

Approved: April 3, 1997
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

A Joint meeting with the House Taxation Committee was held at 9:00 a.m. on January 28, 1997 in Room 313-S of the Capitol.

All members were present except: Broderick Henderson (Excused)
Barbara Allen (Excused)
Carol Beggs (Excused)
Lisa Benlon (Excused)
Annie Kuether (Excused)
Bill McCreary (Excused)
Ethel Peterson (Excused)
Bonnie Sharp (Excused)
Bob Tomlinson (Excused)

Committee staff present: Renae Jefferies, Revisor of Statutes
Beverly Renner, Committee Secretary

Conferees appearing before the committee: Tom Severn, Legislative Research
Secretary John LeFavre, Department of Revenue

The House Committees on Economic Development and Taxation met jointly to receive a briefing on the CFO article, "State Taxes: A Guide for the Besieged", in which Kansas was compared unfavorably to other United States locations.

Tom Severn, Legislative Research distributed pertinent excerpts from the article (Attachment 1) and related his difficulty in getting information about the preparation of the article and the responses to the survey quoted in the article (Attachment 2). His findings that there was a 30% response rate to the survey led to a conclusion of questionable legitimacy.

Secretary John LeFavre, Department of Revenue answered questions from the committees and cited complementary articles from various sources (Attachment 3) that would tend to refute the results of the survey quoted in the CFO article.

The meeting concluded with the decision that the Chairmen will co-author a letter to the CFO Magazine.

The meeting was adjourned at 11:00 a.m.

STATE TAXES: A GO

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hen Tenneco Inc. spun off its agricultural- and construction-equipment subsidiary, Case Corp., in June 1994, the new company's senior vice president and CFO,

Ted French, knew from the start that Case's state tax payments might be substantial. Nevertheless, the \$16 million that Case paid out to the states in its first full year took French by surprise. As a taxable spin-off, "we had to accept some handcuffs on our legal structures until January 1, 1997, to preserve federal and international tax benefits for Tenneco," says French. "But that doesn't mean we should be free game for state tax collectors."

A \$5 billion company, Case had some heavyweight in-house talent to call on, including Steven Mielke, Case's director of federal and state taxes, and John Evard, vice president and general tax counsel. And they had plenty of options. Already the company has made preliminary moves, such as relocating some business operations out of high-tax states. And, Case could consider reducing franchise taxes by reorganizing its parent company and subsidiaries into different states; separating its operating entities according to profit levels to reduce income taxes; or even establishing a separate entity to receive intangibles income. "We have no shortage of ideas," says Mielke.

But the Racine, Wisconsin-based company still faces a major problem: how to implement a strategy that will not only reduce taxes, but will also withstand the rabid aggressiveness of state revenue departments. "We know we can manage our tax rate better," says Mielke, "but there's a lack of certainty right now about how states will treat particular structures and activities in future audits. So we're planning and documenting carefully. We just want to be ready for anything."

They need to be. Since the late 1980s, states have taken the offensive in expanding and enforcing their tax laws. Motivated by declining federal support and growing budget deficits, they have sought to close numerous "tax gaps"—the real and perceived amount of taxes owed each year that aren't collected. And given better trained audit agents and some creative legal minds, "states are doing the job they've been charged with," says George Bradford, director of taxes for U.S. Steel Group, in Pittsburgh, "and doing it better than they used to."

In fact, state taxes no longer take a back seat to federal tax concerns in terms of complexity or cost. "There are 50 states, most with three or four different taxes,

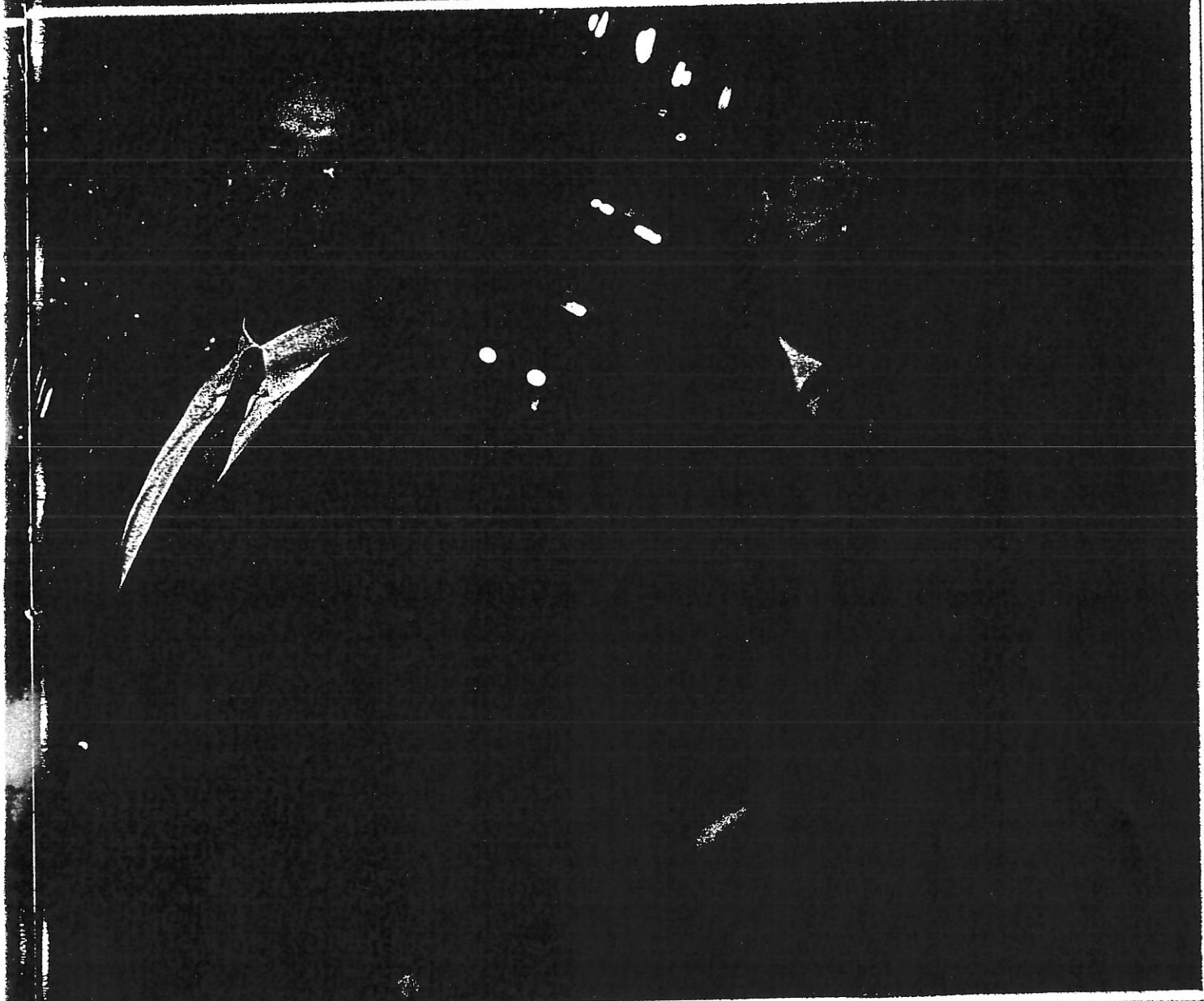


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aggressiv**

BY IAN SPRINGST

HOUSE ECONOMIC DEVELOPMENT
January 28, 1997
Attachment 1

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d eral taxes. It's the ever-changing, even more
e state tax bite that's driving companies crazy.

"We know we can manage our tax rate better," says Case's Mielke. "But there's a lack of certainty about how states will treat particular structures and activities in future audits."

using 20 different models of taxation," explains John Forch, national partner for Coopers & Lybrand LLP's multistate tax practice. To complicate matters, says Michael Lippman, national partner in charge of state and local tax technical services at KPMG Peat Marwick LLP, due to a lack of legal precedent, "the states aren't just enforcing the rules, they are trying to enforce the rules as they wish they were."

The irony lies in the mixed message the states are sending: while state politicians and economic development officials bend over backwards to retain and attract employers, revenue commissioners are tracking down and squeezing corporate taxpayers for every available cent. According to a recent Coopers & Lybrand study, in fact, 58 percent of fast-growth companies saw their proportionate state and local tax bills increase by an average of 27.2 percent last year. And for all growth companies in the survey, state and local payments accounted for an estimated 22.2 percent of the total corporate tax payment, up from 19.2 percent in 1994.

In their defense, the states say they're only responding to the changing face of business. Over the past 50 years, says Harley Duncan, executive director of the Federation of Tax Administrators (FTA), in Washington, D.C., "sources of income and business practices have changed and the tax bases have been eroding. To do nothing would be unfair to the remaining taxpayers." As for the aggressiveness of their actions, the states make no apologies. Says Robert A. Judge, secretary of revenue for Pennsylvania, "The law is the law. Companies doing business in this state need to pay their fair share of taxes."

For companies, dealing with this increasingly unpredictable tax environment is akin to being attacked by a swarm of bees—you never know where you're going to get stung. Some states are clearly less predictable than

others. According to an exclusive CFO survey of tax directors at the *Fortune* 100 and practice leaders at the top 10 accounting firms, the most capricious states are Louisiana, Massachusetts, California, Kansas, Pennsylvania, and New York (see chart, below). But the practices and theories of those states have been picked up by others, creating a corporate tax environment that is increasingly inequitable. The result, says Forch, is that "compliance, let alone planning, is very difficult, and companies are leaving money on the table."

The Nuances of Nexus

Companies are being stung most over issues of nexus—the amount or type of activity that gives a state the right to impose taxes. Certain states—Florida, Ohio, and South Carolina among them (see chart, page 30)—have become positively predatory about asserting nexus and demanding revenues. "They've realized that the payback on \$1 in additional discovery and audit staff budget can be \$5 or \$10 in additional taxes," says Vincent Fong, vice president of tax at Levi Strauss and Co. "So why not go after it?" The result? According to a recent KPMG Peat Marwick survey, some 35 percent of CFOs and tax directors now say nexus uncertainty is their top state tax concern, outpacing apportionment and audit concerns.

For years, states have relentlessly tried to lower nexus thresholds. In one early gambit, many states insisted that remote sellers, such as mail-order companies, should remit sales taxes simply because they targeted a state's market. In the now-famous 1992 decision, *Quill Corp. v. North Dakota*, the U.S. Supreme Court ruled that physical presence is required to create sales tax nexus. But the enthusiasm of tax collectors has hardly diminished, and confusion has ensued.

Recent court decisions have interpreted *Quill* in ways that have raised the nexus bar in some states, while

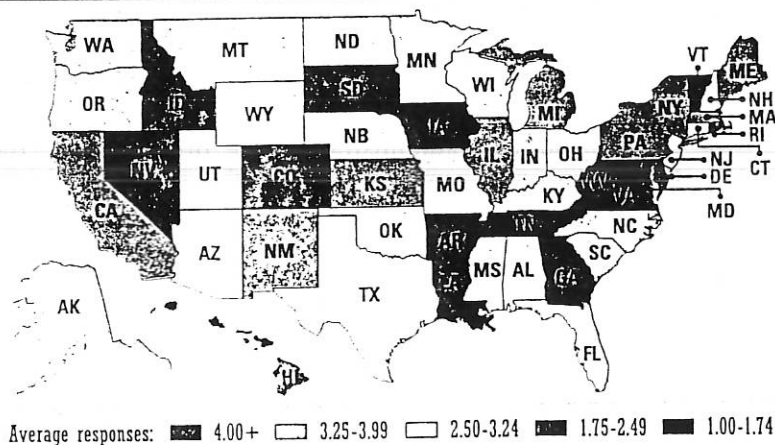
CFO STATE TAX SURVEY

WHOSE TAX ENVIRONMENT IS FAIR?

A fair and predictable tax environment allows companies to plan and file with certainty. But respondents believe regulations and interpretations in several states lack definition. They ranked tax environments on a scale of 1 (fair and predictable) to 5 (unfair and unpredictable).

WHERE TO EXPECT THE UNEXPECTED

Louisiana: 4.09	Kansas: 3.70
Massachusetts: 3.89	Pennsylvania: 3.67
California: 3.79	New York: 3.58



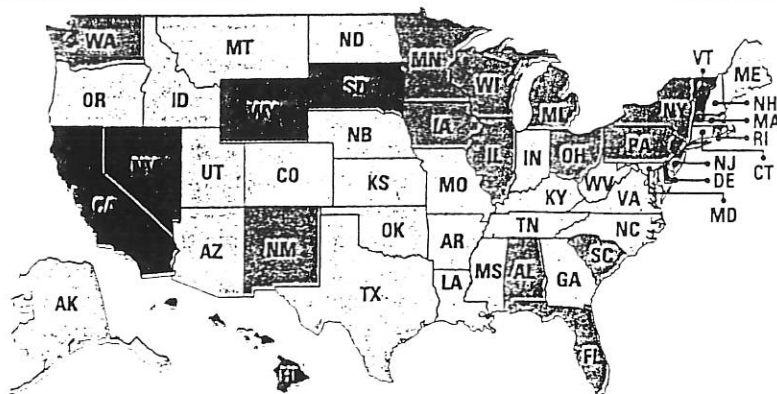
CFO STATE TAX SURVEY

WHO WANTS YOU ON THEIR TAX ROLLS?

States interpret nexus with differing levels of assertiveness. Some try to beef up their tax rolls in unconstitutional ways. Others use such practices as nexus questionnaires, outsourcing, and out-of-state audits. Survey respondents ranked states' use of nexus on a scale of 1 (not aggressive) to 5 (very aggressive).

WHERE NEXUS WILL GET YA

California: 4.15	South Carolina: 3.71
New York: 3.74	Florida: 3.58
Ohio: 3.74	Massachusetts: 3.57



Average responses: 4.00+ 3.25-3.99 2.50-3.24 1.75-2.49 1.00-1.74

lowering it in others. For example, more than a few visits a year by sales or service people into New York is now enough to incur sales tax nexus there, according to the New York Court of Appeals. But in Florida, three days at a trade show isn't enough to trigger tax, according to a state Supreme Court decision in *Share International v. Florida Dept. of Revenue*.

"For both states and companies, defining nexus is like trying to put your finger on a drop of mercury," says William McArthur, president and executive director of the Committee on State Taxation (COST), a lobbying and planning group based in Washington, D.C. "Just when you think you have it, it slips away."

Slippery definitions of nexus, however, have allowed states to explore numerous avenues in pursuing out-of-state companies. Many states, for example, now send nexus questionnaires to out-of-state businesses they discover through audits of in-state businesses, run out-of-state discovery and audit offices in major business hubs, and occasionally trade information with one another. For instance, the six states in the Great Lakes States Compact automatically query audited companies on nexus in the other member states. Even more drastic, a handful of states, including Pennsylvania and New Jersey, outsource discovery and collection work to out-of-state law and CPA firms—often referred to as "bounty hunters." And states with a heavy reliance on sales/use taxes, such as Florida, have turned up the heat on resident companies to remit use taxes on out-of-state purchases.

As Pennsylvania's Judge says, "We need to continue to be very aggressive in our discovery of companies with a presence in the state." That should be expected of any good tax administrator. The problem in Pennsylvania and many other states is that nexus isn't defined in regulations. "We're trying to clarify our definition and write nexus regulations, but it takes a little time," says Judge.

Yet, with or without clear regulations, once a state claims nexus, it is reluctant to let go. Take the experience of Atmel Corp. in Ohio: Five years ago, the semi-

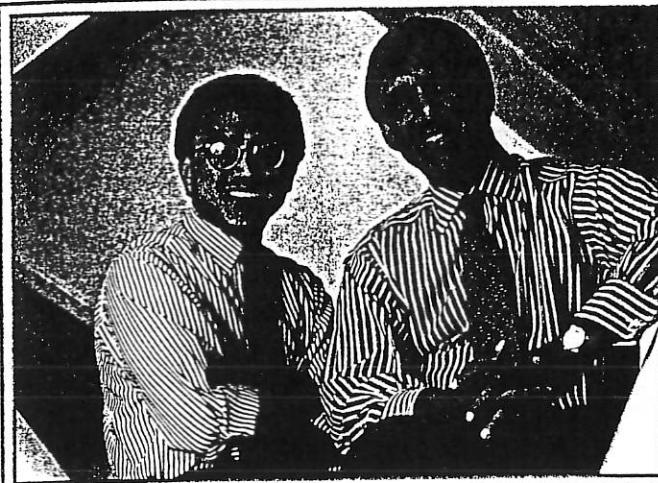
conductor maker closed its sales office in Columbus, moved all assets and payroll out of state, and contracted with an independent firm to sell its products in Ohio, where sales amount to about \$5 million a year. Atmel's finance and tax manager, Andy Wong, concluding the company no longer had nexus, stopped filing income and franchise tax returns in the state. But the Ohio Revenue Department insists that Atmel pay franchise taxes for 1992 onward, asserting that physical presence is not necessary to trigger franchise tax nexus. "They keep writing us letters demanding that we file, and we keep writing back explaining that we don't have nexus," says Wong.

To its credit, the Ohio Department of Taxation wants to make its tax structure more friendly to business. In fact, the department commissioned a study that suggested the elimination of the franchise tax. But until that happens, "the franchise tax is a privilege tax, and isn't protected by the same shield as the income tax," says John P. McAndrew, administrator of Ohio's income and franchise tax audit division.

Wong characterizes the whole experience as "harassment," and says, "it has tainted our view of locating operations in Ohio." His attitude is not unique. According to the CFO survey, state tax policies have a negative influence on location and expansion decisions in many states, especially California, Pennsylvania, and Louisiana (see chart, page 34). "Business decisions come first," says Atmel CFO Kris Chellam, "but if we can act in a neutral way that minimizes any tax, we'll do it."

Questions Over Intangibles

The fiercest nexus battles, however, are being waged over intangibles income—from both the sale of services and the use of intangible assets such as accounts receivable, patents, trademarks, and computer software. Asserting that *Quill* applies only to sales/use tax nexus, and that federal law offers some income tax protection for companies selling only tangible goods, some states now claim that income from intangibles



Atmel's Andy Wong and Kris Chellam

used in their states creates "economic nexus"—a virtual presence—for income taxes and franchise taxes. And they are taxing companies through "legislation, policy decisions, and audit positions," says Mary Jane Egr, national coordinator of state and local tax for Grant Thornton LLP. "It's all over the map."

Financial service providers, for example, are now subject to income or franchise tax in eight states that have adopted legislation that requires no physical presence and only a minimal economic presence. In Massachusetts, for example, banks or other lenders with as few as 100 customers or \$10 million in assets or \$500,000 in receipts attributable to sources within the state, must file returns on their income apportionable there. Upwards of a dozen other states are considering similar legislation.

States have headed in this direction ever since the controversial 1993 case *Geoffrey Inc. v. South Carolina Tax Comm'n*. In that case, the South Carolina Supreme Court determined that Geoffrey Inc., a Delaware holding company subsidiary of the Toys "R" Us Corp. set up to receive trademark royalty income, had an economic presence in the state that was enough to trigger

income tax nexus even though the holding company had no physical operations there.

While the U.S. Supreme Court refused to hear *Geoffrey*, six states have adopted *Geoffrey*-like regulations and seven more have applied its precept through informal audit positions. Worse, most of the states adopting these new nexus guidelines have applied the standards retroactively, since there is no statute of limitations on the nonfiling of tax returns.

The fallout from *Geoffrey* is of particular concern to companies that sell or license intangibles. "It's something to be considered very carefully," says George de Urioste, CFO of Remedy Corp., a software firm in Mountain View, California. "Is software a tangible or an intangible product, a service to charge for or intellectual property to collect royalties on? Technology has always evolved faster than tax law, so we'll see how states find new ways of interpreting these things."

The sale of data and services over the Internet is also "too big now for states to ignore," says Karl Frieden, a senior manager and Internet specialist with Arthur Andersen LLP, in Boston. Illinois and New Jersey, for instance, now impose sales tax on electronic transmission of software, but not on other types of electronic data or services transmitted on the Internet.

Audit Angst

Not content with just expanding their tax rolls, many states have intensified their audit procedures. "State auditors have been running wild through companies in the past couple of years," says Kenneth T. Zemsky, Arthur Andersen's state and local tax practice lead partner for the northeast region. By playing fast and loose with the rules, auditors are trying to source as much income into their own states as possible, and challenging companies to take them to court. "It's not just the dollars involved, which aren't usually that material," he says. "Companies are just outraged to be treated this way."

Ivan Shandor, vice president of tax at \$9.5 billion Baxter International Inc., in Deerfield, Illinois, sees it

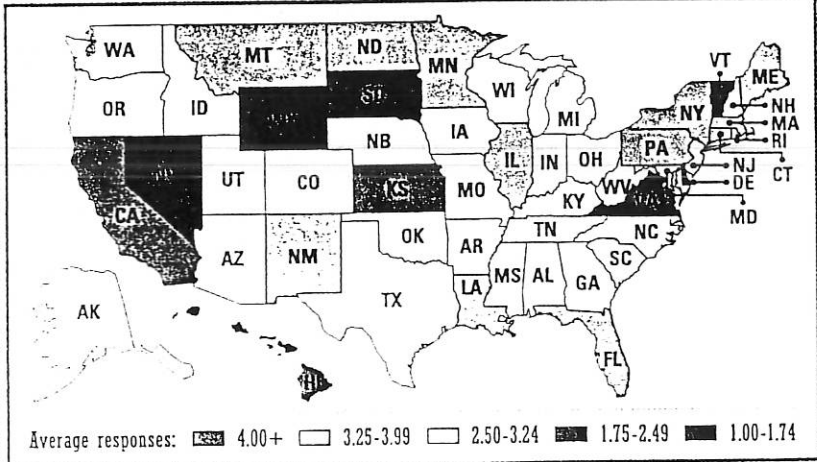
CFO STATE TAX SURVEY

WHICH AUDITS ARE TOUGHEST?

Increasingly, states challenge apportionments and the sourcing of income during audits, and use discretionary powers to adjust returns. Survey respondents ranked the states on sourcing of income on a scale of 1 (not aggressive) to 5 (overly aggressive).

WHERE YOU'LL BE CHALLENGED

Kansas: 4.17	Pennsylvania: 3.75
California: 4.13	Maine: 3.73
Louisiana: 3.88	Massachusetts: 3.65
New York: 3.81	Illinois: 3.59
New Mexico: 3.79	Minnesota: 3.59



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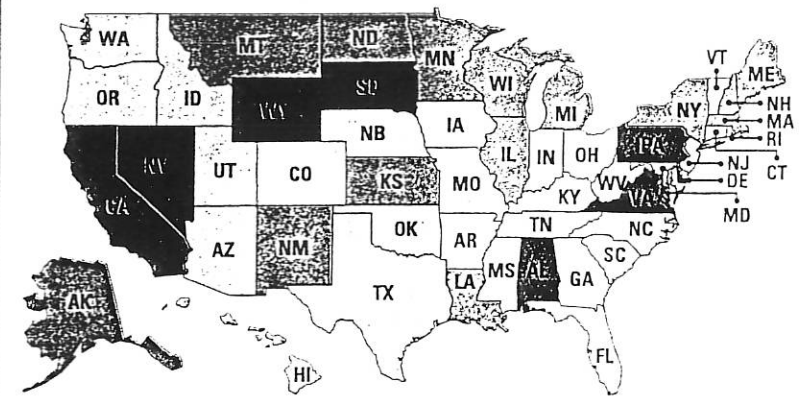
CFO STATE TAX SURVEY

WOULD YOU LOCATE OR EXPAND HERE?

Fiscal policy has always influenced business decisions, but unfavorable policies and attitudes are turning companies against certain states. Survey respondents rated tax policy influence on business decisions on a scale of 1 (very positive) to 5 (very negative).

WHERE TO AVOID

California: 4.12	Kansas: 3.69
Pennsylvania: 4.00	New Hampshire: 3.67
Louisiana: 3.75	Michigan: 3.53
North Dakota: 3.71	Illinois: 3.50
Massachusetts: 3.70	Maine: 3.50



Average responses: 4.00+ 3.25-3.99 2.50-3.24 1.75-2.49 1.00-1.74

every day. "Auditors are asking more questions, requesting more documentation, taking inconsistent approaches, creating aggressive interpretations of statutes and rules," recites Shandor. Since the health-care-supplies giant operates and sells everywhere in the United States, nexus isn't an issue. But the flood of recent audits certainly is. "Our biggest problem is the time we have to spend on audits and the time we spend gathering the data," says Shandor. "We can have 8 to 15 states in here at any one time auditing us. The worst is when they want documents that are spread out around the world, because they don't trust or understand our internal financial information systems."

"Some state auditors are stretching for the outer limits of taxation right now," agrees Paul Frankel, a well-known state tax practitioner, and a partner at Morrison & Foerster in New York, "and bigger out-of-state companies are sometimes getting hit the worst."

At The New York Times Co., for example, vice presi-

would have had significant cost. "Not only were they wrong, but the case would have had great precedent value for the state," says Nied.

Daniel Langford, vice president of tax at Sonat Inc., headquartered in Birmingham, Alabama, has also felt forced into the courts. "The state of Alabama for the past two years has been taking positions in income and franchise tax audits that it can't really support in code or regulation," says Langford, vice president-tax at the \$2 billion gas and oil concern. "You can do something sanctioned by the code that you've done for seven years running, and all of a sudden they're disallowing it." As a result, the company has brought three lawsuits against the state. And in one instance, the state handed Sonat a \$12 million assessment after it disallowed a \$185 million



"Auditors are asking more questions, requesting more documentation, taking inconsistent approaches, creating aggressive interpretations of statutes and rules," says Baxter's Ivan Shandor.

dent of taxation Thomas Nied has wrestled with the increased use of discretionary adjustment powers among the three main states the publisher files in—Massachusetts, New York, and New Jersey. "More and more, the states want to allocate or reallocate interest and other expenses between entities," Nied says, adding that "dealing with such income tax challenges is often very hard due to the lack of precedent and clear regulation at the state level."

Nied, like many tax watchdogs, is often willing to settle small issues with states. But when states become more aggressive, Nied fights back. For example, the company finally won an entity combination case last year against the State of New York, on an audit that

deduction for intercompany dividends received from a subsidiary.

Riding the Tidal Wave

Challenging audit positions may be cathartic and precedent setting. But tax directors, faced with tight head counts, zero-growth budgets, and limited time, can fight over only the most important issues. Consequently, many companies are rethinking their legal structures and operating policies to lower their effective rates. Others are moving large operations and headquarters out of high tax states; witness Scott Paper Co.'s (now part of Kimberly Clark Corp.) planned move from Pennsylvania to Delaware and Florida.

Some are cutting "incentive" deals to remain where they are (see "There's No Place Like Home," January). Still others are trying to work with the states to streamline the audit procedure. As Kendall Houghton, general counsel of COST, likes to say, "Just because state tax is a tidal wave doesn't mean you can't ride it."

At the U.S. subsidiary of ABB Asea Brown Boveri Ltd., the \$34 billion international power and engineering giant, for example, the tax function was completely overhauled five years ago, resulting in state and local tax savings. According to Julietta Guarino, vice president of taxes and customs, one reason was a significant reduction in legal entities, which in turn lowered the company's effective state rate. "The reduction in complexity not only saves us money, it saves us time," says Guarino, pointing out that ABB now files far fewer state tax returns.

On the audit front, ABB went a step further. "We approached our home state—Connecticut—first, and asked if they'd undergo a quality initiative on sales/use

tax audits with us, and they said, 'A what?'" recalls Guarino. But once the initiative was explained, the state agreed: Guarino and the ABB tax team discussed with Connecticut sales tax representatives what the auditors needed, how they interpreted state regulations, and what the company's information systems could provide. The initiative with the state "helped more than halve the audit cycle from about two years to seven months, and the final assessment was immaterial, whereas in the previous cycle it was substantial," says Guarino, who has repeated the process with other states, saving "hundreds of hours."

Other companies are just starting the process. FileNet Corp., a \$300 million seller of document management software and services, recently allowed a team from KPMG Peat Marwick to review its operations for potential tax savings. "The last thing we want to do is create headaches for our accounting and operations people, but if changes can be made in our legal structures that will save us money and work with our business plans,

STATE TAX REFORM: ONLY SMALL VICTORIES

Focused state tax reforms and limited unifications are possible. "When business and state interests can agree on an issue, change can occur," says William McArthur, president and executive director of the Committee on State Taxation (COST), which lobbies for its *Fortune* 500 members at the state level. "But even then, it is a long, slow process."

One group that's been at it for 30 years ago is the Multistate Tax Commission (MTC), a group of 40 states and the District of Columbia dedicated to promoting unification of state tax codes and regulations. While the MTC now limits its agenda mostly to multistate cooperation, it has made some inroads. For instance, the National Nexus Program allows companies that have likely triggered different types of nexus, but not filed, to anonymously negotiate voluntary compliance agreements. Not surprising, the program has gained quick acceptance with companies cleaning up their tax histories and states looking to add taxpayers to their rolls. In 1993, just 11 companies reached 105 agreements with participating states; last year, 27 companies made nearly 300 such deals; and this year 40 companies are already in the pipeline.

The MTC also pushes for administrative uniformity and puts forward model regulations. Working with COST, for example, the MTC recently created the Multistate Alternative Dispute Resolution Program, the only forum for interstate tax conflict

relief. In addition, its model regulation for financial institution net income apportionment has been adopted by nine states over the past year and a half. And it is also working with COST, the Federation of Tax Administrators, and the Tax Executives' Institute on a model regulation for electronic tax payments and tax return filing. They hope this will answer many questions companies have about retaining records from purchasing card and electronic payment transactions for state tax purposes.

STATE ATTEMPTS

For their part, a handful of states are trying to clarify their application of tax laws. For instance, lawmakers in Alabama just passed two bills clarifying the deductions for subsidiaries of



William McArthur

out-of-state companies located in the state. And in the area of discretionary adjustments of inter-company transfers, Illinois and Connecticut last year issued new regulations outlining when and how such powers would be used. "This state had a reputation for

ambushing taxpayers and making aggressive interpretations of statutes," says Gene Gavin, commissioner of revenue services in Connecticut. "Now that we've issued regulations in this area, at least taxpayers know where we're going to be looking and how we'll interpret what we see." The result, he says, has been significantly reduced audit assessments over the past year.

So it appears some aspects of state tax may become simpler, or at least clearer, with time. As Bob Hanson, tax commissioner of North Dakota and chairman of the MTC, explains, "Revenue departments have become more proactive in explaining what state interpretations are, but still need to do more. No one wants to take the 'gotcha' approach anymore." ■ I.S.

we will consider them," says Brian Colbeck, director of taxes at the Costa Mesa, California-based company. Specifically, because FileNet generates revenues from several types of sales—software, hardware, and service—and has grown by acquisition, the company now has some flexibility about where it registers corporate entities, and how it interprets state apportionment formulas. "In the end, it may reduce our overall rate by a percentage point or so, but that's not insignificant," says Colbeck, who managed to keep FileNet's effective state tax rate at a below-par 3 percent last year.



ABB's Julietta Guarino

Reinforced Confusion

Still, planning strategies and court challenges are just plays in a game with ephemeral rules and no time limit. Worse, there are no substantive improvements on the horizon. The obvious solution is uniform tax laws—as members of both the Multistate Tax Commission and COST would like to see (see sidebar, page 37). But while some progress has been made on such issues as financial service income apportionment and telecommunications taxes, the whole is still a confusing mishmash.

"Uniformity in tax laws would eliminate cost and confusion for companies," says Timothy Higgins, national partner of state and local tax services at Ernst & Young LLP. "But it's a political quagmire at the state level." Indeed, state legislators and governors continue

to see fiscal policy alternately as bait to promote their state economies and as a trap to raise tax dollars. Even the FTA's Duncan agrees. "It's not the way of the states to sit down and work out a common direction," he says. "They all go at their own pace and in their own direction. The result, predictably, is a huge burden on taxpayers."

But the states are not solely to blame. The truth is that many companies *like* the in-state favoritism, the different apportionment formulas, the complex nexus rules, and the variable models of taxation—when it favors their situation. And companies quietly approve of the status quo for the same reason—

the perception that the differences create opportunities for tax rate arbitrage that are greater than the cost of compliance, audit defense, and planning combined.

The current drive by tax administrators and accounting firms to focus on planning opportunities assumes that this cost-benefit equation can still be tipped in favor of corporations. However, if the states continue to apply aggressive interpretations of tax law, that may no longer be the case. Taxes saved may soon be offset by the time and expertise needed to fight a multifront battle. And at that point, experts say, corporate interests may be better served by a simpler, nationwide approach to state taxation. ■

Ian Springsteel is CFO's staff writer.

WHERE TO GO FOR HELP

For advice on state tax planning or for complete overhauls, the following consulting services are available:

Committee on State Taxation.

This well-respected lobbying, legal advocacy, and planning group based in Washington, D.C., counts nearly all of the *Fortune* 500 among its members, but it also welcomes smaller companies; (202) 484-5222.

Arthur Andersen. State Tax Analysis and Reduction Process, William Curley, managing director; (213) 614-6560.

KPMG Peat Marwick. State and Local Tax Practice, Douglas Green, national director; (212) 758-9700.

Coopers & Lybrand. The State Tax Minimalization and Recovery of Tax (SMART) program. John Forch, partner in charge, Multistate Tax Services, at (202) 822-4035; or Bill Coe, national director, SMART Program; (212) 259-1693.

Price Waterhouse. Multistate Tax Consulting Services, Ruurd Leegstra, partner in charge; (212) 596-7000.

Ernst & Young. SALT (State and Local Tax) Value Analysis, Timothy J. Higgins, partner in charge; (202) 327-9601.

Deloitte & Touche. Multistate Tax Practice, Jack Cronin, national partner; (213) 688-6969.

Grant Thornton. State and Local

Tax Consulting, J. Thomas Johnson, national director; (312) 565-3471.

PUBLICATIONS:

State Tax Notes, published weekly by Tax Analysts, Arlington, Va. Offers technical articles and arguments on varied state tax issues; \$949 a year; (800) 955-2444.

State Income Tax Alert, published biweekly by Professional Newsletters Inc., Atlanta. Offers general articles and breaking news in state tax arena; \$247 a year; (770) 457-1000.

Multistate Tax Portfolios, book or CD-ROM of expert analysis for state tax planning, from Tax Management Inc., a division of the Bureau of National Affairs; (800) 372-1033.

CFO

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Contact: Julia Homer
617-345-9700x204

State Taxes: Ranking the Toughest Climates for Business California and Massachusetts lead CFO Magazine's List of Most Egregious States

Boston, Mass. -- Much has been written about the time and money spent complying with the federal tax code. But according to an August feature in *CFO* magazine, "State Taxes: A Guide for the Besieged," it's the state efforts to expand and enforce their tax laws that are making corporate executives crazy. The result? The tax practices in many states are literally driving business away.

"When you consider that there are 50 states, most with three or four different taxes, using 20 different models of taxation, and infinite interpretations of tax laws," says Julia Homer, *CFO* editor-in-chief, "it's no wonder that companies are reconsidering where they do business."

According to an exclusive *CFO* survey of tax directors at the *Fortune* 100 and practice leaders at the top 10 accounting firm, the most capricious states include Louisiana, Massachusetts, California, Kansas, and Pennsylvania. In those states, respondents say, the tax environment is literally "unfair and unpredictable." And when it comes to negatively affecting business relocation or expansion decisions that same list can be expanded to include North Dakota, New Hampshire, Michigan, Illinois, and Maine.

Companies say they are being stung most over issues of nexus -- the amount or type of activity that gives a state the right to impose taxes. Certain states Florida, Ohio, and South Carolina among them -- have become positively predatory about asserting nexus and demanding revenues. And not content with just expanding their tax rolls, many states -- especially Kansas, California and Louisiana -- have intensified their audit procedures.

The irony of the situation is that states are adopting a siege mentality over taxes at the same time they are promoting business retention programs. "State revenue department speak with forked tongues," says Homer. "They stumble all over each other doling out tax breaks to retain and attract favored companies. At the same time, they pursue tax collection more aggressively than ever before, particularly from out-of-state companies that do business in the state."

To combat the treatment, some companies are rethinking their legal structures and operating policies to lower their effective tax rates. Others are moving large operations and headquarters out of high tax states. Some are cutting "incentive" deals to remain where they are. Still others are trying to work with the states to streamline the audit procedure. As Kendall Houghton, general counsel of the Committee on State Taxation, says, "Just because state tax is a tidal wave doesn't mean you can't ride it."

The
Economist

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HOUSE ECONOMIC DEVELOPMENT
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Attachment 2

The answer, most experts agree, is a uniform tax law. But since state legislators and governors continue to see fiscal policy alternately as bait to promote their state economies and as a trap to raise tax dollars, the issue is likely to remain bogged down in politics. And what doesn't help is that corporations actually like the status quo -- as long as it can be tipped in their favor. The result, says Homer is that "with federal disbursements to states declining and demands for services on the rise, companies must accept that their state tax burden is only going to increase."

CFO magazine is a monthly magazine based in Boston, Massachusetts, and read by 365,000 corporate finance executives. *CFO* is a publication of The Economist Group.

CFO's 1996 State Tax Survey

Please rank each question on a scale of 1 through 5. If you have no opinion about a particular state or question, leave it blank. All information will be used in the aggregate.

Please fax this survey back to (617) 951-4090 by June 19. Thank you for your participation.

- A** What is your overall impression of the tax environment in this state?
(1 fair and predictable — 5 unfair and unpredictable)
- B** How would you rate this state's stance on establishing corporate income tax and sales/use tax nexus?
(1 not aggressive — 5 overly aggressive)
- C** How would you rate this state's stance on the sourcing of income for corporate income tax purposes during audits? (1 not aggressive — 5 overly aggressive)
- D** How would you rate the independence of this state's pretrial appeals process from its audit function?
(1 very independent — 5 not independent)
- E** How much does this state's revenue department policies influence firms' decisions to locate or expand there? (1 very positively — 5 very negatively)

	A	B	C	D	E		A	B	C	D	E
Alabama	_____	_____	_____	_____	_____	Montana	_____	_____	_____	_____	_____
Alaska	_____	_____	_____	_____	_____	Nebraska	_____	_____	_____	_____	_____
Arizona	_____	_____	_____	_____	_____	Nevada	_____	_____	_____	_____	_____
Arkansas	_____	_____	_____	_____	_____	New Hampshire	_____	_____	_____	_____	_____
California	_____	_____	_____	_____	_____	New Jersey	_____	_____	_____	_____	_____
Colorado	_____	_____	_____	_____	_____	New Mexico	_____	_____	_____	_____	_____
Connecticut	_____	_____	_____	_____	_____	New York	_____	_____	_____	_____	_____
Delaware	_____	_____	_____	_____	_____	North Carolina	_____	_____	_____	_____	_____
Florida	_____	_____	_____	_____	_____	North Dakota	_____	_____	_____	_____	_____
Georgia	_____	_____	_____	_____	_____	Ohio	_____	_____	_____	_____	_____
Hawaii	_____	_____	_____	_____	_____	Oklahoma	_____	_____	_____	_____	_____
Idaho	_____	_____	_____	_____	_____	Oregon	_____	_____	_____	_____	_____
Illinois	_____	_____	_____	_____	_____	Pennsylvania	_____	_____	_____	_____	_____
Indiana	_____	_____	_____	_____	_____	Rhode Island	_____	_____	_____	_____	_____
Iowa	_____	_____	_____	_____	_____	South Carolina	_____	_____	_____	_____	_____
Kansas	_____	_____	_____	_____	_____	South Dakota	_____	_____	_____	_____	_____
Kentucky	_____	_____	_____	_____	_____	Tennessee	_____	_____	_____	_____	_____
Louisiana	_____	_____	_____	_____	_____	Texas	_____	_____	_____	_____	_____
Maine	_____	_____	_____	_____	_____	Utah	_____	_____	_____	_____	_____
Maryland	_____	_____	_____	_____	_____	Vermont	_____	_____	_____	_____	_____
Massachusetts	_____	_____	_____	_____	_____	Virginia	_____	_____	_____	_____	_____
Michigan	_____	_____	_____	_____	_____	Washington	_____	_____	_____	_____	_____
Minnesota	_____	_____	_____	_____	_____	West Virginia	_____	_____	_____	_____	_____
Mississippi	_____	_____	_____	_____	_____	Wisconsin	_____	_____	_____	_____	_____
Missouri	_____	_____	_____	_____	_____	Wyoming	_____	_____	_____	_____	_____

TAX MODERNIZATION

Kansas overhauls its tax processing

Whirlwind plan includes business re-engineering effort and consolidation of 50 tax systems

By CLAIRE E. HOUSE
GCN Staff

Kansas state taxpayers and workers won't recognize the state's Revenue Department once Project 2000 gets through with it.

Project 2000, a \$70 million business process re-engineering venture, will revamp the department to improve tax processing and enforce payment compliance, Revenue Secretary John LaFaver said.

In doing so, he said, the project will generate at least \$234 million in revenue over the next 10 years and improve customer service to Kansas taxpayers, who file an estimated 2 million returns annually.

The overhaul encompasses both management and technical projects that include:

- Reorganizing the agency's staff and doing away with separate tax departments
- Implementing a client-server system with a Microsoft Windows NT network supporting 800 users

- Consolidating state taxpayer information from 50 disparate tax programs and using decision support software to enhance account management

- Giving taxpayers various filing channels, including a cutting-edge Internet program

- Rolling out an imaging system to digitize paper tax documents

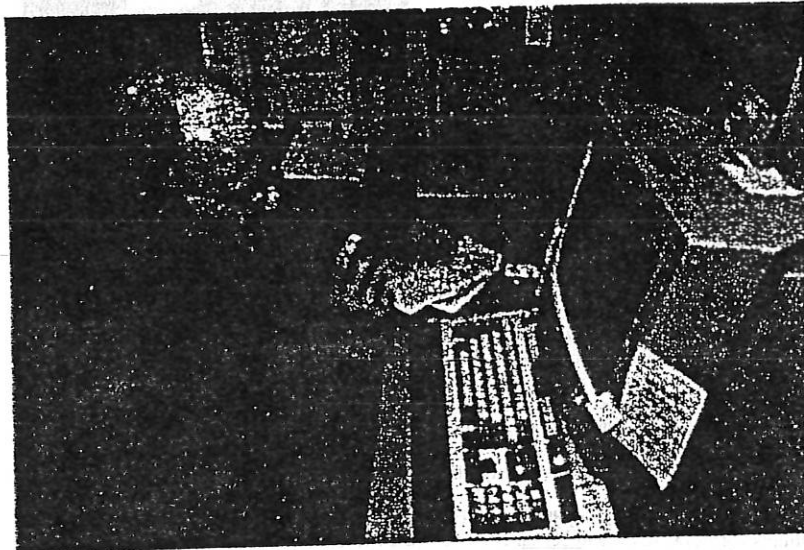
- Creating a new payment remittance system.

The Revenue Department has been trying to improve its tax systems since the early 1980s, Project 2000 director Karla Pierce said. But duplicative work on the more than 50 IBM mainframe systems used throughout the department hamstrung the effort.

More than technology

"In the early '90s, the managers that were here realized that technology alone wasn't going to solve our problems and meet our needs," she said. "We came up with the idea to re-engineer the business process and get the technology to support those processes."

Currently, sales tax, income tax, withholding tax and every other kind of tax each has its



GCN photo courtesy of Kansas Revenue Department

Tax collector Kevin Kaul says that the new applications are "speeding up things tremendously" for Kansas Revenue Department workers and for taxpayers as well.

own staff structure, organization and system, LaFaver said. Like most tax organizations, the department was built piece by piece as different taxes were enacted, procedures created and legislation passed, he said.

Some business customers have up to 12 contacts for tax issues and can have pieces of account information in many systems, said Colin Shaw, project director and a vice president of American Management Systems Inc. of Fairfax, Va., which won the re-engineering contract last July.

Additionally, each of the department's separate functional groups, such as collections and auditing, has its own stovepipe and often paper-intensive support system.

But that's all changing thanks to a complete reorganization supported by a fully integrated client-server system with imaging and Internet services, Shaw said.

About 25 ProLiant 5000 servers from Compaq Computer Corp. will house the Windows NT network. An Oracle 7.5 database from Oracle Corp. will consolidate every piece of information about a customer's tax history into a single file. Another database, in Lotus Notes 4.0, will centralize tax policy information.

"The policy and research database will be a common database available to the tax examiner, collections officer, auditor, customer relations representative," and, ultimately, every taxpayer in Kansas via the Internet, Shaw said.

But the real gem of the system is Strata, LaFaver said. A decision-support tool developed by AMS, Strata will take customer account data and score that taxpayer's likelihood of filing and paying proper taxes on time.

Targeted auditing

With Strata, Revenue can focus its efforts more constructively to bring taxpayers into compliance, Pierce said. The department will use Strata's risk-assessment scoring in the Collections Department to decide if it needs to confront a nonpayer with, say, only a letter or phone call vs. an in-depth evaluation or even legal action, she said. Auditors will be able to use the scoring to make informed auditing decisions.

"Today, auditing is more random—there's see TAXES next page

The system will score the likelihood of a taxpayer filing and paying proper taxes.

Strata keeps tabs on delinquencies; Mosaix tracks data for taxes

TAXES from previous page
more suspicion," Pierce said. With the scores, "we will be able to target an entire industry segment, raising the compliance of the whole segment rather than just one taxpayer." She said the account database also will cross-reference outside databases, such as business directories, to keep taxpayer records complete.

Collections is currently using Strata in conjunction with Mosaix, a predictive dialing system from Digital Systems Inc. of Redmond, Wash. Referencing data in the legacy systems, Strata identifies and ranks delinquencies and feeds them into the collections system, Shaw said.

Mosaix calls people on the list, transfers a connected call to a collector and pulls up the account file automatically on screen. The taxpayer and account files can be transferred directly to other departments for handling.

Tax collector Kevin Kaul's workspace used to overflow with a box and a drawer full of paper queries.

"Today that box is gone, the drawer is all cleaned out," he said. And, taxpayers don't wait days to hear back from the department. "We're speeding up things tremendously," he said.

Revenue users are receiving 800 160-MHz Pentiums with 24M RAM and 2G hard drives, half of which are already installed. AMS has been developing the system tools using the object-oriented PowerBuilder 5.0 from PowerSoft Corp. of Concord, Mass. AMS



The re-engineering effort will combine records from 50 systems into one, Revenue Secretary John LaFaver says.

expects to complete the system for Kansas by December 1998, Pierce said.

The department also is opening new filing channels, the most innovative of which is a Java applet that will let users prepare returns online. LaFaver and Shaw said they believe the Kansas Revenue Department is the first state tax agency to use the so-called intelligent form application, set for release March 1.

Taxpayers using Microsoft Explorer or

Netscape Communications Corp.'s Navigator will download tax forms from the World Wide Web, and Java applets will guide them through their return preparations and do the calculations for them, Shaw said. The users then will print and mail the forms, which carry a character band of data—common to commercial tax preparation software programs—for easy reading by the department's imaging software.

Digitized returns

The imaging system, from FileNet Corp. of Costa Mesa, Calif., goes live next month, Pierce said. Kodak ImageLink 923D scanners will capture digital images of the returns, and an NT intelligent character recognition (ICR) engine will interpret the handwritten data. Ultimately, the imaging system will feed the data into the Oracle databases. Until system completion, the data will be submitted to the individual legacy systems for processing.

Payments will be handled by a remittance system from Unisys Corp., which does ICR on the payment voucher and also on the check. By speeding up deposits during the height of the tax season, the system will make the department \$200,000 in interest alone, Shaw said.

But LaFaver is quick to point out that Project 2000 is about much more than technology. "It's totally about rethinking and revamping the notion of what a department of revenue is," he said. "The technology empowers that, gives us leverage." ■

PRACTITIONER'S UPDATE

Russians, Australians Trek to Kansas for Tax Advice

John LaFaver, the secretary of revenue in Kansas, has been down this road before. After revising tax administration in Montana and then Maine, his reputation brought him to Kansas. Now his work is luring inquisitive tax officials from as far



John LaFaver

away as Russia and Australia. But of all the visitors, which have included officials from several states, the most interesting are the Russians. "These were high-level fiscal people. We walked them through our collection system, but what they were most amazed at was our statistics on how many people voluntarily file," LaFaver said. "Their notion of collecting taxes is how many police officers have to knock on doors."

State-of-the-art

The Russians and others are coming to Kansas to get a first-hand look at Project 2000, the code name for LaFaver's overhaul of the department of revenue, whose jurisdiction covers driver's licenses and other certificates as well as tax compliance and collection. For one thing, the project is fine-tuning a tax collection system developed in LaFaver's previous state jobs, including better integration among different divisions of the revenue department. The system is designed so that one division, such as withholding tax, doesn't issue a refund without first checking whether the same taxpayer is delinquent in other areas, such as sales taxes.

LaFaver is also taking Kansas into new areas, such as a "Tax Discovery" system that matches various databases to identify tax scofflaws and quickly implement collections. The system, including computer hardware and software developed with American Management Systems in Arlington, Va., is projected to cost \$70 million by the time it's fully implemented in 1998.

LaFaver figures the department will "more than double" that in new collections over the same period and estimates the system has already identified as many as 400 delinquent taxpayers since it began in 1995, bringing in about \$7 million.

And, in an effort particularly interesting to his Russian visitors, LaFaver is attempting to change the culture of his department to make it more customer-friendly. A learning center has been established to train personnel in "what putting customers first means"—the cus-

tomers being taxpayers, tax professionals and various licensees. The goal, he said, is to make the revenue department as service-oriented as a top financial services firm.

"If I had to cut out part of Project 2000, I'd cut the technology," LaFaver said. "What's more important is the cultural change of the agency."—P.D.



**KANSAS DEPARTMENT OF REVENUE
PUTTING THE CUSTOMER FIRST EVERY TIME**

**Presentation to the Senate Assessment and Taxation Committee
January 23, 1997**

To effectively change large, traditional organizations, the leaders must begin by establishing a vision of the future. This vision must communicate the values that will guide the organization.

In June 1995, Secretary John LaFaver and senior department leaders met to establish the vision for the future. This vision directs all changes being implemented in the Department.

Our Vision for the Department of Revenue

- **We will put the customer first every time**
- **We will be the benchmark for the nation**
- **We will sustain a team environment**

WE WILL PUT THE CUSTOMER FIRST EVERY TIME

What do our customers expect from the Department of Revenue?

During statewide meetings we listened to taxpayers, business owners and local units of government describe their expectations of the Department of Revenue. Twelve expectations were communicated to the Department. We developed a survey and ask for those themes to be prioritized.

The top five expectations of Kansas Taxpayers are:

- Friendly attitude by Department associates
- Simple forms in plain language
- Equal treatment of all taxpayers
- Knowledgeable people answering the phone
- One person to handle my account -- start to finish

What best business practices of Kansas companies should the Department implement?

We visited a number of Kansas companies and asked for their best advice on how to provide superior customer service, work in a team environment and train associates to be customer service oriented. Some of the companies we talked with include Boeing, Hill's Pet Foods, Heinz Pet Products, Security Benefit Group of Companies and Hallmark Cards. We documented the following best practices from our benchmarking visits.

- Providing customer service through one stop shop
- Mystery shopper program to monitor customer service
- Use of data-driven decision making
- Team approach to management
- Job rotation for team members
- Team based reward programs
- Continuous improvement programs

How will we know when we are putting the customer first?

We have established performance goals to measure our progress towards achieving the vision. The goals measure what the taxpayers think of us, how well our processes work and how well our associates can do their jobs. If we do all of these things well, the customers will be paying the correct amount of tax due.

WE WILL BE THE BENCHMARK FOR THE NATION

As a benchmark for the nation the performance of our business operations will be second to none. Our new business operations are designed to provide the services our customers want and need. We are installing new technology to enable efficient operations and training our human resources to be effective service providers. Some of the outcomes of the new operations are listed below.

Provide multiple but simplified ways to communicate with the Department

An example of this is the new Telefile program that is available statewide this year to short form filers. This program enables taxpayers to complete an 11 line worksheet, dial a toll free number and key the information into the phone. The system computes the tax liability and refund amounts, gives the taxpayer a confirmation number and then the refund is mailed within 5-7 days. The system is available 24 hours a day and no forms are mailed to the Department.

Calibrated compliance actions ensure everyone pays their fair share

Our approach to ensuring everyone pays their fair share requires the Department to view ourselves as service providers not tax collectors. The services delivered are based on the least intrusive compliance tool needed to bring the taxpayer into compliance. This approach benefits both the taxpayer, by being less intrusive and the department, by allowing better utilization of our limited resources.

Single point of contact to handle all aspects of taxpayers business

No longer will taxpayers have to guess which department to go to for services. We are organizing around customer segments and training associates to be customer account representatives. They will be knowledgeable about all tax types related to the customers they are assigned. Each opportunity to provide service to a customer is an opportunity to enable the customer to stay in voluntary compliance.

To provide this exceptional level of customer service the Department must organize so the operations focus on the customer. The structure must eliminate functional silos. By organizing with a customer focus, jobs are designed to enable associates to provide the required service to the customer. Measures provide the information to hold associates accountable for the service they deliver.

WE WILL SUSTAIN A TEAM ENVIRONMENT

Changing our culture to enable customer service and teamwork

We are recognizing and rewarding behavior that puts the customer first. The Secretary has a "Customer First Award" that is given to associates when a customer reports having received great customer service. Names of award winners are published in the Department newsletter. A team of associates is identifying additional ways to recognize behaviors aligned with our new culture.

Newly hired managers value customer service and teamwork

A new approach to hiring associates was used to select the four process managers who lead and manage the new operations. Each manager has proven customer values, has worked in a team environment and has experience in managing effective operations.

NEW DIRECTION IN AUDIT

Audits provide education and problem identification

A very high percentage of Kansas Taxpayers want to file and pay the correct amount of tax. The new role of the audit process is to provide the education so the taxpayer can comply with the tax laws in the least intrusive manner. It also must identify areas of the law that are unclear and difficult to administer. These problem areas must then be communicated to the legislature for your consideration.

Trusting taxpayers to audit their own books

We recognize that Kansas businesses are asking employees to do more work with fewer resources, and so we are simplifying the audit process. Audit processes are being implemented which will minimize the intrusion on taxpayers.

An example is an audit method we call a self audit. In this audit the department provides the taxpayer with a form and instructions on how to complete it. The taxpayer completes the form and returns it to the department. If a taxpayer is unable to complete the form, an auditor will travel to the taxpayer's location and provide assistance. The key element in these new audit methods is that the department trusts taxpayers to audit their own books. These initiatives are very efficient in utilizing scarce audit resources.

Improving the quality of the audits performed

The Department has implemented initial steps to improving the quality of the audits. Improved auditor training programs are in place. The Multi-State Tax Commission presented a seminar for Department auditors in December 1996. Audit report cards are being provided to taxpayers to allow them to give their opinion on the performance of our auditors. The ratings to date have been very favorable. A new problem resolution process has been implemented within the Audit Bureau for corporate income tax assessments. This has been successful in allowing taxpayers to settle disputes informally. Auditors reviewed Department policy and practices from the taxpayers point of view. Their goal was to evaluate whether current policy and practices were being administered consistently. A number of suggestions to simplify and clarify existing laws were documented.

Voluntary compliance vs. revenue driven audits

Our goal is to obtain the highest level of voluntary compliance with the Kansas tax laws. Traditional audits will still be a part of the Department's compliance program, but they will no longer be the primary focus. Compliance programs that bring many taxpayers into

voluntary compliance instead of those that maximize the revenue of one taxpayer are win-win situations for the state and its taxpayers.