

PERFORMANCE AUDIT REPORT

**Reviewing the Department of Revenue's
Enforcement of Kansas Motor Fuels Tax**

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
May 1994**

Legislative Post Audit Committee

Legislative Division of Post Audit

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PERFORMANCE AUDIT REPORT

REVIEWING THE DEPARTMENT OF REVENUE'S ENFORCEMENT OF KANSAS MOTOR FUELS TAX

OBTAINING AUDIT INFORMATION

This audit was conducted by Kelan Kelly, Jim Davis, and Cindy Lash. If you need any additional information about the audit's findings, please contact Mr. Kelly at the Division's office.

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Reviewing the Department of Revenue's Enforcement of Kansas Motor Fuels Tax

Summary of Legislative Post Audit's Findings

State law imposes a tax on gasoline, gasohol, diesel fuel, and LP gas. These taxes are paid by fuel distributors and importers, and their cost is passed along to the consumer. Motor fuels sales to the U.S. Government, between distributors, on Indian reservations, and shipments out of State are tax-exempt. Motor fuels tax fraud may be a major source of lost revenue for states. This audit's scope did not permit us to determine the amount of Kansas motor fuels taxes lost to evasion. However, if nationwide estimates are accurate, Kansas could lose up to \$66 million in fiscal year 1994.

Has the Department established adequate controls and provided sufficient resources to ensure that it is collecting all motor fuels taxes due the State? The Department's procedures do not ensure that all taxes due the State are paid. It has not required fuel distributors and retailers to keep records that would enable it to ensure all motor fuels taxes are paid. It also is not enforcing statutory reporting requirements for transporters of motor fuels. In addition, there is no formal referral process within the Department for cases of suspected fraud, nor is it possible to uncover fraud with the information and reports currently being submitted.

Staff resources committed to auditing and investigating compliance with motor fuels tax laws are not adequate. The 0.5 full-time-equivalent auditors can't conduct complete audits of the almost 1,000 distributors annually, as required by State statute. Also, the Department has no staff dedicated to investigating motor fuels tax fraud. Compared with the states we contacted, Kansas has one of the lower staffing ratios.

Many states we contacted and the federal government have implemented procedures to help control fraud. These procedures range from additional reporting requirements to moving the point of taxation.

What resources outside the Department of Revenue are available to assist in the enforcement of the State's motor fuels tax laws? Two agencies—the Board of Agriculture's Division of Weights and Measures and the Highway Patrol—have resources that could be used, on a periodic basis, to assist in enforcing motor fuels tax laws. Such resources are not available on a consistent basis, but to the extent they can be used, they could provide useful information to Department officials. In five of the six states we contacted, the agency responsible for motor fuels taxes was the only agency directly involved with enforcing the state's motor fuels taxes.

This report includes several recommendations for the Department. We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.


Barbara J. Hinton
Legislative Post Auditor

REVIEWING THE DEPARTMENT OF REVENUE'S ENFORCEMENT OF KANSAS MOTOR FUELS TAX

The Legislature has imposed a tax on motor fuels sold in the State to be used for the cost of constructing, widening, maintaining, purchasing right-of-way, and repairing the public highways of Kansas. During fiscal year 1993, more than \$263 million in motor fuels taxes were collected by the Department of Revenue.

The Kansas Independent Oil Marketers Association has expressed concerns to Legislators regarding tax evasion of motor fuels in Kansas. According to recent newspaper accounts, fuel tax fraud is becoming a costly problem for many states.

Apparently one opportunity for fraud comes from misdirecting fuel allegedly destined for a low-tax state to an adjacent higher-tax state. Missouri's gasoline tax is three cents per gallon less and Oklahoma's tax is two cents per gallon less than Kansas' tax, which creates an incentive and opportunity for unscrupulous distributors to re-route trucks and create false paperwork showing that fuel was delivered in Missouri or Oklahoma when it actually was delivered in Kansas. The Legislative Post Audit Committee directed the Legislative Division of Post Audit to conduct a performance audit examining this issue. This audit addresses the following questions:

- 1. Has the Department established adequate controls and provided sufficient resources to ensure that it is collecting all motor fuels taxes due the State?**
- 2. What resources outside the Department of Revenue are available to assist in the enforcement of the State's motor fuels tax laws?**

To answer these questions, we reviewed statutes and regulations governing motor fuels taxes, reviewed the Department's policies and procedures for enforcing these taxes, reviewed a sample of motor fuels tax returns, examined budget data, interviewed officials in the Department of Revenue, Board of Agriculture, and Kansas Highway Patrol, talked to a representative from the Kansas Independent Oil Marketers Association, and contacted a sample of comparison states and the U.S. Internal Revenue Service about their enforcement activities. At the Legislative Post Audit Committee's direction, we did not try to specifically identify the amount of taxes being evaded in Kansas. In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office.

In general, we found that the system the Department has established for tracking motor fuels taxes does not provide complete information to ensure that it is collecting all the motor fuels tax due the State. Although the Department does a reasonably good job of ensuring that motor fuel distributors account for all the fuel they buy, the control system cannot verify that reported "non-taxable" fuel sales really are tax-exempt. As a result, the Department cannot be sure that all the tax owed is collected. The Department does not have sufficient resources dedicated to

the collection of motor fuels taxes, and it has made only minimal efforts to document or investigate potential fraud. Kansas could use controls implemented by the federal government and some other states to help ensure better control over motor fuels tax collections, but it will first have to consider the cost-effectiveness of these procedures. The Board of Agriculture and the Kansas Highway Patrol have very few staff resources available to assist the Department with enforcing Kansas motor fuels tax laws. The resources these agencies do have generally provide information to the Department and are not directly involved with enforcement activities. The other states we contacted also rely primarily on their revenue-collecting agencies for enforcing motor fuels tax laws.

These and related findings will be discussed in more detail following a brief overview of Kansas' motor fuels tax collection system.

Overview of Kansas' Motor Fuels Tax Collection System

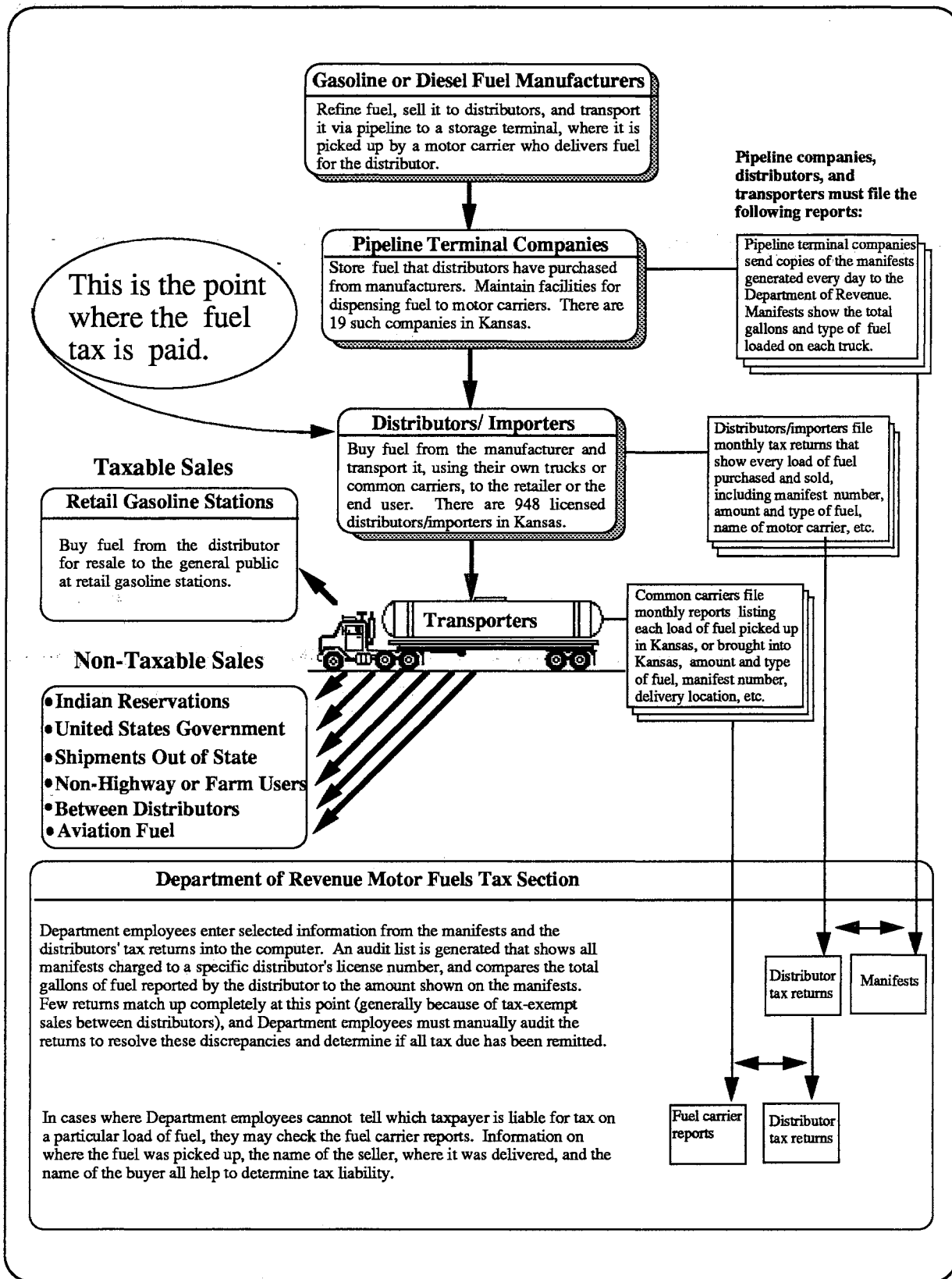
Kansas statutes impose a tax on motor fuels, including gasoline, gasohol, diesel fuel, and LP gas. The revenue generated from this tax is used solely for roads—purchasing right-of-way and constructing, widening, maintaining, and repairing public highways. The tax is 18 cents per gallon on gasoline and gasohol, and 20 cents per gallon on diesel fuel. In this audit, we did not include LP gas, because it constitutes only 0.2 percent of motor fuels revenue collections.

Over the past five years, Kansas' revenues from motor fuels taxes on gasoline, gasohol, and diesel fuel have risen from \$169.3 million to \$263.3 million, or about 55 percent. This increase in revenue is due to several increases in the tax rate, totaling seven cents per gallon from fiscal year 1989 to 1993. These tax increases were necessary to fund the comprehensive highway program passed by the 1989 Legislature. The number of gallons on which tax was collected actually decreased by nearly four percent during those years.

Motor fuels taxes are paid by licensed distributors and importers, and the cost of the tax is passed along to the consumer. Licensed distributors buy fuel from a manufacturer—often a major oil company such as Amoco or Phillips—and the fuel is sent via pipeline to a storage terminal, where it is picked up by a motor carrier hired by the distributor. (Importers are slightly different, in that they buy motor fuel out-of-State, and have it trucked into Kansas for delivery.) The distributors and importers are liable for tax on all motor fuel purchased at the storage terminal or imported into the State. When they subsequently sell the fuel, tax is included in the price. Distributors and importers are required to submit monthly tax returns to the Department of Revenue, and to remit the tax due.

The graphic on the following page contains a simplified version of the motor fuel distribution process. In actual practice this process is more complex, because distributors frequently sell fuel tax-free to one another before it is eventually sold to a taxable entity.

Some sales of motor fuels are exempt from Kansas tax. For example, Kansas does not assess tax against distributors or importers for fuel that will be sold to the United States government, or on Indian reservations. In addition, fuel purchased in Kansas but sold out-of-State is not subject to Kansas tax, nor is aviation fuel or fuel intended for non-highway or farm use. The table on page five shows the number of gallons of tax-exempt gasoline and gasohol sold in fiscal year 1993, and the amount of taxes foregone. Sale of motor fuel between licensed distributors also is tax-exempt, but when that fuel is finally sold to the end-user it either becomes taxable, or fits into one of the exemption types listed below.



**Tax Exempt Sales of Gasoline and Gasohol
Fiscal Year 1993**

<u>Exemption Type</u>	<u>No. Gallons Exempt</u>	<u>Taxes Foregone</u>
Shipments Out-of-State	558,422,628	\$100,516,073
Non-Highway or Farm Users	16,937,344	3,048,722
U.S. Government (including sales on Indian Reservations)	10,606,995	1,909,259
Aviation Fuel	<u>6,743,416</u>	<u>1,213,815</u>
Total Exemptions	592,710,383	\$106,687,869
Total Gallons Sold	1,803,890,645	
Percent Gallons Exempt	32.9%	

Before fiscal year 1994, the Department did not record the number of gallons of diesel fuel exempt from tax. However, data for the first five collection months of the fiscal year show that of the 438 million gallons of diesel fuel sold, 284 million gallons (64.9 percent) were tax-exempt. If these months are typical of the remainder of the year, we estimate taxes in the amount of \$136.5 million will be foregone on 682 million gallons of tax-exempt diesel fuel in fiscal year 1994. Unlike gasoline and gasohol, most tax-exempt sales of diesel fuel (nearly two-thirds) are for non-highway and farm use.

Because shipments out-of-State comprise the majority of all tax-exempt gasoline and gasohol sales, we looked to see if they increased as a percentage of total gasoline sales when the tax rate increased from 1989 to 1993. Shipments out-of-State did increase over this period from 23.4 percent of total gasoline sales in fiscal year 1989 to 33.4 percent in fiscal year 1992, but dropped to 31.0 percent in fiscal year 1993. The fact that shipments out-of-State have increased as the Kansas fuel tax rate increased is not, by itself, an indication that motor fuels tax evasion is increasing.

**National Publications Point to Motor Fuels Fraud
As a Major Source of Lost Revenue
For States and the Federal Government**

Evasion of state and federal motor fuels tax is very difficult to estimate, but the industry trade journal "The Petroleum News" recently suggested that tax may be evaded on one in four gallons of diesel fuel and one in 25 gallons of gasoline sold in the United States.

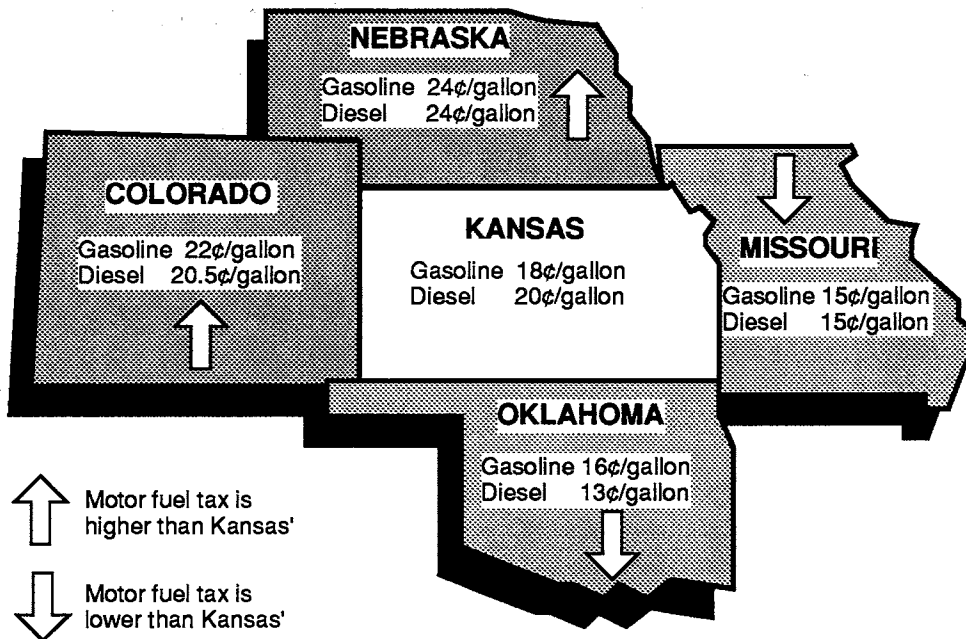
There is significant opportunity for tax evasion on diesel fuel because there are a lot of tax-exempt uses for diesel fuel. For example, diesel fuel is essentially the same product as home heating oil which is exempt from tax. This gives distributors an opportunity to evade tax by misrepresenting the intended use of the fuel. Evasion of gasoline tax is believed to be a less-pervasive problem, because the tax-exempt, non-highway uses for gasoline (general aviation, farm and industrial use, etc.) involve a relatively small amount of fuel compared to the amount used in general highway travel.

Motor fuels taxes can be evaded in a number of ways, but most evasion schemes fall into one of the following categories:

- failure to file required reports or returns (attempting to operate completely outside the system)
- filing false information that either misrepresents taxes as having been paid, or that underestimates tax liability
- falsely claiming an exemption from taxes
- failure to pay taxes that have been assessed

Department officials and industry representatives think the biggest problem in Kansas comes from distributors falsely claiming exemptions to which they are not entitled. For example, a distributor may report to the Department of Revenue that a load of gasoline is being exported to a retail station in Missouri, pay the tax on that load to the State of Missouri, but actually sell the fuel to a retail station in Kansas. The distributor is paying Missouri tax of 15 cents per gallon on the load instead of the Kansas tax of 18 cents per gallon, thus realizing a savings of 3 cents per gallon. On a typical 8,500-gallon load of gasoline, the distributor would evade \$255 in motor fuels tax. (Before April 1, 1994, Missouri tax was only 13 cents per gallon, which would have allowed unethical distributors to evade \$425 in taxes on a typical load.)

Gasoline and Diesel Fuel State Tax Rates in the Five-State Region



As the map shows, Missouri and Oklahoma have lower tax rates than Kansas. This provides a financial benefit to distributors who falsely claim to be exporting fuel to these states, pay the lower tax in these states, but actually sell the fuel in Kansas. Similarly, distributors in Nebraska and Colorado could defraud their state governments of motor fuels tax revenues by falsely reporting exports to Kansas, because Kansas has a lower tax rate than either of those two states.

The map on the facing page shows tax rates for gasoline and diesel fuel in the states surrounding Kansas. As the map shows, there is an opportunity for Kansas distributors to evade motor fuels tax by falsely claiming to deliver fuel in either Missouri or Oklahoma. However, as the map also shows, there is no incentive for distributors to evade motor fuels tax by falsely claiming to deliver fuel in Colorado or Nebraska because their tax rates are higher. Kansas probably benefits from the higher tax rates in Colorado and Nebraska, because distributors in those states may be trying to evade their taxes by falsely claiming to deliver fuel in Kansas and paying the Kansas motor fuels tax. This is one reason why it is difficult to determine just how much motor fuels tax revenue Kansas is losing.

Another example of falsely claiming an exemption occurs when a distributor reports to the Department that a load of gasoline is being delivered to a retail station on an Indian reservation in Kansas, but actually delivers the fuel to a retail station off the reservation. As reported by the distributor, no tax is due on this load. In the case of an 8,500-gallon truck, the distributor avoids paying \$1,530 in taxes if the load is gasoline or gasohol, and \$1,700 if the load is diesel fuel.

The scope of this audit did not involve attempting to determine how much motor fuels tax revenue Kansas is actually losing to evasion. However if Kansas followed the pattern reported in "The Petroleum News," in fiscal year 1993 it could have lost as much as \$13 million in gasoline and gasohol taxes. We were unable to calculate potential tax loss for diesel fuel for 1993 because, until 1994, the Department only received information on the number of gallons of diesel fuel on which tax was paid (rather than on total sales). However, based on our estimates of the amount of diesel fuel that will be sold in fiscal year 1994, if petroleum industry estimates of evasion are correct, the potential tax loss due to evasion could be as much as \$52.6 million.

Has the Department Established Adequate Controls and Provided Sufficient Resources to Ensure That It Is Collecting All Motor Fuels Taxes Due the State?

We found that the Department's system of controls over motor fuels taxes could be improved. The Department does a reasonably good job of ensuring that motor fuel distributors account for all the fuel they buy. However, the control system does not allow the Department to verify that fuel sales claimed as "non-taxable" really are tax exempt. As a result, the Department cannot be sure that it is collecting all the tax owed. The Department does not have sufficient resources to ensure the collection of all motor fuels taxes, and it has made only minimal efforts to document or investigate potential motor fuels tax fraud. The federal government and some other states have implemented controls that Kansas could use to help ensure better control over motor fuels tax collections. These and related findings are discussed in more detail in the sections that follow.

The Department's Procedures Don't Ensure That All Taxes Due the State Are Paid

State law makes the Department of Revenue responsible for enforcing the State's motor fuels tax laws. The law gives the Department responsibility for designing and providing the forms used by those who report motor fuels information, for issuing licenses and exemption permits, and for enforcing rules and regulations.

The Department has designed a system that requires all those who manufacture, import, distribute, or transport motor fuels to be licensed and to file certain reports with the Department. (See the chart on page four of the overview section of this report.) Distributors purchase fuel from manufacturers at pipeline terminal companies. Pipeline company operators send in daily reports to the Department showing the amount and type of fuel they sell to each distributor. Distributors are required to file a monthly tax return that shows the amount of each type of fuel purchased from manufacturers and the amounts they resold, including the amounts of each type of fuel not subject to tax.

The Department does a good job of auditing returns and ensuring that fuel is accounted for. The Department matches the amounts of fuel shown on each distributor's monthly tax return against the amount of fuel manufacturers sold to each distributor as shown on the daily reports from the pipeline companies. Accounting for all the fuel that leaves the terminals is important because distributors often resell fuel to other distributors tax-free. Because of the multiple levels of sales and resales, it would be relatively easy for those purchasing this fuel to evade taxes if the Department was not able to account for all fuel purchased from terminals.

The matching process also involves auditing reports from pipeline companies, distributors, and transporters to ensure that taxes are paid on all sales distributors

report as taxable. We tested a sample of 20 tax returns for the month of May 1993, and found that the Department was checking the returns, accounting for all the fuel purchased by each distributor, and billing taxpayers for additional tax when appropriate. However, we did notice several weaknesses in the system.

The Department has not required fuel distributors and retailers to keep records that would enable it to ensure all motor fuels taxes are paid. When motor fuel distributors file their monthly tax returns, they show the total number of gallons of each type of fuel they purchased from manufacturers. They also show the number of gallons of each type of fuel they sold to retailers, as well as the number of gallons sold to tax-exempt entities. The tax they owe is then computed on the number of taxable gallons purchased from the manufacturer, less tax-exempt sales made during the month. Under its current procedures, the Department has no way to verify that the amounts claimed as tax-exempt are legitimate.

In order to know if tax-exempt sales were valid the Department would need to know exactly where the fuel was delivered and to whom. State law gives the Department the authority to require that such information be reported. However, it currently does not require distributors and transporters to provide an exact location, including street address, when reporting the destination of motor fuels they sold or transported. Also, the Department currently does not require retail gas stations or other end users of motor fuels to maintain or report any information on motor fuels purchases. Without this information, the Department cannot trace the movement of motor fuel from its point of origin at the pipeline terminal to the point where it is sold to the final user to determine if tax is due. The Department has recently added a special projects position funded through a grant from the Federal Highway Administration to determine what the State would need to do to implement a complete fuel tracking system.

The exact location of delivery is important for tracing shipments of fuel to determine whether the distributor is entitled to claim an exemption from the motor fuels tax. For example, if a distributor reports making a tax-exempt sale to a gasoline station on an Indian reservation, the Department could match information provided by retail stations to the information reported by the distributor and determine whether that shipment of fuel actually was delivered on the reservation. If it was, that shipment was legitimately claimed as tax-exempt. If it was delivered to a gas station off the reservation it should not have been claimed as tax-exempt, and the tax should have been paid on it.

Even if distributors reported exact addresses of fuel shipments, the Department could not require out-of-State retailers to file reports showing that they actually received the fuel shipments shown on distributor's reports. However, if exact addresses were reported by those transporting fuels, the Department would have a check on the distributor's claim by matching the shipments reported by the distributor as exports on a certain day to the shipments reported by transporters to see if they really were delivered out of State on that day. While this does not provide direct verification for this type of exempt sale, the Department could feel fairly confident that the sale really was an export.

<p align="center">What The Department Would Need To Do To Determine Whether Non-Taxable, In-State Fuel Sales Are Legitimately Tax-Exempt</p>	<p align="center">What The Department Could Do To Help Ensure That Non-Taxable Fuel Sales Out of State Are Legitimately Tax-Exempt</p>
<ol style="list-style-type: none"> 1. Require motor fuel distributors to report the exact name and location, including street address, where fuel was delivered. 2. Require motor fuel transporters to report the exact name and location, including street address, where fuel was delivered. 3. Require retail gas stations and others to whom the fuel is delivered to keep and possibly report the date, amount, and distributor or transporter of all motor fuel shipments they receive. 4. Compare the information in no. 1 and no. 2 with the information reported or kept in no. 3. That way the Department could match the information distributors report with the records maintained by the gasoline stations to determine that there was not more fuel being delivered to the stations than was being reported for tax purposes. 	<p>The Department can't verify that non-taxable fuel sales out of State are legitimately tax-exempt because it can't require out-of-State retailers to report on shipments of fuel from Kansas, or submit to field audits of their records. However, it can do the following:</p> <ol style="list-style-type: none"> 1. Require motor fuel distributors to report the exact name and location, including street address, where fuel was delivered. 2. Require motor fuel transporters to report the exact name and location, including street address, where fuel was delivered. 3. Compare the information in no. 1 with the information reported in no. 2. That way if a distributor reports making a tax-exempt sale to another state, the Department could, at a minimum, match the information from the two reports to determine if a shipment of fuel was delivered to a station out-of-State that day, as claimed by the distributor. <p>While this does not provide direct verification, it would give Department staff a reasonable assurance that the fuel did really go out of State, and was really tax-exempt.</p>

The Department is not enforcing the statutory reporting requirements for transporters of motor fuels. We attempted to review some transporters' reports filed with the Department to see if cross checking between distributor reports and transporter reports was possible. We found that although State law requires reports from transporters, the Department currently does not require them from all transporters. In six of the 11 cases we looked at, no transporter reports were filed. In three of those six cases, the distributor delivered the fuel in trucks it owned, and therefore was not required to file a report according to Department staff. In the other three cases, the transporter simply did not send in a report.

The Administrator of the Motor Fuels Tax Section told us that the Section does not have enough staff to review these reports regularly, and so it does not enforce the filing requirements. Instead, staff use transporter reports only as an additional source of information if there is confusion over which distributor is liable for tax on a particular load of fuel.

Even when a motor fuel transporter files a report showing where a fuel shipment was delivered, the Department seldom uses the information provided to verify that the distributor actually had fuel delivered to that location. Again, this is an

important comparison for determining whether sales claimed as tax-exempt are valid. The comparison also would help ensure that the Department is not losing tax revenue by allowing distributors to claim tax exemptions on sales for which tax actually is owed.

The Department has done little to investigate motor fuels tax fraud. Officials in the Department's Motor Fuels Tax Section and Division of Alcoholic Beverage Control told us it is not possible to uncover fraud with the information and reports currently being submitted. The Motor Fuels Tax Section administrator told us that staff can question things like significant increases in exported fuel, but they have no way to determine whether fraud is happening.

If staff in the Motor Fuels Tax Section suspect fraud they can request an audit from the Audit Services Bureau, or they can refer their suspicions to the Criminal Fraud Unit in the Division of Alcoholic Beverage Control. However, there is no formal system for referring cases of possible fraud from the Motor Fuels Tax Section to the Division of Alcoholic Beverage Control for investigation. Officials with the Division of Alcoholic Beverage Control told us that they are looking at how other states make such referrals between agencies, and that they plan to develop procedures for making referrals.

Investigators from the Division of Alcoholic Beverage Control told us that the Motor Fuels Tax Section usually does not provide the kind of information it needs to pursue cases of suspected tax fraud. According to officials with the Division's Criminal Fraud Unit, the information they have received so far concerning motor fuels tax fraud has been based on suspicions rather than investigative leads. Investigators told us they need more specific information in cases involving motor fuels tax evasion before they can proceed with their investigations. This information includes the specific retailer that was supposed to take delivery of fuel. If retailers had to report every delivery of fuel they received, the tracking system would be complete for investigation purposes.

Investigators also said that the results of thorough fraud audits by the Audit Services Bureau would provide helpful information for investigating cases of potential fraud. The audits performed so far on cases under investigation have lacked several necessary elements of a fraud audit, including a list of all retailers the distributor sold fuel to and a review of distributor bank records. The Audit Services Bureau does not have any certified fraud auditors. However, Audit Services Bureau staff have received limited training on detecting fraud.

The Criminal Fraud Unit currently has two open, but inactive, motor fuels cases involving potential fraud. So far the only work investigators have been able to do involves surveillance, which is very time consuming and has tended to disprove the allegations of fraud involving distributors.

Staff Resources Committed to Auditing and Investigating Compliance With Motor Fuels Tax Laws Are Not Adequate

State law requires the Department to designate a sufficient number of auditors and a sufficient number of motor fuels enforcement inspectors. The law requires enforcement inspectors to engage exclusively in motor fuels tax enforcement. It also requires the Department to conduct a complete audit of each licensed distributor and certain permit holders at least once in each year.

Based on our observations, conversations with Department staff, and review of other states, we concluded the Department does not have enough staff devoted to enforcement of the State's motor fuels tax laws. Currently, the Department has 6.25 full-time-equivalent staff devoted to motor fuels tax enforcement (3.25 who process returns, one special project position, one clerical support position, and one administrator), 0.5 full-time-equivalent staff in the Audit Services Bureau who perform field audits of distributors, and occasional access to investigation agents in the Division of Alcoholic Beverage Control.

The Department currently has no staff dedicated solely to field investigation of motor fuels tax fraud.

The Department is six months behind in processing motor fuels tax returns. Despite the assignment of a temporary staff person to audit taxpayer returns, the Motor Fuels Tax Section is running nearly six months behind in performing the work needed to complete the audit process. The Administrator of the Motor Fuels Tax Section told us the current staffing level for processing taxpayer returns is not adequate. She also stated that the Section did not have a backlog of returns to process before July 1, 1993 when the law requiring reporting on sales of diesel fuel went into effect.

The Department of Revenue has tried twice in recent years to get additional staff for the Motor Fuels Tax Section. The Department requested one additional position in fiscal year 1992 and one for fiscal year 1995. The request for an additional staff person in 1992 was turned down by the Legislature, and the request for 1995 was removed by the Division of the Budget. Department officials told us they have not tried to reallocate resources from other sections to motor fuels tax.

It is not possible to conduct complete audits of almost 1,000 distributors annually, as required by State statute, with 0.5 full-time-equivalent auditors. State law requires a complete audit of every licensed distributor at least once each year. The Department's Audit Services Bureau has a staff of five who spend about 85 percent of their time auditing interstate trucking companies because the Department is required to do this under the International Registration Plan and the International Fuel Tax Agreement. Staff spend an additional five percent of their time conducting audits of diesel fuel users. This means that these auditors are not available to conduct many audits of motor fuels distributors.

In calendar year 1993, the Audit Services Bureau completed only 12 audits of motor fuels distributors. In the first four months of calendar 1994, staff had completed six audits of motor fuels distributors. Officials in the Audit Services Bureau told us that a typical distributor audit takes about two weeks. These audits involve going to distributor's offices and matching the number of gallons reported to the Department with the number of gallons from records maintained by the distributor. The Department received four new auditor positions in the Audit Services Bureau for fiscal year 1995 which could help conduct distributor audits.

The Department has no staff dedicated to investigation of motor fuel tax fraud. The Motor Fuels Tax Section can refer cases of suspected fraud to the Division of Alcoholic Beverage Control for investigation, but fraud investigators in this Division spend most of their time investigating fraud in other types of taxes.

Compared to six other states we contacted, Kansas was near the low end in the number of staff per dollar of motor fuels taxes collected. We contacted the states of Colorado, Illinois, Nebraska, Pennsylvania, Texas, and Virginia to gather information about their staffing levels and motor fuels tax collections. As the following table shows, at 2.6 employees per \$100 million of motor fuels tax collected, Kansas had one of the lower staffing levels of the states we contacted. Only Texas and Colorado have fewer staff for their volume of revenue. Nebraska, with 13.6 employees per \$100 million in taxes, had the highest staff level of the states we reviewed.

Motor Fuels Tax Collections Per Assigned Staff
(Dollars in Millions)

<u>State</u>	<u>No. of Staff</u>	<u>Total Collections(a)</u>	<u>Staff per \$100 Million of Motor Fuels Taxes</u>
Texas	37	\$2,082.7	1.8
Colorado	7	\$382.7	1.8
Kansas	7	\$266.3	2.6
Illinois	42	\$1,013.1	4.1
Virginia	44	\$625.4	7.0
Pennsylvania	95	\$986.0	9.6
Nebraska	31	\$228.0	13.6

(a) Dollar amounts represent fiscal year 1993 for each state except Illinois, which is calendar year 1993, and Virginia which is calendar year 1992.

It is difficult to determine what is a sufficient level of staffing for this function. Officials in most of the other states we contacted said that they did not think they had sufficient staff to ensure that all motor fuels taxes were collected. However, based on our review, it did not appear that the Department of Revenue was

able to keep up with all the requirements placed on it by law and the current system of collecting motor fuels tax in Kansas.

Some States and the Federal Government Have Taken Steps to Control Fraud

The six states we contacted were pointed out to us by officials with the Federation of Tax Administrators as having "good" controls for ensuring that motor fuels taxes are collected. We also contacted the Internal Revenue Service to find out what the federal government was doing about motor fuels tax evasion. Our review of these control systems revealed that Kansas already has many of the elements that the "good" states have. For example, all of the states require licenses and bonds for those responsible for paying the motor fuels taxes, and all the states match information from the various reports they receive. However many of these six other states and the federal government have taken some additional steps to help control fraud:

Steps related to making it more difficult to cheat on the amount of taxes owed

- *Move the point of taxation.* The federal government has put the point of taxation for both gasoline and diesel fuel at the terminal. This means that the owner of the fuel at the terminal is liable for the tax when the fuel is sold to a distributor. The main advantage to having the tax assessed at the terminal is far fewer returns to process. If Kansas moved its taxation point to the terminal it would reduce the number of motor fuels tax returns filed from 948 to about 120. Other advantages include having fewer places to inspect and eliminating the up-front exemptions, although Kansas still could allow certain tax breaks by giving refunds for tax-exempt sales. The main disadvantage to having the tax assessed at the terminal is the increase in the number of refund claims the Department would have to process.
- *Require everyone involved with motor fuels to be licensed.* Nebraska and Texas now require this, which gives them important information on these companies and individuals to be used for reporting and inspection activities. Requiring licenses is also a way to help ensure compliance. The state can revoke licenses for those who are not in compliance with motor fuels tax laws, which would prohibit them from legally selling, receiving, or delivering motor fuels.
- *Do not allow an immediate exemption for out-of-State sales.* Require distributors to seek a refund for out-of-State sales rather than allowing an immediate exemption for such sales. Virginia distributors who sell fuel across state lines must initially pay Virginia motor fuels tax, and apply for a refund by supplying documentation that the fuel was sold in another state. This makes it far more difficult for people to evade tax on fuel exports.

Steps related to filing information to improve the ability to track motor fuel sales

- *Require everyone in the distribution chain to file at least an informational report.* Nebraska and Texas now do this. By requiring total reporting, these state's control systems have a lot of cross-checks, which makes it difficult to cheat on taxes without significant collusion.
- *Require the exact destination of fuel to be specified.* By knowing the exact street address, rather than simply the city and state (as Kansas currently receives), it is possible to track fuel deliveries. Cross-checks in reporting become more accurate when the address is specified, and if surveillance is necessary in cases of suspected fraud, it can be better targeted.

Steps related to increasing enforcement capabilities

- *Add investigation staff dedicated to motor fuels tax enforcement.* Illinois, Texas, Pennsylvania, and Virginia all dedicate investigation staff to motor fuels taxes enforcement. These staff conduct surveillance and investigate cases of suspected fraud.
- *Provide a sufficient number of staff to conduct on-site audits of distributors.* Virginia has a staff of 14 auditors who conduct in-house audits of the home offices of each licensee on a two-year to three-year cycle. The federal government conducts on-site examinations of taxpayer books and records to check for compliance with federal motor fuels tax laws.
- *Conduct inspections of fuel inventories.* The federal government will start inspecting fuel inventories as another check on compliance with federal motor fuels tax laws. The Internal Revenue Service expects to have regulations and procedures specifying which inventories will be inspected, and how the inspections will be carried out by July 1, 1994.

What Resources Outside the Department of Revenue Are Available To Assist in the Enforcement of the State's Motor Fuels Tax Laws?

Very few staff resources in other State agencies are available to assist in the enforcement of Kansas motor fuels tax laws, and the resources that are available generally only provide information to the Department and do not actually carry out direct enforcement activities. The Board of Agriculture's Weights and Measures Division has assisted the Department of Revenue's Motor Fuels Tax Section by collecting data on how many gallons actually have been sold at selected stations. If this data were collected and given to the Department on a regular basis, Department personnel could compare actual gallons sold with gallons reported as sold on distributors' and importers' reports. In addition, the Kansas Highway Patrol plays a limited role through its regulation of motor carriers which includes carriers of motor fuels. Other states we contacted also rely almost exclusively on their revenue collection agencies for enforcing the motor fuels tax laws. These and related findings are discussed in more detail in the sections that follow.

Two State Agencies Currently Provide Assistance to the Department of Revenue with Motor Fuels Tax Enforcement

The Board of Agriculture and the Kansas Highway Patrol could assist the Department of Revenue in enforcing the State's motor fuels tax laws. Both agencies have staff whose activities relate to motor fuels taxes, but only indirectly. Neither can provide consistent resources to help ensure that motor fuels taxes are collected.

The Board of Agriculture has provided limited motor fuels tax enforcement assistance to the Department of Revenue through its Weights and Measures Division. One way the Department can be sure the correct amount of tax is being paid is to compare distributor and importer reports with the actual amount of fuel sold in the State. If more fuel is sold than is reported as taxable by distributors and importers, the Department would have a clear indication that fraud was probably occurring.

The Weights and Measures Division of the Board of Agriculture has six staff members in its Refined Fuels Program who are responsible for ensuring the accuracy of all retail gasoline and diesel fuel pumps in the State. The field staff in this program and licensed technicians under contract with the Division have, at the request of the Motor Fuels Tax Section, taken readings from pump "totalizers" (devices that show the total number of gallons sold through a pump) at designated stations to help Department officials determine the amount of fuel delivered to those particular retail locations. In addition, according to Board of Agriculture officials, 13 inspectors in other programs within Weights and Measures could be made available on a limited basis to take and report on totalizer readings.

Retail stations are not required to have working totalizers on all their pumps, but new regulations taking effect after July 1, 1994 will require them. Currently, many retailers' pumps have totalizers, but according to Board of Agriculture officials, many are not operational. Gathering totalizer information and sharing it with the Department's Motor Fuels Tax Section is not currently available on a regular basis. However, it could be a valuable investigative tool for Department personnel.

The Kansas Highway Patrol also plays a limited role, through its motor carrier inspection activities, in enforcing the State's motor fuels tax laws. The Patrol's Motor Carrier Inspection Division makes sure that motor carriers have the proper permits to operate in Kansas, including interstate fuel permits. Inspectors also check manifests for all vehicles, including those that transport motor fuel. Manifests are checked to make sure they are properly completed and contain information on the identity of the shipper and receiver, the destination, and the type of cargo. In addition to checking manifests, inspectors check to see that drivers have come from where they are supposed to, that they are going to the correct destination, and that they have the authority to carry the vehicles' contents.

The Highway Patrol currently has 126 staff participating at various levels in motor carrier enforcement, including 21 inspectors whose primary duty is to inspect motor carriers, 10 inspectors in its Weights Enforcement Unit, and 95 troopers who have received training to inspect carriers. Officials told us they plan to train 30 more troopers for inspection activities.

In Each State We Contacted, One Agency Is Primarily Responsible For Collecting and Enforcing Motor Fuels Tax Laws

As noted earlier, we contacted six other states during this audit. We asked them which state and local agencies were involved with enforcing the motor fuels tax laws in those jurisdictions.

In five of the six states we contacted, the State agency directly responsible for collecting motor fuels taxes was the only agency directly involved with enforcement activities on a regular basis. In Nebraska, a second state agency—the State Patrol—is used directly to enforce the motor fuels tax laws by staffing a toll-free telephone line for motor fuel transporters to report changes in their destinations. Staffing this telephone line involves only one staff person.

In Nebraska and Pennsylvania, other agencies occasionally are involved in motor fuels tax enforcement through the enforcement of motor carrier regulations. Although all six states have agencies responsible for certifying the accuracy of fuel pumps, most do not assist with enforcing motor fuels tax laws.

Appendix A (on page 21-23) shows a summary of information provided to us by other states' motor fuels tax officials about assistance they receive from other state agencies, as well as additional information provided by these states' officials.

Conclusion

Although it is difficult to accurately estimate the amount of revenue that may be lost to motor fuels tax evasion, the potential is large. If the level of fraud suggested by a petroleum industry trade publication is occurring in Kansas, the State could be losing as much as \$66 million a year in combined gasoline and diesel fuel taxes. The main problem with the Kansas system for collecting motor fuels taxes is that it does not provide a complete trail that allows fuel sales and deliveries to be traced to their final destination. Without such a trail, the Department cannot verify that the hundreds of millions of dollars worth of fuel sales that are claimed to be non-taxable each year are truly tax-exempt sales.

Other states and the federal government have instituted a variety of controls to help ensure that they collect all the motor fuels taxes due in their jurisdictions. These controls range from placing the point of taxation higher up in the distribution chain, to requiring more detailed recordkeeping and reporting of fuel deliveries. Each of these options has advantages from the State's perspective but may place additional recordkeeping and reporting burdens on the industry. While it is clear that the Department will need to take action to improve its control system, Department officials will need to carefully consider each of the various alternatives and choose the course of action that provides the highest level of control with the least burden and cost to the Department and the industry.

Recommendations

1. To help ensure that it is collecting all the motor fuels tax due the State, the Department of Revenue should thoroughly investigate options for improving controls over the collection of motor fuels tax and report its findings and recommendations to the 1995 Legislature. In investigating various options, the Department should take into account the cost-effectiveness of the controls to be implemented as well as the paperwork burden that could be created for the Department and the industry. At a minimum the options considered by the Department should include the following:
 - a. moving the point of taxation further up the distribution chain to the owner of the fuel at the terminal, and requiring those persons claiming exemptions to apply for a refund and submit documentation showing that fuel sales were tax exempt.

- b. leaving the point of taxation the same, but requiring that all out-of-State sales initially be taxable, and requiring those claiming exemptions to apply for a refund and submit documentation showing the fuel sales were tax exempt.
 - c. leaving the point of taxation the same and requiring distributors' and transporters' reports to contain complete addresses showing where fuel was delivered.
 - d. leaving the point of taxation the same and requiring retailers to provide reports of motor fuels purchased, or at a minimum, requiring them to keep records of the dates and amounts of fuel purchased from distributors so that Department staff could audit those records.
2. To ensure that it is in compliance with the statutes governing motor fuels tax, the Department should do the following:
 - a. enforce the requirements contained in K.S.A. 79-3416 relating to motor carrier reporting.
 - b. conduct annual audits of each distributor as required by K.S.A. 79-3419, or propose legislation to allow the Department more flexibility in determining when such audits should be conducted.
3. To help ensure that suspected cases of fraud can be thoroughly investigated, the Department should develop a coordinated system for identifying and investigating potential motor fuels tax fraud. This system should include specific steps to be taken if fraud is suspected, and clearly identify which staff are responsible for completing each step.
4. To ensure that any errors in motor fuels tax returns are discovered and additional taxes due are billed in a timely manner, the Department should devote the resources necessary to eliminate the backlog of unprocessed motor fuels tax returns.



APPENDIX A

Survey of Motor Fuels Tax Collection Officials In Other States and the Federal Government

We contacted representatives of the states of Colorado, Illinois, Nebraska, Pennsylvania, Texas, and Virginia, as well as agents of the Internal Revenue Service, to obtain information on their motor fuels tax collection system. Information on Kansas is also included in the appendix.

	Kansas	Colorado	Illinois	Nebraska
Who Remits Motor Fuels Taxes?	Gasoline and diesel fuel - distributor	Gasoline - distributor Diesel - retailer	Gasoline - distributor Diesel fuel - distributor and bulk user	Gasoline and diesel fuel - distributor
Who Must File Reports?	Distributors, importers, terminals & refineries, liquid fuel transporters, and oil companies.	Licensed distributors.	Distributors, suppliers, and bulk users.	Operators, distributors, carriers, and retailers.
Information That Must Be Reported	Number of gallons of fuel purchased, exempt sales, bill of lading, fuel imported (or handled totally in-state) and fuel exported, origin and destination.	Name and license number of seller, name of carrier, point of origin, destination city, type of fuel, date, bill of lading, and number of gallons.	Beginning and ending inventory, total amount of fuel received, number of gallons of taxable and tax-free fuel sold, exports, exempt sales, and fuel blended in-state.	Number of gallons sold, names of owner/seller and purchaser; and destination state.
Controls	Reports from pipeline companies showing all fuel dispensed are matched to distributors' monthly returns. Transporters' reports are sometimes used to help verify ownership of the fuel for tax purposes.	Data are entered into the computer and calculations are checked; field staff conducts random spot checks of parties in the chain.	Exempt sales are reviewed and staff follow up on those that look suspicious; match distributors' and bulk users' returns for taxable and tax-exempt sales; and check to see if bulk users can store as much fuel as distributors reported.	Reports are manually reviewed to see that they are properly completed and internally consistent. Returns are matched to other reports to trace fuel through the whole chain. Transporters must call to change destination of fuel coming into the State.
Exemptions Allowed	Sales to the federal government, Indian reservations, aviation consumers, and the first sale to a distributor who resells to another distributor; sales for off-road use and for export to other states.	Sales to the state and federal government; sales for off-road use, home heating and export to other states.	Sales to the federal government, foreign governments, local public transit agencies, and aviation consumers.	Sales to the federal government and Indian reservations; sales of dyed diesel fuel; sales for export to other states.
FY93 Motor Fuels Tax Collections	\$266.3 million	\$382.7 million	\$1.0 billion (CY93)	\$228 million
Number of Taxpayers	948	Approximately 600	7,221	Approximately 1,000
Number of Staff Assigned	7	7	42	31
Other Agencies Involved With Motor Fuels Tax Enforcement	Highway Patrol-motor carrier enforcement activities. Board of Agriculture-regulates gas pumps.	None	None	State (Highway) Patrol in its motor carrier enforcement activities.
Enforcement Staff Contributed By These Agencies	None	None	None	1

Pennsylvania	Texas	Virginia	Federal Government
Gasoline - distributor Diesel - retailer	Gasoline and diesel fuel - distributor	Gasoline and diesel fuel - distributor	Owner of the fuel at the point it is delivered to the distributor.
Owners of the fuel at the point it is delivered to the distributor, retailers, and motor carriers.	Each party in the distribution chain.	Each party in the distribution chain, except retailers.	Owner of the fuel at the point it is delivered to the distributor (and, as of 7/94, terminal owners and operators, and dealers of diesel fuel).
Inventory on-hand, receipts and disbursements, amount of diesel sold tax-free, exemption type, and number of gallons sold.	Number of gallons sold, name of purchaser, destination with street address, and tax-exempt sales.	Inventories, sales and receipts.	Beginning 7/1/94: name and registration number of all owners of fuel at every terminal, type and quantity of fuel owned, and the dates fuel was removed from the terminals.
For gasoline sales, distributor-to-distributor transactions appear on monthly reports; for diesel sales, the dealer-users' reports are checked against transporters' reports.	Reports are required from all who handle fuel, data is entered into the computer and calculations are checked; random field audits are performed.	All taxable sales are checked against receipts from other taxpayers' reports or informational reports.	IRS conducts a compliance check on each registrant every 2 years, uses a classification system for determining which returns will be audited each year, and examines books and records at taxpayers' locations.
Sales to the state and federal government, volunteer fire companies, ambulance and rescue services, non-profit/non-public schools, electric coops, and second class county port authorities; sales for export to other states.	Sales to the state and federal government; sales for off-road use.	Sales to the state, local, and federal governments, and aviation consumers; sales for off-road use.	Sales to state and local governments, non-profit educational organizations, and commercial airlines (aviation fuel); sales for U.S. military vessels and aircraft, and export to foreign countries.
\$986 million	\$2.1 billion	\$625.4 million (CY92)	NA
Approximately 5,600	24,305	Approximately 7,000	Approximately 900 in Kansas
95	37	44	5 agents in Kansas are responsible for 46 excise taxes.
Department of Transportation in its motor carrier regulation activities.	Department of Agriculture regulates meters at pumps.	None	Have some joint audit agreements with states; also have information sharing with most states.
None	None	None	NA



Appendix B

Agency Responses

On April 22, we provided copies of the draft audit report to the Department of Revenue, the Board of Agriculture, and the Kansas Highway Patrol. Their responses are included as this appendix.

STATE OF KANSAS

Nancy Parrish, Secretary of Revenue
Robert B. Docking State Office Building
915 S.W. Harrison St.
Topeka, Kansas 66612-1588

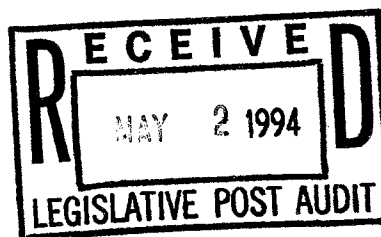


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Department of Revenue
Office of the Secretary

May 2, 1994

Barbara J. Hinton
Legislative Division of Post Audit
Merchants Bank Tower
800 SW Jackson, Suite 1200
Topeka, KS 66612-2212



Dear Ms. Hinton:

I appreciate this opportunity to respond and extend my thank you to you and your staff for the professional manner in which the audit regarding Kansas Motor Fuel Taxes was conducted. Our response is divided into three sections: corrections and clarifications to the performance audit report, responses to the recommendations contained in the report, and the Department's recommendations for potential statutory changes.

Once again we would like to extend our appreciation to the staff assigned to this performance audit. All were very courteous, conscientious and professional during the course of the audit. The performance audit recommendations certainly will be helpful to the department in improving controls over the collection of motor fuels and in investigating suspected cases of motor fuel tax fraud.

Sincerely,

A handwritten signature in cursive script that reads "Nancy Parrish".

Nancy Parrish
Secretary of Revenue

Corrections and Clarifications

Page 1, paragraph 3: The first Sentence should read: "Apparently one opportunity for fraud comes from misdirecting fuel allegedly destined for a low-tax State to an adjacent high-tax State."

Page 9, paragraph 1: Distributor's remit tax based on the number of gallons of fuel received, less exempt sales made during the month, regardless of whether gallons were sold or not. Taxes are not remitted based on the number of taxable gallons sold.

Page 10: Item 4 in the table suggests that the Department could match information from distributors regarding sales to the Indian reservations with the records kept by the station on the reservation. This is not entirely correct, in that the State has no authority to require information from stations located on the reservations.

Page 11, paragraphs 3 and 4: The information in these paragraphs should be clarified. The information needed to generate investigative leads would be discovered during a fraud audit. The Department does not employ trained fraud auditors that could conduct thorough fraud audits, therefore, the Audit Services Bureau has not conducted any fraud audits.

The Motor Fuels Tax Sections has referred two cases for investigation to the CFU. The CFU has not received investigative leads that would justify large investments in surveillance hours. The problem remains transforming the general suspicious information into specific investigative leads. Currently, neither the Motor Fuel Tax Section nor the Audit Services Bureau have the specialized fraud-audit personnel necessary to provide such investigative leads.

Page 12, paragraph 1: It should be clarified that the Motor Fuel Tax Section has only has 3.25 FTE's dedicated to the task of performing desk audits. The other 3 positions are administrative, clerical and a special projects position. The special projects position is not permanent, funded by a Federal Grant Program, thus solely dependent upon federal appropriations. The number of FTE staff in the Audit Bureau assigned to perform field audits of distributors is .5 (1/2 FTE).

Page 12, paragraph 5: The Statement is made that the Audit Bureau has a staff of five who audit for fraud. This is not correct. The auditors in the Audit Services Bureau are not fraud auditors, and uncovering fraud is not their primary mission. Also, the third sentence should read: "However, they spend about 85% of their time auditing interstate trucking companies because the Department is required to do this under the International Registration Plan (IRP) and the International Fuel Tax Agreement (IFTA)."

RESPONSE TO RECOMMENDATIONS

Recommendation #1

The Department will thoroughly investigate each option and develop a strategy for improving controls for the collection of motor fuel taxes to submit to the 1995 Legislature. We will consider all options to determine those most effective in reducing fraud, taking into account cost-effectiveness and burdens on the Department and industry. At a minimum, the following concerns and comments must be considered regarding each option:

Option a. Examine moving the point of taxation further up the distribution chain, to the owner of the fuel at the terminal, and require those claiming exemptions to apply for a refund.

While moving the point of taxation is a possibility, it's a very complex issue the Department will need to review extensively. Some of the issues involved are related below.

Since January 1994, the Federal Government taxes both motor vehicle fuels and diesel fuel at this higher level. At present, there is insufficient data to determine the effectiveness of this federal change.

No state has implemented this practice. The Department must consider the issue of imports and exports between Kansas and surrounding States. This is not an issue for the Federal Government. Moving the point of taxation to the position-holder in the terminal would require those persons purchasing fuels for export to pay the Kansas motor fuel tax to the position-holder, pay the tax due the State to which the fuel is exported, then apply for a refund of the Kansas tax.

This option states that we would require documentation showing that fuel sales were tax exempt. Under current procedures, Kansas requires the distributor to report the exact destination of the exported fuel. This information is verified with the taxing authorities of those States to which the fuel was exported. Assuming that this control would remain in place, it is doubtful that a refund could be issued to the applicant in less than 60 to 90 days. In addition, taxing at this level complicates the fuel tracking systems that the Department, Federal Government and other states are attempting to implement. (The importance of tracking fuel to exact destination is stated several places throughout the audit report.)

This option would reduce the number of filers remitting State motor fuel taxes. Even though the number of filers would be reduced, the in-office audit requirements remain the same, as the same amount of fuel is being distributed, and the number of refunds required to be processed increases substantially. The

Internal Revenue Service is currently experiencing a large influx of refunds, for which it was not prepared. In addition, we would need to consider what effect this might have on Kansas industry. Distributors may elect not to purchase fuel from Kansas terminals and refineries, purchasing it in the State where destined.

Option b. Examine leaving the point of taxation the same, require all out-of-State sales to be initially taxable, requiring those claiming exemptions to apply for a refund, and submit documentation showing the fuel sales were tax exempt.

The Department fails to see any substantial benefit in this option. The number of tax filers would remain the same, refunds would increase substantially, and the refund process would create a burden on the Department and industry. The problem of verifying the exemption remains the same whether it is claimed on the tax return or claimed through a refund. In addition, distributors would be entitled to a handling allowance on fuel that is eventually exempt. Distributors are currently allowed a handling allowance of 2.5% on taxable product (motor vehicle fuel receipts less exempt sales). Implementing this option would reduce revenues by approximately 2.8 million dollars. In addition, many of the same issues discussed in option 1a above would apply here (e.g., exports).

Option c. Examine leaving point of taxation the same, and require distributors' and transporters' reports to contain complete addresses showing where fuel was delivered.

The Department is involved in the development and adoption of the 11 point plan of the Federation of Tax Administrators. One of the points in the plan is adoption of the uniform forms developed by the Uniformity Committee. The uniform form for distributors and transporters does not require street addresses. Kansas has adopted these forms and is currently in compliance with the 11 point plan. Information provided on the current reports usually provides sufficient information to determine the exact destination, but not in all cases. We feel that licensing retailers and requiring that the distributors and transporters report the retail license number, rather than the exact address, might be an alternative. This would provide complete data necessary to track the fuel, and provides controls over retailers fraudulently claiming exemptions or refunds. Implementing additional licensing requirements would mean additional staff resources which the Department does not currently have available.

Option d. Examine leaving point of taxation the same, and require retailers to provide reports of motor fuels purchased, or at a minimum require them to keep records.

The Department feels this option may provide benefit. The associate hired through the Federal Grant Program has been researching ways of implementing a full fuel tracking system. Requiring retailers to file informational reports has been discussed at length, noting that the information only has value if the information can be

matched. Without automating, and with the current staffing level, the information would be difficult to assimilate. In addition, informational reports provided by retail stations owned by the licensed distributor would be an exact duplication of information on the distributor's tax return, and would not add value to the issue of uncovering fraud. Third-party retail informational reports would provide the most beneficial information. Licensing retail stations suggested under option 1c above would enable the Department to require informational reporting with revoking powers, should the retailer fraudulently report or fail to report. At a minimum, the Department could require record keeping requirements that would be available through audit.

Recommendation #2

a. Enforce the requirements contained in K.S.A. 79-3416, relating to motor carrier reporting.

The Department has begun implementation of this recommendation. Uniform Carrier reports adopted by the Federation of Tax Administrators have been printed and are in use. A draft notice of filing requirements has been prepared for notifying carriers of their filing requirements. As in option 1d above use of the information supplied by the carriers' reports requires automation and staffing resources. Third-party carriers' reports (common carriers) would provide the most beneficial information.

b. Conduct annual audits of each distributor, as required by K.S.A. 79-3419, or propose legislation to allow the Department more flexibility in determining when such audits should be conducted.

We agree with the second half of the recommendation and the Department plans to seek legislation removing this strict requirement.

Completing an audit of each distributor annually would result in approximately \$1,927,000 annual costs to the Department. Using a conservative estimate, two weeks is required to audit each distributor. We would need to hire 41 new auditors to audit each of the 950 distributors once each year. Salary, benefits, equipment and travel for each auditor would cost \$47,000, times 41 auditor positions equals an annual expenditure of \$1,927,000. This figure does not include costs for office space, clerical help and management for this large work force.

The requirement for a complete audit of each distributor each year is not reasonable, and would not be an effective use of limited resources. Even with the estimate of the dollars lost to fuel tax fraud, it is not certain that annual audits of distributors would significantly curtail the fraud. These audits would do little to catch the unregistered distributors operating outside the system, and would not verify that all exemptions are proper. Kansas statutes do not require annual audits of any other tax type or taxpayer.

Recommendation #3

The Department agrees with this recommendation. Associates from the Department's Criminal Fraud Unit and the Motor Fuel Tax Section will be participating in cross-training May 2 and 3, in an effort to facilitate the work flow.

In order to detect and thoroughly investigate potential incidents of fraud the Department would need the following resources:

- A. Investigative auditors specially trained to perform fraud audits who are dedicated to investigating fuel tax fraud. Revenue auditors are not trained to perform fraud audits and Revenue Enforcement Agents assigned to the Criminal Fraud Unit do not have accounting backgrounds. With such investigative auditors, the Department could bridge the gap that currently exists between suspicious information and investigative leads.
- B. Field compliance agents to:
 - produce investigative leads through interaction with industry during routine inspections
 - document key points that can be used in investigations/audits
 - ensure that retailers and distributors are maintaining the required records
 - run routine spot checks to verify that retailers' records correspond with distributor's tax returns
 - take totalizer readings and check for the use of dyed (tax exempt) fuel, short of an audit, allowing the Department to target audit and investigative resources.

The amount of resources in each of the above areas is not available at this time, due to lack of time, resources and knowledge about the scope of the problem. Information will be provided to the 1995 Legislature.

Recommendation #4

The Department also agrees with this recommendation. However, additional resources within the Department are not available for reassignment. Additional Departmental staffing would be required. A complete resource requirement analysis will be supplied to the 1995 Legislature with the Department's findings and recommendations for improving controls over the collection of motor fuel taxes.

DEPARTMENT'S RECOMMENDATIONS FOR POTENTIAL STATUTORY CHANGES

In addition to those options provided by the Legislative Post Audit team, the Department would also offer the following options for consideration:

Strengthen Criminal and Civil Penalties.

Penalties need to be sufficient to deter fraud.

Provide penalties for using dyed fuel for a taxable purpose.

1994 enacted House Bill 2809 provides a motor fuel tax exemption for fuel which is dyed according to IRS code and which is used for a nontaxable purpose. The State should adopt penalties similar to those imposed by the federal government to deter the amount of tax-exempt fuel used for a taxable purpose. In addition, the State should employ fuel inspectors to detect improper use of dyed fuel.

Increase Licensing requirements.

Prior to licensing a distributor to purchase fuel, the Department should have the ability to conduct complete background checks. Individuals defrauding one state of tax tend to move to other states, using the same schemes over again. The Department should have the ability to deny a license to anyone not passing the background check or meeting the minimum requirements for being a distributor.

License Retail Stations

This recommendation was made in response to the auditor's recommendations 1c and 1d. This would allow the Department to readily use information filed. Systems could be developed to match information and report discrepancies.

Provide the Director the Authority to Revoke distributor licenses and exemption permits for failure to maintain required records.

The Department needs the authority to revoke licenses and permits when required records are not maintained.

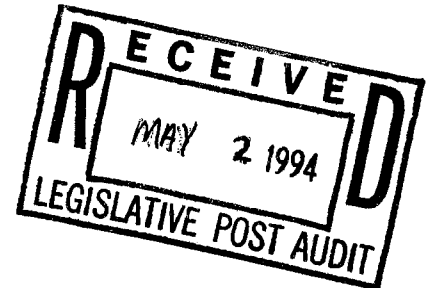


Joan Finney, Governor of Kansas
Phillip A. Fishburn, Acting Secretary of Agriculture
Donald L. Jacka, Assistant Secretary of Agriculture

901 S. Kansas Ave.,
Topeka, KS 66612

April 29, 1994

Ms. Barbara J. Hinton
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Topeka, Kansas, 66612-2212



Dear Ms. Hinton:

This is our response to the draft copy you provided us of your performance audit report, "Reviewing the Department of Revenue's Enforcement of Kansas Motor Fuels Tax".

The draft report accurately reflects information provided by Mr. DeVern Phillips, the State Sealer.

I would respectfully wish to review and evaluate any additional commitment of manpower offered to take and report on totalizer readings beyond the manpower which is currently funded by the Refined Fuels Program. I would wish to assure that the commitment is on a limited basis; properly accounted for and funded; and finally, that the time was not at the expense of other programs.

Secondly, I believe it is prudent to note that the new regulations requiring that retail stations have totalizers on the pumps may not take effect on July 1, 1994 as noted on page 17.

It is our belief that random reporting of totalizer readings by the inspectors assigned to the Refined Fuels Program will indeed improve the accuracy of the reported information and thus enhance the collection of motor fuels taxes. The Department of Revenue may wish to generate a random computer list or a compliance list of totalizers that they would like for us to check as we make our inspections.

Thank you for allowing me to provide comments and corrections relative to your final report. The Department of Agriculture is willing to cooperate with the Department of Revenue and is optimistic that we can assist in this endeavor by helping to assure the accuracy of the totalizers.

Sincerely,

Phillip A. Fishburn
Acting Secretary
(913) 296-0897

PAF:jad

KANSAS HIGHWAY PATROL

Service—Courtesy—Protection

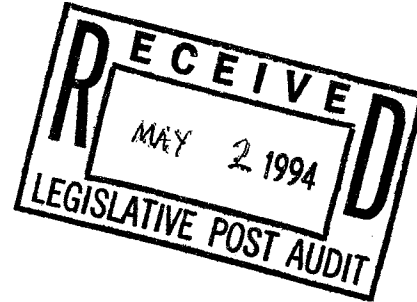
Joan Finney
Governor



Col. Lonnie R. McCollum
Superintendent

April 27, 1994

Ms. Barbara J. Hinton
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Legislative Division of Post Audit
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Topeka, Kansas 66612-2212



Dear Ms. Hinton:

I have reviewed your draft response to question number two concerning your performance audit report entitled, "Reviewing the Department of Revenue's Enforcement of Kansas Motor Fuels Tax".

With regard to the Kansas Highway Patrol, I find the response to be accurate.

Thank you for affording me the opportunity to participate in this review.

Sincerely,

A handwritten signature in cursive script that reads "Lonnie R. McCollum".

LONNIE R. MCCOLLUM
Superintendent

LRM:BG:tlr



