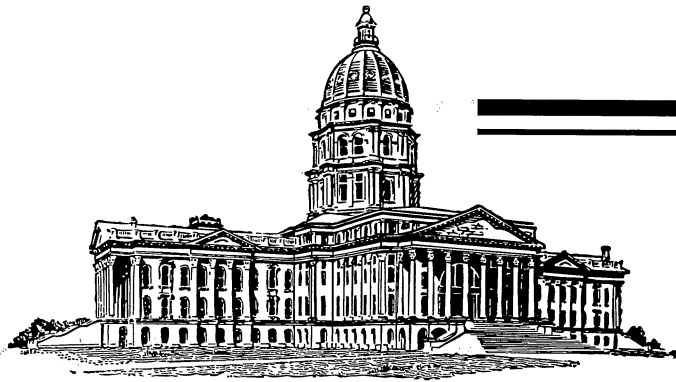




PERFORMANCE AUDIT REPORT

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

A K-GOAL Audit

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

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$7 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

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November 8, 1996

To: Members, Legislative Post Audit Committee

Senator Lana Oleen, Chair
Senator Anthony Hensley
Senator Phil Martin
Senator Alicia Salisbury
Senator Don Steffes

Representative Jim Lowther, Vice Chair
Representative Tom Bradley
Representative Duane Goossen
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Representative Ed McKechnie

This report contains the findings, conclusions, and recommendations 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. 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 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.

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

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 page 26
consistent when reviewing exempted sales. 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.

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APPENDIX A: Properties or Services That Are page 35
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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.**

Reviewing Sales Tax Enforcement and Collection Efforts At the Department of Revenue:

A K-GOAL Audit

The Department of Revenue is the major tax-collecting agency for the State. It has eight major divisions and spent more than \$70 million during fiscal year 1996. One of the largest taxes administered by the Department is the retailers' sales tax. During fiscal year 1996, the Department collected more than \$1.2 billion from sales taxes. The Division of Taxation is primarily responsible for administering the sales tax program. In 1996, the Division employed 284 people and spent almost \$15 million. The efforts of the Division of Taxation are supplemented by the Division of Collections, which is responsible for collecting delinquent taxes. In 1996, this Division employed 96 people and spent more than \$3.2 million.

Recently, legislative concerns have been expressed about the effectiveness and efficiency of the Department's sales tax collection process. Legislative concerns also have been expressed about the sales tax exemption process, particularly with regard to whether it makes sense to place the burden of proof on the retailer to make sure that exemption certificates are valid. In addition, there is uncertainty about whether the Department's auditors are treating taxpayers in a fair and consistent manner.

The Legislative Post Audit Committee approved this audit to satisfy the requirements of the Kansas Governmental Operations Accountability Law (K-GOAL). This law requires the Legislative Division of Post Audit to conduct a performance audit of specified State agencies each year on an eight-year cycle. The purpose of these audits is to periodically review the operations of the selected agencies, determine the necessity, propriety, and legality of their operations, identify areas of inefficiency and ineffectiveness, and provide information to allow the Legislature to take action to retain appropriate and effective governmental operations, or to terminate inappropriate or obsolete governmental operations. This audit addresses the following questions:

- 1. Is the Department of Revenue effectively and efficiently collecting sales taxes?**
- 2. Is the sales tax exemption program administered consistently, fairly, and according to State law?**

To answer these questions, we reviewed applicable statutes, Department publications and administrative regulations, and other written materials pertaining to Kansas sales tax. We examined various Department records including revenue and expenditure records, Audit Services Bureau working papers, and computerized records of taxpayer account histories. We also interviewed members of the Department, and surveyed revenue departments in other states and 100 businesses that recently had been audited by the Department's Audit Bureau. In addition, staff from the Department's Bureau of Information Systems developed several computer programs to sort and analyze taxpayer sales tax records for us.

In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office, except we didn't perform specific testwork to determine the reliability of all Department of Revenue computerized data or other state data that we used in this audit.

In general we found that the Division of Collections, which is responsible for collecting past due sales taxes, doesn't have the basic management information it needs to know whether it's effective or efficient. Using data from computer programs developed specifically for this audit, it appears the Division hasn't been very effective or efficient. On the other hand, the Audit Bureau has been a cost-effective part of the Department's collection efforts.

We found that administration of the Sales Tax Exemption Program isn't always consistent, fair, or in accordance with State law. Because parts of the sales tax law are difficult to interpret, it's very likely that the law isn't applied consistently. In fact, Audit Bureau staff acknowledged there are many inconsistent interpretations, and other problems within the Bureau. Although many claim that holding the seller responsible for determining whether transactions should be exempt from sales tax is unfair, this is probably the most practical system. Finally, we found that at least one aspect of the sales tax regulation isn't being enforced.

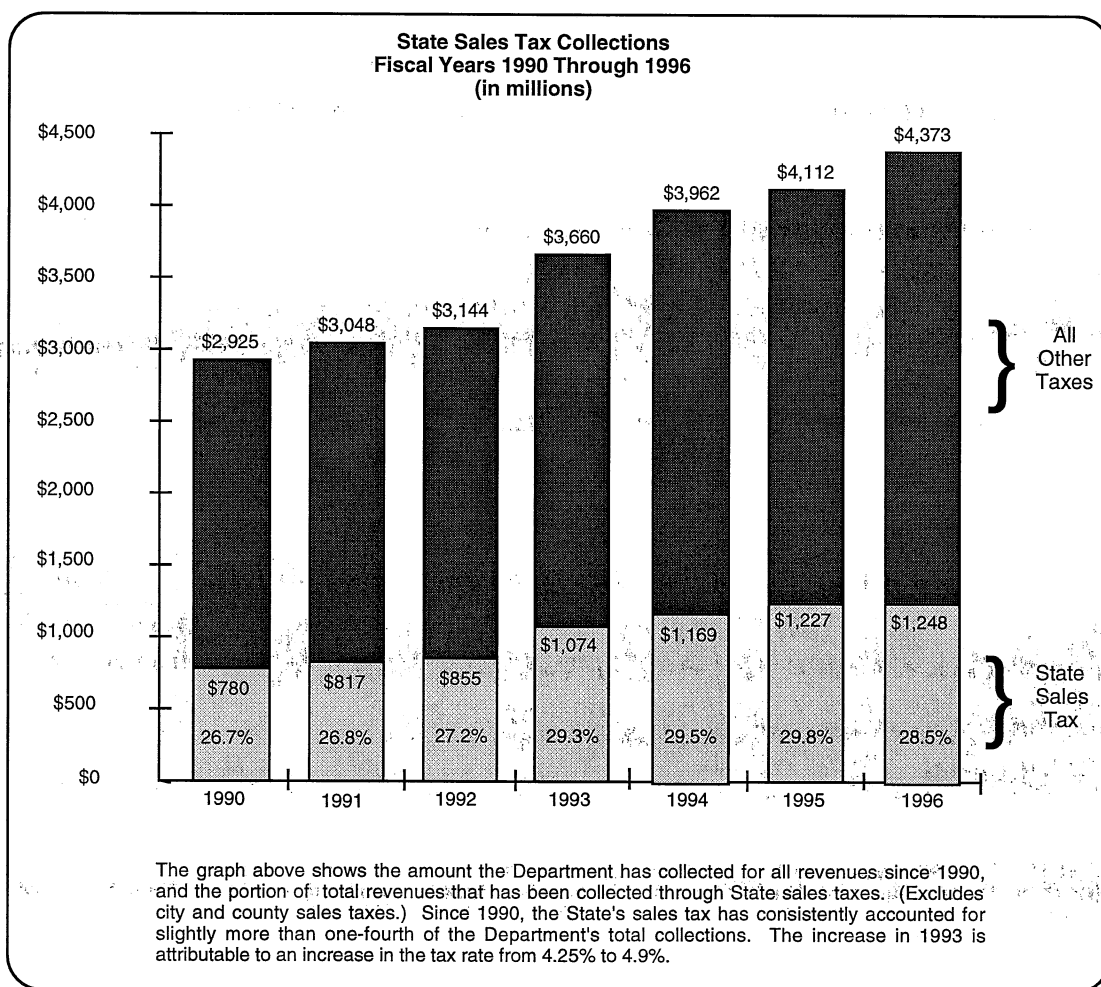
These and other findings will be discussed in more detail after a brief overview.

Overview of the State's Sales Tax

Sales Taxes Accounted for About 30% of the State Taxes Collected In Fiscal Year 1996

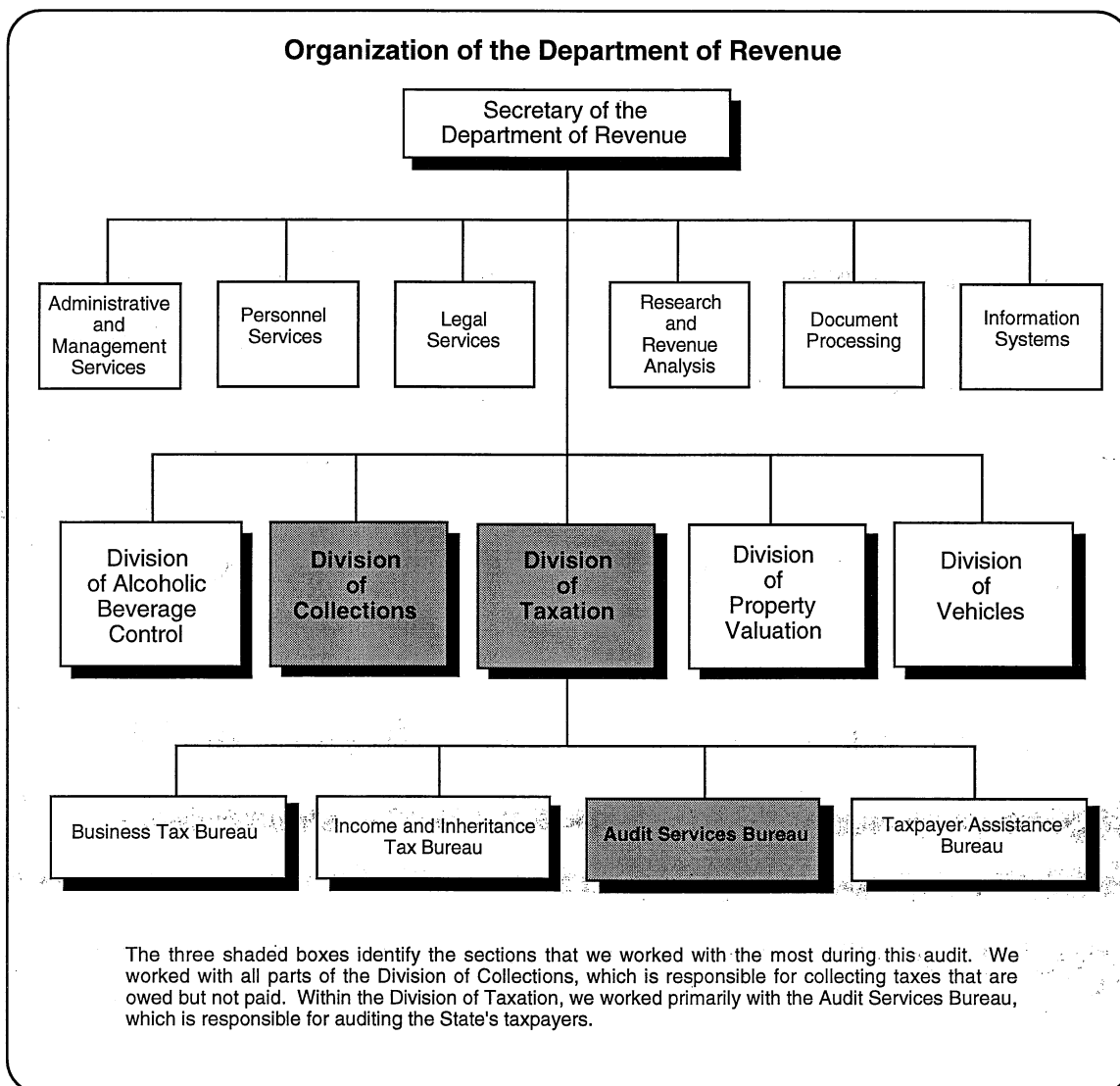
The State collects more than \$4 billion annually in corporate and individual income taxes, sales and consumer use taxes, and motor fuels and other taxes. In fiscal year 1996, State sales taxes accounted for about \$1.25 billion, or almost \$3 out of every \$10 in taxes collected. The State sales tax rate is 4.9%. The graph below shows that the State's sales tax collections have grown from \$780 million in fiscal year 1990 to nearly \$1.25 billion in fiscal year 1996.

The Kansas Retailer's Sales Tax Act, first adopted by the 1937 Legislature, currently specifies 20 different categories of property or services that are subject to the sales tax. Those are listed in Appendix A. The Act also exempts some sales of tangible personal property and services from the sales tax. Those exemptions cover a wide range of property and services.



The Department of Revenue is the State's tax collection agency. The Department's Division of Taxation is responsible for administering and enforcing almost all the State's taxes, including the sales tax. It provides guidance to retailers collecting and remitting the tax, oversees their activities through its Audit Bureau, and manages the Department of Revenue's system of appeals when retailers disagree with the amount of tax the Department is trying to collect from them. The Division also administers sales and transient guest taxes enacted by local units of government in the State.

The Division of Collections is responsible for collecting taxes owed but not paid. Its collection efforts include letters, telephone calls, investigations, seizures of assets, garnishments, and closing businesses. An organization chart for the Department of Revenue is presented below.



The Department Is Implementing New Technology and Processes to Manage the State's Tax Programs

Kansas Tax 2000 is the name given to a major project the Department has undertaken to redesign its core business processes, restructure the agency, and develop and purchase new computerized tax-management systems. To implement this project, the Department contracted with American Management Systems, Inc. American Management Systems began work in June 1995.

The project has several years to go before it is fully implemented, so we couldn't do any testwork to determine if it will improve the Department's operations. But we were able to learn what types of things the project is expected to do. For example:

- Through the Tele-file project, taxpayers will be able to file their returns with a touch-tone telephone.
- Through the purchase and use of an imaging machine, the Department will be able to electronically process taxpayers' returns and payments. The machine will enter this information into the Department's taxpayer database, then will prepare the checks for deposit.
- Through the implementation of a new computerized account management system, known as KICS, the Department's Division of Collections expects to improve its ability to manage taxpayer accounts, including the pursuit of past-due accounts.

As of October 1996, American Management Systems had been paid nearly \$750,000 for professional services and computer hardware and software. Payments to the company are based on additional revenues the Department generates as a result of improvements from Kansas Tax 2000 initiatives. Before a payment can be released, Department officials, the Director of the Budget, and the Director of the Legislative Research Department must certify that the project has generated additional revenues, and must verify the amount of those revenues.

The contract with American Management Systems says the company could be paid as much as \$49.9 million over the life of the project, which extends through June 2002, if additional revenues generated from the project total at least \$190 million.

Is the Department of Revenue Effectively and Efficiently Collecting Sales Taxes?

The Department of Revenue's efforts to collect sales taxes are carried out by its Division of Collections and its Division of Taxation's Audit Bureau. The Division of Collections, which is responsible for collecting past due sales taxes, doesn't have the basic management information it needs to know whether it's effective or efficient. As a result, we asked the Division to develop some of that information for us. That information seems to show the Division hasn't been very effective or cost-efficient. A major problem is that the Division doesn't keep up with accounts as it should. On the other hand, the Audit Bureau, which identifies additional sales taxes due, has been a cost-effective part of the Department's collection efforts. These and other findings are described in detail in the sections that follow.

The Department's Collection Efforts Generally Involve a Very Small Percentage Of Sales Taxes Paid Each Year

State sales taxes accounted for about \$1.25 billion of the State's tax collections in fiscal year 1996, which represented a significant portion of the State's General Fund revenues. Like most states, Kansas has no way of knowing how much sales tax revenue really is owed in any year, compared to the amount actually paid. However, Department records indicate that as much as 99% of the sales tax revenues collected are remitted voluntarily and on-time by retailers. Thus, a very small percentage of sales taxes—perhaps between \$10 million and \$20 million—involves the Department's collection efforts.

The job of identifying sellers who owe more taxes than they have paid generally belongs to the Department's Audit Bureau. About two-thirds of the Bureau's 49 auditors work on sales tax audits. When the Audit Bureau determines through an audit that a seller owes more taxes than were paid, the seller can appeal the audit to the Audit Bureau. If the taxpayer remains unsatisfied, he or she can appeal to a Department administrative law judge, then to the Board of Tax Appeals, and eventually through the court system. At any point, the seller and the Department can agree to a negotiated settlement.

The job of collecting delinquent sales taxes from taxpayers belongs to the Division of Collections. The Division has nearly 100 employees. The Division was established in November 1987 to, according to Department officials, "provide for centralized and progressive action in the collection of delinquent taxes and the effective management of accounts receivable." The Division is responsible for collecting all types of delinquent taxes, not just sales taxes.

The Division of Collections Doesn't Have the Information It Needs to Know Whether It's Effective or Cost-Efficient

To ensure that its collection efforts are adequate, the Division of Collections should have reasonable policies and procedures for its collection efforts, and a means to measure the effectiveness and cost-efficiency of those efforts.

In February 1996, the Division implemented a new business process that was intended to enhance its collection efforts. The new process divided nearly all collection work into three stages. We reviewed the Division's January 1996 policies and procedures manual, which describes in detail the processes and the responsibilities of each stage. We found that, overall, the Division of Collections appears to have the right tools in place to collect past due accounts.

Given the Division of Collections' responsibilities for collecting delinquent taxes and managing accounts receivable, it's also important for the Division to have accurate and reliable information about the following:

- the total amount of delinquent taxes owed at a given point in time, by type of tax, with information about how long those taxes have been owed, and whether that amount is increasing or decreasing over time
- the amount of new delinquent taxes it's assigned to collect each year, by type of tax
- the amount of delinquent taxes actually collected each year, by type of tax

During this audit, we found that the Division's basic management information for delinquent taxes was either highly suspect or non-existent. As a result, the Division doesn't have the information it needs to measure its effectiveness and cost-efficiency. For example, 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 reported were inaccurate, and could be overstated by as much as one-third. One reason they cited was that no uncollectible accounts had been written off since 1991. In summary, a Department official stated that the Department as a whole was "plagued by a lack of information."

This lack of basic management information seriously hampers the Division of Collections' ability to manage its area of responsibility. For example, the Division can't tell how well it's doing in any particular area—such as by tax type or stage—and whether it should change tactics because of inadequate performance. Further, the lack of basic data prevented us from making several comparisons we had intended to make in this audit.

We asked the Department of Revenue to develop information for us about delinquent taxes received as a result of the Division of Collections' efforts. Department staff wrote several special computer programs for us. We shared the resulting information with several Department officials, and asked if they knew of any reason why that information wouldn't be reliable. Because they hadn't seen this kind of information before, they told us they couldn't confirm its reliability. Nonetheless, they acknowledged that they didn't see any logic errors in the information, or in how it was produced. We used this information in our analysis of the Division of Collections' cost-efficiency and effectiveness.

The Division of Collections Doesn't Appear to Be Very Cost-Efficient or Effective

In determining the cost-efficiency of the Division's collection efforts, we attempted to gather comparative information from revenue departments in eight states—Arizona, California, Florida, Iowa, Massachusetts, Minnesota, Missouri, and Texas. We selected these states because they were geographically close to Kansas, or they were recognized as leaders in collecting and managing state revenues.

Only three states—Florida, Iowa, and Texas—provided us with sufficient information about their collections operations to use in this audit. Although we made reasonable attempts to try to get comparable and reliable information from other states, we couldn't audit the accuracy of that information. Thus, the comparison information from these other states should be used as good indicators, and can't be relied on as absolute facts.

Information provided by the other states indicates that Kansas' Division of Collections collects less in sales taxes per dollar spent and per employee than any of those other states. The table below provides these comparative figures.

**Comparative Efficiency of the Division of Collections
In Collecting Sales Taxes**

State	Sales Taxes Received (in millions)*	Division Expenditures (in millions)	Sales Taxes Received per \$1 Spent	No. of Employees	Sales Taxes Received per Employee
Texas	\$ 271.8	\$ 18.0	\$ 15	443	\$ 614,000
Florida	378.7	29.2	13	867	437,000
Iowa	19.7	2.1	9	94	209,000
Kansas	20.0	3.2	6	96	208,000

* Because these states have a different sales tax rate than Kansas, we adjusted their reported receipts to reflect the amounts that would have been collected using Kansas' sales tax rate of 4.9%.

As the table shows, Kansas collects about \$6 for every \$1 the Division of Collections spends. This is lower than the other states in our sample. Also, Kansas' amount collected per employee is lower than two of the other states, but about the same as Iowa, which collected a similar amount to Kansas and has about the same number of employees.

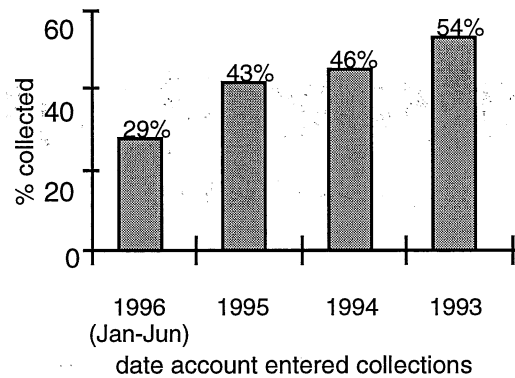
The Division of Collections collects most of what it's going to collect early in the process, but we couldn't determine whether it collects enough money to be considered effective. Using the information developed by one of the computer programs which analyzed the amounts collected by the Division through mid-September 1996 for all sales tax filing periods between January 1993 and June 1996, two points became very clear:

- For this period, the Division has collected about 46% of the amounts assigned to it for collection. Because we had neither comparative figures from other states nor a quantified goal adopted by the Department, we weren't able to evaluate the

Division's collection percentages. Nevertheless, the Division needs to establish a reasonable collection target, and measure its progress toward that target. Otherwise, the Division has no way of measuring its effectiveness.

- The timeliness of collection efforts has a significant impact on the amounts collected. Our analysis showed that the Division collects most of what it's going to collect fairly early in the collection process. That seems reasonable because, as time elapses, taxpayers can become harder for the Division to locate, and the tax delinquencies they owe can become more difficult to collect. As shown in the accompanying graph, the data show the Division collects most of what it's going to collect in the first 21 months of the collection process. As more time passes, the total amount collected grows at a much reduced rate. This demonstrates it's critical for the Division to perform timely collection efforts.

Percentage of Delinquent Sales Taxes Collected Over Time



As the graph shows, by September 1996 the Division had worked the 1995 accounts for up to 21 months, and had collected 43% of the delinquent balance. As of September 1996, the Division had worked the 1993 accounts for up to an additional 24 months, but had collected only an additional 11% of the delinquent balance.

Our Review of a Sample of Delinquent Sales Tax Accounts Identified Several Problems With Collection Activities

The Division of Collections has adopted three different "stages" of collection effort, which we refer to as Stages I, II, and III. In general, the higher the stage, the more aggressive the collection efforts taken. The glossary of terms on page 10 provides more information about the specific activities within these stages.

Because the Division of Collections has the most success collecting the delinquent taxes it's going to collect within about 21 months of when those taxes were due, its collection efforts have to be timely. Given its three collection stages, the Division not only has to be doing the right things for the stage the account is in, but it also has to make sure the account progresses through the collection stages appropriately. To find out if that's been happening, we reviewed a sample of 49 delinquent accounts.

Glossary of Terms Used in this Report

Stage I	Known as the "front end" of the collections process, Stage I involves establishing the amount due and obtaining basic information about the debtor, including name, address, and phone number. Collectors in this stage send letters to the taxpayer and make telephone calls in an attempt to collect delinquent amounts.
Stage II	Known as the "enforcement" part of the collections process, Stage II involves more assertive telephone calls and letters than Stage I. Collectors in this stage also conduct preliminary investigations about taxpayer assets if seizure activities become necessary.
Stage III	Known as the "hard core" part of the collections process, Stage III involves legal collection activities such as seizures of assets, garnishments, or closings of businesses.
Tax Warrants	A tax warrant is a legal document used by the Department to secure a tax liability, and to enhance the State's chances for collecting the debt. Tax warrants empower the Department to use garnishments and seizures as legal methods of collection. If a tax warrant isn't filed before the statute of limitation expires (3 years from the date of the delinquency), these methods are no longer available, and the Department has no other recourse for collection of the debt.
Seizures	After filing a tax warrant, the Department can confiscate cash at the business' location and in the business' bank accounts. The Department also can do a second seizure and seize corporate officer assets, such as the business owners' personal bank accounts.
Garnishments	A garnishment is a legal proceeding the Department can use to take possession of a delinquent taxpayer's money or property to apply to the taxpayer's debt. After filing a tax warrant, the Department can garnish wages, commissions, and bank accounts.
Injunctions	An injunction is a petition the Department files with the courts to prohibit businesses from operating because of sales or withholding tax delinquencies. According to Department officials, injunctions are used as a last resort.

The accounts we reviewed aren't representative of all Division of Collections accounts. Rather, we focused on accounts that had been in the collection process for at least one year. Those accounts are, by definition, problem accounts to some extent. We wanted to see whether the Division had followed appropriate procedures for those accounts, and what might be contributing to the problems experienced in collecting these accounts.

At the time of our review, the 49 accounts in our sample had total delinquent balances due of slightly more than \$2 million, or an average of almost \$42,000 each. We looked at each account's history in the collections process, including collection actions and progression from stage to stage.

The Division's collection actions seemed appropriate for the collection stage the account was in. Records we reviewed showed that, while accounts were in Stage I the Division's actions comprised phone calls and letters. Although copies of

actual letters sent weren't available for our review, the Division's Manual states that letters in this Stage generally have more the tone of a request. While accounts were in Stage II, the Division's actions also comprised phone calls and letters. Again, copies of the actual letters sent weren't available, but the Manual's standard letters for this Stage generally have a more serious tone.

While accounts were in Stage III, the Division's actions included filing tax warrants, making cash seizures, and obtaining injunctions. Those actions, more legal in nature, are appropriate to Stage III. In our sample, we saw tax warrants filed on 15 accounts, cash seizures made on three accounts, one garnishment, and one injunction.

However, the Division didn't always move accounts progressively through its collection stages. For the 49 cases in our sample, we expected to see that the longer an account had been in the collections process, the more likely it was to be in Stage III, where the most aggressive collection efforts are made. That didn't always turn out to be the case.

We found that accounts in the collections process between one and two years were mostly in Stages I and II, and accounts in the collections process between two and three years were mostly in Stage III. That seems reasonable. However, for accounts that had been in the collections process more than three years, about half were in Stage III and half were in Stage I. The table below shows the results of this review.

**Analysis of a Sample of Delinquent Sales Tax Accounts
As of Late August 1996**

Time in the Collections Process	No. of Accounts	Delinquent Amount	Number of Accounts In		
			Stage I	Stage II	Stage III
1 - 2 years	17	\$ 232,125	9	5	3
2 - 3 years	11	381,297	2	3	6
More than 3 years	21	1,433,152	10	1	10
Total	49	\$ 2,046,574	21	9	19

We asked Division officials about the seemingly large number of old accounts in Stage I, which involves the least-aggressive collection effort. They cited the following reasons for this situation:

- The Division ceases its collection efforts on accounts that have been transferred to the Division of Taxation's Business Tax staff for review. Delinquent accounts are transferred when there is some disagreement with the taxpayer about the amount due. About one of every three accounts in our sample had been transferred to Business Tax, and they spent an average of 11 months in the Business Tax review, with two of those accounts spending more than

two years. Thus, while time is passing by, the Division is not undertaking collection efforts.

- Similarly, when a taxpayer who owes delinquent taxes files for bankruptcy, the Division's collection efforts are put on hold. The Department files the appropriate legal documents to protect its claim for taxes, and after bankruptcy proceedings are completed, the account is transferred back to Stage I. Bankruptcy claims were filed in nine of our accounts, of which two have been settled and rerouted to Stage I.

To find out more about the progression of accounts through the collection stages, we analyzed the individual accounts we selected for testing.

In many cases, the Division of Collections' actions were lenient toward taxpayers who owed delinquent sales taxes. Effective collection requires continuous contact with the taxpayer to provide a constant reminder of the debt owed. Effective collection also requires monitoring to identify when an account should progress to the next collection stage. If collection efforts are too lenient, taxpayers who owe delinquent sales taxes may not be as likely to pay the amounts they owe.

Based on our sample of accounts, we identified three particular ways in which the Division wasn't keeping up with its accounts.

- *Many accounts in our sample went for long periods of time without any collection action other than a computer-generated monthly billing.* In fact, 37 of the 49 accounts (three out of every four) had one or more periods of at least six months with no documented phone calls or letters. That would seem to be a contributing factor to the delinquency of the accounts in our sample.

Taxpayers Can Remain Delinquent for Several Years

One account we reviewed was a grocery store that became delinquent and entered the collections system in September 1991. The account has remained delinquent continuously since that time, and the total balance due as of October 15, 1996, was \$67,126, of which about \$26,000 is more than one-year past due. In addition, this account has at least two non-filed returns, each of which may represent an additional \$9,000 to \$10,000 of sales tax liability.

We identified a number of problems with the way the Division of Collections handled this account:

- Although the account has remained delinquent throughout this period, we identified three periods of eight months or longer during which no actions by Division of Collections' staff were recorded in its computer system. Generally, collection activities are more successful when consistent follow-up is maintained.
- The business is still operating and presumably generating large amounts of cash. The taxpayer has sent numerous bad checks to the Division over the years, and the account has been residing in a Collections' "bad check follow-up" state since September 1995. Very little real collection work has occurred on this account since then.
- The account has remained in Stage I, or the least-aggressive level of the collection process, for five years. Stage I only involves phone calls and letters to the taxpayer.

- *The Division didn't react to repeated broken pay plans by moving the account to a more stringent collection stage.* When a taxpayer agrees to a payment plan and breaks that plan, it's an indication that more stringent collection efforts are needed. In fact, the Division of Collections recently adopted an operating rule that when a taxpayer agrees to—but then breaks—two payment plans while in a particular collection stage, the Division should move that account to the next collection stage. That seems to be a reasonable operating procedure.

In our sample, we saw 12 accounts with two or more broken payment plans within the same collection stage. In eight of those cases, the Division failed to move the account to the next stage. In one of those cases, the taxpayer had agreed to and broken six payment plans within one stage. In another case, the taxpayer had made and broken four. Four of the eight occurrences happened after the Division adopted its new rule, the other four happened before. However, regardless of whether it's an adopted rule or not, the use of broken payment plans as a way of identifying the need for more stringent collection efforts is reasonable.

- *The Division didn't always file tax warrants when it should have.* The Division uses tax warrants to secure a tax liability. That's important because, unless a tax warrant is filed, a tax liability more than three years old can't be collected because of the statute of limitations. Division policies require a tax warrant to be filed when certain conditions exist, such as when an account moves from Stage II to Stage III. That policy also should call for a periodic review of old accounts to ensure that the statute of limitations' time limit doesn't expire before a warrant is filed.

In our sample, we found six instances where Division policy would call for tax warrants to be filed, but those warrants weren't filed. Although the amount of delinquent taxes at risk because of the statute of limitations wasn't significant in these cases, future instances might involve larger amounts.

Taxpayers Often Make and Break Promises to Pay the Taxes They Owe

A computer wholesaler owed the Department more than \$6,000 as of October 15, 1996, plus additional liability from at least 14 non-filed returns. This account became delinquent in June 1993. The Division made some calls and sent a letter, and the taxpayer filed some returns. The taxpayer sent bad checks in early 1994. In April 1994, the Division made another call and the taxpayer entered a "promise-to-pay" plan. This promise to pay was broken just one month later in May 1994. Through the rest of 1994, the taxpayer made and broke two additional pay plans. A fourth payment plan was entered and apparently the taxpayer made payments according to the plan. In February 1995, the taxpayer submitted more bad checks. In July 1995, the account was routed to Stage II, and the Division sent a letter to the computer wholesaler notifying it of an intent to file a tax warrant.

In February 1996, the account was routed to Stage III. In April, a revenue agent made an on-site visit to the business. In June, the Division prepared and filed a tax warrant. That same month, the taxpayer entered his fifth promise to pay, which was broken immediately. The same trend continued for the rest of 1996, and in July the taxpayer entered and broke his sixth pay promise to pay. In October, the taxpayer broke his seventh promise to pay. The company continues to operate and the Division hasn't taken any additional action against the taxpayer.

Collection Activities Ceased on One Account for About Two Years

An electric company owed the Department more than \$28,000 as of October 15, 1996, plus an additional unknown amount from at least two non-filed returns.

This account became delinquent in November 1992 and remained in Stage I until August 1993. During this time, the Division of Collections made some calls to the taxpayer and sent some letters. According to Division records, in August 1993, the account was routed to the Department's Business Tax Section for some adjustment. The account remained with the Business Tax Section for more than two years. In accordance with its procedures, the Division of Collections ceased all collection activities on this delinquent account while it was in Business Tax. However, the taxpayer continued to remit other sales tax returns during this period.

In early 1996, the Division returned this case to its active caseload, but no collections actions were recorded until September 1996, when a letter was sent. A small portion of the sales tax liability (\$70) has expired on this account, because no tax warrant was filed before the statute of limitations expired.

The Division's new computer system is designed to produce reports which identify accounts that have remained in inactive states for too long, and the system also will automatically route some accounts to another area for review, after a certain number of pre-set days.

Division officials attributed some of these past problems to a lack of staff. Although we didn't attempt to analyze the Division's staffing needs in this audit, we did note that Iowa's tax collection staff is about the same size as Kansas' collection staff, and handles about the same amount of taxes. This comparison, although limited, doesn't suggest that Kansas' tax collection function is understaffed.

Department officials also told us that Project 2000 will address some of these problems by automating some collection tasks that have had to be performed manually in the past. For example, the Division has begun using an automatic telephone dialer. This computerized system dials the taxpayers phone number, and screens out busy signals, no-answers, and answering machines. This frees up the collector's time, and allows more productive and frequent phone contacts. In addition, the new computer system has built-in routing features, which will move accounts automatically from one collection stage to another when certain events occur. For example, after an account has been in Stage I for 128 days, with some exceptions the computer system automatically will route that account to Stage II.

The Department's Audit Bureau Appears to Be a Cost-Efficient Part of Its Collection Efforts

The Department of Revenue's Audit Bureau conducts periodic audits of taxpayers. These audits address not only sales taxes but also other taxes collected by the Department, such as corporate income taxes. If the audit finds that the taxpayer hasn't remitted enough taxes to the Department, the Bureau assesses additional taxes. During fiscal year 1996, the Bureau's auditors assessed additional taxes due of about \$24 for every dollar spent by the Bureau. However, depending on the circumstances, the taxpayers might negotiate a settlement with the Bureau for less than the assessed amount, or the taxpayers might appeal the assessment and end up paying a lesser amount.

Even considering that not all audit assessments are eventually collected, the Bureau still is cost-efficient at bringing in additional tax moneys. The Department of Revenue historically has kept track of how much is collected based on its assessments, and has compared that figure to the cost of operating the Audit Bureau. Although those figures don't report sales taxes separately from other taxes, they should be representative of the cost-efficiency of the Bureau in bringing in additional sales tax dollars. Those figures show that the Bureau is a cost-efficient part of the Department's collection efforts, bringing in an average of \$12 for every \$1 spent during the most recent five fiscal years. The annual comparative figures are shown below.

Audit Bureau Assessment Collected From All Taxes Compared to Costs			
Fiscal Year	Assessments Collected (in millions)	Bureau Expenditures (in millions)	Revenues Collected per \$1 Spent
1992	\$ 25.9	\$ 2.5	\$ 10
1993	27.1	2.5	11
1994	48.4	2.7	18
1995	30.0	2.8	11
1996	27.0	2.8	10
5-Year Average	\$ 31.7	\$ 2.7	\$ 12

A change in the Department's perspective on the Audit Bureau's function will change the Bureau's way of selecting businesses to audit. Historically, the Bureau has selected businesses to audit based on the likelihood of generating a large assessment of additional taxes. That was based on the Bureau's primary goal of bringing in as much additional tax revenue as possible. However, according to Department officials, by late 1997 the Bureau will have a new primary goal.

That goal will be to audit samples of companies within specific segments of the business community, and determine whether there is a lack of compliance with the sales tax laws within that segment. If specific problems are detected, the Department will implement a plan to educate all taxpayers within that segment about the problem areas, and work to achieve overall compliance. In that way, the Department intends to improve taxpayers' compliance with the law, and correspondingly increase tax collections.

It's clear that this new process will change the way the Bureau selects businesses for audit. Department officials told us that, in the long run, they expect audit assessments to decrease.

The Tax Discovery Unit Is Having Success at Finding Unregistered Taxpayers

As a part of Project 2000, the Department of Revenue and its contractor for the project, American Management Systems, Inc. (AMS), formed the Tax Discovery Unit. The Unit began operating in October 1995. The purpose of the Unit is to identify taxpayers that:

- aren't registered with the Department, and aren't paying any taxes at all
- are registered, but aren't remitting the proper types of taxes

To identify such taxpayers, the Unit obtains computerized data about taxpayers, such as their names, addresses, and tax identification numbers, from organizations like the Kansas Bar Association, or from building permits issued by cities. The Unit then does a computer match against Department records. Businesses that don't show up in the Department's records are investigated by Unit staff. After eliminating any obvious errors, Unit staff contact the remaining taxpayers, make various inquiries, and determine whether those taxpayers are remitting all the taxes that should be paid. For example, a business that sells merchandise at retail should be remitting at least two types of taxes — sales tax and employee withholding (income) tax. When the Unit "discovers" a taxpayer who isn't in full compliance with Kansas tax laws, the Unit works with that taxpayer to get him or her registered. The main focus of the Unit is to get taxpayers registered and in compliance in the present. Its secondary task is to collect for unpaid taxes from the past.

Tax Discovery Unit statistics indicate that, through September 13, 1996, the Unit had discovered 967 businesses that weren't remitting one or more taxes to the State. These businesses have paid a total of \$951,000 in back taxes. Below is a brief summary of one of the Unit's best "discoveries" to date.

Through an analysis of carwashes, the Unit identified a carwash facility in western Kansas that hadn't remitted any sales tax since at least 1986. By working with the business' accountant, the Unit determined the unpaid sales tax liability to be about \$95,000 through the end of 1995, not including any amount for past due interest and penalty. The carwash paid about \$28,000 on this debt, plus about \$3,500 in interest. Department staff agreed to forego the remaining tax liability. The carwash also paid about \$9,200 for its sales tax liability for the first two quarters of 1996, and is now filing monthly sales tax returns.

According to Unit staff, the carwash's accountant, a certified public accountant, told them he was unaware the carwash was supposed to be collecting and remitting sales tax for this service. He claimed ignorance of the law.

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.

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, its new role in the Department's education process likely will cause audit assessments to decrease in the long run. Again, this process should be monitored over time to ensure the Department is achieving the results it intends.

Recommendations

1. To monitor and improve its effectiveness and cost-efficiency, the Department's Division of Collections should do the following:
 - a. 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. The Department should then use that information to help assess ways to adjust or streamline its collection process accordingly.
 - b. adopt a target figure for the Division to collect (expressed as a percentage of the amount assigned to it for collection) and periodically assess how well it has met that target.
2. To improve its collection practices, the Division of Collections should do the following:
 - a. review the assigned collection stage for each delinquent sales tax account to see if it's appropriate, and make adjustments as necessary.
 - b. periodically review its delinquent tax accounts for situations where no collection efforts have been made for some time, and take corrective action.
 - c. periodically analyze delinquent tax accounts that haven't been 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.
3. To fully protect the State's interest in past due delinquent sales tax accounts, the Division of Collections should file tax warrants on a timely basis, as called for by Division policies.
4. To ensure that the new approach the Audit Bureau plans to use for selecting businesses to audit is effective, the Department of Revenue should monitor for improvement in voluntary compliance with sales tax laws that might be attributable to that new approach.

Is the Sales Tax Exemption Program Administered Consistently, Fairly, and According to State Law?

In any sales transaction, the Department of Revenue has placed the "burden of proof" on the seller for deciding whether a sales tax exemption requested by a buyer should be granted. If the seller grants the exemption, Department auditors later may decide that the transaction shouldn't have been exempted from sales tax, even if the seller made what he or she considered to be a "good-faith" effort to determine whether the transaction should be tax-exempt. The Department also requires the seller to pay any tax he or she failed to collect from the buyer. Although many view this process as unfair, it's essentially the same process followed by all other states we contacted. Other options for treating sales tax exemptions have both advantages and disadvantages to either the State, the buyer, or the retailer.

Beyond the "burden-of-proof" issue, we found that the way the Sales Tax Exemption Program is administered isn't always consistent, fair, or in accordance with State law. One contributing factor is that some areas of the law are difficult to interpret. Department auditors usually don't document the reasons why they reject a sales tax exemption, which means neither we nor Audit Bureau managers can tell whether the auditors' determinations were proper or consistent. Our in-depth review of several cases revealed a number of inconsistencies, and audit staff acknowledged there are many inconsistent interpretations and other problems within the Bureau. They pointed to poor training, lack of written guidance, and inadequate supervision as parts of the cause. In one case, the Bureau directed staff not to enforce a regulation related to sales tax exemptions that was on the books. Such actions make it even more difficult for sellers of goods and services to know what's required of them, and which exemptions will be acceptable. These and other findings are presented in the following sections.

The Department of Revenue Makes Sellers of Goods and Services Responsible for Deciding Whether to Grant an Exemption

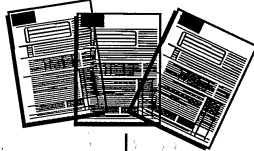
State law imposes a sales tax on the retail sale of tangible, personal property, or on any of the services listed in the Kansas Retailers' Sales Tax Act. For example, people pay sales tax when they buy groceries or other items from Wal-Mart. They also pay sales tax on labor services, such as when a plumber makes repairs on their homes. However, items that sellers buy to resell to someone else, such as the clothing or lawn mowers Wal-Mart buys, aren't taxed when the seller buys them. The exemptions written into the law are listed in Appendix B.

Buyers of goods or services who think what they're buying is exempt from sales tax request an exemption from that tax. Through its administrative regulations, the Department of Revenue has placed the "burden of proof" on the seller for deciding whether an exemption requested by a buyer should be granted.

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. An exemption certificate is a paper document developed by the Department of

Collection of Sales Taxes in the State of Kansas

Step 1: The seller registers with the State as a business operating in Kansas.



Step 2: A buyer makes a purchase from the seller.



If the buyer doesn't claim the transaction is exempt from sales taxes:

If the buyer claims the transaction is exempt from sales taxes:

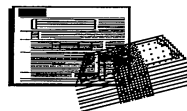
Step 3: The seller calculates the amount of sales taxes owed on the transaction. The buyer remits this amount as part of his or her payment for the purchase.



Step 3: The buyer gives an exemption certificate to the seller, who decides if the transaction should be exempted from sales taxes.



Step 4: The seller submits a sales tax return to the Department. The seller also remits the funds collected for sales taxes since the last return was submitted.



Step 5: The Department's staff check the sales tax return for accuracy, and post the seller's remittance to the seller's account.



Step 6: If there are any outstanding balances on the seller's account, the Department's staff works to collect those amounts from the seller.



Step 7: The Department may send an auditor to review the seller's company records, including exemption certificates, and possibly assess the seller for additional sales taxes.



Revenue that sets out in detail the reasons why the sale is exempt from sales tax. Blank certificates are readily available, and anyone can obtain one, complete it, and give it to a seller.

The Department of Revenue doesn't approve these documents prior to their use. In fact, the Department won't see completed exemption certificates unless they're examined in the course of an audit. As a result, sellers are responsible for the day-to-day administration of the State's sales tax exemption program. If the seller thinks the sale qualifies for an exemption from sales tax, he or she doesn't charge the tax. If the seller thinks the sale doesn't qualify for an exemption, he or she does charge the tax.

Currently, the Department has approved the use of 24 different exemption certificates. Examples of two certificates are shown in Appendix C. The buyer must completely fill out an exemption certificate before it becomes valid. That includes identifying the buyer's name, a description of the property or services being purchased, and the seller's name. Sellers aren't required to submit the exemption certificates they receive from buyers to the Department of Revenue. But they are expected to keep exemption certificates on file with their other sales tax records.

In addition to making sure the certificate is filled out completely, the Department of Revenue, through administrative regulations, requires the seller to make a reasonable and prudent inquiry of the buyer regarding the item being purchased and the basis for the exemption claimed. When Department auditors subsequently review a transaction to determine whether it should have been exempted from sales tax, two criteria they analyze are the "should have known" and "good faith" tests.

The "should have known" criterion means the seller should have a sufficient understanding of the sales tax law to know whether to exempt a transaction from sales tax. The "good faith" criterion applies only to Kansas "resale" exemption certificates. "Good faith" means there was no evidence to indicate the seller didn't fulfill his or her duties as a retailer.

Department regulations provide that a seller shall be presumed to have taken a resale certificate "in good faith" in the absence of evidence to the contrary, and specify the evidence that would overcome that presumption. Such evidence would include sellers exempting the purchase of items that aren't the type normally sold by the buyer. The box on the facing page provides additional information about the "should have known" and "good faith" tests.

When Department auditors audit a seller, they review transactions exempted from sales tax to determine whether those sales should have been exempted. As part of that review, the auditors examine the applicable exemption certificates submitted by buyers. In some cases, the auditors' decision is easy to make—for example, if an exemption certificate is missing or not completed. In other cases, the decision is more difficult—for example, if there's a question about whether the product sold was used as claimed by the buyer.

If the Audit Bureau determines that a transaction shouldn't have been exempted from sales tax, additional sales tax is owed to the State. The Department's

**Sometimes the Answers to the "Should Have Known" and "Good Faith" Tests
Are Easy to Determine, and Sometimes They Are Difficult**

Administrative regulations specify that sellers must make a reasonable inquiry of the buyer regarding the item purchased and the basis for the exemption claimed. When auditors review a transaction, to determine whether it should be exempt from sales tax, the two criteria they should analyze are the "should have known" and "good faith" tests.

According to administrative regulations, "should have known" means the seller should possess the knowledge to know whether to exempt a transaction from sales tax. Two examples are shown below.

The agricultural exemption allows certain people to purchase property or services tax exempt because it will be used exclusively in farming, ranching, or aquaculture. If a farmer tries to buy a television set and claim an exemption, it's very likely that auditors would disallow that exemption because the seller should have known that television sets aren't used to directly enhance farming, ranching, or aquacultural interests.

On the other hand, if a farmer buys spark plugs, the seller wouldn't know whether the farmer intended to use those spark plugs on farming equipment or on his personal automobile. If the spark plugs were to be used on a tractor, the sale would be exempt from sales tax. If they were intended to be used on the personal automobile, the transaction would be taxable. In this case, there's no way a seller could have known about the intended use; that's why the State requires sellers to inquire about the "intended use" of the merchandise.

The "good faith" criterion applies only to exemption certificates for the purchase of goods that later will be resold. When the Bureau's auditors review a taxpayer's records, they're supposed to assume that the taxpayer accepted resale exemption certificates in good faith, unless they can find evidence to the contrary. According to the Department's administrative regulations, such evidence would include the following:

- The taxpayer exempts items that are not the type normally sold by the buyer.
- The taxpayer repeatedly fails to obtain exemption certificates on exempted sales.
- The taxpayer solicits improper resale exemption certificates.
- The taxpayer honors certificates that don't have a Kansas sales or compensating (use) retail registration number.

general policy is to assess those additional taxes against the seller, rather than against the buyer who didn't pay the tax. The Department's rationale for that policy is that State law makes the seller responsible for collecting the tax, and that it's too difficult for the Department to attempt to collect sales tax from numerous buyers, as opposed to just one seller.

Sales tax audits issued between March and July 1996 showed that the auditors assessed about \$415,000 in additional sales taxes because they had questions about exemption certificates accepted by sellers. More than 80% of this amount is related to the sale of items that subsequently would be "resold" by the buyer, or to items the buyer reportedly intended to use in producing other products. The Department asked the sellers to pay these additional taxes. However, the actual amounts paid could be significantly different from the amounts assessed. That's because if the seller disagrees with the amount assessed, the seller has options for appealing the assessment. (See the box describing the appeals process on page 29.) Nevertheless, sellers generally end up paying some additional amounts.

Some businesses, especially those working with the construction industry, have raised concerns about the fairness of the Sales Tax Exemption Program. For example, in February 1995 the Senate Assessment and Taxation

Committee heard testimony about auditors' unfair treatment of certain businesses that had accepted exemption certificates. That Committee chastised the former Director of the Audit Bureau about this practice.

We spoke with Department officials and several people who testified before the Committee. They told us that, in late 1994 and early 1995, the Audit Bureau conducted several audits which produced large audit assessments, primarily because of the disallowance of exemption certificates. Several of the audits were of businesses that sell building and construction materials. These businesses complained to Department management and their legislators about the approach taken by the Department's sales tax auditors. According to these businesses, they were taking sales tax exemption certificates in good faith, only later to have the auditors disallow them.

To combat this problem, several bills were proposed during the 1995 and 1996 legislative sessions that would have reduced the requirements placed on sellers to "make prudent inquiries of" buyers about their intended use of merchandise being purchased for resale. These bills would have made it much easier for sellers to comply with the good faith test. In the Department's view, however, these bills would have adversely impacted the Department's ability to hold seller's responsible for collecting sales taxes, as required by law. The Department didn't support these bills, and they didn't pass.

Although businesses that have been audited may not agree with the auditors' findings, they don't seem to have much problem with how the auditors conducted the audit. As part of our audit work, we surveyed 100 businesses that recently had been audited, and received responses back from 31. Those responses seem to indicate no serious problems with how the audits were conducted. Survey responses included the following:

- 24 of the businesses responding (77%) said they were satisfied with the way the auditors conducted the audit; only 1 business disagreed with this statement
- 22 of the businesses responding (71%) said the auditors were fair and impartial; only two businesses disagreed with this statement
- 22 of the businesses responding (71%) said the auditors clearly explained why they questioned certain transactions; only three businesses disagreed with this statement
- 29 of the businesses responding (94%) said the auditors were courteous; only 1 business disagreed with this statement

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

In this audit, we contacted officials in six other states and made various inquiries about how they administer their sales tax laws, and how they handle transactions that are exempted from sales tax. All the other states' officials we contacted said they use exemption certificates to document reasons for not charging sales tax, and the only way they check for compliance with the sales tax law is to have their auditors conduct sales tax audits.

These states, like Kansas, hold sellers responsible for determining whether exemption certificates should be accepted, and usually hold sellers responsible for paying the sales tax if an exemption is disallowed. The following table provides information about Kansas' and certain other states' policies and procedures for sales tax exemptions.

Sales Tax Exemption Policies and Procedures In Kansas and Other States				
State	Party Responsible for Collecting Sales Tax	Is This Party Compensated?	Action Required to Verify Exemption	Party Responsible for Paying Sales Tax if Exemption is Disallowed
Arkansas	Seller	No	Sellers must compare sale to laws to determine if actually exempt	Usually the seller
Florida	Seller	Yes	Sellers must check the certificate against the sale to ensure correctness and compliance with the law	Usually the seller
Iowa	Seller	No	Sellers must question the buyer to determine if the exemption is valid	Usually the seller
Kansas	Seller	No	Sellers must question the buyer to determine if the exemption is valid	Usually the seller
Minnesota	Seller	No	Sellers must question the buyer to determine if the exemption is valid	Usually the seller
Nebraska	Seller	Yes	Sellers must know the laws and use this information to determine if the exemption is valid	Usually the seller
Oklahoma	Seller	Yes	Sellers must use good faith and get complete paperwork	Usually the seller

According to the literature we read during this audit, 45 states impose sales taxes, and all these states operate in a similar manner to that described in the table.

Other ways of handling sales tax exemptions would have advantages and disadvantages. One option—requiring sales taxes to be paid on all purchases, and allowing buyers to request refunds from the Department for purchases that are tax-exempt—would remove the burden of proof from the seller completely and place it with the Department. This option is similar to the way exemptions for motor fuels taxes are handled. However, handling sales tax exemptions this way likely would require the Department to create a large bureaucracy to administer the Program.

Another way to relieve the burden on sellers would be to make the buyer responsible for paying the sales tax if an exemption later were disallowed. If buyers knew the Department would come consistently after them to pay the tax, they may be more careful about the exemptions they claim. However, this approach would involve significantly more time and resources from the Department.

These options, and some of the advantages and disadvantages of each, are shown in the table on the facing page.

Some Aspects of the Sales Tax Law Make It Difficult For Sellers to Know Whether a Sale Should Be Exempted

In 1995, the Taxpayer Assistance Bureau received more than 30,000 phone calls from taxpayers who had questions about how to interpret or apply the sales tax laws. In this audit, we interviewed Department officials, representatives of trade associations, and a sample of businessmen. All seemed to agree that the laws aren't always clear or easy to deal with. In addition, 41% of the audited businesses we surveyed said the sales tax law wasn't clearly written, while only 26% thought it was. Specific issues that came up in those discussions or arose during our analysis are presented below.

- *The law allows a large number of exemptions.* Currently, State law provides for about 50 different exemptions from sales tax. That can make it difficult for a seller to know about all the exemptions he or she should know about. This can be especially difficult for certain sellers—such as grocery stores, discount department stores, lumber yards, and the like—that might have dozens or hundreds of clerks faced with making sales tax exemption decisions.
- *Parts of the law pertaining to contractors are difficult to apply.* For example, sales of supplies to a contractor who has an inventory of supplies aren't taxable, while sales of supplies to a contractor who doesn't have an inventory are. It's very difficult for even an informed seller to know whether or not the buyer has an inventory. Department staff go so far as to say the parts of the law pertaining to contractors are illogical and contradictory.
- *Parts of the law exempting the sale of an "ingredient or component part" and items "consumed in production" can be difficult to apply.* These two sections can apply to many varied situations, and therefore it's difficult to handle all situations consistently. For example, paper napkins, plastic silverware, and take-out containers are exempt when purchased by a restaurant. Also, propane and diesel fuel are exempt when they are used to produce hot asphalt.
- *The exemption of sales of "major" components of manufacturing machines is difficult to apply.* Because the law doesn't define the term "major," it's almost impossible for a seller to know whether a particular sale should be exempted. For example, taxpayers sometimes consider small replacement parts, such as spark plugs and belts, to be major components because the machinery won't run without them. However, auditors only consider replacement parts to be major when the cost is capitalized.

Alternative Methods of Collecting Sales Taxes Due When a Sale Is Exempted From Sales Tax in Error

Options	Advantages	Disadvantages
Current Practice: Usually pursue the retailer for uncollected sales tax	• It is more cost-effective to pursue the retailer. It doesn't take as much time and manpower to work with one business as it would to pursue many buyers. • Other states, in most cases, hold the retailer responsible for collecting sales taxes, so Kansas' practices are in keeping with national trends.	• The buyer is the one who benefited because he/she didn't pay the sales tax, but the retailer is required to pay if Department auditors decide the tax should have been paid. • The retailer may have done everything expected to make sure an exemption was valid, but still may have to pay the sales tax if Department auditors decide it should have been paid.
Option 1: Pursue the buyer for uncollected sales tax	• The buyer who owed the tax would be required to pay it. • If a buyer gives a bad certificate to one retailer, he/she may be handing out bad certificates to other retailers. Pursuing the buyer may stop this practice.	• In some audits, there may be many buyers to pursue, which would require the Department to spend more resources collecting the taxes owed. Department officials told us they don't have the resources to pursue all the buyers who owe sales taxes.
Option 2: Require sales taxes to be paid on all purchases, and allow buyers to request a sales tax refund for purchases that are tax exempt	• Retailers wouldn't have to deal with exemptions, which would lessen their responsibilities. • The State could earn interest income on the additional sales tax revenues it receives while waiting for taxpayers to request their refunds.	• This would require the Department to add staff and create a new bureaucracy. Department costs would increase. • Businesses would have to wait for their refund payment before they could invest that money in their business.

- *The terms "good faith" and "should have known" are difficult to interpret. These terms apply to audits of exemption certificates, and the sellers' acceptance of those certificates. The Department of Revenue and businesses disagree over the meanings of these terms, and the degree to which a seller should be expected to "investigate" a customer's business before granting a sales tax exemption. Although the Department says it only requires good judgment and common sense, sellers think the Department is asking them to "grill" each customer about the intended use of the items being purchased.*
- *Buyers aren't required to provide enough information to sellers so that sellers can make informed decisions about exempting sales. State law requires sellers*

to base their decisions on knowledge about the buyers' businesses, including the intended use of the products purchased. The buyer is required to provide an exemption certificate, but that certificate doesn't provide the kind of information the seller needs to make his or her decision. As a result, Department auditors may question transactions that should be exempt just because they appear to be out of the ordinary. Take the situation where a car dealer buys plywood from a lumber store. That transaction would seem to be the purchase of an item not normally resold by the buyer. However, if the car dealer intended to use the plywood to customize vans, and was required to provide this additional information on the exemption certificate, both the seller and Department auditors would have information that could justify the exemption.

The Department of Revenue could attempt to clarify some of the hard-to-apply provisions of the law through administrative regulations. Although the Department is authorized to issue administrative regulations to implement State law, Department officials told us they've been reluctant to modify the regulations because they think the Legislature should clarify ambiguities in the law first. However, if the Department issued administrative regulations, those regulations still would be subject to legislative review before becoming final.

Department of Revenue Auditors Haven't Always Been Consistent When Reviewing Exempted Sales

We tried to review a sample of audits to determine if the auditors consistently handled similar kinds of transactions. However, the auditors' documentation was

The Department Is Conducting More Seizures Now Than in the Past

The Collections Division has changed its focus from closing down businesses who don't remit their sales taxes to performing more seizures of liquid assets. A combination of fewer Division attorneys, and a change in leadership in late 1994 is responsible for this change of tactic. Now instead of filing injunctions, which prohibit the business from operating due to violations of the sales tax law, the Division is conducting more and more seizures to satisfy the past-due debt. Injunctions do remain an option and are considered the last resort to collect past-due debt.

The number of injunctions filed has dropped from 53 in calendar year 1992 and 65 in calendar year 1993, to 6 in calendar year 1995. Since December, 1994 the Division has conducted 166 seizures, and before that time seizures were very rare, according to Department officials. Of these 166 seizures, 37 resulted in the Division obtaining enough money to satisfy the tax debt. To-date, the largest amount collected in a seizure was \$320,000, and 52 seizures have yielded amounts greater than \$10,000.

Businesses Complained About the Sales Tax Laws But Didn't Complain About the Department's Sales Tax Auditors

We surveyed a random sample of businesses recently audited by the Department's sales tax auditors. Overall, those who responded spoke favorably of the auditors. However, 14 of the 31 respondents, or 45.2%, made a comment somewhere on their response noting that the State's sales tax laws are confusing, and/or need revision. Some of the specific comments were:

- "The laws are too vague and subject to misinterpretation or different interpretations by each different auditor."
- "The laws are 'very confusing for a small contractor.' The State 'needs one rate. Hard to decide what is exempt.'"
- "I think all tax law is too wordy for the average person to decipher or comprehend."

**The Department Estimates that the Sales Tax Exemptions Written into the Law
Cost the State About \$2.5 Billion Per Year In Lost Revenues**

One question legislators frequently ask is how much tax revenue does the State forego when it implements a sales tax exemption. Responsibility for developing the "cost" estimate for each exemption rests with the Bureau of Research and Revenue Analysis within the Department of Revenue.

We obtained the Bureau's most recent estimate for the amount of sales tax revenue foregone through sales tax exemptions. According to the Department's estimate, the exemptions in the law "cost" the State nearly \$2.5 billion each year. More than \$2 billion is attributable to the exemptions specified in K.S.A. 79-3606, and the remaining amounts are attributable to the exemptions specified in K.S.A. 79-3603. The sales tax exemptions fall into the following three general categories:

- *Buyers.* Direct purchases by certain agencies or groups are exempt from sales tax because of who they are; for example, government agencies and nonprofit hospitals. The Department estimates the value of these exemptions to be \$215 million.
- *Items.* Specific items purchased by certain industries and groups are exempt from sales tax because of the type of item purchased; for example, farm machinery and lottery tickets. The Department estimates the value of these exemptions to be more than \$1 billion.
- *Uses.* Other items are exempt from sales tax because of how they are used; for example, items that are consumed in production, and items that become part of a larger whole or finished product. The Department estimates the value of these exemptions at more than \$1.2 billion.

Of these three groupings, only the first two exclude the taxing of retail transactions, which represents real sales tax foregone. The third grouping—the use exemption—merely ensures that only the final retail transaction is taxed.

A complete listing of the exemptions and the estimated lost revenues is listed in Appendix B.

insufficient to allow us to do that. Although the Department's audit reports and workpapers listed the specific transactions the auditors questioned, those documents didn't indicate the reasons why specific transactions were questioned. For example, we might see a transaction was disallowed because the auditor had a problem with an exemption certificate, but it wasn't clear from the audit workpapers whether the problem was an incomplete certificate, a certificate that didn't fit the circumstances, or a certificate that simply wasn't there.

Without such information, we couldn't tell whether the auditors' judgments were consistent or appropriate. More importantly, without that information the Audit Bureau itself can't ensure that its auditors are doing their jobs in a proper and consistent manner. We think the Audit Bureau needs to improve significantly in this area.

To review the consistency and appropriateness of the Audit Bureau's work, we had to rely on interviews of the Bureau's staff (all four audit managers and about one-third of the staff that actually conduct sales tax audits), and a detailed review of three specific cases brought to our attention. That work, although more limited than we would have liked, did point out several problems. Those are discussed on the following page.

The audit managers and auditors we interviewed acknowledged that they handle exempted transactions inconsistently. They said such inconsistencies were likely, at least among different offices. Further, their responses indicated significantly different attitudes and approaches to their work. For example, some auditors measure the success of an audit by the amount of the tax assessment generated, while others say they try to educate the taxpayer about the sales tax law and will give the benefit of the doubt to the taxpayer in many occasions.

Along these same lines, auditors gave considerably different answers about how they would handle a transaction involving an exemption certificate that is completely filled out, but may not fit the circumstances. Some auditors said they would question it, while others said they would not. Some auditors said they would make an audit referral on the buyer (recommend that the Bureau audit the buyer), and others said they would not. The disparity between the types of answers we received to these types of questions shows that Audit Bureau staff aren't consistent in their approach to auditing, and therefore aren't treating taxpayers consistently.

Finally, staff we interviewed expressed many concerns and complaints about the Audit Bureau's operations. Some of the items cited were minor in nature, but others represent significant problems for the Audit Bureau. The more significant problems are listed below.

- The Bureau doesn't have an up-to-date policy and procedures manual for staff to use and consult for guidance when problem situations arise.
- All the staff auditors said that, unless they specifically ask for it, they don't receive supervision or assistance from the audit managers when they are in the field doing audit work.
- Nearly all the Bureau's auditors and audit managers expressed some doubt about whether the Bureau treats all taxpayers and handles similar transactions consistently. Auditors are based in Wichita, Kansas City and Topeka, and there was general agreement that within each office, auditors generally do about the same thing. But because of the attitude of different managers, most staff thought there was inconsistency among the three offices.
- In all, 11 of the 16 auditors and audit managers interviewed (69%) described the Bureau's training program as insufficient or said it needs improvement.

In November 1995, the Audit Bureau instructed its staff not to enforce an administrative regulation relating to sales tax exemptions. Department administrative regulations specify that all tools, equipment, and machinery purchased to perform construction services are subject to sales tax. However, in late 1995 the Department of Revenue was receiving an increasing number of complaints from members of the construction industry and legislators about its ongoing rejection of exemption certificates.

In response to this situation, the Audit Bureau issued a memorandum instructing its staff to honor any resale exemption certificates sellers had granted for the purchase of contractor materials and supplies, and for tools, equipment, and machinery used to perform construction services "until further notice." The memorandum says the policy change was being made in an effort to appease the

Formal Appeals Are Filed on About 20% of the Sales Tax Audits Issued by the Audit Bureau

One way to gauge the fairness of sales tax audits is to determine how many or how often sales tax audits get appealed. The reasons for appeals are varied and depend upon the individual situation. But one common reason is that the taxpayer feels the amount of the assessment is more than it should be. Initially when an audit is appealed, the Audit Bureau tries to resolve the appeal by working with the taxpayer. We tried to get data on the number of appeals the Audit Bureau resolves, but Bureau officials told us their data was incomplete.

When taxpayers are unable to resolve their appeal with the Audit Bureau, the next step is to make a formal appeal. In calendar year 1995, the Department of Revenue received 213 notices that auditees wanted to formally appeal their sales tax audits. In fiscal year 1995, the Audit Bureau issued 1,043 sales tax audits. Because of timing differences these numbers aren't exactly comparable, but these data indicate that approximately 20% of the audit reports issued were appealed formally.

The appeal process is overseen by a Department administrative law judge. Ultimately, the administrative law judge rules on the issues in the case and decides the final assessment amount the taxpayer must pay. This amount may be as much as 100% of the original assessment, or it may be as little as nothing. The following table shows the outcomes on appeals settled in calendar year 1995, and in calendar year 1996 through September 30, 1996.

**Formal Appeals of Sales Tax Audits
Calendar Year 1995 and Calendar Year 1996 through September 30**

	<u>1995</u>	<u>1996</u> <u>(First 9 months)</u>
Number of Appeals Filed	213	178
Number of Appeals Resolved	218	159
Total Amount of Assessments for Settled Appeals	\$10.1 million	\$5.6 million
Total Amount of Settlements for Settled Appeals	\$4.2 million	\$3.0 million
Difference Between Assessments and Settlements	\$5.9 million	\$2.6 million
Percent of the Assessments That Were Negotiated Away	58.6%	45.7%
Average Audit Appeal	\$46,194	\$35,270
Average Audit Settlement	\$19,139	\$19,145
Average Audit Difference	\$27,055	\$16,126

As the table shows, the administrative law judge closed 218 cases in 1995, and 159 through September 30, 1996. The average assessment for the 1995 cases was slightly more than \$46,000. The average settlement for these cases was slightly more than \$19,000. This means the Department negotiated away more than 58% of the original assessments. For 1996, the Department has negotiated away almost 46% of the original assessments.

Department officials cite basic three reasons for assessments being reduced.

- Often penalties are abated when taxpayers appeal the assessment.
- Sales tax assessment amounts related to "gray areas" are abated because the Department can't be certain the taxpayers actually owe these dollars. According to some of the auditors we interviewed, this happens because they may list a transaction even when they aren't certain the taxpayer has erred and owes taxes. But the auditors think that, because the taxpayer can appeal the assessment, it's better to err on the State's side.
- Other amounts are abated because taxpayers provide better information than what was available during the audit, and this information shows the taxpayers don't owe the amounts.

construction industry, and thus preempt the legislation being proposed. This legislation would have reduced the requirements placed on sellers to "make prudent inquiries of" buyers.

According to Department officials, the change directing the audit staff to honor all contractor resale exemption certificates was made because they think the applicable parts of State law place unreasonable requirements on sellers. Under those circumstances, the Audit Bureau's change in policy regarding sales of materials and supplies could be seen as reasonable. However, purchases of tools, equipment, and machinery by a contractor don't seem to be difficult for a seller to deal with because such sales generally aren't exempted by law under any circumstances. Further, the Department's administrative regulations clearly require sales tax to be collected on such purchases. Given that situation, in our view, it wasn't appropriate for the Audit Bureau to allow these items to be purchased tax exempt. As of October 1996, this policy was still in effect.

The results of our three case studies also identified several problems with how the Audit Bureau deals with sales tax exemptions. In reviewing these cases, we interviewed the audit staff involved, interviewed representatives of the businesses involved, and reviewed applicable records and documents at the Department and two of the three business. In general, we found the following:

- In settling one case, the audit manager allowed exempt sales of hand tools, even though the Department's regulations specifically require hand tools to be taxed.
- In another case, the auditor sometimes accepted memos on customer letterhead and sales tax registration certificates as "proof" that a transaction was exempt from sales tax, when those documents clearly weren't exemption certificates and should have been rejected. The auditor sometimes rejected such documents, too.
- Although the Department's general policy is to hold the seller responsible for sales taxes on inappropriately exempted sales, the Audit Bureau audits businesses for sales tax on both sales and purchases. This practice raises the risk that sales tax on the same transaction could be assessed from both the buyer and the seller. In fact, we identified one such situation. The Bureau has made assessments against two businesses—one the seller and the other the buyer for the exact same transactions.
- In one case, it appeared the Audit Bureau wanted to hold a seller responsible for paying sales tax, even when it wasn't clear whether the sales were retail or wholesale transactions. This distinction is vital because sales of a product to a buyer who will be reselling that product aren't subject to sales tax.

In this case, a beverage company provided pop machines to business offices, and sold those offices soda pop to resell to employees. The Bureau argued that the machines belonged to the beverage company, which then was selling directly to the offices' employees. However, during the audit, the Bureau's auditors didn't contact any of the businesses with the soda pop machines to find out whether they saw themselves as the retailer and had remitted sales tax. This case is still in the appeals process.

About 13% of the Department's Active Appeal Cases Have Been Open for More Than Three years

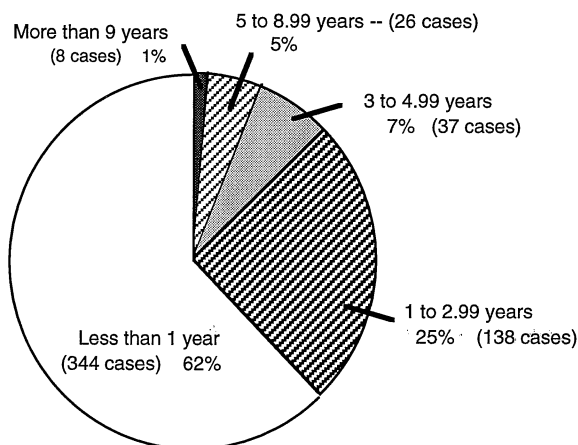
Recent newspaper articles have noted that the State of Kansas and its Department of Revenue have a poor reputation among businesses because of tax policies. One of the problems cited for contributing to this was the Department's backlog of audit appeals waiting for settlement.

We reviewed the Department's records on appeals to determine how long it takes to settle an appeal. Based on a sample of 49 cases that were closed in 1995 and 1996, the Department took an average of 202 days, or almost sev-

en months, to settle appeals. We also reviewed a listing of the cases that were open as of September 30, 1996, to learn how long those cases have been active. The chart below summarizes this information.

As the chart shows, about 13% of the appealed cases have been open for more than three years. The Department recognizes this as a problem, and recently instituted new procedures that are intended to speed up the settlement process and allow appeals to be settled in a more timely manner.

Age of the Department's Active Appeals



As of September 30, 1996, the Department had 556 active appeals that hadn't been settled. As the chart shows, the majority of these were less than one year old. But 71 appeals, or about 13%, were over three years old. The average age was 1.3 years. (No data were available for three cases.)

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.

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 acknowledge 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.

Recommendations

1. 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
2. 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, that 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 that are appealed and resolved by the Audit Bureau. The audit working papers also should show how and why audits were settled for amounts different than assessed in the official audit report.
3. To help sellers determine whether a transaction should be exempted from sales tax, the Department should amend its exemption certificate forms to require buyers to disclose how they intend to use the merchandise being purchased.

APPENDIX A

Properties or Services That Are Subject to Sales Tax

According to the State's sales tax laws in K.S.A. 79-3603, the gross receipts from 20 different categories of goods or services are subject to retailers' sales tax. Those categories are as follows.

- Retail sales of tangible personal property.
- Intrastate telephone or telegraph services.
- Sales or furnishing of gas, water, electricity, and heat.
- Sales of meals or drinks.
- Sales of admissions to any place providing amusement, entertainment, or recreation services.
- Operations of any coin-operated device dispensing or providing tangible personal property, amusement, or other services except laundry services.
- Hotel room rentals.
- Rentals or leases of tangible personal property.
- Dry cleaning, pressing, dyeing, and laundry services except those rendered through coin-operated devices.
- Washing and waxing services for vehicles.
- Cable, community antennae, and other subscriber radio and television services.
- Sales of tangible personal property to contractors, subcontractors, or repairmen for their use in building, improving, altering, or repairing real or personal property of others.
- Fees and charges by public and private clubs, drinking establishments, organizations, and businesses for participation in sports, games, and other recreational activities. (This does not apply to political subdivisions or organizations exclusively providing services to persons 18 years of age or younger.)
- Dues charged by public and private clubs, drinking establishments, organizations, and businesses to allow members the use of their facilities for recreation or entertainment.
- Sales of motor vehicles or trailers.
- Services of installing or applying tangible personal property.
- Services of repairing, servicing, altering, or maintaining tangible personal property.
- Fees or charges made under service or maintenance agreement contracts for services.
- Sales of computer software and sales of services to modify, alter, update, or maintain computer software.
- Telephone answering services, including mobile phone services, beeper services, and other similar services.

APPENDIX B

Estimated Costs to the State for Sales Tax Exemptions

We asked Department officials how much sales tax revenue is foregone due to sales tax exemptions. We obtained the Bureau of Research and Revenue Analysis' most recent estimate for the amount of sales tax revenue foregone for each sales tax exemption. According to the Department's estimate, the sales tax exemptions in the law "cost" the State nearly \$2.5 billion each year.

Classification of Sales Tax Exemptions				
Written into Kansas Law				
Classification of Exemption				
Statute	Exemption	Item	Buyer	Use
79-3603	All Services Exempt Specific Taxed	326,251,000		
79-3603	Original construction svcs now exempt	79,438,000		
79-3603	Admission to cultural & historical event triennial	1,153,000		
79-3603	Coin operated laundry	821,000		
79-3603	IRB's - machinery and equipment exempt	106,000		
79-3603	Motor vehicles & equipt. for stock	20,000		
79-3603	Political sub. rec. org. 18 yrs & under	n/a		
79-3603	Entry fee national sport event if spectators taxed	n/a		
79-3606	Ingredient or component part			1,044,750,000
79-3606	Animals, fowl, & aquatic plants for ag. use	267,346,000		
79-3606	Political subdivision: hospital, bloodbank		139,471,000	
79-3606	Consumed in production			132,624,000
79-3606	Tang pers. prop. taxed by excise tax	98,000,000		
79-3606	Gas, elect. water - residential use			62,144,000
79-3606	Machinery & equip. in prod.	49,000,000		
79-3606	Aircraft - sales & repair - interstate	41,437,000		
79-3606	Nonresident mtr. veh. & aircraft	40,572,000		
79-3606	Prop. pur. by contractor: if institution exempt		37,932,000	
79-3606	All farm machinery & equipment	37,401,000		
79-3606	Public or private school or ed. institution		29,631,000	
79-3606	Tang pers prop pur for interstate use	26,766,000		
79-3606	Prescription drugs	20,292,000		
79-3606	Enter. zone prop., serv., mach. & equip	13,605,000		
79-3606	Food stamps	6,341,000		
79-3606	Repair RR rolling stock - interstate	5,939,000		
79-3606	Prosthetic devices	5,765,000		
79-3606	Propane, LP - residential use			3,821,000
79-3606	Serv. by ad. agency or lices. broadcast station		3,689,000	
79-3606	Lottery tickets	3,430,000		
79-3606	Prop. pur. by contractor: if for US gov. exempt use		2,882,000	
79-3606	Used mobile homes for dwelling	2,557,000		
79-3606	Isolated or occasional sales	2,225,000		
79-3606	Lease/rental films, records, tape	2,070,000		
79-3606	Agricultural land seeds, trees	1,447,000		
79-3606	Food served employees	1,384,000		
79-3606	Rental of property used as dwelling/more 28 days			1,243,000
79-3606	40% of new mobile homes	964,000		
79-3606	WIC vouchers	907,000		
79-3606	Rentals of textbooks	849,000		
79-3606	Food for homebound	650,000		
79-3606	All sales, com.-based mental health,		608,000	
79-3606	Drill bits & explosives for oil & gas	352,000		
79-3606	Repair of pipeline equipment	312,000		
79-3606	Purchases, youth develop. programs		240,000	
79-3606	Pur. by museum, ect. for space exploration		231,000	
79-3606	Weatherization - low income	115,000		
79-3606	Admission annual event sponsored by nonprofit	115,000		
79-3606	Medical supp. & equip - nursing homes	114,000		
79-3606	Insulin	103,000		
79-3606	Public health educational matrls.	47,000		
79-3606	Groundwater mgt. district purch's		15,000	
79-3606	Port authority purchases		0	
79-3606	Pur. by public broadcasting station		n/a	
	subtotal	\$1,037,894,000	\$214,699,000	\$1,244,582,000
	Grand Total		\$2,497,175,000	

APPENDIX C

Two Exemption Certificates Currently Authorized by State Law

The following exemption certificates are two of more than 20 certificates currently authorized by State Law. These copies were obtained from the Department's "Kansas Exemption Certificates" booklet. Each page shows an example of the certificate, at the top of the page, and instructions for use at the bottom of the page.

**KANSAS DEPARTMENT OF REVENUE
RESALE EXEMPTION CERTIFICATE**

The undersigned **Kansas retailer** certifies that the tangible personal property purchased from:

Seller: _____
Business Name

Address: _____
Street, RR or P. O. Box City State Zip + 4

will be resold by me in the form of tangible personal property. I hereby certify that I hold valid Kansas sales tax registration number _____, and I am in the business of selling _____
(Attach copy of certificate)

(Description of product(s) sold - food, clothing, furniture, etc.)

Description of tangible personal property purchased:

I understand and agree that if the items purchased with this certificate are used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business, I am required to report and pay the sales tax, based upon the purchase price of the items.

Purchaser: _____
Kansas Retailer Name

Address: _____
Street, RR or P.O. Box City State Zip + 4

Authorized Signature: _____ Date: _____

THIS CERTIFICATE IS NOT VALID UNLESS COMPLETED IN ITS ENTIRETY.

WHO MAY USE THIS CERTIFICATE?

Only those businesses that are registered to collect Kansas sales tax and provide their valid Kansas sales tax number on this form may use this certificate to purchase inventory without tax. A copy of the buyer's Kansas certificate of sales tax registration may be attached to this form to verify the number given. See also "Resale Exemption Certificate Requirements" on page 2 of this booklet.

Non-profit groups and organizations will also use this certificate when buying items to be resold at a fund raising event, provided they have a temporary or permanent Kansas sales tax number issued by the Kansas Department of Revenue.

Wholesalers and buyers from other states not registered in Kansas should use the multi-jurisdiction exemption certificate on page 20 to purchase their inventory. HOWEVER, if the inventory item purchased by an out-of-state buyer is drop shipped to a Kansas location, the out-of-state buyer must provide a Kansas sales tax number, either on this certificate or the multi-jurisdiction exemption certificate, for the sale to be exempt.

Contractors, subcontractors, or repairmen may NOT use this certificate to purchase their materials, parts, or tools. Retailer/Contractors (defined on page 7) should use the Retailer/Contractor exemption certificate on page 35 to purchase their inventory.

WHAT PURCHASES ARE EXEMPT?

Only goods or merchandise intended for resale (inventory) are exempt. Tools, equipment, fixtures, supplies, and other items purchased for business or personal use are TAXABLE since the buyer is the final consumer of the property.

The items purchased with this certificate must correspond to the type of business buying them. For example, a retail clothing store may only reasonably purchase items of wearing apparel and accessories with this certificate. All other kinds of items are not usually sold by a clothing store to their customers and, therefore, cannot be purchased with this certificate. Refer to the example on page 3 of this booklet.

LABOR SERVICES

This certificate applies ONLY to items of tangible personal property. A contractor may not use an exemption certificate to purchase the labor services of another contractor or subcontractor. Taxable labor services performed by a contractor CANNOT be purchased exempt from sales tax unless a valid project exemption certificate has been provided. Refer to pages 7 and 8 of this booklet.

KANSAS DEPARTMENT OF REVENUE
INGREDIENT OR COMPONENT PART EXEMPTION CERTIFICATE

The undersigned purchaser certifies that the tangible personal property purchased from:

Seller: _____
Business Name

Address: _____
Street, RR, or P. O. Box City State Zip + 4

is exempt from Kansas sales and compensating use tax for the following reason:

K.S.A. 79-3606(m) exempts all sales of tangible personal property that becomes an ingredient or component part of tangible personal property or services produced, manufactured or compounded for ultimate sale at retail within or without the state of Kansas.

Description of tangible personal property purchased:

The undersigned understands and agrees that if the tangible personal property is used other than as stated above or for any other purpose that is not exempt from sales or compensating tax, the undersigned purchaser becomes liable for the tax.

Purchaser: _____
Business Name

Kansas Tax Registration Number: _____
Kansas Sales Tax Number or Kansas Manufacturers' or Processors' Exemption Number

Address: _____
Street, RR or P. O. Box City State Zip + 4

Authorized Signature: _____ Date: _____

THIS CERTIFICATE IS NOT VALID UNLESS COMPLETED IN ITS ENTIRETY.

WHO MAY USE THIS CERTIFICATE? Any business registered in Kansas buying raw materials or parts that meet the definition of an ingredient or component part (page 5) may use this certificate. The buyer must have either a Kansas sales tax number or a Kansas Manufacturers' or Processors' Sales Tax Exemption Certificate Number (page 8). Buyers from other states that are not registered in Kansas should use the multi-jurisdiction exemption certificate on page 20 to purchase their ingredient or component parts.

WHAT PURCHASES ARE EXEMPT? Only items that meet the definition of an ingredient or component part (page 5) are exempt. Whether or not the item qualifies for exemption depends on **how it is used** in production or processing. An item may be taxable for one use and exempt for another use, even though purchased by the same consumer. Each item and its use must be separately measured against the definition to determine whether the sale is taxable or exempt.

CONTAINERS AND SHIPPING CASES: Included as ingredient or component parts are containers, labels, and shipping cases used to distribute property manufactured or produced for sale. To be exempt, the container or other shipping or handling material must actually accompany the product sold, and must NOT be returned for reuse to the manufacturer or producer. Containers, wrappers and other similar materials are **TAXABLE** when purchased by a business providing a nontaxable service or when used for any purpose other than the distribution and sale of taxable property.

EXAMPLES: The following items are exempt as ingredient or component parts when used in these industries or applications.

- Paper & ink used in the publication of newspapers.
- Clay, paints, & glazes used to make pottery or china.
- Stryofoam plates, cups, paper napkins, plastic silverware, and take-out containers purchased by a restaurant.
- Frames, springs, foam, & fabric used to make mattresses or furniture.
- Gold, silver, gems, & beads used to make jewelry.

PROVIDING OF SERVICES: The term "service" refers only to **TAXABLE** services. Businesses providing nontaxable services (accountants, doctors, lawyers, day care centers, etc.) must pay sales tax on all property used to provide their services.

CONTRACTORS: This certificate may **NOT** be used by contractors, subcontractors, and repairmen to purchase their materials. Materials and parts purchased by contractors are **TAXABLE** unless purchased or removed from a tax-exempt inventory with a project exemption certificate. (See page 8.)

APPENDIX D

Survey of Businesses That Were Audited by Department of Revenue Sales Tax Auditors

We obtained a list of names and addresses for the businesses audited by the Department's sales tax auditors during the past fiscal year. The list contained 670 names, and from this, we selected a random sample of 102 businesses to survey. Of these, 50 were located in-state and 52 were located out-of-state.

We mailed the survey on Monday, August 19, 1996. Generally, the survey asked for the businesses' opinions about the following:

- explanations provided to them about their audits
- the conduct of the auditors during the process
- the State's sales tax laws
- exemption certificates

We asked for scaled responses as follows: strongly agree, agree, neither agree nor disagree, disagree, or strongly disagree. Throughout this audit report, when referring to survey responses, we grouped strongly agree and agree, and we grouped strongly disagree and disagree.

Two surveys were returned because the address was no longer valid, which left 100 surveys that could have been returned. We received 31 completed surveys for a response rate of 31%.

SURVEY OF BUSINESSES THAT WERE AUDITED BY DEPARTMENT OF REVENUE SALES TAX AUDITORS

The Legislative Post Audit Committee has directed the Legislative Division of Post Audit to conduct a performance audit which reviews the Kansas Department of Revenue's sales tax enforcement and collection efforts. As part of the audit, we want to learn what retailers think about the sales tax audit process, whether retailers have any specific complaints, and whether retailers have any suggestions for improving the audit process. In addition, we want to learn what retailers think about other portions of Kansas sales tax law. To help gather this information, we are sending a survey to 100 retail business that were audited by the Department of Revenue since July 1, 1995.

We would appreciate it if you would take time to answer the following questions. The returned surveys will be included in the audit working papers which will become public once the audit is completed. Please return the completed surveys in the enclosed, self-addressed, postage - paid envelope by August 30, 1996. If you have questions, please contact Chris Clarke, Tracey Elmore, or Joseph Lawhon at Legislative Post Audit, 800 SW Jackson, Suite 1200, Topeka KS, 66612, or call 913-296-3792.

Please check the response that seems most appropriate to the following statements. A few statements ask you to list specific concerns or problems.

1. Department of Revenue auditors gave our business sufficient time to prepare for the audit.

32.3% Strongly Agree	61.3% Agree	6.4% Neither Agree nor Disagree	0.0% Disagree	0.0% Strongly Disagree
<i>Total of 93.6% agreeing</i>				

2. Upon arrival, the auditors clearly explained the purpose of the audit.

19.4% Strongly Agree	54.8% Agree	16.1% Neither Agree nor Disagree	9.7% Disagree	0.0% Strongly Disagree
<i>Total of 74.2% agreeing</i>				

3. Upon arrival, the auditors clearly explained the period of time the audit would cover.

22.6% Strongly Agree	67.7% Agree	9.7% Neither Agree nor Disagree	0.0% Disagree	0.0% Strongly Disagree
<i>Total of 90.3% agreeing</i>				

4. While conducting the audit, the auditors were courteous.

42.0% Strongly Agree	51.6% Agree	3.2% Neither Agree nor Disagree	3.2% Disagree	0.0% Strongly Disagree
<i>Total of 93.6% agreeing</i>				

5. When questioning the amount of sales tax collected on specific transactions, the auditors clearly explained the reasons why they were questioning those transactions.

19.4% Strongly Agree	51.5% Agree	19.4% Neither Agree nor Disagree	6.5% Disagree	3.2% Strongly Disagree
<i>Total of 70.9% agreeing</i>			<i>Total of 9.7% disagreeing</i>	

6. While conducting the audit, the auditors did not appear to have a preconceived plan for generating a tax assessment.

20.0% Strongly Agree	50.0% Agree	23.4% Neither Agree nor Disagree	3.3% Disagree	3.3% Strongly Disagree
<i>Total of 70.0% agreeing</i>			<i>Total of 6.6% disagreeing</i>	

7. While conducting the audit, the auditors took time to answer any questions we had about Kansas sales tax law, record-keeping practices, and the like.

32.3% Strongly Agree	38.7% Agree	19.3% Neither Agree nor Disagree	9.7% Disagree	0.0% Strongly Disagree
<i>Total of 71.0% agreeing</i>				

8. During the field exit conference, the auditors satisfactorily discussed the preliminary results of their audit.

16.1% Strongly Agree	61.3% Agree	9.7% Neither Agree nor Disagree	12.9% Disagree	0.0% Strongly Disagree
<i>Total of 77.4% agreeing</i>				

9. During the field exit conference, the auditors explained the appeal process.

16.1% Strongly Agree	61.3% Agree	12.9% Neither Agree nor Disagree	9.7% Disagree	0.0% Strongly Disagree
<i>Total of 77.4% agreeing</i>				

10. Throughout the audit, the auditors appeared to be fair and impartial.

35.5% Strongly Agree	35.5% Agree	22.6% Neither Agree nor Disagree	6.4% Disagree	0.0% Strongly Disagree
<i>Total of 71.0% agreeing</i>				

11. Overall, our business was satisfied with the way in which the auditors conducted the sales tax audit.

29.0% Strongly Agree	48.4% Agree	19.4% Neither Agree nor Disagree	0.0% Disagree	3.2% Strongly Disagree
<i>Total of 77.4% agreeing</i>				

12. If you have any specific complaints about the audit process, or any other information about the audit process that you would like to pass on, please list them here.

Ten, or 32.3%, of the respondents answered this question, making the following comments:

- The audit process was delayed.
- State laws are too vague and open to different interpretations by different auditors.
- My office should have been given the benefit of the doubt rather than assumed to be guilty.
- The fines and penalties assessed after an audit are too expensive.
- The Department's auditor was well prepared.
- The process was delayed which cost us additional interest.
- Our office can't collect taxes from offices that won't pay.
- The auditor didn't communicate the audit findings before the assessment was made.
- The audit process is one-sided.
- Our office is waiting for a response from the Department so we can file our sales tax returns.

13. If you have any suggestions for improving the audit process, please list them here.

Six, or 19.4%, of the respondents answered this question, making the following comments:

- The present laws and information guides should be trashed.
- Tax rates, penalties, and interest in Kansas should be lower.
- Audits should only cover the most recent year of business.
- Companies that won't pay taxes due to other companies should be audited.
- Exit conferences are needed so there will be no surprises.
- Taxpayers need more guidance from the Department on how to comply with State tax laws.

14. Kansas sales tax law is clearly written.

3.7% Strongly Agree	22.2% Agree	33.4% Neither Agree nor Disagree	18.5% Disagree	22.2% Strongly Disagree
<i>Total of 25.9% agreeing</i>			<i>Total of 40.7% disagreeing</i>	

- 14a. If you disagree, please identify the portions of the law that need to be revised, or the portions you find confusing.

- Three respondents, or 9.7%, said all parts of the laws are confusing and/or need revision.
- Three respondents, or 9.7%, said the parts of the laws regarding exemption certificates are confusing and/or need revision.
- Four respondents, or 12.9%, said the parts of the laws regarding construction are confusing and/or need revision.
- Two respondents, or 6.5%, had other comments.

15. State law does NOT place an unnecessary burden on my business by requiring my employees to determine whether a buyer's claim to exempt a transaction from sales tax is valid.

3.5% Strongly Agree	13.8% Agree	44.8% Neither Agree nor Disagree	17.2% Disagree	20.7% Strongly Disagree
<i>Total of 17.3% agreeing</i>			<i>Total of 37.9% disagreeing</i>	

In total, 14 of the 31 respondents, or 45.2%, made a comment somewhere on their response noting that the sales tax laws are confusing and/or need revision.

16. How often does a buyer ask your business to not charge sales tax on a transaction, either by presenting an exemption certificate or having a blanket exemption on file?

10.3% Never 17.2% Seldom 24.2% Sometimes 41.4% Often 6.9% Always

17. How often does your business deny the buyer's request?

26.9% Never 26.9% Seldom 30.8% Sometimes 11.5% Often 3.9% Always

18. What causes you to reject the sales tax exemption certificate?

Seventeen respondents answered this question, making the following statements:

- Nine respondents, or 29.0%, said they reject sales tax exemption certificates that are invalid or incomplete.
- Seven respondents, or 22.6%, said they reject sales tax exemption certificates if the item or service being purchased is not exempt.
- One respondent, or 3.2%, said they do not accept certain types of sales tax exemption certificates because of the nature of their business.

19. Below list any additional comments, suggestions, or concerns you have regarding Kansas sales tax laws.

Thirteen respondents, or 41.9%, answered this question, making the following comments:

- Kansas taxes place businesses at a disadvantage compared to businesses in Missouri.
- The auditors should go after the customers who won't pay taxes rather than penalizing the seller.
- Original construction laws are vague.
- My business is at a competitive disadvantage because we're surrounded by businesses that don't charge sales taxes.
- The State should use another way to collect taxes besides making dealers responsible for it.
- Cities, water districts, and waste water districts should be exempted from paying sales taxes.
- Each business should have more than one audit to adjust for differences in opinions.
- Buyers should be responsible for taxes due, not the vendors.
- Buyers should be liable when they present incomplete or inaccurate certificates.
- The State needs to present a workshop about the tax laws.
- The State's taxpayers are trying to comply so laws and forms should be simplified.
- The tax laws are too difficult to understand. The State needs to eliminate exemptions and start a new system.
- The taxpayers need information explaining how to file taxes.

Optional information -- In order for us to contact you, should we have any questions about your comments, it is necessary for you to identify yourself.

Business: _____

Name: _____ **Title:** _____

Telephone number: _____

APPENDIX E

Agency Response

A copy of the draft audit report was sent to the Department of Revenue for its review and comment on October 29, 1996. The Department of Revenue's response to the audit is presented in this Appendix.

STATE OF KANSAS

Bill Graves, Governor

DEPARTMENT OF REVENUE

John D. LaFaver, Secretary

Office of the Secretary
Kansas Department of Revenue
915 SW Harrison St.
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FAX (913) 296-7928

Office of the Secretary

November 7, 1996



Barbara Hinton,
Legislative Post Auditor
Legislative Division of Post Audit
800 SW Jackson, Suite 1300
Topeka, Kansas 66612

RE: Performance Audit Report, *Reviewing Sales Tax Enforcement and Collection Efforts at the Department of Revenue.*

Dear Ms. Hinton:

As requested by Legislative Division of Post Audit, I am pleased to respond to the above-referenced Legislative Post Audit draft report.

The Department of Revenue has recognized for some time that the business processes, organizational structure and technology supporting tax administration are in need of substantial revision. For an operation with the responsibility for collecting and administering accounts worth \$4.4 billion annually, the infrastructure necessary to carry out our tasks had been badly neglected for years. Our legacy systems and outmoded procedures have inhibited collection efforts as well as our ability to provide efficient and effective service for Kansas taxpayers. For that reason, we initiated Project 2000 in 1995. Project 2000 aims to change the business of revenue administration by improving customer service, redesigning processes from the taxpayers' point of view, creating a team-based environment, and benchmarking performance against world class financial institutions.

While we have a long way to go, solid performance improvements are underway. For example, the collection process has been streamlined and the new collections management system automatically routes accounts through successive stages of the

collection process. The legislative audit report focuses on our collections performance prior to the initiation of these changes. While it presents a good benchmark for a "before" view of the operation, it appropriately does not purport to evaluate performance enhancements that are well underway.

We agree with the auditors' assessment that portions of the sales tax law are unclear. It is largely this lack of clarity which places an undue burden on merchants who are doing their level best to understand and comply with the law. We believe the legislative auditors are correct in recommending that the law be clarified in several areas (e.g., contractors, consumed in production, component part, etc.). The alternative of not enforcing the law rather than clarifying it, which some have recommended, is properly rejected by both the legislative auditors and the department.

I am pleased to note that your auditors confirmed what my routine audit report cards show every week: taxpayers express high satisfaction with our audit staff and feel they do a professional job. What frustrates taxpayers the most are the unclear and contradictory provisions of our tax laws. The department shares their frustration.

I must express serious concern with the audit's analysis of the "cost efficiency" of the department's audit and collections efforts. Your report concludes that audit efforts are cost efficient because they return \$12 in revenue for every \$1 expended. On the other hand, collections activities are seen as not "very cost efficient" because they return only \$6 for every \$1 spent. This type of analysis can lead to focusing on punitive compliance measures, rather than on enhancing voluntary compliance strategies. When you consider that audit revenues constitute much less than one percent of total collected revenues, you get some idea of how self-defeating a "get tough" audit policy can be. For example, if doubling audit revenues resulted in just a 3% reduction in voluntary compliance, over \$100 million of revenue would be lost. In terms of taxpayer acceptance and fiscal results, a "putting the customer first" approach is clearly more sensible. Audit and collection efforts must be judged by how strongly they enhance voluntary compliance, rather than on simplistic cost-benefit financial equations. There are tax operations in this country that sacrifice voluntary compliance with heavy-

handed audit efforts. While the fiscal result may seem positive, the hidden costs in decreased voluntary compliance can be enormous. I will continue to urge the legislature to reject these sorts of self-defeating strategies.

Response to Recommendations - Collecting Sales Tax

1. While we are implementing management information systems that will yield detailed collection information, we do not intend to reduce our efforts to keeping score on how much money is raised by each collector -- there's much more to it than that. We will continue to be mindful, as explained above, that enhancement of voluntary compliance is our objective. Accomplishing that objective may not always be consistent with collecting maximum dollars in the short run.
2. The Division of Collections is already making improvements in the areas listed in the audit report. We believe that the deficiencies noted are present in only a small percentage of the accounts.

The department's plan for managing accounts includes collections case management software which stratifies accounts according to a risk scoring criteria and then routes the accounts to the appropriate stage in the collection process.

3. We agree that the warrant filing process needs to be automated. In the coming months we will be able to automatically file warrants to protect the state's financial interests.
4. While we agree that voluntary compliance needs to be monitored, it must be understood that these measures are difficult to make. I believe your measurements in this audit report do not adequately show the true cost-effectiveness of either audit or collections efforts. Only when the impact of these efforts on improving voluntary compliance can be measured will we be able to determine the true cost-effectiveness of these tasks.

Response to Recommendations - Sales Tax Exemption Certificates

1. We agree that there is much work to be done in clarifying state tax laws, especially sales tax. Once legislative clarification is completed, the department will make rules and regulations consistent with new laws. The department is presently examining audit issues that are caused by deficiencies in the law. Over the coming months, those conclusions will be shared with legislative leaders.
- 2a. We do not believe that clarification of audit procedures, alone, will "ensure that the sales tax law is consistently applied." Only substantial clarification of the tax code will ensure consistency. However, we are revising the existing audit policy manual and will use the manual in our in-house training efforts. In addition, we are currently preparing an automated policy repository, to be available to all auditors and other staff. This initiative will provide everyone in the department up-to-date policy guidance. However, it will only supplement, not supplant clear tax law.
- 2b. While the Audit Services Bureau provides training for auditors, findings of this report document clear deficiencies in leadership in guiding and directing the audit effort. Over the coming weeks, important long-range personnel decisions will be made on who provides needed policy and procedural leadership in this area. In addition, next month all auditors will attend a three-day policy workshop, which will address key inconsistencies.
- 2c. The Audit Services Bureau will review its audit workpaper documentation standards and upgrade its requirements as appropriate.
- 2d. The department takes seriously its mandate to enforce the law in a fair and reasonable manner. Given the unclear and contradictory provisions of sales tax law, we believe we do pretty well in fulfilling that mandate. The only criticism cited in the audit for not enforcing the law as written is in an area in which the law is unclear and essentially unenforceable. We look forward to assisting the Legislature to remedy this problem.

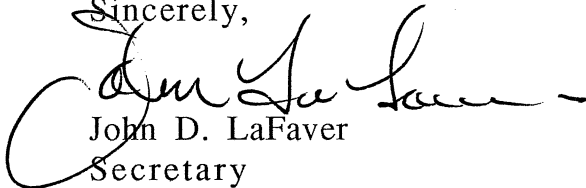
- 2e. We agree that it would be beneficial to provide data to show the number and extent of audits that are appealed and resolved by the Audit Services Bureau.

Our current standard is for audit workpaper files to provide an audit trail which documents the progression from the original assessment to the final settlement. We will take further steps to ensure the standard is followed.

3. The department will consider appropriate changes to the exemption certificate forms which could clarify the legal questions and help taxpayers and merchants make correct determinations.

I want to thank you and your staff for an excellent report that serves to focus attention on badly needed improvements to the tax law and tax administration procedures that can help us assure we are "putting the customer first every time."

Sincerely,



John D. LaFaver
Secretary

