Approved: 1-18-00
Date

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE.

The meeting was called to order by Chairperson Senator Audrey Langworthy at 11:10 a.m. on January 13, 2000, in Room 519-S of the Capitol.

All members were present except: Senator Corbin – Excused

Committee staff present: Chris Courtwright, Legislative Research Department
April Holman, Legislative Research Department
Don Hayward, Revisor of Statutes Office
Shirley Higgins, Committee Secretary

Conferees appearing before the committee: Leo Hafner, Legislative Post Audit
Karla Pierce, Secretary, Kansas Department of Revenue

Others attending: See attached list.

The minutes of the January 12, 2000, meeting were approved.

Senator Langworthy requested the introduction of a bill on behalf of individuals interested in a constitutional amendment relating to the classification and taxation of aircraft and watercraft. She explained that the bill would reclassify aircraft and watercraft similar to the way trucks and recreational vehicles are classified.

Senator Hardenburger moved to introduce the bill, seconded by Senator Steineger. The motion carried.

Leo Hafner, Legislative Post Audit, distributed copies of the performance audit report on the various issues related to the Department of Revenue's handling and processing of income tax returns. The report was published in December of 1999. Copies are available at the office of the Legislative Division of Post Audit. Mr. Hafner pointed out that, although the audit includes information on sales tax, it focuses primarily on individual income tax. He discussed findings on the following questions (Attachment 1):

- Has income tax processing under Project 2000 worked as intended?
  Mr. Hafner said the short answer to this question is, "No." He outlined the primary cause of problems.

- To what extent were refunds delayed in 1999 and what factors contributed to delays?
  Mr. Hafner noted that, on the average, refunds took about twice as long as the previous year. He discussed contributing factors, impacts, and issues related to unclear laws.

- How well did the Department communicate with taxpayers?
  Mr. Hafner reported that the Department's correspondence to taxpayers often was unnecessary or confusing, and it was extremely difficult for taxpayers to get through to the Department. He noted that the Department has made some improvements to the phone system.

- Does the Department have an adequate process for ensuring that checks remitted by taxpayers are properly accounted for and not destroyed?
  Mr. Hafner reported that the Department's procedures were reviewed by CPA firms as part of the annual statewide audit, and no problems were found. He noted that the Post Audit Division also found no problems. In addition, he noted that, even if a taxpayer's check should accidentally reach the warehouse and be shredded, the state would not lose money because the check would not have been posted to the taxpayer's account, thus, the taxpayer would eventually get a bill from the Department.

Karla Pierce, Secretary, Kansas Department of Revenue, followed with a response to the post audit report on the 1999 income tax processing season and outlined the Department's current plans for improving its performance for the upcoming 2000 season. (Attachment 2)

At the outset, Secretary Pierce agreed with the conclusion made in the report that individual income tax processing did not go as smoothly as the Department hoped it would. She pointed out that the report also confirms that 1.2 million individual income tax returns (85% of the total) were processed essentially without problems. She informed the committee that return problems discovered last year were corrected to an accuracy rate of 99.9%. She explained that the demands of implementing the Tax Reform and Relief Act of 1998 contributed to the delays in issuing refunds because changes to Project 2000 as a result of the act were huge.

Secretary Pierce also discussed findings presented in the report regarding the completion of more work with fewer staff than in 1998, the Department's control over checks received from taxpayers, and the overall execution of Project 2000. In addition, she discussed the steps the Department has taken to ensure better communication with taxpayers by telephone and written correspondence.

She also addressed the portion of the report concerning problems the Department may experience with the new sales tax component of the integrated tax system during the upcoming tax season. She reported that, as of November 1999, an integrated tax processing system is in place. She noted that the key challenge in sales tax processing is customer education on the simplified filing requirements.

The meeting was adjourned at 12:00 p.m.

The next meeting is scheduled for January 18, 2000.

SENATE ASSESSMENT AND TAXATION COMMITTEE
GUEST LIST

DATE: January 13, 2000

NAME	REPRESENTING
Leo Hafner	Legislative Post Audit
Allan Foster	" "
Chris Clarke	"
Ross Kopp	AMS / KDOR
Nick Kramer	KDOR
Cynthia Smith	KCPL
Marlee Bertholf	KCCI
Ron Gaches	AMS
Ashley Sherard	O.P. Chamber of Commerce
Shirley Sicilian	KD o Revenue

Legislative Post Audit

Presentation to Senate Assessment and Taxation Committee

"Reviewing Various Issues Related to the Department of Revenue's Handling and Processing of Income Tax Returns"

January 13, 2000

Senate Assessment + Taxation
1-13-00
Attachment 1

Senate Assessment + Taxation
1-13-00

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Question 1- Has Income Tax Processing Under Project 2000 Worked as Intended?

(Page 8) **Examples of Problems**

- Late Refunds
- Duplicate Refunds
- Erroneous Bills for Additional Taxes Due

(Page 9) **Primary Cause of Problems - Innaccurate information getting into the computer**

(#1 Cause)

- Equipment misread tax returns
- Staff miskeyed information
- All information didn't get completely transferred from the old system
- Taxpayer / Preparer Error

(Page 10) **There were a few glitches in the computer programs themselves**

Some of the glitches might have been caught sooner through better testing of the programs.

(Page 11) **Also, there are some additional controls needed to prevent improper payments**

- Better review of manually generated refunds
- Better documentation of changes made to taxpayer accounts.

(Page 15) **New software was installed in November to process sales taxes and to correct problems identified with income tax processing.**

(Page 17) **The new programs may have problems for some period of time because testing had to be condensed into a relatively short time period, and there were some problems with the data that got converted from the old system.**

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Question 2- To What Extent Were Refunds Delayed in 1999 And What Factors Contributed to Delays?

(Page 23) **On average, refunds took about twice as long as last year**

- 4.5 weeks vs. 2.5 weeks
- As of late October 134 refunds (dating back as far as February) still needed to be processed.

(Pages 25-29) **Contributing Factors**

- Reprogramming needed to deal with the 1998 Legislative changes to tax law weren't complete until January 1999. The Department had to do limited processing for 30 days to make sure programs worked, and this created a backlog that was hard to recover from.
- Significantly more refunds had to be processed — 840,000 vs. 620,000 in 1998.
- Problems with inaccurate information caused many returns to get hung up.
- About 14% less staff was available to process refunds
- Taxpayer address changes didn't get entered

(Page 32) **Impacts**

- Taxpayers upset
- More interest was paid on late refunds than in previous years.

(Pages 33-34) **Issues Related to Unclear Laws**

- The law is silent about when interest should be paid on amended returns.
- The Department has granted automatic filing extensions to some taxpayers without clear authority to do so.
- The Department allows extra exemptions on food sales tax at a cost of $3 million annually

Question 3 - How Well Did the Department Communicate With Taxpayers?

(Page 37) **The Department's Correspondence to Taxpayers Often Was Unnecessary or Confusing**

(Page 39) **It Was Extremely Difficult for Taxpayers to Get Through to the Department**

- **There were almost 300,000 more calls than in the previous year, but in all, 11,000 fewer calls got answered**

  Items contributing to the increased number of calls

  - The refund hotline gave out incorrect information about refunds prompting taxpayers to call
  - Frustrated callers who couldn't get through, likely called back several times

(Pages 40-41) **The Department Had More Staff Assigned to Answer Phones in 1999, But Staff Answered Fewer Calls Than in 1998**

Reasons fewer calls got answered

- Staff were unfamiliar with the new system and their new responsibilities
- Some calls were lengthy because staff had the capability of fixing the problem while taxpayers were still on the line.
- During peak processing times, staff were pulled off the phones to help process returns

(Pages 41-43) **The Department Has Made Some Improvements to the Phone System, But If Significant Processing Problems Occur Again, It's Unlikely To'll Be Able to Handle a Large Call Volume**

- **The Refunds Status Hotline Has Been Repaired**
- **Features Like Hold Queues Have Been Added to allow callers to know how many people are on line ahead of them**

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uestion 4 - Does The Department Have An Adequate Process for Ensuring That Checks Remitted by Taxpayers Are Properly Accounted For and Not Destroyed?

(Page 45) **The Department's Procedures have been reviewed by CPA firms as part of the annual Statewide audit, and no problems have been found**

(Page47) **Documents and envelopes are electronically and manually reviewed for checks several times during processing.**

- Envelopes are run through and electronic candling machine and also are manually reviewed.
- Documents also are reviewed for checks as they are assembled for processing

(Page47) **The Department implemented a final review at the warehouse in 1997 when it began shredding documents instead of maintaining them for 3 years.**

- Employees review documents as they are being shredded.
- Any checks found at the warehouse are recorded in a steno pad and returned to the main office to be recorded in the taxpayer's account and deposited in the State treasury.

(Page48) **From December 1998 through June 1999, warehouse staff found 143 checks among the documents they received before they were shredded**

(Page48) **Even if a check is shredded, money won't be lost because the check won't have been posted to the taxpayer's account, and the taxpayer will eventually get a bill**

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Office of the Secretary

TESTIMONY

TO: Senator Audrey Langworthy, Chairperson
Members, Senate Tax Committee

FROM: Karla Pierce, Secretary of Revenue Karla Pierce

DATE: January 13, 2000

Madame Chairperson and members of the committee:

Thank you for this opportunity to discuss the recent Legislative Post Audit report on the 1999 income tax processing season and to outline our current plans for improving the department's performance for the upcoming 2000 season. I'd like to begin my comments by complimenting Barbara Hinton and her audit team on the thorough and professional job they did without undue impact on KDOR's efforts to implement the final Project 2000 tax system release last November.

Just to give you some feel for the scope of the audit, KDOR staff and our contractor, devoted over 1000 hours to the effort. LPA was provided unfettered access to all KDOR staff and even installed a confidential hotline for employees who might want to make comments anonymously. The resulting report is a comprehensive picture of the challenges we faced last year. A picture that is entirely consistent with my testimony to the LPA Committee on July 12th and August 26th of last year.

I'd like to take a couple of minutes to comment on the major points presented in the audit report and then to focus in a bit more depth on our plans for the upcoming tax season. One key conclusion of the report is that individual income tax processing did not go as smoothly as we hoped it would last spring. We agree with this finding.

The report also confirms that 1.2 million individual income tax returns, or 85% of the total "were processed essentially without problems" (p. 8). As you read the fine details of the report--such as 162 duplicate refunds or $84,000 overpayment in interest--please use as a reference point the following information: 1,400 returns are less than 0.1% of the total returns processed and $250,000 represents less than 0.1% of the total dollars refunded.

Senate Assessment & Taxation
1-13-00
Attachment 2

Our tax systems are designed to detect and handle problem returns. A large percent of our resources are assigned to handle exception processing. The tax laws are complicated and taxpayers make mistakes. Finding and correcting return errors are handled in a three-step process. The first step is during processing where we are correcting common mathematical mistakes. The second step is during return posting where we evaluate the returns against a set of business rules that flag returns for manual review. The final step is during the compliance process where we use external data, such as information from the IRS, to select returns to audit.

We use these three techniques to identify and correct each and every account problem detected by our systems and procedures or reported to us by taxpayers. Return problems that we discovered last year were corrected to an accuracy rate of 99.9%.

The audit also confirms that the demands of implementing the Tax Reform and Relief Act of 1998 contributed to the delays in issuing refunds (pp. 25-26). Changes to Project 2000 as a result of the act were huge, primarily because they occurred at the worst possible time. That was in May of 1998, just as the software release scheduled for October 1998 implementation entered it's second month of testing. After the legislation was passed Secretary LaFaver reviewed our options and decided to go forward with the planned October implementation, rather than deferring it until the tax law changes would take effect. To implement the required tax system changes on time, we had to set up a duplicate and parallel design/build project targeted for completion in January 1999. This second implementation required us to complete 35,000 hours of work not originally planned.

I want to be very clear with you that the level of effort required to implement the 1998 tax law changes was unique. Our new tax system is designed to be flexible, and our CIO, Tim Blevins, assures me our Information Systems team has the ability to maintain and enhance this application software. I am confident that the department will be able to respond quickly and cost-effectively to future tax law changes enacted by the legislature.

Another finding presented in the audit is that KDOR completed more work with fewer staff than 1998. We processed 28% more refunds and 37% more total documents with 14% fewer staff (pp. 28-29). And, not only did we process increased volume of returns, we were testing and planning the implementation of the November 1999 software release. This release had to be implemented on time because it was the release that made our sales and use tax applications Y2K ready.

You may recall that some of the LPA Committee members—and the newspapers--were highly concerned that the department did not have sufficient controls over checks we received from taxpayers. I am happy to report that the auditors fully validated that the department does take adequate steps to ensure taxpayers' checks are not accidentally shredded. (p. 46). I'd like to be definitive on this point since it was such a contentious issue. There is no concrete evidence that even one check was shredded by the department in the last year, even though the audit speculates that this could have happened.

Another focus of the report is the overall execution of Project 2000. The audit confirms that Project 2000 has been on schedule and essentially within budget over the last 4 ½ years (pp. 5-6). This fact alone sets Project 2000 far apart from the vast majority of modernization projects attempted in government and the private sector. The Gartner Group reports that 3-5 year projects typically experience "scope creep" of 33 to 60 percent. The literature also reports that two-thirds of business process reengineering projects and 80% of large application development projects fail.

Project 2000 is one of the largest projects ever attempted by Kansas government. It was not conceived as a technology-driven project simply to achieve Y2K compliance. Rather, it was—and is—a comprehensive and systematic effort to change the organization and culture of the department in order to:

- improve customer service for all Kansas taxpayers and other key KDOR stakeholders;
- to eliminate inequity and increase consistency of treatment for business taxpayers;
- to reduce the cost of compliance and, thereby, increase voluntary compliance with Kansas tax law;
- to implement an extensive new compliance strategy that employs new automated tools to ensure efficient enforcement of Kansas tax law; and,
- to increase revenues through improved voluntary compliance.

We are certainly on course for achieving all of these goals. We have already collected nearly $65 million in enhanced revenues. The project has been recognized by many other states, the Federation of Tax Administrators, Governing Magazine and the New York Times. Just last week, Kansas was recognized by Center for Digital Government as being the number one state in e-taxation.

The path we have chosen for KDOR is a difficult one because it requires major business, organizational and technological transformation. As the Gartner Group suggests, few large organizations are very good at these kinds of changes. And, our job has been made more difficult by the state limits on human and financial resources, by implementation of the record-setting 1998 tax relief act and by the complexity of building new tax systems at the same time we had to operate existing ones. But, the bottom line is that this project has been implemented on time and on budget. This success is a result of diligent management; committed leadership and the use of a benefit funded procurement, as established by this legislature 6 years ago.

Now, let me now turn to a discussion of our preparations for the upcoming tax season.

One of the key problem areas noted in the LPA report is the general area of customer communications—which includes answering the phones as well as in-bound and out-bound correspondence with taxpayers. To be blunt, we didn't answer enough phone calls. Our refund status line wasn't working for several months during the tax season and the volume of customer calls we received overwhelmed our antiquated phone system. We've taken a number of steps to ensure that we increase the percentage of calls we receive that we are able to answer:

- The best way to manage phone contacts is to minimize the need for them through timely and accurate processing. Our income tax processing application is more stable going into this tax season than it was last year, and we're positioned for a quicker ramp-up this year than last.
- The refund status line will be online by February 1st, providing complete and accurate information that we will quality control throughout the tax season.
- We installed a new IVR—Integrated Voice Response system—in September and we are on schedule to implement a new telephone switch on March 1st. This equipment will enable us to increase the efficiency of each of our phone contacts with our

customers. We'll be able to provide recorded information where appropriate and to maintain reasonable hold queues rather than busy signals. The new system will also give our managers information on the volume and length of calls and holding times. This information will enable them to allocate staff resources to the phones based on demand as well as to monitor the efficiency of individual phone contacts.

- Finally, upon your approval we will install a new toll free line. This new service may increase phone demand somewhat, but frankly I do not believe people get up in the morning looking for a reason to call the Department of Revenue, even if it's a free call. The likely result will be that customers who really need to contact the department will be able to make the call and wait on hold on the state's nickel, potentially reducing total call volume by eliminating multiple attempts to get through.

Our new telecommunications technology will not increase the number of people available to answer phones, but it will enable us to use the people we have far more efficiently. As noted in the LPA report, if we experience significant processing bottlenecks, we may not be able to handle the volume of calls we receive (p. 43). Last year's phone problems were an unfortunate, but valuable, lesson to the entire tax operations management team, and I am confident that the steps we have taken will produce dramatic improvements this year.

A second customer contact area highlighted in the LPA report is written correspondence. The report noted that KDOR's letters to taxpayers last tax season were sometimes in error, frequently difficult to understand and occasionally unnecessary (pp. 37-39). And, our customers said the same thing. However, it's important for you to understand the challenges we face in this area.

Our new system is designed to significantly increase automation of customer correspondence. The goal is to provide timely and accurate feedback to our customers regarding filing, payment or billing problems so that corrections can be made with a minimum of staff intervention. To accomplish this goal:

- Our correspondence has to be understandable. We have reviewed and rewritten all of KDOR's standard letters to taxpayers. Unfortunately, tax law is complex and there is often a conflict between KDOR legal counsel's interest in fully defining taxpayer rights and obligations and the customer relations interest in simple and direct communications. This is an area where we plan to make continuous improvement over time.
- The data captured in the new system has to be accurate. As noted in the LPA report, we have a systematic data clean up activity underway. However, tax forms and tax laws are complex, taxpayers make errors, and our data capture systems are not perfect. Therefore, it is inevitable that some bad data gets into the system. When this happens, one of the ways we correct such bad data is through customer feedback to our letters.
- Finally, we have introduced a new approach to large volume correspondence through the use private sector firms. Ensuring a consistent level of quality from these firms has been a problem because of the changes in both the organization and technical environment. We have implemented stringent QA processes in all of our dealings with 3rd party correspondence vendors, but this area remains a risk.

We will be able to improve our correspondence with taxpayers this tax season, but because of the nature of the challenge in this area, I expect that some problems will result as well.

The LPA Report states that KDOR may experience problems during the upcoming tax season with the new Sales Tax component of the integrated tax system (p 15). This component—which is the newest part of the integrated tax processing application--was newly implemented in November and has functioned well since implementation. We have over 10,000 sales tax filers using tele-file and we are introducing PC file for large sales tax filers this month. We have also been very successful in processing tax payments we receive for deposit more quickly than we have been able to in the past. Our key challenge in sales tax processing is customer education on the simplified filing requirements.

Since the November implementation, we have been making substantial progress towards operational stability for all tax types. Over the last three months we have we have executed a detailed plan to validate the quality of the software and business operations. During this period, we have uncovered software defects, data clean-up issues, training and procedural problems that occur when dealing with live data. These incidents generally result from taxpayer behaviors that can't be replicated in a test environment. We have deployed a support team with the capacity to respond to problems quickly in order to minimize potential customer impact. Processing for individual income tax and withholding tax is improving and stabilizing each day. From the standpoint of operational stability we are ahead of last year by four to six weeks.

As of November 1999, we have an integrated tax processing system in place. The system provides comprehensive information about each customer's account. This tax-related information not only contains demographics, but also all financial transactions and a history of customer contacts with KDOR. Because we now have a complete view of the way the customer interacts with the Department, we are able to use this information to customize services we deliver.

For example, we know that a large percentage of the taxpayers don't need to or never want to hear from the Department of Revenue. There is a 100% probability they will remain in compliance voluntarily. Other taxpayers require the Department's assistance to stay in compliance. Our new operations allow us to use the least intrusive tool to bring the taxpayer back into compliance. Based on customer account history, we can determine whether it is appropriate to send a friendly reminder letter or to immediately call the customer requesting they pay back taxes. The same range of audit tools is available to our audit team, from self-audit questionnaires to detailed field audits.

Last fiscal year we completed a compliance initiative on the liquor industry. This initiative included developing a complete tax guide for liquor storeowners. The guide covered all licensing, filing and payment requirements for all tax types. We selected some stores for on site compliance reviews using a checklist to determine compliance levels. Other stores were selected for detailed audits based on their account history. This pilot initiative resulted in registering existing businesses for multiple tax types--such as withholding and sales taxes--and collecting non-filed personal income tax returns. We also assessed $1.0 million in liquor enforcement tax and have realized an on-going increase in voluntary tax payments of about 7% over last fiscal year. This pilot project validated the industry-based compliance concept as an effective strategy for improving overall taxpayer compliance.

Over the next six months KDOR's key goals include improved tax processing during the upcoming tax season, systematic expansion our compliance activities and design and implementation of the corporate income tax component of the integrated tax system. Under our original plan corporate income tax was a KDOR responsibility. We recently engaged AMS to share responsibility for the development, through a contract change funded by cost savings from other elements of the contract. Corporate income tax is scheduled for implementation next fall.

Since the inception of Project 2000, we have collected almost $65 million in incremental revenues to the state, much of which has been applied to financing the project. However, we have already begun to contribute revenues to the general fund. Over the course of the last year the pace of the increase in enhanced revenues has diminished somewhat. During this period, our primary focus has been on completing the integrated tax system platform, without unduly impacting our customers. Today, the ASTRA integrated tax platform, as envisioned in the original Project 2000 plan, is fully in place. Our next major goal revenue goal is to hit $189 million in enhanced revenues so that we can pay our contractor in full for the work they have performed for the state. I am confident that we will be able to achieve this goal well within the two years following the completion of the project, as specified in our contract. We now have the tools in place to achieve this goal as well as our other major objective for Project 2000 - To make the Kansas Department of Revenue a benchmark for the nation.