 1983. All 25 business taxes were to be on that system. More efficient processing of business tax returns and more effective use of business tax information was to have resolved the litany of problems that have been cited with the Department's past tax processing and collection efforts. Such problems were identified by the Department during the 1970s, by the IBM Information Systems Plan in 1980, by Deloitte, Haskins, and Sells in its conceptual design reports, and by Legislative Post Audit in performance

audits conducted in 1982 and 1985. The Department has often stated that a fully integrated tax system would address most of these concerns.

To answer this question, the auditors interviewed Department officials and reviewed pertinent budget documents and memoranda. Department staff estimate that the system's development is 70-80 percent complete, but some of them have expressed concerns that parts of the system's design are cumbersome, inefficient, or outdated. The Department may soon be able to start processing transient guest taxes on the integrated tax system, but it appears to be far from that point for retail sales taxes despite its published time estimates.

Given the continuing problems with the system's development, there appears to be no assurance that a fully integrated tax system will ever be put into place in Kansas. It appears that serious consideration should be given to stopping the development of the current integrated tax system and realistically assessing the steps that need to be taken to fix or replace that system. These findings are summarized below.

## Department Staff Estimate That the System's Development Is 70-80 Percent Complete

Department staff now indicate that the "core" programs of the integrated tax system are largely finished. However, each tax that is "plugged into" the system has some unique features that have to be incorporated into this core system. That requires varying amounts of additional programming, and considerable testing and retesting. Also, before any tax can be operated on the system, the existing information for all those specific tax accounts must be converted and entered into the integrated tax system's master file. For any of the larger business taxes, which have thousands of accounts and up to millions of records, that task could be enormous.

## The Department May Soon Be Able to Process Transient Guest Taxes on the Integrated Tax System, But It Is Far From That Point for Retail Sales Taxes

Since January 1986, the Department has been testing the integrated tax system by processing historical transient guest tax returns through the system to ensure that the results correspond to previous results. In addition, it has been converting and entering historical data for the transient guest tax accounts into the integrated tax system's new master file. That step is nearly complete.

As of early March 1987, Department officials indicated that all the problems that surfaced during these tests should be resolved within a month. At that time, the Department will begin processing current transient guest tax returns through the new system. For about six months, the Department will simultaneously process transient guest tax returns through the old manual system. Once any additional problems that surface have been resolved, the Department will no longer use the manual system for transient guest taxes.

According to Department officials, most of the computer programs needed to incorporate retail sales taxes into the integrated tax system have been written but have not been thoroughly tested. Kansas has about 80,000 retail sales tax accounts, which paid in more than $490 million to the Department in fiscal year

1986. Testing the system for processing retail sales taxes will be far more complex and time consuming than the testing done for the relatively small number of transient guest tax accounts. According to Department officials, the number of retail sales tax accounts and transactions is too large to be tested all at once.

In addition, sales tax information that exists on the current automated sales tax system has not yet been converted and entered into the integrated tax system. Because of the years' worth of data that will have to be converted, this conversion effort will take some time. The Department recently formed a task force to determine the most efficient way of converting the existing data to the new system. Once the programs have been written and tested and the current data have been converted to the new integrated tax system, additional tests have to be run on the entire sales tax portion of the system.

### Department Officials Are Unable to Say At This Point Which Business Taxes Will Eventually Be Placed On the Integrated Tax System

The auditors interviewed the project leader assigned to the integrated tax system project and the Secretary of Revenue about which taxes they eventually expected to be able to process through the integrated tax system. The project leader said he thought the system would still be able to incorporate all the business taxes originally scheduled for inclusion in the system.

The Secretary of Revenue indicated that the system should definitely include the rest of the excise taxes because they are mirror images of the transient guest tax. Excise taxes include the retail liquor and liquor enforcement excise taxes, the bingo enforcement tax, the cereal malt beverage tax, the gallonage tax, and the cigarette tax. These taxes are among the smallest of the business taxes. They generally have 1,500 or fewer tax accounts, and generate from $700,000 to less than $20 million a year in tax receipts.

The Secretary also indicated that once the excise taxes were successfully placed on the system, the Department should examine the other taxes--such as the corporation income tax and the withholding tax--to determine whether sufficient benefits would be gained by putting them on the integrated tax system.

The two taxes cited here are among the largest--second only to the retailers' sales tax. For example, in fiscal year 1986, there were 36,000 corporation income tax accounts, and receipts from that tax totaled more than $81 million. Withholding tax accounts in 1986 numbered 65,000, and receipts totaled nearly $556 million. If the Department should decide not to put these larger taxes on the integrated tax system, or if it is unable to do so, many of the cost benefits and increased efficiencies initially attributed to the integrated tax system will be greatly reduced.

### Department Staff Generally Support the Concept of an Integrated Tax System, But Some Have Expressed Concerns That Parts of the System's Current Design Could Make the System Inefficient and Unmanageable When It Begins to Operate

The auditors interviewed many of the current staff members involved in the integrated tax system's development, all of whom indicated their support for the system. At the same time, however, some of these same people indicated that the

current design of the business integrated tax system had shortcomings that may make it unmanageable and difficult to use. The most frequently cited shortcoming was the design of the system's accounting function, followed by the poor design of the local tax processing function and the use of outdated computer technology. These shortcomings are described briefly in the sections that follow.

**GENERAL INFORMATION ABOUT BUSINESS TAX SYSTEMS IN SURROUNDING STATES**

The auditors contacted staff in the surrounding states to determine what kinds of tax systems they had. Although the auditors were unable to obtain detailed information about actual similarities and differences between those states' business tax systems and Kansas' integrated tax system, it appears that Kansas' system is among the more complex. To greater or lesser degrees, all the states contacted are tackling the process of integrating their business tax processing systems. Also, officials from every state indicated that the development of their systems was both lengthy and costly. General information about tax systems in surrounding states is presented below.

**Oklahoma** Unlike the "master file" database of business tax information that would be created for Kansas' business integrated tax system, Oklahoma's business tax system maintains information about each business tax in separate computer databases. However, because business taxpayers have a single identification number, information from each business tax can be pulled together to provide summary information about an individual taxpayer. Accounting and collections programs are also maintained in separate computer databases. Oklahoma originally anticipated that its business tax system would take seven years to complete at a cost of $13 million, but the project has not received that much support. Currently, only programs for sales tax and franchise tax are complete.

**Nebraska** All business tax information is stored in a common master file, and business taxpayers have the same identification number for all their business tax accounts. The system has a separate accounts receivable file.

**Missouri** Under Missouri's business tax registration system, taxpayers are given the same identification number for all their business tax accounts. All sales tax accounts are currently on Missouri's central registration system; withholding tax will be placed on the system next. Missouri plans to add financial and accounts receivable programs to the system at a later date.

**Colorado** Colorado is in the process of incorporating all business taxes into a system that should be in operation by 1991. If Colorado meets that deadline, total development time for this system will have been about eight years. The accounts receiveable part of that system is already in operation, and a common registration program is ready to go.

**Inefficiencies in the integrated tax system's accounting function may place a drain on the State's computer storage capacity and could limit the Department's ability to respond to taxpayers' inquiries.** The current design takes a manual double-entry accounting system and automates it. According to some Department staff, such an accounting system is inefficient



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because it requires that data be entered several places in the computer's files when one entry would suffice. Also, the design requires a substantial amount of the computer's storage capacity. There is some concern that this will limit the amount of taxpayer information that can be stored on-line.

In addition, in a system as complex as the integrated tax system, one of the most important elements of the design is determining what the people who will use the system need to get out of it. The auditors interviewed many of the people on the Department's staff who will be the key users of the integrated tax system. Some of them said that, during the detailed design phase, Deloitte, Haskins, and Sells had never discussed with them the kinds of information, summaries, and reports they would need from the integrated tax system to improve their ability to respond to taxpayers' inquiries.

For example, the auditors were told that the new system will not provide summary information on one computer "screen" for an individual taxpayer as is currently done. That information will be organized and separated by month, so that no more than one month's transactions can be viewed at a time. Under the system that is currently being used, taxpayer information is organized in a continuous fashion. Some staff members expressed concern that the new system would apparently make it more difficult for them to answer taxpayers' questions about the status of their tax accounts.

**Although processing local sales taxes is a key activity of the Department, the integrated tax system lacks the necessary support for processing those taxes.** Localities in Kansas are increasingly implementing local sales taxes, which businesses submit with the remittances they owe for State sales taxes to the Department. The Department is responsible for ensuring that the local sales tax receipts are distributed back to the appropriate local units of government. During their interviews with the auditors, Department staff commented on the poor design of the local tax processing function. They said that the system needed to be enhanced to provide users with on-line information about those taxes. Such information would then allow them to respond to taxpayers' inquiries.

**Some technical staff indicate that parts of the current design will represent a "step backwards" in technology.** In fact, some parts of the system are less technologically advanced than the Department's current tax processing systems. For example, the current data entry system uses on-line computer technology (taxpayer information can be entered directly into the computer's files). Under the business integrated tax system, taxpayer information typed onto a keyboard will be entered onto a separate data disk, that will then be entered into the taxpayer's computer file.

## The Department Has Not Provided Updated Cost Estimates, But On-Going Expenditures For the Next Several Years Have Been Estimated at More Than $500,000 a Year

Since the consultants left, the Department has incurred only in-house personnel and data processing costs. It has not prepared any estimates of how much it would cost to fully implement the integrated tax system, but some estimates of annual expenditures are available.

In the Department's fiscal year 1988 Information Systems Plan, expenditures for data processing services, computer storage, and the use of terminals and printers are estimated at about $330,000 each for fiscal years 1988 and 1989. Data processing expenditures for fiscal year 1987 were estimated to be $115,932. For the first seven months of the fiscal year, actual data processing expenditures have totaled about $26,000.

On-going personnel costs have been about $183,000 per year. This number is somewhat understated because it computes programmer expenditures using hours actually charged to the project rather than monthly salaries. The figure also excludes fringe benefits.

For the first seven months of fiscal year 1987, nine people worked on the integrated tax system project. These included a project leader, four full-time programmers, two part-time analysts, and two full-time analysts. The Department has recently assigned three additional people full-time to work on the conversion team for the sales tax portion of the project. It is anticipated that these three people will work on the tax system full-time as soon as transient guest tax is implemented. When they do, on-going costs will increase by about $73,000 per year.

### The Department's Time Estimates For Completing Parts of the System Are Misleading, and at a Minimum Suggest the Department Is Vastly Underestimating the Magnitude of the Project

Department officials have estimated that transient guest tax information will be able to be processed on the integrated tax system in 1987. However, they would not give the auditors a firm estimate of when they thought sales tax accounts would be placed on the system. Their estimates ranged from next year to 1995. The Department has provided firm estimates in other sources, however. For example, the Governor's budget for fiscal year 1988 states that retail sales tax accounts should be incorporated into the integrated tax system during the current year.

The Department also stated that sales tax accounts would be incorporated into the integrated tax system by the end of fiscal year 1987 in its fiscal year 1988 Information Systems Plan, prepared in November 1986. According to that plan, all 25 business taxes would be placed on the integrated tax system by fiscal year 1991 as well.

These published estimates appear to be very unrealistic. Without a significant increase in staffing and resources, it seems clear that the Department will not be able to place the retail sales tax on the integrated tax system this year or in the near future. That tax--or any of the other business taxes--cannot be incorporated onto the system until it has been thoroughly tested, the historical information for that tax has been converted and entered into the integrated tax system's database, and the staff has been adequately trained. The prognosis for getting any of the other major business taxes onto the integrated tax system at this point seems minimal at best.

### Conclusion

It is clear that the current tax systems in place in Kansas are inadequate and inefficient, and that the State needs an improved system for collecting, processing, and administering its business tax system.



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An integrated tax system in Kansas offers the advantages of increased efficiency in the Department of Revenue's tax processing, administration, auditing, and collection efforts. It would benefit taxpayers and administrators alike.

Unfortunately, the development of a business integrated tax system in Kansas has been plagued with problems since its inception. The Department of Revenue and its consultants have consistently underestimated the complexity of developing an integrated tax system, and have consistently missed their targeted deadlines. Those problems continue to this day.

The Department is currently working on the system without a realistic long-range plan or realistic time or cost estimates. Nearly seven years after the project was started, only one small tax will be ready this year to be processed on that system. The Department can provide no assurances that a fully integrated tax system will ever be implemented, or that a scaled-back version of the integrated tax system will work well for the taxes that might be included in it.

**Recommendations**

1. The Department of Revenue should continue its efforts to place the transient guest tax system onto the Kansas Business Integrated Tax System, but all further development efforts on the integrated tax system should be halted immediately.

2. The Department should reassess its business tax processing objectives and the ability of the Kansas Business Integrated Tax System to meet those objectives. Following that reassessment, the Department should develop a firm, long-range plan for upgrading the State's ability to efficiently and effectively process and collect business taxes in Kansas. That plan, which should be submitted for legislative consideration, should include realistic cost estimates and attainable deadlines. Elements of this plan should also address provisions for a full-time project manager, adequate resources, and continuity in personnel.

3. As it develops this long-range plan, the Department should consider the cost-benefit implications of the following options:

a. Continue developing the Kansas Business Integrated Tax System, making certain that the problems identified in this report are thoroughly studied and adequately resolved.

b. Discontinue the development of the Kansas Business Integrated Tax System, and upgrade or replace the Department's current individual systems for administering the various tax systems on a tax-by-tax basis. This option would allow the Department to address many of the efficiency problems that have been identified in the past, but would continue the current practice of a non-integrated tax system.

c. Discontinue the development of the Kansas Business Integrated Tax System, and start over to develop an integrated system that will adequately improve the State's system for collecting, processing, and administering business taxes.

4. Whatever action the Department ultimately takes, it should seek assistance and guidance as needed from the Division of Information Systems and Communications. If additional consultants are hired to work on the project, the Department should involve the Division as well, and should ensure that the kinds of problems identified in this report with the Department's oversight and review of the contract process are not repeated.

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## APPENDIX A

### Agency Response

On March 13, 1987, copies of the draft audit report were sent to the Department of Revenue. Its written response is contained in this appendix.



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KANSAS DEPARTMENT OF REVENUE
*Office of the Secretary*
State Office Building · Topeka, Kansas 66612-1588

March 19, 1987

Mr. Meredith Williams
Legislative Post Auditor
Legislative Division of Post Audit
301 Mills Building
Topeka, Kansas 66612



Dear Mr. Williams:

The Department of Revenue has reviewed the draft Legislative Post Audit report dated March 13, 1987 entitled, "Problems Implementing the Kansas Business Tax System (K-BITS)". Given the complexity of the subject, the nature of the findings, conclusions and recommendations contained in the audit report, the department's response is necessarily lengthy.

When the department was advised that a performance audit was to be undertaken on K-BITS, we were encouraged that potentially much could be learned from an independent review of K-BITS. It is apparent that the eight weeks allotted is much too short a time to review this complex tax processing system and coordinate a true performance audit.

Such a "performance audit" on a computerized financial tax processing system would have required the wearing of many hats: computer systems analyst, financial accountant, and business analyst. The concern of the department is that the "audit" simply represents the accumulation of discrete facts about K-BITS and its development, but very little independent analysis of the system.

The audit report bases many of its conclusions on unverified "opinions", "perceptions", and "out-of-context" statements. The failure to penetrate these opinions and evaluate them leads to unsubstantiated recommendations. The report also fails to recognize that K-BITS is not an island unto itself, but rather a project within a large organization that has several missions. What the department



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had anticipated was an integration of the facts into a report which would provide an insight into the problems, decision factors, prioritization of internal programs against legislated programs and other trade-offs associated with govenmental management. This balance is not evident.

Therefore, the department can not agree with the audit report recommendation to terminate K-BITS and conduct a long-range plan following the implementation of transient guest tax because:

a. The recommendation ignores the integration between transient guest tax and sales tax and the significant work that has already taken place on sales tax development. The extent to which they share features and shared code is illustrated by the fact that of the 191 batch programs that have already been coded and tested only 22 are transient guest tax specific.

b. Transient guest tax would not be an effective yardstick on which to evaluate either the performance of K-BITS or its effectiveness in meeting business tax processing problems. An examination of sales tax under K-BITS is a critical element in determining the effectiveness and efficiency of the K-BITS design.

c. As the audit report appropriately indicates, the problems identified in 1980 are the same as those we face today. For example, the accounts receivable for sales tax has increased from $7.5 million in 1980 to approximately $26.7 in 1986. Development of a new design to respond to today's problems would contain many of the same features present in the K-BITS design.

The department believes the appropriate steps are to implement transient guest tax and sales tax and perform a post implementation review before integrating any additional taxes under K-BITS.

The remainder of this document contains the department's response to the audit report which will address in greater detail the specific concerns the department has with the audit.

## I. Disagreements of a Factual Nature

A. Payments to Consultants

The department did not, as asserted on page 14-15 of the audit report, pay the consultant an additional $20,000 to work 20 days beyond the contract termination date. The total cost of the contract, $483,592, represented the entire amount paid to Alexander Grant and Company.

B. K-BITS Design Issues

Three "shortcomings" in the design were reported on pages 19-20 of the audit report. The audit report appears to have taken personal opinions, used them out-of-context, and represented them as fact. The department feels that further clarification of these issues is needed.

**1 a. Accounting Function:** Financial integrity is at the heart of any good tax processing system. Lack of financial integrity in our present business tax systems was the driving force behind the agency's desire to develop K-BITS. While the department has not been satisfied with the project management expertise of Deloittte Haskins & Sells (DH&S), it is **not** prepared to conclude that a Big Eight certified public accounting firm with experience in designing computerized accounting systems developed an inefficient accounting system with K-BITS. However, the department would not wish to understate the difficulties associated with the implementation of a complex financial accounting system.

To determine whether the present K-BITS accounting system is inefficient would require personnel with combined expertise in governmental accounting systems and data processing. No one in the Department of Revenue has these expertise. It is the department's opinion that conclusions were made in the audit report in the absence of an analytical review of this issue. Efficiency is essentially an issue of performance. That review should properly take place during post-implementation review of sales tax.



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The department would welcome and encourage an independent review of this issue during the post-implementation review period.

## 1 b. On-Line Support

A second concern raised by the audit report relates to on-line support to taxpayer inquiries. In essence, the audit report concluded that K-BITS is different from the current business tax systems in this respect. That is certainly true. However, the audit report seems to conclude, or at least repeat the conclusions of "others", that this constitutes a problem.

With integration of multiple taxes, the complexity and costs associated with displaying information on-line increases exponentially. The ability to determine the accounts receivable status of a business via an on-line screen is supported in the K-BITS design. This is available by multiple taxes as well as by each tax separately. If the taxpayer challenges the accuracy of that data, it is true that it will be necessary to page through multiple screens. It is also true that at some point in the examination of the account, the department will have to rely on microfilm copies of returns and related adjustment documents in order to fully review the account.

If the audit report had examined the continuous screen feature present in the current sales tax system the report would conclude that review of the account by filing period, a requirement in communication with difficult accounts, is burdensome at best. When multiple local taxing jurisdictions are involved increased complexity is introduced.

What the audit report failed to address in the discussion of the accounting function of K-BITS are design "trade-offs". Posting accurate data to the Business Master File more quickly will significantly increase taxpayer and agency personnel confidence in the computerized data. That confidence will significantly reduce the number of taxpayer complaints with the current system and reduce the number of financial adjustment documents currently being processed in the sales tax system due to erroneous postings.

Finally, the audit report failed to take note of the significance of filing period accounting. The department's statutory requirement to update interest monthly is not supported in the present sales tax system. Filing period accounting supports that requirement in

addition to supporting the revenue estimating process. Associating business tax liability by filing period offers another degree of precision to the state's task of accurately predicting State General Fund receipts associated with the processing of business taxes. The department's present system only supports "process month" accounting which is often subject to available manpower in the key document processing bureaus. K-BITS will support both process period and filing period accounting. Again, the issue is one of trade-offs and to evaluate a design solely on the basis of "opinions" of some employees working on the system creates indefensible conclusions. The other users of the system include the taxpayer, the legislature, and departmental management.

## 2. Local Sales Tax Issue

The issue of local sales tax processing and its relationship to on-line support is currently being reviewed within the agency. Again, the issue of design trade-offs is relavent. To provide "on-line" information display at the level of detail suggested by some of those quoted in the audit report must be evaluated against issues of system performance and measured benefit. For example, the number of I/O's (input and output read/writes) to support each inquiry vs. other methodologies needs to be examined. The conclusions of that analysis should then be reviewed through post-implementation analysis.

Again, the Department is concerned with the inclination of the audit report to simply repeat "opinions" and "perceptions" out-of-context and in the absence of an independent analytical review.

## 3. K-BITS design "step backwards" in technology

Of all the impressionistic conclusions contained in the audit report, this is the most disturbing and misleading. K-BITS does **not** represent a step backwards in technology nor does it represent "less technologically advanced processing" than currently exists in the department's current tax processing systems.

A major problem with the current tax systems is that erroneous data is posted to master files. The K-BITS design establishes a Work-In-Process (WIP) file for the express purpose of getting data into a temporary file quickly without sacrificing financial integrity. The assertion that the curent tax systems at data entry represent

advanced technology compared to the use of a key-to-disk system (CADES) for K-BITS is misleading.

The current tax systems rely on "on-line" edits whereby the data entry operator is prompted through the entry of return data until certain edits fail. This has the effect of "delaying" initial entry in general and in the worst case relegates portions of the entry staff to performing error resolution functions. This represents inefficiency in personnel management and slows initial posting to a temporary file. Worse still, it represents a compromise between the extent to which a return can/should be throughly edited vs. the time necessary to accomplish the task.

While there is no technical reason that K-BITS could not have adopted the current tax processing data entry philosophy, there are many business and document processing reasons why it was not selected. One of the business reasons is that the CADES system was purchased by the department in September, 1986. Other than monthly maintenance fees, it represents a previous departmental investment. The purchase cost for the system has already been made. Secondly, separating data entry from error resolution functions promotes efficiency.

With K-BITS, on-line entry is not limited to corrections to the WIP File **prior** to Master File posting. On-line support is also provided at tax registration and file inquiries. In other words, there are times when on-line processing is not the most efficient design decision.

**By inference**, the audit report suggests that other examples exist that illustrates that K-BITS is a "step backwards" in technology in comparison with the current tax systems. The department would be interested in the auditors providing other such examples.

## II. K-BITS ESTIMATING PROBLEMS

Much has been made in budget hearings and now in the audit report about the Department's inability to accurately estimate completion dates and project costs for K-BITS. The audit report points out on page 5 and 15 that K-BITS was estimated to be on-line by June, 1983. What the audit report neglects to point out is the assumptions on which those estimates were made were:

- Legislative authorization of nine (9) new technical positions.

Only three technical positions were authorization

- Authorization of $1.275 million in consulting monies, $450,000 in FY 1982 and $825,000 in FY 1983. Only $1.145 million was authorized and the competeive bidding process resulted in only $1.07 million actually being expended.

- Increased assignment to the K-BITS project team of current Departmental analysts and programmers.

- That consultants would perform their responsibilities in an effective manner.

The State of Kansas purchased Systems Development Methodology (SDM-70) in 1981. SDM-70 is a system that provides guidance to systems development personnel in designing and implementing computer systems. This methodology was not available to the department in the early days of K-BITS development to assist in our development or in estimating work associated with budget requests for the project.

The department requested that the audit report consider SDM-70 in order to appreciate the dynamics involved in estimating completion dates and costs at various stages in the systems development life cycle. A single sentence statement in the audit report , "However, the estimates were made before the conceptual design of the project was finished" doesn't do the issue justice.

According to the SDM-70, "When making future projections of the costs, the accuracy of such projections will vary depending upon the point in the system life cycle at which the projection was made". **For example:**

-Completion dates and associated costs are not very meaningful if made anytime before the detailed external specifications are developed. SDM-70 indicates that the possible **variation** could **exceed 100%.**

-Even at the conclusion of detailed external specifications, costs can be expected to vary 20-30%.

The audit report states that the department has expended approximately $2.8 million dollars to date on K-BITS development. In light of SDM-70 guidelines and the point in the project at which the two completion estimates were made that are referenced in the audit report, June, 83 and the end of Fiscal Year 1986. It should not be either surprising or particularly alarming that the department has missed its estimates.

What should be comforting is that the department has weathered many storms along the way and, for all practical purposes, implemented transient guest tax and believes that sales tax and can likewise be implemented under K-BITS.

Utilizing the audit report figures concerning on-going K-BITS costs of $500,000 per year and assuming that it would take two additional years to implement sales tax under K-BITS, the total cost of implementing transient guest tax and sales tax under K-BITS would be approximately $4 million. The audit report cites the State of Oklahoma as estimating $13 million for a business tax system. The cost issue has been addressed in the audit report without consideration of the economic benefits of K-BITS, another issue the department encouraged the audit report to examine.

## III. Miscellaneous comments

The department feels that there are additional points which need to be clarified before turning to the conclusions and recommendations of the audit.

- The major purpose of a tax system is to insure that taxpayers are paying what is owed and not necessarily to insure that everyone's job in the department remains the same. It is recognized that the degree of difficulty associated with some jobs within the department will be increased with the implementation of K-BITS.

- The department is not making a claim that K-BITS is a perfect system. It is, however, making a claim that it represents a significant processing and economical benefit over the current system.

- The department takes exception to the audit report's

statement that vague and imprecise IFB's have contributed to the communication problems between consultants and agency staff. The department followed SDM-70 guidelines in the preparation of its IFB's.

- The issue of "level of detail" as it applies to program specifications is not a black/white issue. There is no universal standard as to what consititutes adequate level of detail. Ultimately it depends on who is being requested to do the coding and the particular knowledge, skills and preferences of the programmer.

## IV. Agency Management Issues

The department's concern about the audit report's failure to provide a balanced examination of the decision-making process that accompanies system implementation in a large agency is illustrated by two (2) examples:

1. Business Decision Process

The audit report states that the department made payments to consultants before all the work was completed in an acceptable manner and that the department modified the contract with AG&Co. such that they were no longer liable for management of the completion of K-BITS. While both are accurate statements in themselves, the audit report neglected to examine the reasons for those agency decisions. In both instances, the best business judgment was applied in order to enable the department to continue toward its ultimate objective; the earliest possible implementation of a computer system that would respond to the many tax processsing and accounts receivable problems that plague the department.

Accordingly, to avoid litagation and its associated delays and expense, the decision was made to get the most out of each consultant firm possible. In the department's judgment, that was accomplished. As the audit report states, the department continued to get revised output from DH&S for five (5) months after the last payment was made. Due to the deficiencies of DH&S staff working on K-BITS, our technicians concluded that we had received all which that firm could accurately and effectively accomplish.



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Regarding AG&Co., the problems of hiring a consultant firm that felt no responsibility for the design they were required to code and implement were insurmountable. Their lack of background in the design in general and the department's processing environment in particular consitituted obstacles that were impossible to overcome. This is particularly true when they won the contract on such a low bid, in excess of $200,00 less than was available for the project, and the program specifications had so many problems. Again, the department made a business decision to accomplish the most possible under difficult and trying circumstances. In the department's judgment, that was accomplished.

2. Agency Priorities: K-BITS

The audit report states that K-BITS appears to lack a high priority in the agency and that staff have been assigned from K-BITS to other projects and that some vacancies have not been filled and reassigned to K-BITS. Again, the discrete facts are accurate. However, the audit report failed to examine the matter to determine why decisions were made.

The agency has certain projects whereby delays in their implementation are more serious than delays in implementation of K-BITS. For example, VIPS, statewide reappraisal, implementation of minerals tax, and legislative modifications of sales tax law to name but a few. In most instances, the agency is not authorized sufficient resources to implement projects in a timely basis: something has to give. In the last couple of years, K-BITS has had to adjust to these factors.

This is not to say that K-BITS is not a significant project in the department nor that it no longer holds the potential for addressing agency processing problems as once envisioned. The point is that agency priority decisions have to be made with the total agency mandate in mind.

## V. Comments on Audit Report Recommendations

The audit report fails to adequately represent the current status of the project nor does it indicate the interrelationships between transient guest tax development and that of sales tax. For that

reason, the recommendation on page 21 that "the Department of Revenue should continue its efforts to place the transient guest tax onto the Kansas Business Integrated Tax System, but all further development efforts on the integrated tax system be halted immediately" is unworkable and inappropriate.

Much is made in the audit report about the fact that transient guest tax represents only 425 accounts out of the approximately 233,000 business tax accounts that would be potentially processed under K-BITS. Two points need to be made on this issue:

1. The number of accounts processed through a series of programs is irrelevant when making conclusions as to the amount of design work completed to date vs. the amount of work yet to be completed.

   What is relevant is the extent to which processing one tax, error free, might say about the design in general and the potential for completing similar taxes in the future.

2. With an integrated tax system, considerable shared code exists. This is particularly true with K-BITS. For example, of the 191 batch programs currently coded and tested in K-BITS, only 22 represent transient guest tax specific programs.

A. Recommendation #1

The Department has a substantial investment in completing both transient guest tax and sales tax under K-BITS. It would be foolhardy to stop with transient guest tax only. The issues of efficiency, performance, and potential for additional tax implementations under K-BITS can best be measured with sales tax implemented. At that point, the department would welcome an extensive EDP and/or financial audit designed to address the adequacy of the design.

B. Recommendation #2

The Department has always intended, through post-implementation review of sales tax, to assess K-BITS in terms of whether it meets agency business tax processing objectives. We would be happy to provide the Legislature with a copy of our findings.



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C. Recommendation #3

The department can not agree with the options presented in the third recommendation of the audit report. The only viable options are:

1. Discontinue the integration of additional taxes after sales tax implementation and examine other system solutions to the processing of the remaining business taxes.

2. Develop a set of implementation criteria for the selection of each additional tax under the K-BITS design and proceed one tax at a time.

The option of reinvesting years and millions of dollars developing a new system designed to address the same processing problems existing in the agency would be foolish. The "new" design would in most cases be a mirror image of the current K-BITS design.

D. Recommendation #4

The department continues to value the guidance and assistance of the Division of Information Systems and Communications. We anticipate a continued good working relationship. The department does not concur with the audit report comment that the Department of Revenue failed to properly perform oversight and review of the contract process with consultants.

In summary, the department would not wish to leave the impression that it performed every task and function associated with the K-BITS project in an exemplary fashion. Mistakes have been made. Much has been learned from the process that should alert us, and hopefully other agencies as well, to the risks and difficulties of large systems development and implementation. Our experience in working with consultant firms has also left us wiser and more prepared should future consultant engagements be necessary.

On the other hand, the department wishes to make clear that the K-BITS experience should not be viewed as a failure. A clear

understanding of the circumstances involved in the process and a knowledge of the complexities encountered should lead one to conclude that the project has continued to progress toward a successful implementation. The ultimate implementation will result in benefits to the department far in excess of the costs.

Should you wish any additional comments or information regarding the subject of K-BITS, please let me know.

HTD/...

Sincerely,

Harley T. Duncan
Secretary of Revenue



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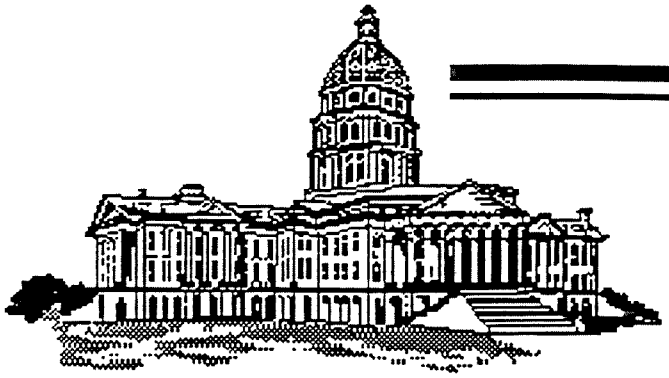

# PERFORMANCE AUDIT REPORT

## DEPARTMENT OF REVENUE
## DIVISION OF TAXATION

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
September 1982

G.O. Comm.
Attach. #4
1/26/89

## FOREWORD

As of the end of fiscal year 1982, more than $16.9 million in sales and withholding tax revenues paid by Kansas citizens had not yet been remitted to the State by businesses that collected the taxes. With such a large amount in outstanding debts from sales and withholding tax collections, it is important that the Department of Revenue maintain an effective system for collecting those amounts and enforcing the law so that additional debts are not allowed to accumulate. Recent concerns over the State's fiscal affairs place even greater importance on ensuring that the Department collects all taxes due the State and that these revenues are managed in a cost-effective manner.

This audit of the Department of Revenue's Division of Taxation was conducted as part of the sunset performance audit of the Department. It focuses on the administration and enforcement of sales and withholding taxes, which accounted for more than half of the approximately $1.35 billion in gross revenues administered by the Division in fiscal year 1981. The Division's effectiveness in administering these taxes was examined in three areas: identifying and registering firms that are required to remit taxes, managing their accounts and periodically updating their filing cycles to ensure that returns are filed according to the schedules called for in the law, and following up and applying penalties on firms not remitting taxes or not filing timely and accurate returns.

The audit concludes that a number of improvements are needed in all three areas examined. It makes a number of recommendations addressing a variety of concerns. However, several common denominators run throughout. Most recommendations call for using resources or laws already available to improve or strengthen management practices, to comply with current laws, and to carry out functions on a more timely basis.

The report recommended improvements that could reap significant benefits. The auditors estimated that at least $4 million a year could be saved from just the few improvements that could be assigned an immediate dollar value. For example, a recommendation to amend the law to provide for more frequent filing periods for withholding tax remittances could increase cash flow and subsequent interest earnings by as much as $3.3 million a year. The auditors also found several instances in which enforcing existing laws could avoid dollar losses. For example, the audit recommends that the Department stop its unauthorized practices of giving blanket extensions for filing retailers' sales and withholding tax returns. Such extensions are not allowed by law and cost the State about $233,000 in foregone interest earnings.

The audit also includes a number of other recommendations with equally important, but less quantifiable, benefits. For example, the audit recommends strengthening the Department's bonding policy to require bonds of all sales and withholding tax accounts at the time of registration and to require an additional bond on "high-risk" accounts. Such a policy could help protect the State from potential losses from delinquent taxes. In addition, the Department's overall collection capabilities would be strengthened because it would not need to rely as much on certain other collection tools, such as warrants, which may not always be effective in collecting delinquent taxes. These and other recommendations to strengthen enforcement of the law could also provide more incentives for businesses to remit taxes on time. Over time, the benefits of more aggressive enforcement and strengthened collection capabilities will be realized in terms of lower tax delinquency rates, improved cash flow, and lower total costs for delinquency follow-up.

Recommendations are made in a number of other areas, including one to use authority already provided in State law to prosecute businesses that continue to make sales after their sales tax registrations are revoked. Such a stringent measure seems warranted because businesses not only are operating in violation of the law, but they also have converted to their own use tax dollars already paid by Kansas citizens.

Taken together, all the report's recommendations--if implemented--could help ensure that the State receives taxes due, is adequately protected from losses from delinquent taxes, and earns all the interest it can on tax revenues.

All the report's recommendations, together with a brief description of the audit's major findings, are presented in the summary that follows this foreword. The Department of Revenue's response to the draft report disagreed with most of the report's recommendations and in some instances questioned the report's accuracy. Legislative Post Audit carefully reviewed all areas of disagreement. This review resulted in a few minor additions and adjustments to the report's text. However, none of these adjustments resulted in changes to the thrust of the report or its recommendations.

Legislative Post Audit appreciates the courtesy and cooperation extended to the auditors throughout the audit by officials of the Department of Revenue. The manager of this audit was Leo Hafner and he was assisted by team members Judith A. Adkison, Roy J. Fitzpatrick, Catherine J. Kutka, and Paula A. (Pam) Michaels. Assistance was also provided by other members of the staff.

Richard E. Brown

RICHARD E. BROWN
Legislative Post Auditor

# Summary of Matters for Legislative Attention

## Audit Findings and Conclusions

This audit of the Department of Revenue's Division of Taxation was conducted in conjunction with the Kansas Sunset Law, which abolishes the Department on July 1, 1983, unless it is continued by an act of the Legislature. Audits are also being conducted of the Division of Alcoholic Beverage Control and the Division of Vehicles.

The audit focused on the Department's administration and enforcement of retailers' sales taxes and withholding taxes because these taxes accounted for approximately 54 percent of the revenues administered by the Division. The audit examined the Department's effectiveness in three areas: identifying and registering firms that are required to remit taxes, managing the accounts and periodically updating their filing cycles to ensure that returns are filed according to the schedules called for in the law, and following up and applying penalties on firms not remitting taxes or not filing timely and accurate returns.

To help assess the Department's performance in each of these areas, the auditors reviewed the activities of various sections within the Division and of related service bureaus in the Department, and assembled cost information on the various steps involved in processing delinquent tax accounts. The Division of Taxation's methods for locating non-filers and those owing additional taxes were reviewed to determine if they were efficient and effective. Finally, a sample of case files for businesses whose December 1980 sales and withholding tax returns were processed after the delinquency cut-off date were reviewed to determine if proper delinquency follow-up procedures had been applied to those accounts.

The following summary describes the auditors' findings in each of the three areas examined, as well as the impacts of those findings on the State's tax revenues and interest earnings.

### Identifying and Registering Businesses

Businesses required by law to remit sales and withholding taxes must register with the Department of Revenue. However, the Department's Field and Audit Services Bureaus attempt to locate firms that have not

voluntarily registered. To assess the Department's effectiveness in locating businesses required to remit withholding and sales taxes, the auditors used a computer to match withholding and sales tax records at the Department of Revenue with the business records at the Department of Human Resources.

The auditors found that the Department has not been locating all businesses that are required to register. Through discussions with Department personnel, the auditors learned that the Department relies principally on its own resources and on voluntary registration by businesses to identify new accounts. The auditors' testwork has shown that using the records available at other agencies, such as the Department of Human Resources, could help locate firms that need to register.

## Managing Tax Remittance Cycles

The second element of an effective enforcement program involves managing the taxpayers' accounts to ensure returns are submitted according to schedules that comply with the law and are cost-effective for the State to process. The auditors found that improvements could be made regarding withholding and sales taxes.

**Amending withholding tax laws.** The State lost an estimated $3.3 million in interest income in fiscal year 1981 because the State's withholding tax law does not require more frequent filing of withholding taxes, based on the amount of tax remitted (withholding tax returns representing annual liabilities of more than $200 are required to be filed each calendar quarter). The auditors' estimate was based on the additional interest revenues that would have been generated if the withholding tax law more closely paralleled the filing provisions of the Retailers' Sales Tax Act--that is, provide for monthly, quarterly, or annual filing, depending on the amounts of taxes remitted.

**Updating sales tax accounts' remittance cycles.** The auditors' review revealed that in 1981, about 38 percent of all active sales tax accounts were filing more frequently than necessary and about 3 percent appeared to be filing less frequently than required by law. Both situations occurred because the Department makes no concerted effort on a regular basis to determine whether sales tax accounts are set up on the proper payment cycle. Instead, the Department depends primarily on voluntary status changes by the firms, or on catching such accounts during normal processing. In short, the accounts are not routinely updated.

Inadequate management of accounts' filing cycles impacts on both the State and the businesses. If the returns are filed more often than necessary, the State and the businesses filing the returns incur losses from handling unnecessary paperwork. Conversely, if accounts are not filed as

often as the law requires, the retailers violate the law. Further, the State loses interest earnings because the State Treasury did not receive the sales tax money as soon as it should have. The auditors estimated that foregone interest and excess handling costs total more than $130,000 each year because returns are submitted too frequently or not often enough.

## Following Up on Delinquent Accounts

The next element of effective enforcement involves the collection of the proper amount of tax on a timely basis and following up on accounts that are delinquent in remitting their taxes. The auditors found a number of problems in identifying delinquent accounts and in collecting on delinquent accounts later on in the follow-up process. The specific problems found with the Department's follow-up procedures and their impacts are summarized below.

**Improving the identification of delinquent accounts.** The first step in following up on a delinquent accounts requires that the Department identify who is delinquent in remitting the taxes and that it assess penalties and interest in those cases as prescribed by law. The auditors found the following problems with regard to determining delinquency:

—**Lenient enforcement of filing deadlines.** The Department granted blanket extensions of deadlines for filing retailers' sales and withholding tax returns during fiscal year 1981, even though there is no statutory provision for this practice. Such blanket extensions caused the State to forego an undeterminable amount of penalty during the fiscal year. In addition, such extensions have slowed the State's cash flow from retailers' sales and withholding tax collections, resulting in about $233,000 in foregone interest for fiscal year 1981.

—**Delayed enforcement of regulations on time extensions.** The Department delayed for more than two years implementation of regulations governing time extensions for filing returns. As a result, the State lost more than $123,000 in potential interest revenues (the one-half of one percent on taxes owed for each month the filing deadline is extended). In addition, the interest rate applied to these accounts receiving time extensions for filing sales tax returns under K.A.R. 92-19-33 is not consistent with the interest rates prescribed in other statutes regarding late filing of taxes.

**Improving the handling of problem accounts.** If delinquent taxes are not collected after first and second delinquency notices, the account is referred back to the Division of Taxation for further action. By now, this account, which has been delinquent three or more months, has become a problem account. Although the auditors found no problems with the Department's issuing first and second notices of delinquency, the audit addresses a number of concerns related to the actions taken on problem accounts.



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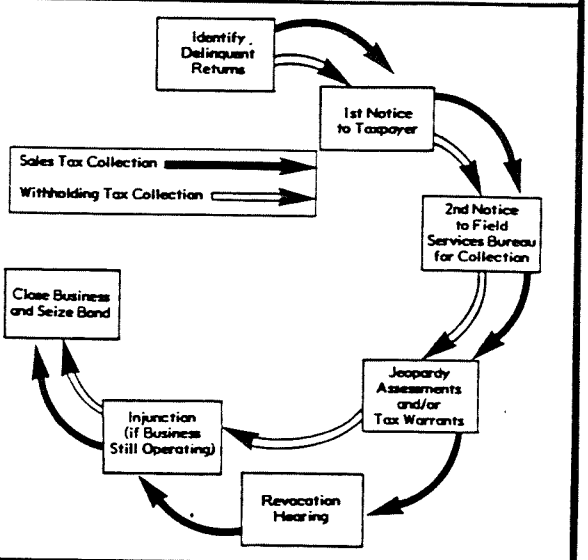
DEPARTMENT OF REVENUE
SALES AND WITHHOLDING TAX COLLECTION PROCESS




Depicted above are the major processes for following up on delinquent accounts for sales and withholding taxes. In general, the further an account goes in the delinquency follow-up process, the more difficult and costly it is to collect. This is particularly true once delinquent taxes are not collected beyond the second notice. By then, these accounts, which have usually been delinquent three or four months, have become problem accounts.

Once an account has become a problem, the actions taken by the Department appear to be less structured and have less stringent time frames for completion. At this point, the Division is given more discretion in both the areas of sales and withholding tax collections. The accompanying figure shows the major processes for following up on delinquent accounts.

The auditors found that in many cases these processes were not instituted on a timely basis and were not used in accordance with statutory mandates. Specifically, the auditors found the following problems with the Department's enforcement of problem accounts:

--**Delays in issuing jeopardy assessments.** The auditors noted that sales tax jeopardy assessments are not always made immediately after the taxpayer fails to file returns after notice from the Director and either terminates business operations or continues the act of making retail sales.

--**Abatement of jeopardy assessments.** The current use of jeopardy assessments by the Department does not appear to be effective as an incentive for businesses to file tax returns.

--**Delays in issuing warrants.** The auditors found that warrants for the collection of delinquent withholding taxes were not being filed as soon as required by law.

--**Lax enforcement of revocations.** The auditors found that the Department lacked uniform, objective criteria for determining when certain businesses sales tax registrations should be revoked. The auditors also found instances in which businesses continued to operate after their sales tax registrations had been revoked--flagrantly violating the law. Although State law gives the State authority to impose fines for such violations, this authority is not being used. Considering that



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these businesses have converted tax dollars already paid by Kansas citizens, such stringent measures would seem warranted.

—**Delays in preparing injunctions.** In reviewing the injunction process, the auditors found timeliness problems regarding both sales and withholding taxes.

—**Ineffective bond policy and practices.** The auditors' review of bonding sales and withholding tax accounts shows that current policies do not appear to be effective. Bonds generally are not sought for withholding tax accounts. Many of the bonds that were posted for sales tax accounts did not cover the liabilities accumulated during the lengthy collection follow-up process. Further, bond amounts apparently were not updated to reflect business' increases in tax liabilities.

## Audit Recommendations and Agency Responses

The draft report was sent to the Department of Revenue for review. This procedure is followed in the preparation of all audit reports. It gives the agency an opportunity to point out any errors of fact, to provide additional information, and to respond to the recommendations. The full text of the Department's response can be found in Appendix C. The following is a list of the recommendations, a summary of the Department's responses to them, and Legislative Post Audit's replies.

**Improving Identification of Businesses Required to Remit Taxes**

To aid identification of businesses required to remit sales and withholding taxes:

1. The Department of Revenue and the Department of Human Resources should execute an interagency agreement whereby each agency makes its records available to the other.
2. To accomplish this agreement, the Legislature should consider introducing legislation amending K.S.A. 74-2424 to allow the Department of Human Resources access to information at the Department of Revenue.

**Agency response.** The Department responded that it was completing a computer systems design that would use the Federal Employer Identification Number. This number could be utilized in a cross-check with Human Resources' files, which retain that identification number. The Department also said that the apparent noncompliance identified by the auditors



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represents a somewhat smaller percentage than what might be concluded from initial reading of the tables presenting the audit findings.

Legislative Post Audit points out that the percentages appearing in the tables are correct. They represent the portion of the sample found to be in violation, not a percentage of active accounts.

**Amending Withholding Tax Laws**

The Legislature should consider amending K.S.A. 79-3298 to provide for filing withholding tax returns monthly, quarterly, and annually, depending on the amounts of taxes remitted.

**Agency response.** The Department indicated agreement with the recommendation, but added that the audit did not mention that the 1982 Legislature passed a law that would allow employers withholding less than $200 a year to file annually rather than quarterly.

Legislative Post Audit has changed the draft report to include information on this statutory amendment. However, the recommendation has not changed because the amendment does not address the larger issues of the audit recommendation--improving cash flow and increasing interest earnings.

**Updating Sales Tax Accounts' Remittance Cycles**

To ensure that sales tax accounts are filed in a cost-effective manner and as required by law, the Department of Revenue should:

1. Periodically review retailers' sales tax accounts to ensure that accounts are placed on a payment cycle that coincides with K.S.A. 1981 Supp. 79-3607 and that maximizes revenue for the State. In implementing this recommendation, the Department should consider using its computer to:

   a. Generate notices to retailers if their filing status has changed or if limits are exceeded for filing quarterly or annually.
   b. Generate lists of status changes to Division personnel for updating accounts' filing status.

2. Identify and assess penalty and interest on those sales tax accounts not filing as frequently as required by law.

**Agency response.** The Department responded that the recommended review is similar to what is already a part of a computer system now being developed that would have the capability of periodically reviewing taxpayer records to identify the relationship of average liability and filing status. It noted, however, that the Department does not intend to seek a change in taxpayer filing status each time a return is filed because, given the impact of seasonal changes on retailers' liabilities, seeking such frequent adjustments in taxpayer filing status would be costly for the State and would harass the taxpayer. Finally, the Department said that the report "erroneously assumes the Department may unilaterally change a taxpayer's filing status to provide for less frequent filing," noting that K.S.A. 1981 Supp. 79-3607 provides that initiative for changing filing status must come from the taxpayer with the subsequent approval of the Director.

Legislative Post Audit points out that the audit does not recommend that the Department change a taxpayer's filing status each time a return is filed. The auditors' intent was that the accumulated liability be checked by computer each time a return is filed and that the status be changed only when the taxpayer has exceeded the specifications of law with regard to filing frequency. Adjustments could be made for taxpayers with a seasonal filing status.

Legislative Post Audit also finds no specific reference in K.S.A. 1981 Supp. 79-3607 specifying that only the taxpayer can initiate a change in filing frequency. The statutory language appears to indicate that the Director has final approval of filing periods as long as the schedules do not violate statutory dollar limits.

**Enforcing Filing Deadlines**

The Department of Revenue should enforce the filing deadlines for retailers' sales tax and withholding tax as outlined in K.S.A. 1981 Supp. 79-3607 and K.S.A. 79-3298. Extensions of time for filing returns should only be granted when the taxpayer has requested such an extension, has posted a bond, and has agreed to pay interest during the extended filing period, as required by Kansas administrative regulations.

**Agency response.** The Department of Revenue said it does not agree with the recommendation and gave four reasons for retaining the grace period. First, the Department said it lacked the personnel needed to separately examine each envelope for a postmark date. Second, ceasing the grace periods would conflict with the Department's accelerated deposit procedure and the State would lose the interest earned from the accelerated deposit of sales and withholding taxes, which was approximately



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$900,000 in fiscal year 1981. Third, the Department said that, in many cases, postmarks are illegible or do not appear on envelopes. Finally, the Department said that the majority of states recognize that the postmark identification method of determining delinquencies is inefficient and would slow processing of returns and remittances. In making this point, the Department encouraged Legislative Post Audit to review processing procedures utilized by private sector recipients of high volumes of mail to determine whether receipt date or postmark date is the more efficient method of determining delinquencies. It concluded that it would develop an annual review of grace periods with the intent of constricting the number of grace days based on analysis of holidays, weekends, and statutorily defined filing dates.

Legislative Post Audit disagrees that complying with filing deadlines will destroy the benefits of accelerated deposit. The checks can be processed for accelerated deposit regardless of when the return is declared delinquent. Regarding the Department's reference to the practices of private sector recipients of high volumes of mail, these entities are not under statutory mandates and can determine timeliness according to postmark or receipt date, depending on preferred business practice. Regardless of the reasons for extending filing deadlines, there is no statutory authority for such extensions. As long as the Department continues to grant such extensions, K.S.A. 1981 Supp. 79-3607 and K.S.A. 79-3298 will be violated.

**Ensuring Interest Rates in Regulations Correspond to Those Given in State Law**

The Department of Revenue should take the action necessary to ensure that interest rates for sales taxes in Kansas administrative regulations correspond to similar interest rates given in Kansas laws.

**Agency response.** The Department said it concurs in the recommendation, pointing out that the statutory interest rate prevails.

**Enforcing Regulations on a More Timely Basis**

To ensure that the Department of Revenue applies all actions available to it in enforcing the State's tax laws, the Department should enforce administrative regulations in a more timely manner after such regulations are approved.

**Agency response.** The Department did not directly respond to the recommendation that it enforce regulations in a more timely manner, but said it is presently enforcing the regulation pertaining to the audit finding.

**Assessing Timely Penalties as Required by Law**

To comply with K.S.A. 1981 Supp. 79-3223, the Department of Revenue should determine the tax due and assess a 50 percent penalty when a taxpayer fails to file a withholding tax return within 20 days of notice by the Director.

**Agency response.** The response stated a number of points. First, the Department said that its position is that K.S.A. 1981 Supp. 79-3223(c), which authorizes the 50 percent penalty is not mandatory, but merely directory only. It further noted that such provisions provide the authority to act and do not dictate strict compliance. Second, the Department said that attempting collection of the tax with a 50 percent penalty added would likely reduce the collection rate. Third, the Department said that applying a 50 percent penalty at such an early point in the delinquency period would be inconsistent with provisions of similar laws, which apply the 50 percent penalty only to fraudulent returns. Fourth, the Department said that it disagrees with the recommendation both legally and philosophically, and that it disagrees with the findings that 11 of 50 delinquent tax accounts were incorrectly assessed a 25 percent penalty. It said the Director of Taxation has complete discretion under the statute to determine when or whether to issue the notice that triggers the 20-day period and that it is incorrect to assume that a first notice of delinquency would trigger a 50 percent penalty. The Department concluded that principles of equity and due process would dictate that the taxpayer be advised of such a severe penalty prior to its imposition.

Legislative Post Audit disagrees with the Department's interpretation of the statute and also notes that the fact that other statutes apply a 50 percent penalty only in cases of fraud has no bearing in this case. If the Legislature had intended this penalty only for fraudulent cases, it would have stipulated this in the law as it did in the other statutes mentioned in the Department's response. Legislative Post Audit also stands behind the report finding that 11 of 50 delinquent withholding tax accounts were incorrectly assessed a 25 percent penalty. However, Legislative Post Audit does agree that the Director of Taxation has complete discretion under the statute to determine when or whether to issue the notice that triggers the 20-day period. The fact is that in the 11 cases mentioned, a notice was issued by the Director.



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**Establishing Minimum Penalties**

To ensure that handling costs are recouped for all businesses that fail to file returns on time, the Legislature should consider amending K.S.A. 79-3615 and K.S.A. 1981 Supp. 79-3228 to provide for a minimum penalty for businesses delinquent in filing sales and withholding taxes. This penalty would also be applied to delinquent returns that owe no tax.

**Agency response.** The Department said it concurs in this recommendation. It also said that it had introduced legislation during the 1980 Legislature that would have imposed a minimum penalty for failure to file, but it did not pass.

**Dating Returns When They Are Received**

To provide a better basis for assessing penalties and interest on delinquent returns and to provide a better basis for determining--after processing--whether a return was timely or not, the Department should establish a procedure for indicating the postmark date on returns.

**Agency response.** The Department again said that developing an enforcement program based on postmark date would not be cost-justified. It added that the incidence of taxpayer challenges regarding whether they are delinquent are too rare to warrant such a procedure.

Legislative Post Audit disagrees that developing an enforcement program based on postmark date would not be cost-justified. (See response and reply under the recommendation on Enforcing Filing Deadlines.)

**Issuing Jeopardy Assessments on a Timely Basis**

To comply with K.S.A. 79-3610 and K.A.R. 1981 Supp. 92-19-36, the Department of Revenue should improve its procedures to ensure that jeopardy assessments are made immediately when a taxpayer fails to file a return after notice from the Director and either terminates business operations or continues the act of making retail sales.

**Agency response.** The Department said it disagrees with the recommendation because of current statutory provisions. It noted that there are several statutory changes that should be considered under the sales and

withholding tax laws to provide an adequate legal basis for making jeopardy assessments. The response included a detailed explanation of why current statutes are deficient in that taxpayers may not receive actual notice of the filing of the warrant and that jeopardy assessments are tied to immediate collection procedures. It called for codifying K.A.R. 92-19-36 by statute to provide a procedure for issuing jeopardy assessments because a taxpayer has failed to file a return and not tie them to immediate collection procedures.

The Department also expressed concerns over practical difficulties in issuing jeopardy assessment warrants following "a first delinquency notice." It said that such assessments could not be undertaken without a significant increase in staff, and that eliminating the second collection mechanism provided by the Field Services Bureau would result in the filing of warrants against the property of taxpayers who had already made payments that had not yet been posted.

Legislative Post Audit points out that the recommendation was not made to call for a procedural improvement, but rather to bring the Department into compliance with current law and regulations. It is interesting to note that K.A.R. 92-19-36, which the Department called for codifying by statute, is the very regulation the Department is not enforcing. The fact that the Department considers changes to the law to be warranted does not negate the fact that it is not in compliance with current law and regulation.

**Using Jeopardy Assessments More Aggressively**

1. To provide more incentive for taxpayers to file returns on a more timely basis, the Department of Revenue should consider holding taxpayers liable for the full amount of jeopardy assessments when such assessments are greater than the amount of actual returns filed. However, to also ensure that taxpayer rights are upheld under the law, notification of jeopardy assessments should be sent by registered mail and should include:

   --Notification of the amount assessed.

   --Notification that a tax warrant has been issued.

   --A warning that failure to request a hearing on the accuracy of the jeopardy assessment will make the taxpayer liable for the full amount assessed or the amount of actual taxes, penalty, and interest due whichever is greater.



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2. As an alternative to the first recommendation, the Department could seek legislation amending K.S.A. 79-3610 and K.S.A. 1981 Supp. 79-3229 to provide for increased penalties when taxpayers do not respond to jeopardy assessments in 15 days.

**Agency response.** The Department said it disagrees with both recommendations. It first reiterated several concerns stated in its response to the previous recommendation regarding the "possible constitutional defects" in the present statutory procedures concerning issuance of jeopardy assessment warrants. The Department further stated that the question of the validity of the assessment and the lien created by the warrant weigh heavily on the Department's current practice of abating jeopardy assessments when the actual liability, penalty, and interest have been paid. Citing a second reason for disagreement with the recommendations, the Department said that if it were to refuse to abate jeopardy assessments, it appears a taxpayer could successfully defeat the estimated assessment by the filing of amended returns. The Department then presented an example of a business in severe financial trouble and concluded that the case illustrates three principles: district courts are generally reluctant to force compliance with jeopardy assessments higher than actual liability, jeopardy assessments are made by estimated amounts based on highest sales months and therefore are often much higher in amount than the actual liability, and warrants are a poor collection tool.

The Department said that in light of the current state of the economy, forcing a taxpayer to pay an arbitrarily high estimated assessment would put taxpayers out of business in many cases, and that such a policy "is not good for either the State or its citizens." The Department said it also does not agree with the second recommendation for the same reasons and that it does not believe that, absent of fraud, this is a viable alternative.

Legislative Post Audit points out that the recommendation considers the "possible constitutional defects" noted by the Department in that it suggests provisions for strengthening the notification process. As a result, the defects that the Department points out as relating to the recommendation in fact do not relate to the recommendation but rather to the current practices of the Department.

Legislative Post Audit acknowledges that a taxpayer could perhaps defeat a jeopardy assessment by filing amended returns. However, no one will know whether this would be an effective remedy for the taxpayer until it is tested.

**Issuing Warrants on a Timely Basis**

To comply with the provisions of K.S.A. 79-3235, the Department of Revenue should adjust its procedures for follow-up on delinquent withholding tax accounts to provide for issuing warrants on delinquent accounts not filing within 60 days of the date the tax was due.

**Agency response.** The Department said it does not agree with the recommendation because it would require the Department to eliminate the second notice in its current collection process. It further noted that to short-circuit a procedure that works (referring to the audit's statement that 88 percent of delinquent returns are filed after the first and second notices) seems unreasonable and that the success rate on warrants is less than 25 percent.

Legislative Post Audit notes that the recommendation was made, not as a procedural suggestion, but rather to bring the Department into compliance with the law. Regardless of whether or not the Department agrees with the recommendation, failure to comply places it in violation of K.S.A. 79-3235.

**Ensuring That Revocations are Enforced**

To help ensure compliance with sales tax enforcement statutes and to help ensure equitable enforcement among all sales tax accounts, the Department of Revenue should:

1. Improve written criteria for determining when sales tax registrations should be revoked. Among other points, the criteria should include for all taxpayers:

   --The number of delinquencies.
   --The dollar amounts owed in delinquent taxes.
   --The length of time the accounts have been delinquent.

2. Ensure that revoked registrations are not reinstated until businesses fulfill necessary requirements for reinstatement.

3. Work with the Attorney General's Office in prosecuting businesses that make sales after sales tax registrations are revoked. The fines should be imposed as already provided in K.S.A. 79-3615.

**Agency response.** Responding to the first recommendation, the Department said that it has had such written procedures for several years



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and included a copy of the procedures as an attachment to the response. The response did not explicitly agree or disagree with the second recommendation. Responding to the third recommendation, the Department said that the present law and staffing of the Department does not lend itself to initiating criminal action against businesses that operate after a registration was revoked. The Department said that discussions with attorneys in the criminal division of the Attorney General's Office concerning potential criminal prosecutions under the same "willful" standard of the income tax laws have led it and the Attorney General's Office to conclude that such prosecutions would be difficult to obtain without the development of proper evidence. It said that the Legal Services Bureau has initiated criminal contempt actions in situations in which a retailer continues to operate in violation of an injunction that was imposed for operating while registration was revoked. It noted, though, that several judges have indicated that they feel this notion "smacks of the debtor's prison concept." It also said that obtaining a conviction for contempt is a difficult and lengthy process and, because of its limited success, is only attempted in extreme cases. The Department concluded that it has no authority to impose fines, either civil or criminal, upon a retailer who violates the Retailers' Sales Tax Act and that the fine provided for in K.S.A. 79-3615 is set forth as limitations for the courts when a conviction is obtained.

Legislative Post Audit acknowledges that the Department is correct in responding that it has written revocation procedures for sales tax accounts, and the text of the report has been adjusted to reflect this. However, it is Legislative Post Audit's opinion that these procedures should provide more clear-cut direction for agency employees. While the procedures for accounts over $2,500 are relatively clear, the procedures relating to accounts in the $0 to $2,500 categories leave revocation entirely to the judgment of delinquency control personnel, as mentioned in the report. It is in these cases that a specified number of delinquencies or dollar amount in arrears is necessary to provide for more equitable administration of the law.

The wording in the text also has been adjusted to more clearly reflect how fines are imposed. It was never the intent of the recommendation nor the belief of the auditors that the Department could impose fines for violation of the Retailers' Sales Tax Act.

**Preparing Injunctions on a More Timely Basis**

To provide more timely and effective enforcement of the law, the Department of Revenue should reduce the time between referral of a case to the Legal Services Bureau and the issuance of a petition for injunction.

**Agency response.** While the Department agreed, in principle, with the recommendation, it took exception to the "selective presentation" of the findings. Specifically, the Department noted that the auditors requested statistical data for fiscal years 1977 through 1981 when only two years were shown in the report. It also said that the chart presenting the findings in the report purports to show no activity is occurring during the legal process. The Department also noted that the report appears to urge the Department to summarily shut down a business as quickly as possible whenever a field representative is unable to collect on an account. It also said that the report "lightly passed over" the Department's procedure of initiating a demand letter prior to formally filing a petition for injunction. It added that this procedure has been successful in collecting taxes, penalties, and interest. In some cases, the Department said it agrees to a payment plan whereby accrued liability is paid over a period of time. Under this procedure, much of the liability accrued on accounts that have been recommended for injunction is collected without the need to force the closure of several hundred businesses per year. According to the Department, this procedure demonstrates that the involvement of attorneys will induce the collection of much of the money the Department has been previously unable to collect. The Department said that the report also fails to note that many injunctions are held open by the courts and that the length of time a case spends on the injunction process is not directly related to laxness. The Department concluded that the fact that 19 of the 30 cases reviewed were dismissed shows the effectiveness of its injunction procedure as a collection tool.

Legislative Post Audit points out that the reason only two years appear in the audit's analysis is that the data supplied by the Department for the first three years is inconsistent with the data for the last two years. Further, Department employees cautioned the auditors on using the entire five-year period for reporting purposes.

The chart in the report illustrating the findings in this area displays the portion of the injunction process attributable to the Department of Revenue prior to filing a petition in relation to the time the court spent resolving the petition. Also, full mention is made in the text that a demand letter is prepared during this time period. Regarding the Department's statement that the report appears to urge the Department to shut down businesses, the accounts referred to in this section of the report have already gone through all other collection efforts and have had their registrations revoked. The businesses are operating in violation of the law and should be closed. The central issue of this audit finding, however, is not whether the business should be closed, but whether the Department is acting quickly to close the business once the decision is made.

**Initiating Procedures in a More Timely Manner**

To ensure that all actions available in enforcing the State's tax laws are applied, the Department of Revenue should



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initiate procedures in a more timely manner after legislation is passed.

**Agency response.** The Department did not respond directly to the recommendation, but described the success of the procedure once it was implemented.

**Strengthening Bonding Policy and Practices**

To help adequately protect the State from losses from unremitted sales and withholding taxes, the Department of Revenue's bonding policy should be strengthened through the following actions:

1. The Legislature should consider amending State law to require all withholding taxpayers to post a bond at the time of registration.
2. The Department of Revenue should take the following actions:
   a. Amend State regulations to require all businesses remitting sales and withholding taxes to post bond at the time of registration equal to an estimated three months' tax liability, and to maintain that bond until a satisfactory payment record is established. (A period of perhaps two years.)
   b. Institute a policy that requires additional bonds for sales and withholding tax accounts that have become "high risk" accounts. The policy should specify:
      --The number of delinquencies that an account can acquire before being designated a "high-risk" account.
      --The point in the collection follow-up process (such as after the business does not respond to the first notice of delinquency) when the additional bond is to be requested.
      --Immediate revocation for sales tax accounts not supplying the required bond.
   c. Periodically review accounts and update them to require additional bonds if the existing bond is found to be insufficient to meet the current average, as called for in State regulations.

**Agency response.** The Department did not specifically agree or disagree with the recommendation, noting that it was a matter that should be addressed legislatively rather than through administrative action. It said that if the Legislature supports the concept of mandatory bonds, some consideration should be given to a uniform bond that would cover all business taxes for which the taxpayer is registered to reduce the taxpayers' paperwork. It also commented that many taxpayers simply cannot qualify for surety bonds and do not have the financial resources to post a cash or escrow bond. It concluded that the Department has an aggressive bonding policy reflected in an increase in cash bonds required from 378 in fiscal year 1978 to 944 in fiscal year 1982.

Legislative Post Audit notes that most of the recommendations in this area do in fact call for Department actions that do not necessarily need to be initiated by the Legislature. Although legislative action would be necessary to require bonds at registration from all withholding taxpayers, K.S.A. 79-3616 appears to already allow the Department such discretion for sales tax accounts. The increase in cash bonds noted by the Department represents only about 6 percent of new registrants. The measure of the effectiveness of a bonding policy is not whether the number of bonds obtained has increased, but whether the State is adequately protected against lost tax revenue when it is necessary to seize a bond. The auditors' testwork displayed in the report demonstrates that nearly $30,000 was unrecovered from only 16 cases because of bonding inadequacies.

## Matters Remaining for Legislative Attention

The Department of Revenue has disagreed with many of the recommendations in this report. Most of the areas of disagreement concerned recommendations that called for compliance with the law. In many instances, the Department's responses implied that it lacked the personnel required to bring the Department into compliance. Legislative Post Audit would note, however, that if the Department implemented one of the recommendations with which it disagreed--updating sales tax remittance cycles--fewer returns would need to be processed, thus freeing up personnel to implement recommendations in other areas, such as reviewing postmarks to enforce filing deadlines. Also, the Department disagreed or did not explicitly agree with several recommendations calling for administrative changes. Finally, several recommendations call for legislative rather than agency action. The recommendations remaining for consideration by the Legislative Post Audit Committee and the Legislature can be summarized as follows:

### Complying With the Law

**Enforcing filing deadlines.** To comply with K.S.A. 1981 Supp. 79-3607 and K.S.A. 79-3298, the Department needs to eliminate the grace periods for filing late returns.

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**Assessing timely penalties.** To comply with K.S.A. 1981 Supp. 79-3228, the Department needs to determine the tax due and assess a 50 percent penalty when a taxpayer fails to file a withholding tax return within 20 days of notice by the Director.

**Issuing jeopardy assessments on a timely basis.** To comply with K.S.A. 79-3610 and K.A.R. 1981 Supp. 92-19-36, the Department needs to issue jeopardy assessments immediately after businesses fail to file returns upon notification from the Director of Taxation.

**Issuing warrants on a timely basis.** To comply with K.S.A. 79-3235, the Department needs to adjust its follow-up procedures to provide for issuing warrants on delinquent accounts not filing within 60 days of the date the tax was due.

**Ensuring that revocations are enforced.** The Department needs to ensure that revocations are enforced and that revoked registrations are not reinstated until businesses fulfill necessary requirements for reinstatement.

**Preparing injunctions on a more timely basis.** To provide more timely and effective enforcement of the Retailers' Sales Tax Act, the Department should reduce the time between referral of a case to the Legal Services Bureau and the issuance of a petition for injunction.

Changing Administrative Practices

**Updating sales tax remittance cycles.** The Department needs to periodically review sales tax accounts to ensure that accounts are placed on a payment cycle that coincides with K.S.A. 1981 Supp. 79-3607.

**Dating returns when they are received.** To provide a better basis for determining--after processing--whether a return was timely or not, the Department needs to establish a procedure for indicating the date filed on returns.

**Strengthening bonding policy and procedures.** Most recommendations in this area call for the Department (not the Legislature, as implied in the Department's response) to initiate action:

--To amend State regulations to require all businesses remitting sales and withholding taxes to post bond at registration.

--To institute a policy requiring additional bonds for "high risk" accounts.

--To periodically review accounts and update them to require additional bonds if bonds are found insufficient.

## Amending State Laws

**Amending withholding tax laws.** The Legislature should consider amending K.S.A. 79-3298 to provide for filing returns monthly, quarterly, and annually, depending on the amounts of taxes remitted.

**Establishing minimum penalties.** The Legislature should consider amending K.S.A. 79-3615 and K.S.A. 1981 Supp. 79-3228 to provide for a minimum penalty for businesses delinquent in filing sales and withholding taxes. The penalty would also be applied to delinquent returns that owe no tax.

**Using jeopardy assessments more aggressively.** The Legislature should consider amending K.S.A. 79-3610 and K.S.A. 1981 Supp. 79-3229 to provide for increasing the penalties when taxpayers do not respond to jeopardy assessments in 15 days. (This recommendation was presented as an alternative to a recommendation that the Department consider holding taxpayers liable for the full amount of jeopardy assessments. The Department disagreed with both alternatives.)

**Strengthening bonding policy and practices.** The Legislature should consider amending State law to require all withholding taxpayers to post bond at the time of registration.

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## APPENDIX C

## Agency Response



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Kansas
DEPARTMENT OF REVENUE

State Office Building
Topeka, KS 66625

August 25, 1982



Dr. Richard E. Brown
Legislative Post Auditor
Legislative Division of Post Audit
301 Mills Building
Topeka, Kansas 66612

RE: Sunset Audit of the Department of Revenue - Division of Taxation

Dear Dr. Brown:

As requested by Legislative Division of Post Audit, the Department of Revenue hereby submits its response to the above-referenced Post Audit draft report. The Department would compliment staff members of the Post Audit Division for their efforts in compiling a series of recommendations designed to improve tax processing in the State of Kansas. Moreover, the Department would express its appreciation for the courteous manner in which the audit was conducted.

Review of the draft audit report, however, indicates certain fundamental deficiencies in statistical methodologies employed as well as in the level of understanding and application of legal principles and procedures.

The Department is troubled by these deficiencies as well as by the omission or misstatement of selected material facts which, if considered, would suggest conclusions much different from many of those contained in the post audit report.

The Department would suggest that the level of analysis is often simplistic, failing to recognize or account for interrelationships in processing decisions and ignoring important policy questions regarding the Department's mission and its impact on the business climate and business decisions in Kansas. As a result, conclusions and recommendations emanating from the report appear to lack the analytical incisiveness and strong conceptual foundation that have characterized previous performance and financial compliance audits of the Department conducted by the Post Audit Division.

Noteworthy is the absence of any recognition of such agency initiatives or accomplishments as:

1. Accelerating deposit procedures for all major tax remittances resulting in an excess of $900,000 in additional interest earnings for the state;

2. Developing the capability to presort mail by carrier route resulting in postage savings exceeding $100,000;

3. Establishing a program for the systematic use of telephones for collecting outstanding liabilities resulting in an annual travel reduction of 300,000 miles and savings of $66,000;



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4. Commencing development of a four-phase computerized integrated business tax system (K-BITS) designed to more effectively process tax returns and to enhance delinquency control, collections, and financial processing functions within the Department;

5. Converting over 600 communications and batch programs from an outdated computer processing unit to the newly acquired DISC mainframe;

6. Recommending and securing passage of numerous statutory changes designed to enhance enforcement and collection efforts of various taxes.

A number of statements and examples from the report clearly illustrate why the Department is concerned about the validity of underlying data and the omission or misstatement of material facts. These examples are presented in the first section of the Department's response. Thereafter, each post audit recommendation will be specifically addressed and agency reaction provided.

Section 1. OBSERVATIONS

Post Audit Report

Page 21. "State sales and withholding tax collections in fiscal year 1981 totaled more than $729.5 million. As of the end of fiscal year 1982, more than $16.9 million in tax revenues paid by Kansas citizens had not yet been remitted to the State by businesses that collected the tax. This total also includes amounts of taxes owed from audit assessments (amounts of tax that a Department of Revenue audit of a business determined as underpaid). The number of such audits conducted by the Department have increased in recent years. It should be noted that the $16.9 million represents an increase of more than 275 percent since fiscal year 1978, when unremitted taxes totaled $4.5 million. Even taking inflation and the increases in the Department's audits into consideration, this increase shows that delinquencies are rising significantly."

Agency Response

1. The inclusion of all unpaid field assessments in an accounts receivable analysis is inappropriate since sales tax assessments exceeding $4 million are currently under appeal and are not liquidated accounts receivable subject to collection. The true accounts receivable for sales and withholding tax as of June 30, 1982, was approximately $12.9 million. It should be noted, that a single assessment issued in May 1982 and now in appeal status totaled $1.89 million - more than 10 percent of the entire amount identified by the post audit report. Moreover, on July 1, 1982, warrants had been filed on accounts representing more than $5 million in accounts receivable, $1.4 million was in bankruptcy status, and an additional $3.81 million was less than 60 days delinquent.

2. The report fails to note that the $16.9 million represents a cumulative amount covering 7 fiscal years. To provide perspective on the effectiveness of the

Department's collection efforts, it should be pointed out that sales and withholding tax collections for that period were $4.04 billion. In other words, only 3/10ths of 1 percent of potential collections were in accounts receivable status ($12.9 million / $4.04 billion). Even if unliquidated sales tax assessments are included in the analysis, the ratio of receivables to collections is only 4/10ths of 1 percent.

3. The report obliquely notes that the number of field audits has increased in recent years and, without providing any specific data on the increase in such audit assessments, concludes that inflation and the increased audits would not account for the significant increase in delinquencies between FY 1978 and FY 1982. Missing from the report is the information that sales tax field assessments were $812,103 in FY 1978 and $8,623,887 in FY 1982 -- an increase approaching 1,000 percent.

***Legislative Post Audit response.*** *The conclusion made from accounts receivable data was that uncollected tax amounts are rising. Even if the entire $4 million in appeals were decided in favor of the taxpayers--which is unlikely--the amount of outstanding taxes due would still show an increase of more than 200 percent. Hence, the conclusion remains the same. The fact that warrants have been filed on $5 million of the amount due is not of great significance. As pointed out in the report, collections from warrants are generally very low.*

*The report does not specifically mention that seven years' worth of accounts receivable are included in the totals. However, because it points out the amounts that are more than one year old, there is evidence that more than one year is included.*

*Finally, the Department provides data on the increase in audit assessments. This data would appear to imply that the entire $8.6 million from fiscal year 1982 would be in the accounts receivable total. However, certain of these amounts would have been paid and as a result not included in the totals.*

Post Audit Report

Page 58. "Improving the enforcement program would reap significant benefits. The auditors determined that at least $4 million a year could be saved from just the few recommendations for which dollar benefits could be estimated. Other recommendations which could not be assigned an immediate dollar value will provide substantial benefits nonetheless. Over time, the benefits of recommendations aimed at more aggressive enforcement should be realized in terms of lower tax delinquency rates, improved cash flow, and lower total costs for delinquency follow-up."



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Agency Response

In addition to questioning certain of the report's conclusions regarding potential interest earnings that would be realized if the auditors' recommendations were implemented, the Department is compelled to note that $3.3 million of the estimated $4 million in benefits is attributable to a single recommendation; namely, requiring monthly remittance of withholding tax. That is a matter wholly within the purview of the Legislature and is not an administrative action that can be taken by the Department. Studies have been conducted by the Department and information regarding this matter has been presented by the Department to the Legislature in prior years.

Post Audit Report

Included for the purpose of demonstrating the Department's handling of certain problem accounts, descriptions of specific cases appear at various points in the report.

Agency Response

The Department has provided as attachments to this letter explanatory responses to the "examples" cited in the report. However, two illustrations of the auditors' failure to fully and accurately describe circumstances involved in these "examples" are set forth below.

The case appearing on page 35 erroneously implies that property owned by the taxpayer was sold prior to the Department's filing of a warrant, thereby depriving the state of proceeds of the sale. A more thorough review by the auditor would have revealed that the state's warrant was timely filed, that the taxpayer still has not sold the property referenced in the field representative's memorandum, and that the state currently has a valid tax lien on the property.

***Legislative Post Audit response.*** *See response to case profiles in Attachment A of the Department's response.*

The Department is puzzled at the absence of any mention in the case described on page 44 of the fact that in 1977 the taxpayer filed for reorganization under the bankruptcy laws and a 15-year plan of arrangement was agreed to by creditors. Under terms of the plan, the Department receives an annual payment of delinquent taxes accrued prior to the plan's inception. Additionally, as is more fully described in the appendix, there are significant legal constraints on the Department's ability to collect penalties as well as to require a bond.

***Legislative Post Audit response.*** *This case has been deleted. See response to the case profile in Attachment A of the Department's response.*



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Post Audit Report

Page 25. The impression left to the reader in the discussion regarding "unauthorized grace periods" is that this is a recent phenomenon perhaps beginning in FY 1981. Further, the questionnaire results presented in Part II of Appendix A and Part II of Appendix B suggest that this procedure may be unique to the State of Kansas.

Agency Response

This procedure began in the late 1960's and appeared in written policy form in April, 1972. Moreover, it was in effect during every prior performance audit and financial compliance audit conducted by the Post Audit Division and was not previously questioned. Based upon a survey by the State of Louisiana in March of this year, 30 states out of 46 responding indicated they use a grace period such as described in the Post Auditor's report. Further, the average "grace" period was 4.5 days with 2 states indicating they use as much as a 10-day grace period.

***Legislative Post Audit response.*** *The auditors did not state or tend to imply that grace periods were a "recent phenomenon." Rather the auditors simply point out that there is no statutory authority in Kansas to grant such grace periods. In addition, even if such authority existed the auditors' testwork indicates that the grace periods may be too long. It should also be noted that this is the first performance audit of the Department's Taxation Division and that all financial and compliance audits do not necessarily examine all areas in the same detail.*

Post Audit Report

Page 25. The Post Audit report presented an analysis of postmarks on envelopes received in the Department during the "grace period" of June 1982. While it was reported that in excess of 6,000 returns were examined, no statement or even footnote appeared in this report describing the problems with legibility and, in many cases, absence of postmarks.

Agency Response

On August 16, 1982, the Department examined a random sample of 500 envelopes to verify a long-standing belief that focusing on postmarks is an unworkable and inefficient method for establishing delinquency dates. It was found that 166 of the 500 or 33 percent of these envelopes presented difficulty in identifying dates. Almost 7 percent of the envelopes had no postmark at all. For sales and withholding tax returns alone, this would constitute almost 60,000 returns anually that would be without postmarks. The Department would suggest that the absence of any mention of this aspect of postmark identification is a major omission that bears directly upon the advisability of implementing such a system.



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***Legislative Post Audit response.*** *The auditors' testwork revealed 430 unreadable postmarks, (approximately 6.7 percent of the sample)--a much lower rate than the 33 percent suggested by the Department.*

Post Audit Report

Page 27. The Post Audit analysis of grace periods concluded that the State lost approximately $233,000 in interest from those remittances.

Agency Response

The initial fallacy underlying this conclusion is the presumption that had the Department not permitted such a "grace period", all taxpayers filing within that period would cease filing late returns. This presumption is speculative at best and certainly contrary to experience. The Department does impose penalty and interest on returns filed after the grace period, but taxpayers continue to file after that time.

***Legislative Post Audit response.*** *The auditors are aware that perhaps not all taxpayers filing within the grace period would file sooner if the grace period were eliminated. However, the fact remains that if these taxpayers wished to maintain a timely filing status they would be forced to file sooner and the State would benefit from several days' additional interest earnings. If they chose to file several days late, the State would be compensated by the penalty and interest charges that would be imposed. Under the Department's current practice, the State receives no benefit.*

*The Department also states that it currently assesses penalty and interest on returns filed after the grace period, but that taxpayers continue to file after that time. This argument does not appear to be valid in this case because the Department is using the actions of delinquent taxpayers to predict what taxpayers who have adhered to a timely filing status might do.*

Another questionable area in the auditors' logic is the assumption that the number of returns received on a given day has a direct relationship to the number of dollars collected or deposited. Deposit statistics for sales tax show that 24 percent of the returns (accounts) contain 94 percent of the collections. Similarly, in withholding, 25 percent of the accounts have 93 percent of the dollars. It is these large accounts which are most likely to file on a timely basis because of the severe penalty and interest charges.

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***Legislative Post Audit response.*** *The auditors acknowledge that a smaller number of large accounts do pay the majority of taxes. Although the dollar amounts of penalties which large firms would have to pay if returns are late may be severe enough to be an incentive for them to file on time, the fact is that they receive no penalty during the grace period. As a result they can still file up to five working days late and enjoy the benefits of being timely.*

*Also, the auditors' analysis showed that after the second day of the grace period, nearly all of the returns were actually delinquent. Therefore, from the third day until the end of the grace period it can be concluded with reasonable certainty that nearly the entire dollar amount collected was delinquent.*

*In addition, it should be pointed out that larger firms are more likely to use sophisticated cash management techniques and hence are more likely to have funds invested to earn interest as long as possible. As a result, it is just as likely that they would delay tax payments as long as possible, taking advantage of grace periods to earn interest on the State's money. Because the envelopes were already separated from the returns when the auditors did their analysis, in order to strike a balance, the auditors assigned an equal probability that any account could be late regardless of size.*

Other major criticisms of this analysis are that only sales tax returns were sampled but the results were applied to withholding returns and that only the first part of June 1982 was sampled but the results were applied to all months of F.Y. 1981.

Finally, the report contains no analysis estimating the negative impact that the postmark identification system would have on interest now earned as a result of accelerated deposit procedures implemented by the Department. This again is a major analytical deficiency.

***Legislative Post Audit response.*** *The auditors sampled only sales tax returns because June was not a month when quarterly withholding returns were due. Because the processes are nearly identical for filing sales and withholding taxes, and because many of the businesses filing both taxes would be the same, the auditors find it difficult to believe that a sample of withholding taxes would show significantly different results from the sample already taken.*

*The Department seems to take exception to the use of only the month of June for the sample but gives no evidence that June is an atypical month.*

*Finally, the auditors fail to see how enforcing the law would have a significant impact on the accelerated deposit system. Whether returns are declared delinquent on the statutory due date or on the fifth or sixth day of the month has little impact on separating the checks and depositing them in the State Treasury.*

Post Audit Report

Page 31. "Therefore, the auditors could not determine whether the 23 returns in question were actually timely or if the Department simply missed them in the delinquency stamping process."

Agency Response

The Post Audit report failed to note that the Department has a computer report produced daily that compares tax month to validation date for the purpose of detecting delinquently filed returns. Any return failing this comparison is listed on the computer report even though it may not have been stamped delinquent. It can be determined from this report what date each return was received.

***Legislative Post Audit response.*** *The Department indicates that the auditors overlooked a report that would determine the date a return was filed. The report mentioned in the Department's response will not prove whether or not a return was filed on time because the "validation date" is not the date received. While a return may be received on a given date, it may not be validated until several days later. The fact that a validation date does not document when a return was filed is the specific problem noted by the auditors.*

Post Audit Report

Page 32. "The auditors' review indicates that the Department is generating second notices of delinquency within the time period prescribed by Departmental procedures. It also appears that the field service representatives are completing their collection efforts and returning the assignments to the Division of Taxation, on the average, within 29 days."

Agency Response

Since the initiation of a phone power collection program in 1979, designed to reduce travel costs and more effectively utilize field services personnel, the Field Services Bureau is completing its collection efforts and returning assignments within an average of 20 days.

***Legislative Post Audit response.*** *The Post Audit calculation was based on experience from one month--December 1980--only. Based on dates stamped on documents, 29 days was the average period for completion. Monitoring experience over the entire period since 1979 may produce results suggested by the Department. However, no conclusions or recommendations were drawn from this data. Therefore, the text remains unchanged.*

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Post Audit Report

Page 50. "Corporate forms of business generally are required to post a bond equal to three months tax liability when obtaining a sales tax registration certificate, but proprietorships and partnerships generally are not bonded at registration."

and

Page 52. The Post Audit report characterized the Department's practice of only requiring bonds of corporate forms of business as "unequal and inconsistent administration of the Retailer's Sales Tax Act."

Agency Response

The Post Auditor's characterization of the Department's practice of requiring surety bonds of only corporate forms of business as "unequal and inconsistent administration" evidences a lack of understanding of the basic legal principles involved in collecting taxes from business assets. The regulation which requires all corporations to post a bond at the time of registration was adopted in 1978 for valid legal and practical reasons.

As a general principle of corporate law, directors and officers are not personally liable for corporate debts. Liability for withholding tax is an exception to this rule, but with respect to liability for retailer's sales tax, it is well-settled that only corporate assets are exposed to the liability. Personal assets of the owners of proprietorships and partnerships, on the other hand, may be made available for payment of the liabilities of the business. Thus, when a proprietorship or partnership dissolves or becomes indebted beyond its means, the assets owned by each individual owner may be made available to satisfy the debts of the business.

When a corporation dissolves or becomes overextended, however, the same principles are not true. If the corporate liabilities exceed its assets, there will be no way to collect the excess tax liability. Therefore, requiring all corporations to post bonds at their inception is a valid requirement, whereas the same requirement for other forms of business ownership would be unnecessary in most cases. Experience has also shown that many corporations further insulate the business from liabilities by leasing real and personal property rather than by owning it. This fact further justifies the special need for requiring corporate bonds.

As a further note, the Department wishes to point out that it is on record as having recommended legislation which would make corporate officers and directors personally liable for sales tax as well as withholding tax. Post audit staff had advised members of the Department's staff that it intended to recommend the same legislation in its report, but no such recommendation was made.

***Legislative Post Audit response.*** *The auditors understand the legal protection afforded corporate forms of business and understand why bonds are required on corporate forms of business. In stating that the bonding policy was unequal and inconsistent, the audit did not indicate that the Department should make it consistent by ceasing to require bonds from corporate businesses. Instead the auditors maintain that consistency should occur by requiring bonds from proprietorships and partnerships as well. Legislative Post Audit concurs with the Department's statement that "requiring all corporations to post bonds at their inception is a valid requirement . . . ." The auditors disagree, however, that "the same requirement for other forms of business ownership would be unnecessary in most cases."*

*As illustrated by the example on page 53 of the audit report, the State lost nearly $30,000 because no bond or an inadequate bond was obtained from 16 businesses which closed. Thirteen or 81 percent of these businesses were proprietorships or partnerships.*

*The audit team does not specify that certain recommendations will be made in an audit report. The team considers numerous topics and recommendations during an audit. Often, time does not permit areas to be sufficiently explored to make a recommendation. In other cases, Legislative Post Audit may determine that a recommendation is not warranted.*

Section II: RECOMMENDATIONS

Post Audit Recommendations

Page 12.. "To aid identification of businesses required to remit sales and withholding taxes:

1. The Department of Revenue and the Department of Human Resources should execute an interagency agreement whereby each agency makes its records available to the other.

2. To accomplish this agreement, the Legislature should consider introducing legislation amending K.S.A. 74-2424 to allow the Department of Human Resources access to information at the Department of Revenue."

Agency Response

It is the position of the Department of Revenue that in the absence of legislation, permitting access by the Department of Human Resources to departmental tax records would violate current State law and disclosure agreements with the Internal Revenue Service.

The Department is currently completing Phase III of a four-phase systems design effort referred to as the Kansas Business Integrated Tax System (K-BITS). Once



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implemented, such a recommendation as discussed in the Post Audit report would be of more practical value in that a common identification number - Federal Employer Identification Number (FEIN) - would be embedded in departmental computer files. The FEIN could then be utilized in a cross-check with Human Resources' files since they currently retain the FEIN.

With respect to the 37 sales tax accounts "apparently" not in compliance, the Department would note that 14,865 new sales tax accounts were registered in fiscal year 1981 alone. It is doubtful that a manual search through more than 4,600 business accounts would be cost-justified given the extraordinarily small potential for increasing the level of compliance. If the Department had additional resources available for enforcement activities, they undoubtedly would be applied to a more beneficial endeavor.

As a point of clarification, the Department would note that the "apparent" noncompliance identified by the auditor represents only 1.8 percent of active withholding accounts and 0.05 percent of active sales tax accounts, not 6.6 percent and 0.8 percent respectively, as might be concluded from an initial reading of the tables appearing on pages 10 and 11 of the report.

***Legislative Post Audit response.*** *The percentages appearing in the tables are correct. They represent the percent of the sample found to be in violation, not a percent of active accounts.*

Post Audit Recommendation

Page 15. "The Kansas Legislature should consider amending K.S.A. 79-3298 to provide for filing withholding tax returns monthly, quarterly, and annually, depending on the amounts of taxes remitted."

Agency Response

Legislative adjustment of the filing status of withholding accounts based on the amount of taxes remitted would result in an improved cash flow, larger interest earnings, and a reduction in the number of tax returns processed for withholding accounts with smaller remittances.

The Post Audit report failed to note an initiative of the Department of Revenue relative to this recommendation. The Department of Revenue proposed Senate Bill 791 that was enacted during the 1982 Legislative Session and became law effective July 1, 1982. This law would allow an employer who is required to withhold less than $200 in any calendar year to file annually rather than quarterly. It is estimated that there will be approximately 11,000 accounts that withhold less that $200 annually and therefore, will only need to be processed once per year rather than quarterly.

***Legislative Post Audit response.*** *The text of the report has been adjusted to include information contained in the Department's response. Although this amendment to the law will reduce the number of small returns filed, it does not address the larger issues of the audit recommendation, primarily increased cash flow and greater interest earnings.*

Post Audit Recommendation

Page 20. "To ensure that sales tax accounts are filed in a cost-effective manner and as required by law, the Department of Revenue should:

1. Periodically review retailer's sales tax accounts to ensure that accounts are placed on a payment cycle that coincides with K.S.A. 1981 Supp. 79-3607 and that maximizes revenue for the State. In implementing this recommendation, the Department should consider using its computer to:

   a. Generate notices to retailers if their filing status has changed or if limits are exceeded for filing quarterly or annually.

   b. Generate lists of status changes to Division personnel for updating accounts' filing status.

2. Identify and assess penalty and interest on those sales tax accounts not filing as frequently as required by law."

Agency Response

The Department recognizes that a periodic review of the sales tax accounts and subsequent adjustment of filing frequency could result in some reduction in the number of returns processed each year. It is for this reason that the K-BITS system referenced earlier in this letter is being designed with the capability of periodically reviewing taxpayer records to identify the relationship of average liability and filing status. It should be pointed out that the Department has no intention of seeking a change in taxpayer filing status each time the taxpayer files a return as suggested on page 19 of the report. Given the impact of seasonal changes on the liability of any one retailer, it would be costly for the State and harassment of the taxpayer to seek such frequent adjustments in taxpayer filing status.

Since a review capability similar to that recommended by the Post Auditor is already a part of the K-BITS system now being developed, the Department does not intend to make a major investment of limited data processing resources to modify the current system.

Finally, it must be pointed out that the report erroneously assumes the Department may unilaterally change a taxpayer's filing status to provide for less frequent filing. K.S.A. 1981 Supp. 79-3607 provides that initiative for such a change must come from the taxpayer with the subsequent approval of the Director.

***Legislative Post Audit response.*** *The suggestion on page 19 of the audit was not that the Department change a taxpayer's filing status each time a return is filed. The auditors' intent was that the accumulated liability be checked by computer each time a return is filed and that the status be changed only when the taxpayer has exceeded the specifications of law with regard to filing frequency. Adjustments could be made for taxpayers with a seasonal filing status.*

*Finally, Legislative Post Audit finds no specific reference in K.S.A. 1981 Supp. 79-3607 specifying that only the taxpayer can initiate a change in filing frequency. To the contrary, all references to filing periods state that the taxpayer may, with the approval of the Director of Taxation and upon such conditions as the Director may prescribe, "file an annual or quarterly return." This language appears to indicate that the Director has final approval of filing periods as long as the schedules do not violate statutory dollar limits.*

*However, even if the Department truly believes it does not have the unilateral authority to change a taxpayer's filing status, it appears that it should either request such authority or at least notify such taxpayers that they may file less frequently. Such action appears warranted considering the fact that the auditors found that more than one in five sales tax returns handled by the Department in 1981 may have been unnecessary.*

Post Audit Recommendation

Page 27. "The Department of Revenue should enforce the filing deadlines for retailers' sales tax and withholding tax as outlined in K.S.A. 1981 Supp. 79-3607 and K.S.A. 79-3298. Extensions of time for filing returns should only be granted when the taxpayer has requested such an extension, has posted a bond, and has agreed to pay interest during the extended filing period, as required by Kansas administrative regulations."

Agency Response

The Department of Revenue does not concur with the recommendation that the administrative procedure of permitting grace periods cease. Reasons for retaining this grace period are as follows:

1. The Department is not adequately staffed to separately examine each envelope for a postmark date. A significant increase in personnel would be required to permit timely processing of returns in envelopes having an identifiable postmark date. This personnel requirement is not addressed in the post audit report.

2. Such a practice would conflict with the Department's accelerated deposit procedure and, therefore, cost the State more money than the Post Auditor contends would be gained through the elimination of grace periods. The total interest earned due to accelerated deposit of sales and withholding taxes in FY 1981 was approximately $900,000.

3. While the Post Audit Report neglected to mention the problem with postmarks, the Department has documented earlier in this letter the problems with legibility and, in many cases, absence of postmarks on envelopes.

4. The majority of states recognize that the postmark identification method of determining delinquencies is inefficient and would slow processing of returns and remittances. The Department would also encourage the post auditor to review processing procedures utilized by private sector recipients of high volumes of mail to determine whether receipt date or postmark date is the more efficient method of determining delinquencies.

The Department will develop an annual review of grace periods with the intent of constricting the number of grace days based upon an analysis of holidays, weekends, and statutorily defined filing dates.

***Legislative Post Audit response.*** *Regardless of the reasons for extending filing deadlines, there is no statutory authority for such extensions. As long as the Department continues to grant such extensions, K.S.A. 1981 Supp. 79-3607 and K.S.A. 79-3298 will be violated.*

*Complying with filing deadlines should not destroy the benefits of accelerated deposit. The checks can be processed for accelerated deposit regardless of when the return is declared delinquent.*

*Regarding the Department's reference to the practices of private sector recipients of high volumes of mail, these private entities are not under statutory mandates and can determine timeliness according to postmark or receipt date depending on preferred business practice. However, the Department has filing deadlines specified by law. If these statutory filing provisions are unworkable, the Department should work with the Legislature to have statutory mandates changed rather than disregard them.*

Post Audit Recommendation

Page 28.

"1. The Department of Revenue should take the action necessary to ensure that interest rates for sales taxes in Kansas administrative regulations correspond to similar interest rates given in Kansas laws.

2. To ensure that the Department of Revenue applies all actions available to it in enforcing the State's tax laws, the Department should enforce administrative regulations in a more timely manner after such regulations are approved."



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Agency Response

1. This is a minor housekeeping recommendation with which the Department concurs. Clearly, the statutory interest rate prevails.

2. The Department is presently requiring a cash bond or assessing interest where a permanent filing extension has been granted.

Post Audit Recommendation

Page 30. "To comply with K.S.A. 1981 Supp. 79-3228, the Department of Revenue should determine the tax due and assess a 50 percent penalty when a taxpayer fails to file a withholding tax return within 20 days of notice by the Director."

Agency Response

It is the position of the Department of Revenue that subsection (c) of K.S.A. 1981 Supp. 79-3228, which authorizes the 50 percent penalty, is not mandatory, but merely directory only. Under Kansas law, provisions like K.S.A. 1981 Supp. 79-3228(c) provide the authority to act and do not dictate strict compliance.

The Department's policy has consistently been to refer delinquent accounts to its Field Services Bureau for collection prior to adding any penalty so severe that it would frustrate collection efforts. According to figures set forth in the Post Auditor's report, the Department has an 88 percent success rate in collection after only two contacts with the taxpayer and before initiating further administrative or legal action. Attempting collection of the tax with a 50 percent penalty added would be likely to reduce the collection rate both in terms of numbers of taxpayers and dollars.

It is also the Department's position that application of the 50 percent penalty at such an early point in the delinquency period would be inconsistent with provisions of similar laws. An analogy can be drawn to K.S.A. 1981 Supp. 79-3615, as amended by Chapter 422 of the 1982 Kansas Session Laws, under which a 50 percent penalty is only applicable where failure to file was with fraudulent intent. This was also true under the statute prior to the recent amendments. Under 79-3228(c), the 50 percent penalty is also applicable to fraudulent returns. To apply such a penalty to a return which could be as few as 35 days late would be inconsistent with the terms of the section in question.

The Department of Revenue disagrees with this recommendation both legally and philosophically. It was incorrectly stated in the report that 11 of 50 delinquent withholding tax accounts were incorrectly assessed a 25 percent penalty. The Director of Taxation has complete discretion under the statute to determine when or whether to issue the notice which triggers the 20-day period and it is incorrect to assume that a mere first notice of delinquency would trigger a 50 percent penalty. Principles of equity and due process would dictate that the taxpayer be advised of such a severe penalty prior to its imposition.

***Legislative Post Audit response.*** *The Department's response suggests that whether a statute is directory or mandatory determines whether the Legislature expects strict compliance with its provisions. Legislative Post Audit extensively reviewed case law in this area and in no case was it suggested that the official whose actions are outlined by a directory statute is less obligated to comply than those whose actions are outlined in mandatory statutes. In fact, in Wilcox v. Billings; 200 Kan. 654,657; the court says:*

> *"The difference between directory and mandatory statutes, where their provisions are not adhered to, is one of effect only; the Legislature intends neither to be disregarded."*

*The only difference between a directory and a mandatory statute is not, as the Department suggests, a matter of whether or not the Department should follow the statute. Rather, it affects the remedy available to the taxpayer for incorrectly assessed penalties. The fact that this is a directory statute means that the taxpayer must pay the penalty even though not assessed as the statute directs. If the statute were mandatory the taxpayer could claim that the noncompliance with the statute relieved him of his responsibility to pay.*

*The fact that other statutes only apply a 50 percent penalty in cases of fraud has no bearing on this case. If the Legislature had intended this penalty only for fraudulent cases it would have stipulated this in the law as it did in the other statutes mentioned. Legislative Post Audit disagrees that the report incorrectly states that 11 of 50 delinquent withholding tax accounts were incorrectly assessed a 25 percent penalty. The Department maintains that "the Director of Taxation has complete discretion under the statute to determine when or whether to issue the notice which triggers the 20-day period." The auditors agree. The fact is that in the 11 cases mentioned, a notice was issued by the Director.*

Post Audit Recommendation

Pages 30-31. "To ensure that handling costs are recouped for all businesses that fail to file returns on time, the Legislature should consider amending K.S.A. 79-3615 and K.S.A. 1981 Supp. 79-3228 to provide for a minimum penalty for businesses delinquent in filing sales and withholding taxes. This penalty would also be applied to delinquent returns that owe no tax."

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Agency Response

The Department of Revenue concurs with this recommendation. At the Department's request, Senate Bill No. 834 was introduced during the 1980 session. It would have imposed a minimum penalty for failure to file of $10 or 10 percent of the liability. The bill further provided that after 60 days delinquency, the penalty would have increased to $25 or 25 percent of the liability. Those provisions were rejected by the House Assessment and Taxation Committee.

Post Audit Recommendation

Pages 31-32. "To provide a better basis for assessing penalties and interest on delinquent returns and to provide a better basis for determining--after processing--whether a return was timely or not, the Department should establish a procedure for indicating the postmark date on returns."

Agency Response

For reasons stated previously in this letter, developing an enforcement program based on postmark date would not be cost-justified. The Department currently has an effective method for assessing penalties and interest on delinquent returns. Finally, the incidence of taxpayer challenges regarding whether they are delinquent as claimed by the Department are too rare to warrant such an elaborate and expensive procedure.

***Legislative Post Audit response.*** *See response under the recommendation on Enforcing Filing Deadlines.*

Post Audit Recommendation

Page 36. "To comply with K.S.A. 79-3610 and K.A.R. 1981 Supp. 92-19-36, the Department of Revenue should improve its procedures to ensure that jeopardy assessments are made immediately when a taxpayer fails to file a return after notice from the Director and either terminates business operations or continues the act of making retail sales."

Agency Response

The Post Auditor recommends that the Department of Revenue should make jeopardy assessments of sales tax immediately after notice to the taxpayer that said taxpayer has failed to file a return. In addition to the fact that it would be a physical impossibility to do so under current staff levels, the Department of Revenue disagrees with the recommendation because of current statutory provisions. Further, the Department recommends that statutory changes be considered under the sales tax and withholding tax laws to provide for an adequate legal basis for making jeopardy assessments.

K.S.A. 79-3610 gives the Director authority to estimate sales tax liability where no return has been filed. It also authorizes an assessment of sales tax when tax collection is in jeopardy. It requires a warrant to be issued under procedures provided by the income tax law and give the taxpayer 15 days from the date of the filing of the warrant in which to request a hearing on the correctness of the jeopardy assessment. Nowhere is there a provision requiring that the taxpayer receive notice of the filing of the warrant. The Department does, however, mail a copy of the warrant to the taxpayer's last known address. The statute is deficient in this regard.

A second problem is caused by the reference in K.S.A. 79-3610 to warrant procedures under K.S.A. 79-3235. That section provides for a warrant directing the sheriff of the county in which the warrant is filed to levy and execute upon property of the taxpayer. A jeopardy assessment which the Post Auditor contends will achieve filing compliance should not require actual collection steps to be taken by levying against property of the taxpayer. The Department recommends that authority be given by statute to issue jeopardy assessments when a return has not been filed without the need to use the warrant procedure outlined in the income tax law. The purpose of such a jeopardy assessment should be solely to establish a priority of claim in the amount of an estimated assessment. It should not be tied to an immediate collection procedure.

Because of the statutory deficiencies in the jeopardy assessment area, the Department adopted a regulation in 1978 (K.A.R. 92-19-36) which provides that failure to file a return after notice from the Director is an act tending to prejudice collection within the meaning of the jeopardy assessment statute. The substance of this regulation should be codified by statute.

In summary of this recommendation, a separate procedure should be statutorily provided for the issuance of a jeopardy assessment when such jeopardy assessment is made solely because a taxpayer has failed to file a return.

Similar provisions should be included in the withholding tax law. It is also deficient and should not be tied to the income tax warrant filing procedure. Again, a regulation adopted in 1968 was necessary to give the withholding tax jeopardy assessment provisions any vitality.

It is the Department's position that we are operating at the outer limits of what could or should be done under current statutory authority. To speed up the process, as the Post Auditor suggests, would deal due process a severe blow.

Aside from legal infirmitites previously noted, the Department would experience significant practical difficulties in issuing jeopardy assessment warrants following a first delinquency notice. The number of such warrants and assessments could not be undertaken without a significant increase in staff provided to the sales and excise tax bureau and the field services bureau. A more substantial problem, however, would occur by virtue of eliminating the collection mechanism provided by the field services bureau. Without taxpayer contact, large number of warrants would be filed against property of taxpayers who had already made payments which had not yet been posted. The Department would then be responsible for the $15 court costs required to

release the warrants filed too quickly. Issuing the releases and obtaining vouchers for payment of court costs would involve a massive increase in paperwork and would not be possible with current staffing.

***Legislative Post Audit response.*** *The recommendation was not made as a procedural improvement, but rather to bring the Department into compliance with current law and regulations. It is interesting to note that the Department in its response calls for codifying by statute the provisions of K.A.R. 92-19-36. This is the very regulation which the Department is not enforcing and which prompted the recommendation. The fact that the Department considers changes to the law to be warranted does not negate the fact that they are not in compliance with current law and regulation.*

Post Audit Recommendation

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"1. To provide more incentive for taxpayers to file returns on a more timely basis, the Department of Revenue should consider holding taxpayers liable for the full amount of jeopardy assessments when such assessments are greater than the amount of actual returns filed. However, to also ensure that taxpayer rights are upheld under the law, notification of jeopardy assessments should be sent by registered mail and should include:

--Notification of the amount assessed.

--Notification that a tax warrant has been issued.

--A warning that failure to request a hearing on the accuracy of the jeopardy assessment will make the taxpayer liable for the full amount assessed or the amount of actual taxes, penalty and interest due whichever is greater.

2. As an alternative to the first recommendation, the Department could seek legislation amending K.S.A. 79-3610 and K.S.A. 1981 Supp. 79-3229 to provide for increased penalties when taxpayers do not respond to jeopardy assessments in 15 days."

Agency Response

The Post Auditor recommends that the Department of Revenue should consider taxpayers liable for the full amount of a jeopardy assessment when it is greater than the amount disclosed by the filing of actual returns. The Department of Revenue strongly disagrees with this recommendation.

As was noted in the response to the previous recommendation, there are a number of possible constitutional defects in the present statutory procedures concerning issuance of jeopardy assessment warrants. These include the fact that the taxpayer

may not receive actual notice of the filing of the warrant and the issuance of the warrant may well lead to levy and execution upon the taxpayer's property. Again, the Department's recommendation would be to codify adequate safeguards in the statutes.

As these defects relate to the Post Auditor's recommendation, it should be evident that where a taxpayer receives no notice of the filing of the warrant, he or she cannot very well request a hearing within 15 days of the filing of the warrant. The validity of the assessment and the lien created by the warrant are then called into question. This is but one factor which weighs heavily on the side of abating jeopardy assessments when the actual liability, penalty and interest have been paid.

A second reason with both legal and practical implications is the ability of the taxpayer to file amended returns within the period of the statute of limitations. While this issue is untested, it appears that if departmental policy was to refuse to abate jeopardy assessments, a taxpayer could successfully defeat the estimated assessment by the filing of amended returns.

A recent and ongoing foreclosure action with which the Department is involved illustrates several salient points which weigh heavily in favor of the Department's present practice. The taxpayer/defendant is represented by a member of the Kansas legislature. Considerable liability for both withholding tax and sales tax had accrued against the taxpayer whose property was subject to foreclosure and was claimed by a cross-petition filed by the Department of Revenue. Almost all of the liability was established by the filing of jeopardy assessment warrants.

Counsel for taxpayer/defendant moved the Court to allow his client a sixty-day period in which to file actual returns to establish the amounts of tax due and owing the Department of Revenue. In a pretrial order issued in June of 1982, the Court specifically found and held that the defendant should be allowed to file appropriate returns to establish liability, penalty and interest.

The taxpayer in this case will probably owe less than one-fourth the amount established by jeopardy assessments. His business had been winding down and he was in severe fianacial trouble. Jeopardy assessments had no effect, abated or not, on his incentive to file returns because he could not pay any of his numerous creditors.

The principles illustrated by this case are not atypical. First, District Courts are generally reluctant to force compliance with jeopardy assessments higher than actual liability. Second, the jeopardy assessments are, of necessity, made by estimated amounts based on highest sales months and are therefore often much greater in amount than the actual liability. Third, warrants are a poor collection tool. They are effective in establishing priority as of their filing date and to prevent the voluntary sale of property, but since the Department of Revenue receives no superpriority, as do county real property taxes, they are not effective to net any proceeds free and clear of other liens. Warrants filed by the Department of Revenue only create liens which are subject to interests of prior lienholders. The Department has neither the ability to foreclose its own liens nor to redeem property subject to foreclosure. Typically, a mortgagee bids only the amount of its prior mortgage at the sheriff's sale and the Department of Revenue receives nothing towards its lien. The same principles create difficulty in executing on warrants as well, since prior lienholders would have to be paid first out of the proceeds of the sheriff's sale.

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Finally, jeopardy assessments do not have the effect of forcing the filing of actual returns. A taxpayer who cannot pay the estimated liability often has trouble paying the actual amount as well. Unless some other collection method is used, actual returns will not be filed voluntarily. To whatever extent a jeopardy assessment does induce the filing of actual returns, that effect will not necessarily be lessened by abatement of the estimated liability.

The Post Auditor does note that it is a consistent practice of the Department of Revenue to apply a 25% penalty plus interest to the liability established by the filing of actual returns. This represents a substantial profit to the State for the taxpayer's use of the State's money. Trying to force a taxpayer to pay an amount two or three times greater than actual liability plus penalty and interest would seem to be unconscionable.

The Post Auditor urges the use of the jeopardy assessment as an aggressive enforcement tool. The Department would take exception with this characterization. As was previously explained, the warrant cannot be considered an effective tool to collect taxes. Absent an attempted voluntary sale of property, a tax warrant can be largely ignored.

The Post Auditor also contends that a taxpayer's knowledge of the abatement policy gives no incentive to file returns. We also disagree with this premise. A very small percentage of taxpayers are even aware of such a policy. There may, however, be some merit in a policy of trying to force payment of the full estimated assessment after a second or third delinquency, but this may be legally infeasible without strong legislation.

The Post Auditor does not seem to recognize that the state of the economy has caused numerous business to fail or teeter on the brink of bankruptcy. The Department of Revenue is involved in nearly 200 active foreclosure cases at present. Bankruptcy filings are at an all-time high. To force a taxpayer to pay an arbitrarily high estimated assessment would put taxpayers out of business in many cases. Such a policy is not good for either the State or its citizens.

The Post Auditor suggests, as an alternative to eliminating abatement of jeopardy assessments, that the Department of Revenue could seek legislation providing increased penalties when taxpayers do not respond to jeopardy assessments. For numerous reasons already expressed, it is not believed that this alternative, absent fraud, is an effective, feasible or equitable solution.

***Legislative Post Audit response.*** *The Department mentions possible constitutional deficiencies concerning notice to the taxpayer in issuing jeopardy assessments. A close reading of the audit recommendation reveals that the auditors did consider such deficiencies and suggested provisions for strengthening the notification process. As a result, the defects which the Department points out as relating to the recommendation do not relate to the recommendation but rather to the current practices of the Department.*

*The second reason the Department gives for not aggressively enforcing jeopardy assessments is that, although the issue is untested, the taxpayer could defeat the jeopardy assessment by filing amended returns. No one will know whether this would be an effective remedy for the taxpayer until it is tested.*

Post Audit Recommendation

Pages 40-41. "To comply with the provisions of K.S.A. 79-3235, the Department of Revenue should adjust its procedures for follow-up on delinquent withholding tax accounts to provide for issuing warrants on delinquent accounts not filing within 60 days of the date the tax was due."

Agency Response

The Department of Revenue does not agree with the recommendation of the Post Auditor that warrants be issued within 60 days of the date a withholding tax account was due. In effect, adopting such a recommendation would require the Department to eliminate the second notice aspect of the current collection process. Based upon data provided in the Post Auditor's report, the present procedure results in a success rate of approximatly 88 percent while the success rate on warrants is less than 25 percent. To short-circuit a procedure that works, for one that has been characterized by the Post Auditor as ineffectual, seems unreasonable.

***Legislative Post Audit response.*** *The recommendation was not made as a procedural suggestion, but rather to bring the Department into compliance with the law. Regardless of whether or not the Department agrees with the recommendation, failure to comply places it in violation of K.S.A. 79-3235. In addition, the second notice would not have to be eliminated; it could be speeded up.*

Post Audit Recommendation

Page 46. "To help ensure compliance with sales tax enforcement statutes and to help ensure equitable enforcement among all sales tax accounts, the Department of Revenue should:

1. Develop written criteria for determining when sales tax registrations should be revoked. Among other points, the criteria should include:

   --The number of delinquencies.

   --The dollar amounts owed in delinquent taxes.

   --The length of time the accounts have been delinquent.

2. Ensure that revoked registrations are not reinstated until businesses fulfill necessary requirements for reinstatement.

3. Work with the Attorney General's Office in prosecuting businesses that make sales after sales tax registrations are revoked. The fines should be imposed as already provided in K.S.A. 79-3615."

Agency Response

The Department agrees with the Post Audit recommendation that written procedures are desirable to increase the probability that an objective method for revoking sales tax registrations is utilized. The Department has had such written procedures for several years - a copy of this procedure appears as an attachment to this letter.

The Post Auditor also recommends that personnel of the Department of Revenue work with the Attorney General's Office in prosecuting businesses that make sales after sales tax registrations are revoked. It is the opinion of the Department of Revenue that neither the Department of Revenue nor the Attorney General's Office has sufficient staff to initiate a comprehensive program of tax-related criminal prosecutions.

Under the organizational structure of the Internal Revenue Service, all criminal investigations are performed by specifically-trained special agents who recommend prosecution to the U. S. Attorney's Office. None of the investigatory work is performed by the prosecuting agency. The state has never authorized or funded the establishment of a criminal investigative unit within the Department of Revenue. Auditors and field personnel involved in the normal assessment and collection process are neither qualified nor trained to provide the investigatory evidence necessary to allow the Office of the Attorney General to obtain a conviction under a statute which makes "willful" violations of law a crime.

Discussions with attorneys in the criminal division of the Attorney General's Office concerning potential criminal prosecutions under the same "willful" standard of the income tax laws have led the Department and the Attorney General's Office to conclude that such prosecutions would be difficult to obtain without the development of proper evidence.

If K.S.A. 79-3615 were amended to provide that the operation of a business after registration was revoked was a crime without regard to intent, such prosecutions would be easy to obtain and examples could be made of flagrant violators. The present law and staffing of the Department does not lend itself to initiating criminal action.

The Legal Services Bureau has initiated criminal contempt actions in situations where a retailer continues to operate in violation of an injunction which was imposed for operating while registration was revoked. These contempt citations have resulted in several retailers being jailed for short periods of time but by-in-large have not been extremely sucessful because of reluctance of the courts to jail individuals for civil taxation violations. Several judges have indicated that they feel this notion smacks of the debtor's prison concept. Obtaining a conviction for contempt is a difficult and lengthly process and, because of its limited success, is only attempted in extreme cases.

The Post Auditor recommends that the Department should impose fines pursuant to K.S.A. 79-3615. This statement, perhaps more than any other contained in the Post Auditor's report, evidences a lack of understanding of the legal processes involved in Kansas law. The Department has no authority whatsoever to impose fines, either civil or criminal, upon a retailer who violates the Retailer's Sales Tax Act. The fine provided for in K.S.A. 79-3615 are set forth as limitations for the courts when a conviction is obtained.

***Legislative Post Audit response.*** *The Department is correct in responding that it has written revocation procedures for sales tax accounts and the text of the report has been adjusted to reflect this. However, it is Legislative Post Audit's opinion that these procedures should provide more clear-cut direction for agency employees. While the procedures for accounts over $2,500 are relatively clear, the procedures relating to accounts in the $0-to-2,500 categories leave revocation entirely to the judgment of delinquency control personnel as mentioned in the report. It is in these cases that a specified number of delinquencies or dollar amount in arrears is necessary to provide for more equitable administration of the law.*

*The wording in the text also has been adjusted to more clearly reflect how fines are imposed. Although the wording in the draft report was somewhat unclear, it was never the intent of the recommendation nor the belief of the auditors that the Department could impose fines for violation of the Retailers' Sales Tax Act.*

Post Audit Recommendation

Page 48. "To provide timely and effective enforcement of the law, the Department of Revenue should reduce the time between referral of a case to the Legal Services Bureau and the issuance of a petition for injunction."

Agency Response

The Department agrees that timely enforcement of the law has undeniable merit, but it objects to the selective presentation on pages 46-68 of the Post Audit report. For example, while the auditors requested statistical information regarding sales tax injunctions for the fiscal years 1977 through 1981, they chose to report only the

last 2 years. Part of the problem with the delay in filing sales tax injunctions is the tremendous increase in filing of these injunctions over the last few years - 84 sales tax injunctions in FY 1977 and 249 in FY 1981. This number increased to 300 in FY 1982 and is projected to be over 350 in FY 1983. This increase has been absorbed with no increase in staff size in the Legal Services Bureau.

The Post Audit report also lightly passed over the fact that the Department initiated a demand letter procedure prior to formally filing a petition for injunction. At the time the audit was conducted, the Department was experiencing a backlog of 170 sales tax injunctions. The Department hired a temporary clerical employee and has subsequently issued 170 demand letters resulting in collections on 50 of the accounts. Injunction petitions are presently being filed on the remaining 120 accounts. While the demand letter procedure adds to the length of time in filing injunctions, the effectiveness of such a procedure is clear. At the present time, the Department is current in processing under its sales tax injunction procedure.

The chart on page 47 of the report purports to show that no activity is occurring for long periods of time prior to filing of the injunction petition or resolution of the matter in court. The report states that the time involved in the courts for 20 of the 30 cases reviewed averaged less than the processing time at the Department. The report does not explain that, for the remaining 10 cases, the time in court was 8 times greater than the time spent in departmental processing or that the majority of the overall time for all 30 cases was spent in the court system.

The report appears to urge the Department to summarily shut down a business as quickly as possible whenever a field representative has been unable to collect on an account. The Department's goal has been to give the taxpayer an opportunity to become current while continuing to operate his business. By implementing a demand letter procedure, the Department has been extremely successful in collecting taxes, penalty and interest on these accounts. In some cases where there is no other alternative, the Department agrees to a payment plan whereby accrued liability is paid over a period of time. Under this procedure, much of the liability which has accrued on accounts which have been recommended for injunction is collected without the need to force the closure of several hundred businesses per year. Therefore, the referral of such accounts from the Department's field representatives should be viewed as a referral for collection rather than a recommendation for immediate injunction. The history of the procedure amply demonstrates that the involvement of attorneys will induce the collection of much of the money the Department has been previously unable to collect.

The report also fails to note that many injunctions are held open and on file with the courts for indefinite periods of time while the courts assist in monitoring payment of the accrued liability. Courts are generally reluctant to issue an injunction when a taxpayer is making progress toward coming into compliance. For the above-stated reasons it should be clear that the length of time a case spends in the injunction process is not directly related to laxness of enforcement.

Finally, the fact that 19 of the 30 cases reviewed were dismissed shows the effectiveness of the Department's procedure as a collection tool.

***Legislative Post Audit response.*** *The reason why only two years of statistical data regarding sales tax injunctions appear in the report is that the data supplied by the Department for the first three years is inconsistent with the data for the last two years. Department employees cautioned the auditors on using the entire five-year period for reporting purposes.*

*The auditors disagree that the chart on page 47 purports to show that no activity is occurring during the legal process. The chart merely displays the portion of the injunction process attributable to the Department of Revenue prior to filing a petition in relation to the time the court spent resolving the petition. Full mention is made in the text that a demand letter is prepared during this time period.*

*The response states that the report urges the Department to summarily shut down a business as quickly as possible whenever a field representative is unable to collect on an account. The accounts referred to in this section of the report have already gone through all other collection efforts and have had their registrations revoked. Hence, these are not businesses which simply did not pay taxes after contact from a field representative. Instead, they are operating in violation of the law and should be closed. The issue is not whether the business should be closed. That decision was made when the Department referred the case for an injunction. The issue is whether the Department is acting quickly to close these businesses once the decision is made rather than allowing them to continue to violate the law.*

*Finally, the Department states that the report fails to note that many injunctions are held open by the courts and that the length of time a case spends in the injunction process is not directly related to laxness. Page 48 of the report states "Once an injunction is filed, its time spent in court depends on the timing of hearings and continuances granted by the court. Thus, the Department would expect to have little control over reducing the second phase of the process--court time."*

Post Audit Recommendation

Page 49. "To ensure that all actions available in enforcing the State's tax laws are applied, the Department of Revenue should initiate procedures in a more timely manner after legislation is passed."

Agency Response

In 1980 the Department requested introduction of the legislation which was ultimately passed and which now permits use of the injunction tool to aid in collection of withholding liabilities. The Department has now implemented the procedure and is experiencing success in collecting on problem withholding accounts. Since April 1,

1982, 53 withholding accounts have been referred to the Legal Services Bureau by the Withholding Tax Unit. Approximately $28,500 has been collected from these accounts. Twenty-nine, or 54.7 percent of these accounts, have reached resolution through injunction, declaration of bankruptcy or payment of liability.

***Legislative Post Audit response.*** *The Department's response indicates success in collecting problem withholding accounts since injunctions have been initiated in April 1982. The point made by the audit report is that such success could have been realized more than one and one-half years sooner if the Department had promptly implemented powers authorized by the Legislature in 1980.*

Post Audit Recommendation

Page 56. "To help adequately protect the State from losses from unremitted sales and withholding taxes, the Department of Revenue's bonding policy should be strengthened through the following actions:

1. The Legislature should consider amending State law to require all withholding taxpayers to post bond at the time of registration.
2. The Department of Revenue should take the following actions:
   a. Amend State regulations to require all businesses remitting sales and withholding taxes to post bond at the time of registration equal to an estimated three months' tax liability, and to maintain that bond until a satisfactory payment record is established. (A period of perhaps two years.)
   b. Institute a policy that requires additional bonds for sales and withholding tax accounts that have become "high risk" accounts. The policy should specify:
      --The number of delinquencies that an account can acquire before being designated a "high risk" account.
      --The point in the collection follow-up process (such as after the business does not respond to the first notice of delinquency) when the additional bond is to be requested.
      --Immediate revocation for sales accounts not supplying the required bond.
   c. Periodically review accounts and update them to require additional bonds if the existing bond is found to be insufficient to meet the current average, as called for in State regulations."

Agency Response

Initiation of a mandatory bonding policy for all sales and withholding accounts is a matter which should be addressed legislatively rather than through administrative action. Further, if the Legislature supports the concept of mandatory bonds, some consideration should be given to a uniform bond that would cover all business taxes for which the taxpayer is registered. Such a procedure would reduce the paperwork required of the taxpayer.

Experience has shown that many taxpayers simply cannot qualify for surety bonds and do not have the financial resources to post a cash or escrow bond.

Finally, the Department would submit that it currently has an aggressive bonding policy reflected in an increase in cash bonds required from 378 in FY 1978 to 944 in FY 1982.

***Legislative Post Audit response.*** *Although, as pointed out in the report, legislative action would be necessary to require bonds at registration from all withholding taxpayers, K.S.A. 79-3616 appears to already allow the Department such discretion for sales tax accounts.*

*Also, the Department offers an increase in cash bonds from 378 to 944 in fiscal year 1982 as evidence of an aggressive bonding policy. It should be pointed out that this number represents only about 6 percent of new registrants. The measure of the effectiveness of a bonding policy is not whether the number of bonds obtained has increased but whether the State is adequately protected against lost tax revenue when it is necessary to seize a bond. The auditors' testwork displayed on page 53 of the text demonstrates that nearly $30,000 was unrecovered from only 16 cases because of bonding inadequacies.*

Respectfully Submitted,

Michael Lennen

Michael Lennen
Secretary of Revenue

GAR:v/l/S695/1



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## ATTACHMENTS

A. Case Study Analysis

B. Memorandum Regarding Readability of Postmarks

C. Revocation Selection Criteria

## EXAMPLE, PAGE 17

The business described in the example ceased having taxable retail sales in 1977. However, it continued to file returns with the Department as "no tax due". With each sales tax return sent to the business, the Department enclosed a "notice of change of business" form which the taxpayer was instructed to complete should the business be discontinued. The company did not provide the Department with this information. When the company became delinquent for October, 1981, the firm was contacted by the Field Service Bureau. The field representative found the business no longer engaged in taxable sales and promptly notified the Sales and Excise Tax Bureau. The account was closed out effective September 30, 1981.

***Legislative Post Audit response.*** *The point of the profile is that there is no systematic monitoring of accounts for proper filing frequency. The fact remains that the taxpayer filed monthly returns indicating "no tax liability" for four full years before the effective closeout date made by the Department. In addition, the Department's response states that the account was closed effective September 30, 1981. Account records in the possession of the auditors show returns filed through December 1981 (due January 30, 1982) and a record of fieldman contact in February 1982.*

## EXAMPLE, PAGE 19

The business described in this example represents a small home appliance repairman located in eastern Kansas. The audit report recommends that since the taxpayer qualifies for quarterly reporting of the tax, the Department should have placed the account on a quarterly reporting basis. The audit report also indicates that the taxpayer has been delinquent in filing 24 of the last 25 monthly returns filed for the period ending October, 1981.

Two fallacies are apparent in the Post Auditor's assertion that this taxpayer should have been "placed on a quarterly payment cycle". First, under the statute (K.S.A. 79-3607), the change of filing status is an option available only to the taxpayer, with approval of the Director of Taxation. Second, the fact that the taxpayer had been delinquent 24 of 25 months would contraindicate the allowance of such a change. The Post Auditor seems to suggest that, where monthly payments are not made in a timely manner, the Director should force the taxpayer to file less often. The Department believes this is an illogical conclusion.

Monthly filing would permit closer monitoring and more frequent follow-up on the account.



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***Legislative Post Audit response.*** *The point of the profile used by Legislative Post Audit is that frequent processing of small amounts of tax and frequent follow-up to collect those small amounts is not cost-effective for the State. In this case the average tax liability of the account was only about $28 a month, generating an average penalty and interest assessment of about $3.50. This amount would hardly seem to cover the cost of field personnel efforts to collect. As a result, the monthly monitoring preferred by the Department appears to be inefficient and not cost-effective. The auditors disagree that the provisions of K.S.A. 79-3607 preclude the Department from changing a taxpayer's filing frequency.*

EXAMPLE, PAGE 35

The example, in part, states "In August, the field representative repeated the request (for a warrant) as the taxpayer was selling his property". This statement is highly misleading as the field representative wrote "Issue warrant as soon as possible as T.P. (taxpayer) has house for sale".

This memorandum was written on August 18, 1981, a warrant was issued on August 19, 1981, and filed with the court on September 1, 1981. The warrant is still on file with the court and the house owned by the taxpayer has not been sold. It is totally inaccurate to say that the "State lost $6,500 in unremitted taxes".

***Legislative Post Audit response.*** *The auditors agree that some clarification of this case is necessary. However, the basic facts of the case as described in the draft report were correct. Also, the major conclusion drawn--that warrants are not always timely filed--remains intact. The Department's argument that a warrant was issued on August 19, 1981, contains two flaws. First, the Department ignores the fact that field personnel initially requested the warrant in June (nearly three months before it was issued). Second, records at the Department's Field Services Bureau show that the warrant issued on August 19, 1981, was for $490.98 in unpaid withholding tax not the nearly $6,500 in unpaid sales taxes mentioned in the report. A warrant for $6,361.03 to cover unpaid sales tax was not issued until September 11, 1981--a month later than the Department's response would indicate. It is therefore difficult to understand how a warrant filed in September subsequent to a request in June can be termed "timely filed."*

*The Department response indicates that the audit report erroneously implies that property owned by the taxpayer was sold prior to the Department's issuance of a warrant. In order to avoid any inaccurate implications, the profile has been adjusted to supply additional detail.*

EXAMPLE, PAGE 44
(Case No. 1)

The implication that Case #1 cited at Page 44 of the report is illustrative of the Department's tax enforcement of the sales tax act is based on a misunderstanding of the unique circumstances surrounding that case and a failure to investigate the legal constraints that the Department was operating within. No case handled by the Department during the last 4 years could be less typical of what normally transpires than the case cited in Example 1.

In order to fully comprehend what transpired in this case and the reasons for the legal staff's handling of the case, some historical perspective is needed.

The business involved in this case filed for reorganization under the bankruptcy laws in April of 1977. Finally, after 3 unsuccessful attempts, a plan of arrangement was agreed to by the creditors in October of 1977. This plan, which is in effect until 1992, was approved by the U.S. Bankruptcy Court. The business involved in this case was several hundred thousand dollars in debt and to reach agreement on a plan of arrangement was a very difficult task. Under the plan of arrangement, the Department of Revenue has been, and will continue to receive, annual payments to apply against accrued liability.

The business was ordered to remain current following the adoption of the plan of arrangement and it should be kept in mind that refusal to accept the plan would have jeopardized receipt of any of the accrued tax liability. It is clear that the best course of action was to work closely with the business in order to ensure that all current liabilities were paid while at the same time applying sufficient pressure to assure that payments of accrued tax liabilities were in fact made.

Specific attention is given to the fact that the Department failed to secure a bond from the business which had been requested at the time the business sales tax registration had been revoked. This is due to the fact that, at the time the plan of arrangement was approved, the Bankruptcy Court would not approve an additional bond for the business because there were not sufficient funds. To refuse to sign the plan of arrangement because of the lack of a bond requirement would not have been a sound decision. It should be pointed out that there was a bond in effect at the time. The Department requested a bond again in 1979 but once again, sufficient funds were not available and the Bankruptcy Court would not approve such a bond.

Because the business became delinquent in the payment of its current sales tax liability, the Department, in September of



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1979, collected in excess of $30,000, which again brought the entire sales tax liability up to date. When the business again became delinquent in 1980, the Department, in October of 1980, secured cashier's checks in the amount of $42,267.38 to again bring taxpayer's tax liabilities up to date. After a period of compliance, the business in question has again become delinquent and the Department has again initiated action to bring the business into compliance.

The Department has been criticized for abating certain penalties and interest at the time the delinquent taxes were collected but unfortunately the reasons and rationale for these decisions were not investigated by the post audit representatives or at the very least were not understood. Part of the penalties and interest had been incurred prior to the approval of the plan of arrangement in 1977. The penalties would have been dischargeable in bankruptcy and hence could not have been collected by the Department. For this reason, the penalties were not included in the plan of arrangement and were certainly not collectible when later abated. The interest, for reasons not known to the present legal staff, was also not included in the plan of arrangement. Consequently, the Department could not have collected the interest which accrued prior to the adoption of the plan at the time it was finally abated.

Other penalties and interest abated had accrued after the plan was in effect and were based on taxes due after the plan was approved but are not collectible under the Bankruptcy laws. Case law indicates that, unless the penalties represent an actual pecuniary loss by the creditor, they are not recoverable. The interest had to be waived in order to bring the business into current compliance. The Department's best judgment was that securing the entire tax liability was the primary objective and that objective should not be jeopardized by demanding the interest as well.

The Department has been successful in securing the sales tax owed by the business in question. Adopting the approach suggested in the report would have jeopardized collection of accrued as well as current liabilities.

***Legislative Post Audit response.*** *Based on information supplied in the Department's response, Legislative Post Audit has removed this case as an example of a business allowed to operate for extended periods of time without a valid sales tax registration. The auditors felt that, due to the sketchy nature of the existing documentation, the case should be removed from consideration in the interest of accuracy. It should be pointed out that much of the information relating to the bankruptcy action was not contained in the taxpayer's sales tax file when the auditors reviewed it. Subsequent contacts with the Department have revealed that much of the documentation that does exist was later obtained from the taxpayer's*

*withholding tax file or from a special bankruptcy file maintained by the Department's Field Services Bureau. But even with these additional files, the documentation of the bankruptcy action is somewhat sketchy. For instance, the Department states that the bankruptcy court would not allow a bond at the time of the bankruptcy and that an additional bond requested in 1979 was also denied by the court. However, there does not appear to be any documented evidence of a court denial in either case.*

*Also, some errors of fact are contained in the Department's response. The response states that the bankruptcy plan of arrangement was for 15 years and will last until 1992. However, through a review of documents and contacts with Department employees after the response was received by Legislative Post Audit, the auditors learned that the plan will last 10 years and will expire in 1987. Likewise, the Department states that it has been receiving, and will continue to receive, annual payments to apply against the taxpayer's accrued liability. The auditors' review of bankruptcy documents indicates that the Department is among a group of creditors whose claims were to be satisfied over the first four years of the bankruptcy plan. Hence, the Department should have received final payment in 1981. To say that the Department will continue to receive payments on the accrued liability is incorrect.*

*Finally, the Department states that it was unjustly criticized for abating penalties that were disallowed as a result of the taxpayer's bankruptcy action. If the Department were to maintain better documentation of the reasons for abatements, perhaps such criticism could be avoided in the future. This is especially true when abatements of large amounts are involved, such as the more than $7,000 abated in this case. The explanation of the abatement as stated on the abatement document reviewed by the auditors was, "Please abate amounts representing penalty and interest through August 1979 which the Director agreed to waive in lieu of the taxpayer's financial problems." If these amounts are not allowed by the bankruptcy court, this reason for the abatement should be stated in the explanation.*

EXAMPLE, PAGE 45
(Case No. 2)

By working with the attorney for this taxpayer during the summer of 1981, the Department collected all delinquent returns and the tax, penalty and interest for those returns in August, 1981. Inadvertently, the existence of some prior penalties was not discovered at that time and the taxpayer's registration was reinstated. The mistake was discovered by the Department and appropriate action has been initiated to recover the penalties as well as delinquent taxes which had accrued after August, 1981. These proceedings had been initiated prior to the time the Post Auditor's report made mention of the delinquent penalty. At the present time, negotiations are already under way to bring this account back into compliance.



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The Department did not collect an additional bond because a $150 bond was already on deposit with the Department and, after receiving the delinquent returns, it was determined that the existing bond was sufficient since it exceeded three (3) months cumulative tax liability.

***Legislative Post Audit response.*** *The Department's response does not appear to question the facts presented. Instead, the Department makes an effort to detract from the points being made by stating that penalties were not discovered at the time the account's record was reinstated, and that taxes were subsequently collected. The issues remain that the Department's records should be accurate and up-to-date so that accounts are not reinstated when they have not fulfilled the requirements of the Retailers' Sales Tax Act. Also, the account did operate without a valid registration for seven months before the Department filed a petition for injunction.*

EXAMPLE, PAGE 49

This example, as portrayed by the Post Auditor, carries the implication that the Department of Revenue could have taken steps to force the taxpayer to either file actual returns or cease doing business. The example fails to note that during the eight-year period referred to, the Department had no ability to require the posting of a bond, revoke the registration of the business or enjoin its operation. This is precisely the type of case which led to the Department requesting such powers in 1980. The legislation as passed, however, does not confer the power to revoke delinquent accounts and conditions injunctions on the attempted evasion or defeat of taxes due. The statute should be amended to authorize revocation and condition the injunction upon the failure to possess a valid registration. The present form of the statute has led to some of the difficulty in establishing procedures for obtaining withholding tax injunctions.

***Legislative Post Audit response.*** *It appears that the Department is not disputing the facts presented but instead did not fully understand the point being made by the presentation of the profile. The auditors are aware that no authority existed to enjoin the account from operating prior to 1980. The point being made is that when authority was obtained, this account should have been acted upon immediately rather than waiting for one and one-half years.*

*It also would appear that the Department's interpretation of K.S.A. 1981 Supp. 79-3294(a) is more restrictive than necessary. The Department states that the law conditions injunctions on the attempted evasion or defeat of taxes due. However, the law allows the Director of Taxation to bring an action for injunction when an employer "...fails to truthfully account for and pay over withholding tax or attempts in any manner to evade or defeat such tax..." (Underscoring added.)*

Attachment B

# M E M O R A N D U M

TO: Gary A. Russell, Manager
Planning & Research Services Bureau

DATE: August 16, 1982

SUBJECT: Readability of Postmarks

FROM: Lanny N. McMahan

On August 16, 1982, a survey was taken on a sample of 500 random envelopes. The purpose of the survey was to check the readability of postal service postmarks. The sample envelopes contained a variety of tax type information including: sales, individual estimated, corporation estimated, homestead, individual income, vehicles and miscellaneous Of the 500 envelopes checked, 166 were found with problem postmarks. In other words, one out of every three (3) envelopes surveyed, or 33%, contained a postmark that was difficult or impossible to read or contained no postmark at all. The following is a breakdown of the various problems discovered and the percentage that problem represents to the total envelopes surveyed.

| NUMBER | PROBLEM | PERCENT OF 500 SURVEYED |
|---|---|---|
| 34 | No Postmark | 6.8% |
| 41 | Postmarks Blurred | 8.2% |
| 48 | Postmarks Stamped Over Other Printing | 9.6% |
| 36 | Postmarks Appear To Be Different Date Than They Actually Are | 7.2% |
| * 7 | Metered Date Different Than Cancellation Date | 1.4% |
| 166 - Total Problems | | 33.2% |

* Another possible problem is the dependability of the date used on metered mail. (Total metered mail is not considered a problem in this survey) Of the 500 envelopes surveyed 45 were machine metered. Metered mail does not have to be cancelled by the post office, however many are. Of those cancelled by the post office, seven (7) showed a different cancellation date from the metered date. Conclusion, 15.6% of all metered mail is post office handled after the metered date.

The 500 envelopes used in the survey have been separated from the normal work-flow and are located in my office should you or anyone else wish to view the various problems discovered in postmark readability. Should you have any questions on the subject please contact me.

Records Services Bureau

Lanny N. McMahan

Lanny N. McMahan, Revenue Manager

LNM:bf
cc: Robert R. Revenew
Glenna Slater
Mark Clements



A-60

| CLASS | 1ST NOTICE | ACTION | 2ND NOTICE | ACTION |
|---|---|---|---|---|
| I (Good: over $2,500) | Printout | Call immediately. 10 day follow-up. If no response set for revocation. | Printout | Compare printout with revocation hearing docket. If not scheduled for hearing set for revocation. |
| II (Bad: over $2,500) | Printout | Set for revocation immediately unless one (1) month only delinquent. | Printout | Compare printout with revocation hearing docket. If not scheduled for hearing set for revocation. |
| III (Good: $300-$2,500) | Prinout | Mail to taxpayer normal follow-up. | Printout | Mail to field. |
| IV (Bad: $300-$2,500) | Printout | Mail to taxpayer or set for revocation per judgement of Delinquenty Control Section. | Printout | Set for revocation remainder of accounts in this class which were not set for hearing on 1st notice. |
| V (Good: $0-$300) | Printout | Mail to taxpayer normal follow-up. | Printout | Mail to field. |
| VI (Bad: $0-$300) | Printout | Mail to taxpayer or set for revocation per judgement of Delinquency Control Section. | Printout | Mail to field. |



Attachment C

4-6-1