



# **PERFORMANCE AUDIT REPORT**

**REVIEWING SALES TAX ENFORCEMENT AND  
COLLECTION EFFORTS AT THE  
DEPARTMENT OF REVENUE:**

**A K-GOAL Audit**

## ***Executive Summary*** *with Conclusions and Recommendations*

**A Report to the Legislative Post Audit Committee  
By the Legislative Division of Post Audit  
State of Kansas  
November 1996**

# ***Legislative Post Audit Committee***

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## ***Legislative Division of Post Audit***

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LEGISLATURE OF KANSAS  
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November 14, 1996

To: Members of the Kansas Legislature

This executive summary contains the findings and conclusions, together with a summary of our recommendations and the agency responses, from our completed performance audit, *Reviewing Sales Tax Enforcement and Collection Efforts at the Department of Revenue*.

The report also contains appendices showing properties or services subject to sales tax in the State of Kansas, estimated costs to the State for sales tax exemptions, examples of exemption certificates, and the results of a survey of businesses recently audited by the Department.

This report includes several recommendations for improving the Department's Division of Collections' effectiveness, cost-efficiency, and collection practices, and for clarifying the State's sales tax law. This report also includes recommendations for improving operations at the Department's Audit Bureau and for improving the exemption process.

If you would like a copy of the full audit report, please call our office and we will send you one right away. We would be happy to discuss these recommendations or any other items in the report with you at your convenience.

A handwritten signature in black ink, reading "Barbara J. Hinton". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Barbara J. Hinton  
Legislative Post Auditor



# **Reviewing Sales Tax Enforcement and Collection Efforts at The Department of Revenue**

## **EXECUTIVE SUMMARY**

### **LEGISLATIVE DIVISION OF POST AUDIT**

#### **Question 1: Is the Department of Revenue Effectively and Efficiently Collecting Sales Taxes?**

**The Division of Collections doesn't have the information it needs to know whether it's effective or cost-efficient.** ..... page 6  
*During this audit, we found that the Division's basic management information for delinquent taxes was either highly suspect or nonexistent. The Division doesn't know the total amount of money it takes in on an annual basis for all delinquent taxes, nor how much it takes in annually for any of the State's individual taxes. Department officials also acknowledged that accounts receivable figures were inaccurate and could be overstated by as much as one-third.*

**The Division of Collections doesn't appear to be very cost-efficient or effective.** ..... page 8  
*Information provided by revenue departments in Texas, Florida, and Iowa indicates that Kansas' Division of Collections collects less in sales taxes per dollar spent and per employee than these states.*

**Our review of a sample of delinquent sales tax accounts identified several problems with collection activities.** ..... page 9  
*We reviewed 49 accounts with an average balance due of \$42,000. We found that the Division didn't always move these accounts progressively through the collection stages, and, in many cases, the Division's actions were lenient toward taxpayers. For example, 37 of the 49 accounts had one or more periods of at least six months with no documented phone calls or letters. In eight cases, the Division didn't react to repeated broken pay plans by moving the account to a more stringent collection stage. In six cases, the Division didn't file tax warrants when it should have.*

**The Department's Audit Bureau appears to be a cost-efficient part of its collection efforts.** ..... page 14  
*During fiscal year 1996, the Bureau's auditors assessed additional taxes due of about \$24 for every dollar spent by the Bureau. Not all audit assessments are eventually collected, but the Bureau still brought in an average of \$12 for every \$1 spent during the most recent five fiscal years.*

**Question 1 Conclusion:** *The Division of Collections lacks the basic management information it needs to know whether it's doing a good or bad job. Using data from computer programs developed specifically for us, it appears the Division could do much better. It's imperative that Project 2000 develop the capability for management to measure its performance. Otherwise, no one will ever truly know if the changes being made through Project 2000 are worthwhile.* ..... page 16

*It's generally accepted that collection efforts are more successful the sooner they occur, and that a collection agency regularly needs to contact its "clients" about staying current. But in our review of cases, we*

saw instances where delinquent taxpayers went months without being contacted. This single omission violates both collection principles. Overall, the Division has the proper collections tools in place, but it needs to use them when it's appropriate to do so.

Historically, the Audit Bureau has more than paid for itself through its work. While this should continue, the Bureau's new role in the Department's education process likely will cause audit assessments to decrease in the long run. Again, the Department should monitor the audit process over time to make sure it achieves the intended results.

**Question 1 Recommendations.** A brief summary of the report's ..... page 17 recommendations, along with a summary of applicable comments from the agency, is presented below.

To monitor and improve its effectiveness and cost-efficiency, we recommended the Department of Revenue's Division of Collections regularly gather information about tax collections per dollar spent and per employee, and compare those amounts to its own past experience and to similar figures from other states. We also recommended the Division adopt a target figure for its actual tax collections as a percentage of amounts assigned to it for collection, and periodically gather actual figures for comparison to that target.

To improve its collection practices, we recommended the Division of Collections review the assigned collection stage for each current account to see if it's appropriate, and make adjustments as necessary. We also recommended the Division periodically review its accounts for situations where no collection efforts have been made for some time, and take corrective action, and periodically analyze accounts not pursued for extended periods of time because of their involvement in other Department processes, such as Business Tax resolution, and work with applicable staff to get those accounts back into an active collection status.

To fully protect the State's interest in past due accounts, we recommended the Division of Collections file tax warrants on a timely basis as called for by Division policies.

To ensure that the new perspective of the Division of Taxation's Audit Bureau for selecting businesses to audit is effective, we recommended the Department of Revenue monitor for improvement in voluntary compliance with sales tax laws that might be attributable to that new perspective.

The Department's response says that its infrastructure needs have been badly neglected for years and for that reason, the Department initiated Project 2000 in 1995. The Department generally concurred with our recommendations.

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## **Question 2: Is the Sales Tax Exemption Program Administered Consistently, Fairly, and According to State Law?**

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**The Department of Revenue makes sellers of goods and services responsible for deciding whether to grant an exemption.** ..... page 18  
*When a seller grants a sales tax exemption, he or she should obtain an exemption certificate from the buyer to document the reason for the exemption. When Department auditors audit a seller, they review this documentation to determine whether the exempted sales should have been allowed. Sales tax audits issued between March through July 1996 showed that the auditors assessed about \$415,000 in additional sales taxes because they had questions about the exemption certificates accepted by sellers.*

*Some businesses, especially those working with the construction industry, have raised concerns about the fairness of the Sales Tax Exemption Program. In February 1995, the Senate Assessment and Taxation Committee heard testimony about auditors' unfair treatment of certain businesses that had accepted exemption certificates. The Committee chastised the former Director of the Audit Bureau about this practice.*

**Although the way the sales tax exemption program is set up may place an unfair burden on sellers, the programs of other states we contacted are similar.** ..... page 22  
*We contacted officials in Arkansas, Florida, Iowa, Minnesota, Nebraska, and Oklahoma, and, based on the information they provided, each of these states manages its sales tax exemption program in a manner similar to Kansas. Sellers are responsible for determining whether exemption certificates should be accepted, and sellers are usually responsible for paying the sales tax if an exemption is disallowed.*

*Other ways of handling sales tax exemptions would have advantages and disadvantages. One alternative to sales tax exemptions is to require sales taxes to be paid on all purchases and then allow buyers to request refunds from the Department for purchases that are tax-exempt. This option would remove the burden of proof from sellers. However, it would require the Department to create a large bureaucracy to administer the Program. Another alternative is to make buyers responsible for paying the sales tax if an exemption is disallowed later. This option would relieve sellers of the burden of paying sales taxes on disallowed exempted sales. But this option would also require more time and resources from the Department.*

**Some aspects of the sales tax law make it difficult for sellers to know whether a sale should be exempted.** ..... page 24  
*We interviewed Department officials and representatives of trade associations, and we surveyed a sample of businesses recently audited by the Department. These people seemed to agree that the State's sales tax laws aren't always clear or easy to deal with. The specific issues noted were as follows.*

- *The law allows a large number of exemptions which makes it difficult for sellers to know all they should about exemptions.*
- *The parts of the law pertaining to contractors are difficult to apply.*

- The parts of the law exempting the sale of an "ingredient or component part" and items "consumed in production" can be difficult to apply.
- The exemption of sales of "major" components of manufacturing machines is difficult to apply because the law doesn't define "major."
- The terms "good faith" and "should have known" are difficult to interpret.
- Buyers aren't required to provide enough information to sellers so that sellers can make informed decisions about exempting sales.

**Department of Revenue auditors haven't always been consistent when reviewing exempted sales.** ..... page 26  
*Because of insufficient documentation, we were unable to review a sample of audits to determine if the auditors consistently handled similar kinds of transactions. However, we interviewed all of the Audit Bureau's managers and about one-third of the Bureau's sales tax auditors. From these interviews, we learned that the auditors have different attitudes and approaches to their work which may promote inconsistency.*

*In November 1995, in response to complaints about its ongoing rejection of exemption certificates, the Audit Bureau instructed its staff not to enforce a particular administrative regulation relating to sales tax exemptions. The regulation in question specifies that all tools, equipment, and machinery purchased to perform construction services are subject to sales tax.*

**Question 2 Conclusion:** The current situation of making the seller responsible for determining whether any particular sale should be exempted from sales tax isn't the most fair system, but it's probably the most practical system. Because buyers are the ones who owe the State sales tax, the most fair system would have the State consistently go after these people. But to do this, the Department probably would need to add staff. .... page 31

*Because parts of the sales tax law are difficult to interpret, it's very likely that the law isn't applied consistently. While the Department could adopt additional administrative regulations to interpret the law, the Department contends it would be better for the Legislature to modify the law. Although this matter clearly needs additional study, the best alternative seems to be a combination of both of the above. In this audit, we have identified several exemptions which need to be clarified, one way or the other.*

*The Audit Bureau needs to make some changes because its staff acknowledges many problems exist within the Bureau. These changes won't require a complete upheaval of the organization. With improved training, better policies and procedures for how staff should handle and document questioned transactions, and management focusing on consistency, the Bureau can become a valuable tool for the Department, rather than the thorn-in-the-side that it has recently been portrayed as.*

**Question 2 Recommendations.** A brief summary of the report's recommendations, along with a summary of applicable comments from the agency, is presented below. .... page 32



*Where possible, the Department should adopt rules and regulations clarifying confusing areas of State law. For those areas that the Department feels are beyond its responsibility to interpret, the Department should notify the Legislature's House and Senate Taxation Committees about aspects of the law that are confusing, and need clarification. Specific topics identified in this audit that need to be addressed include:*

- *Whether the Department should pursue unpaid sales tax from the buyer or seller*
- *The definitions of "ingredient or component part," and "consumed in production"*
- *The definitions of "good faith" and "should have known"*
- *The definition of contractor*
- *Whether the number of exemptions should be decreased*

*To ensure that the sales tax law is consistently applied by the Audit Bureau, and to improve its general operations, the Bureau should:*

- a. *Develop and maintain a comprehensive policy and procedures manual. This manual should contain the specific information, such as policy directives written by the Tax Policy Group, auditors need to consistently apply the sales tax law.*
- b. *Develop a specialized training program that focuses on a consistent interpretation of the sales tax law. This will require audit managers to become more consistent with each other in their perspectives. Such training might include having audit managers occasionally go out to the field to observe and supervise audits in progress.*
- c. *Require its auditors to clearly document in their audit working papers the reasons why questioned sales tax transactions are disallowed.*
- d. *Require its auditors to enforce all aspects of the sales tax law as written.*
- e. *Maintain data to show the number and extent of audits appealed and resolved by the Audit Bureau. The audit working papers also should show how and why audits were settled for amounts different from assessed in the official audit report.*

*The Department should amend its exemption certificate forms to require buyers to disclose how they intend to use the merchandise being purchased. This information would help a seller determine whether to exempt the sale from sales tax.*

*The Department's response says that it agrees that portions of the sales tax law are unclear and the law should be clarified in several areas. The Department generally concurs with our recommendations.*

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This audit was conducted by Joe Lawhon, Chris Clarke, and Tracey Elmore. If you need any additional information about the audit's findings, please contact Mr. Lawhon at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call (913) 296-3792, or contact us via the Internet at [LPA@postaudit.ksleg.state.ks.us](mailto:LPA@postaudit.ksleg.state.ks.us).

