

**KENTUCKY'S TAX PROTEST SETTLEMENT  
PROCESS**

**March 2002 – PERFORMANCE AUDIT**



**EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS**

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The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

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EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS

March 28, 2002

To the People of Kentucky

The Honorable Paul E. Patton, Governor  
Dana Mayton, Secretary, Revenue Cabinet  
Debra Eucker, Acting Director, Division of Protest Resolution  
Director, Division of Legal Services

Re: Performance Audit of Kentucky's Tax Protest Settlement Process

Ladies and Gentlemen:

We present our report on Kentucky's tax protest settlement process. We are distributing this report in accordance with the mandates of Kentucky Revised Statute 43.090. In addition, we are distributing copies to members of the General Assembly committees exercising oversight authority over revenue issues, as well as other interested parties.

Kentucky Revised Statute 43.090 (1) requires an agency to which a report of the Auditor of Public Accounts pertains to notify the Legislative Research Commission and the Auditor of Public Accounts, within 60 days of completion of the audit report, which of the audit recommendations have been implemented and which have not. After an appropriate period of time, we will contact the Division of Protest Resolution in the Revenue Cabinet to determine whether the report's recommendations have been implemented, and we will then advise the Legislative Research Commission regarding the status of that implementation. Once we are advised that the recommendations have been implemented, they will be considered closed.

Our Division of Performance Audit evaluates the effectiveness and efficiency of government programs. The Division also performs risk assessments and benchmarks government operations. We will be happy to discuss with you at any time this audit or the services offered by our office. If you have any questions, please contact Gerald W. Hoppmann, Director of our Division of Performance Audit, or me.

We appreciate the courtesies and cooperation extended to our staff during the course of this performance audit.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Ed Hatchett".

Edward B. Hatchett, Jr.  
Auditor of Public Accounts



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# Executive Summary

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<b>Audit Objective</b>	Evaluate the efficiency and effectiveness of the Kentucky Revenue Cabinet's (Revenue) tax protest settlement process.
<b>Background</b>	<p>The Division of Protest Resolution (Division) within the Department of Law in the Revenue Cabinet administers taxpayer protest resolution and settles tax controversies. KRS 131.110 sets forth the right of a taxpayer to protest any assessment resulting from a Revenue audit.</p> <p>KRS 131.030(3) gives Revenue the broad discretionary power to "settle tax controversies based on the hazards of litigation applicable to them." Furthermore, KRS 131.030(3) states "the Revenue Cabinet is encouraged to settle controversies on a fair and equitable basis." Revenue's inducement to settle a tax protest includes (1) the specific risk of diminished revenue arising from an adverse decision, (2) the generalized risk of adverse precedent for other cases, or (3) the risk of an assessment of attorney fees.</p>
<b>The Division Forgave More Than \$12 Million Over a Three-Year Period Without Adequate Policies and Procedures.</b>	For calendar years 1998-2000, the Division settled 319 protests collecting \$21.6 million of a potential \$33.9 million in tax, penalties, and interest receivable. The Division had no framework of policies and procedures, instead relying on management directives contained in various memoranda. Although the memoranda broadly discuss certain facets of a review officer's duties and responsibilities, they did not contain enough specificity to ensure that officers were able to accurately determine the hazards of litigation or how to compute a settlement.
<b>The Division's Review Officers Are Not Required to Have Legal Training</b>	The Division's review officers have no formal legal training, despite the fact that they are expected to evaluate the hazards of litigation applicable to each case. Five surrounding states (Tennessee, Virginia, Ohio, Illinois, and Indiana) require employees responsible for negotiating settlement agreements to attain higher educational levels than are required in Kentucky. These states primarily employ attorneys or CPAs. Also, Revenue has not provided specific training related to protest and settlement resolution. According to the Division's Director this type of training is very costly, but is being considered.
<b>The Division Does Not Effectively Collect, Maintain, Track, or Analyze Settlement Data</b>	The Division does not effectively collect, maintain, track, or analyze tax settlements and related documentation. Division staff could not provide information on the number and amount of settlement agreements. Furthermore, there is no central repository for settlement data; and a comprehensive analysis of settlement data has never been attempted. As a result, the Division is unable to respond to inquiries from such entities as the Legislature or the Auditor of Public Accounts.
<b>The Division Does Not Require Files to be Properly Organized or Maintained</b>	Written policies and procedures governing file organization and maintenance do not exist. We found that many of the files were difficult to access. The corporate tax files proved to be especially difficult to review because all historical and audit material is combined in the same file folder. There are no separators for the files, which are often filled beyond capacity. This both promotes inefficiency and prevents the Division from safeguarding important taxpayer files. Additionally, we were not able to obtain all the corporate information requested because pertinent data was never entered into the Division's accounts receivable tracking software program.
<b>Necessary Adjustments To Revenue's Accounts Receivable System Not Entered</b>	The Division's review officers fail to make routine adjustments to the Compliance and Receivables System (CARS) that would assure chronological accuracy of Revenue's accounts receivable balance in that system. Instead of currently documenting a true history of the case, review officers typically wait until after the settlement becomes final to document adjustments. This creates a misstatement of Revenue's accounts receivable balance.

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## Executive Summary

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### Agency Recommendations

### Agency Recommendations

We recommend:

1. The Division develop and implement detailed policies and procedures for negotiating, drafting, and executing settlement agreements.
2. The Division clearly define “hazards of litigation” and the resulting calculations of the settlement value.
3. Revenue assign an additional attorney to the Division to review proposed settlements. In addition, Revenue should provide training in protest and settlement resolution.
4. Revenue, in consultation with the Personnel Cabinet, review minimum education requirements for review officer job classifications to ensure that officers possess appropriate skills and training.
5. Revenue ensure that review officers are made aware of new tax case law immediately upon conclusion of court proceedings.
6. The Division take immediate steps to improve the condition and accessibility of its files, including the development and implementation of policies and procedures on file contents, organization, and maintenance.
7. Revenue develop or purchase software applications that will capture settlement data, generate detailed reports for analysis, and properly archive information.
8. The Division develop and implement written policies and procedures to ensure the proper archiving of electronic records.
9. The Division require review officers to update bills in CARS, to ensure that all adjustments are currently reflected in the system.
10. Revenue internal auditors routinely test and verify the validity of the accounts receivable.

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<b>Acronyms and Terms</b>	<b>APA</b> Auditor of Public Accounts	
	<b>CARS</b> Compliance and Receivables System	
	<b>Division</b> Division of Protest Resolution	
	<b>KRS</b> Kentucky Revised Statutes	
	<b>PRP</b> Protest Resolution Program	
	<b>Revenue</b> Kentucky Revenue Cabinet	



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# Chapter 1

## Introduction

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### Background

The Division of Protest Resolution (Division), which is under the Department of Law in the Revenue Cabinet (Revenue), administers taxpayer protests and settles tax controversies. The Division is divided into three (3) sections:

1. Sales and Use Tax Section;
2. Corporate Tax Section; and
3. Severance and Miscellaneous Tax Section.

Each of the three sections is headed by a Section Supervisor and staffed by review officers. An acting Director (Director) currently supervises one Assistant Director, two Section Supervisors, seventeen review officers, and one administrative assistant. The Assistant Director is performing the duties of the third Section Supervisor until the vacancy is filled.

Kentucky Revised Statutes (KRS) 131.110 provides taxpayers the right to protest any assessment resulting from audits performed by Revenue. For example, as a result of an audit, a taxpayer may face additional tax liability because of adjustments related to unallowable deductions, capital purchases subject to use tax, etc.

In an attempt to reduce the time and costs associated with litigation, Revenue has been granted the power to settle protests out of court. KRS 131.030(3) states “the Revenue Cabinet is encouraged to settle controversies on a fair and equitable basis and shall be authorized to settle tax controversies based on the hazards of litigation applicable to them.” Hazards of litigation are issues such as diminished revenue because of losing a particular issue, establishment of an unfavorable legal precedent, or the possibility of attorney fees being assessed against the state.

To fulfill its duty to administer taxpayer protests, the Division’s review officers evaluate protest cases for statutory compliance, regulatory compliance, adherence to Revenue policies and procedures, and generally accepted auditing principles. Review officers confer with taxpayers, or their attorneys and accountants, to identify pertinent facts. Protest conferences are held to negotiate with taxpayers and their representatives. Review officers make litigation or settlement recommendations to the Director. Generally, settlements result in writing off a portion of the assessment in lieu of expending legal resources in litigation and risking losses in a court proceeding.

According to Division staff, Revenue does not tender settlement offers. Instead, during negotiations, a taxpayer initiates a settlement offer. Review officers accept the offer or extend a counter-offer. If compromise is reached, a settlement agreement is drafted for the taxpayer’s signature. Once the taxpayer and Revenue have signed, the agreement is considered final. According to Revenue policy, the terms of the settlement agreement are strictly confidential. Language in the agreement enjoins the taxpayer and Revenue from revealing the specific terms of the settlement.

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**Audit Focus and  
Objective**

No internal or external reviews of the tax settlement process have been conducted since Revenue gained statutory authority to settle tax disputes in 1992. Current and projected budget shortfalls have intensified the need to ensure that programs are efficient and that revenues are maximized. Therefore, the Auditor of Public Accounts (APA) has undertaken this performance audit to determine whether the Division's tax protest settlement procedures and practices are efficient, effective, and allow the Commonwealth to collect the maximum amount consistent with the taxpayer's liability.

We reviewed 319 cases that were settled during calendar years 1998, 1999, and 2000. However, because Revenue does not track settlement agreements, we could not verify that this population reflects all settlements for the period. We addressed the following objective:

**Evaluate the efficiency and effectiveness of the Kentucky Revenue Cabinet's tax protest settlement process.**

To accomplish our objective we:

- Reviewed Kentucky statutes and regulations, as well as other states' statutes and regulations;
- Interviewed officials from other states about their management practices;
- Reviewed files for the identified population;
- Reviewed policies and procedures provided by Revenue;
- Interviewed Revenue officials; and
- Surveyed all the Division's review officers.

We followed *Government Auditing Standards* promulgated by the Comptroller General of the United States.

**See the Scope and Methodology section in Appendix I for additional elaboration.**

Our assessment of the tax protest settlement process was limited to the following types of taxes. See Appendix V for additional information about these taxes.

**Sales and Use Tax:** Taxes levied on the retail price of merchandise and collected by the retailer. Taxes levied for the privilege of storing, using, or consuming tangible personal property in Kentucky, if sales tax has not been paid.

**Corporate Tax:** Corporate license or income taxes levied in return for doing business in the Commonwealth.

**Individual Income Tax:** Annual taxes levied on an individual's net income.

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## Chapter 2

# Findings and Recommendations

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### **The Division Forgave More Than \$12 Million Over a Three Year Period Without Adequate Policies and Procedures**

In calendar years 1998, 1999, and 2000, the Division did not have adequate policies and procedures. During this period, the Division collected \$21.6 million of \$33.9 in receivables consisting of tax, penalties, and interest for settled cases. In the absence of authorized and adopted policies and procedures, review officers relied on directives contained in various memoranda from Division management. Although the memoranda broadly discussed facets of a review officer's duties and responsibilities, they lacked adequate specificity to ensure a consistent, informed evaluation of the hazards of litigation or a reliable computation of settlement amounts. For example, one memorandum dated March 25, 1999 defines *settlement* very broadly, to wit:

*Settlement shall mean a compromised amount of tax liability is agreed upon between the Cabinet and the taxpayer whenever disputes arise regarding interpretation/enforcement of tax law or administrative regulations. Settlements for current audit periods shall always be formalized as a legal document that is binding to the Kentucky Revenue Cabinet and the taxpayer and shall not prejudice either the taxpayer or Kentucky Revenue Cabinet in regards to future audit periods. Whenever possible, formal settlements should clarify taxpayer's requirements and Cabinet's expectations in regards to future filing practices.*

The same memorandum states that, *when preparing a "Settlement Memo," the review officer shall discuss the method used in arriving at the amount of the settlement and obtain approval for the settlement from your supervisor.* However, there is no mention whatsoever related to the criteria a review officer should use when determining the hazards of litigation. As illustrated, it is clear that review officers in the past have had the authority to draft settlement agreements, without proper written guidelines.

Revenue could not identify and explain the mechanics of individual settlement agreements because of the absence of specific guidelines for the settlement process. For each settlement, officials could not delineate what portion related to tax, penalties, or interest. In addition, it is impossible to glean from the files what criteria the review officers used to reach settlements. Finally, we could not ascertain whether review officers had conferred with Revenue attorneys or tax policy experts during the tax settlement process. Meaningful policies and procedures would ensure that cases are settled in a manner that is fair, consistent, and in the best interest of the Commonwealth. Specific policies and procedures are also a basis for establishing benchmarks by which to measure performance.

The Division currently is comprised of many long-tenured review officers. However, if faced with significant turnover, the Division has no formal policies and procedures to ensure that the settlement process could continue seamlessly.

The following table provides additional information on the amount of money forgiven in each category of tax during the three-year period of review.

**Table 1**  
**Summary of Cases Reviewed**

<b>Tax</b>	<b>Number of Files Reviewed</b>	<b>*Potential Receivable Amount</b>	<b>Settlement Amount</b>	<b>Difference</b>
Sales & Use	272	\$27,219,257	\$16,153,339	\$11,065,918
**Corporate Income & License	46	6,673,395	5,468,646	1,204,749
Individual Income	1	6,865	5,000	1,865
<b>Total</b>	<b>319</b>	<b>\$33,899,517</b>	<b>\$21,626,985</b>	<b>\$12,272,532</b>

Source: Auditor of Public Accounts, from information provided by the Division of Protest Resolution.

\*Includes a total of final assessment, interest, and penalties.

\*\*Corporate information was missing from three case files. If the assumption is made that the potential receivable amount is at least equal to the settlement amount, an additional \$1,371,983 could be added to the difference for a total \$2,576,732.

The settlement memorandum to guide review officers in determining hazards of litigation was in the process of being revised by the Division Director. The proposed revisions that were reviewed during our audit appeared to provide better guidance. However, this does not replace the need for formal policies and procedures.

**Other States Offer More Guidance**

Other state taxing authorities emphasized in interviews the importance of established procedures for settling tax disputes. The Director of Problem Resolution in the Indiana Department of Revenue stated that audit staff follows pre-established rules for each category of tax. In addition, tax and interest is delineated in each settlement. An official from the Ohio Department of Taxation stated that they have a formal process for tax settlement. Their process allows them to settle the tax first, and then recalculate interest. This is not done in Kentucky.

**The Division’s Review Officers Are Not Required to Have Legal Training**

Educational requirements for tax protest review officers in Kentucky are not as stringent as educational requirements in other states. According to the Job Class Specifications found on the Kentucky Personnel Cabinet’s website, a Revenue Review Officer I is only required to have a bachelor’s degree with twenty (20) hours of accounting credits. This educational requirement remains the same for Review Officers II and Review Officers III, who are required to have slightly more years of on-the-job experience. None of the positions’ job specifications require an academic background that equips recruits for proper evaluation of the “hazards of litigation” applicable to tax protests.

In contrast, five surrounding states require advanced educational levels for employees charged with negotiating settlement agreements. Three of the five

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## Chapter 2 Findings and Recommendations

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states (Illinois, Ohio, and Tennessee) primarily authorize attorneys to settle tax protest cases. Indiana restricts settlement authority to CPAs. Virginia requires staff to have academic qualifications in tax policy beyond a bachelor's degree and according to a spokesperson there, most staff have law degrees.

The Director stated that since review officers can request advice from Revenue attorneys and tax experts and are primarily responsible for communicating the taxpayers' offer of settlement to supervisory levels, legal training is not a priority. Although we understand Revenue's argument, we still believe it is important to ensure that review officers are equipped with enhanced education and training. According to the Director, Revenue is considering a contract with an outside vendor to provide training in protest and settlement resolution. The cost for such instruction is approximately \$5,000 and Revenue has not contracted for the service.

Kentucky's 17 review officers are not attorneys, yet they make initial determinations about the hazards of litigation. Revenue has named a licensed attorney as Acting Director of the Division. However, less highly compensated attorneys in a lower job classification could achieve the time-consuming legal review of cases more efficiently.

### **The Division Does Not Collect, Maintain, Track, or Analyze Settlement Data**

The Division has not collected, maintained, tracked, or analyzed tax settlements and related documentation. As a result, the Division could not provide the following basic information about the cases we reviewed:

- Total number of cases settled.
- Number of settled cases by tax category and amount.
- Breakdown by case of tax, penalties, and interest amounts.
- Computer-generated reports on settled cases.
- Total of settlement receivables.

Furthermore, there is no central repository for settlement data and an analysis of settlement data has never been attempted. This lack of data makes it difficult for the Division to develop trend information, track performance, or make strategic plans for management and training purposes.

We requested three years' settlement data from the Division in order to compare the total assessment accounts receivable to the actual amount agreed upon in the settlement process. The data was unavailable. We manually reconstructed the information by requesting numerous billings and taxpayer account histories, performing lengthy analyses, and computing various totals from these documents.

The necessary bills and documentation were produced after repeated requests. Division officials attributed the delays to (1) off-site printing of bills and taxpayer account histories, and (2) system overload resulting from the printing of a "uniquely high volume of material." Some records were never provided. According to staff from Revenue's Department of Information Technology, it was possible that those records had never been transferred into Revenue's current accounts receivable system.

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## Chapter 2

### Findings and Recommendations

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#### Practices Make Independent Verification Difficult

The Division's records management practices make it difficult for meaningful internal or external evaluation of settlement data. Auditors were repeatedly told that the Division did not compile this type of settlement information since it had not been requested in the past by legislators or other outside entities. As an executive branch cabinet, Revenue is subject to external scrutiny and legislative oversight. Revenue is also subject to the provisions of KRS 43.050, which empowers the Auditor of Public Accounts to independently audit the performance of all spending agencies of the state. By failing to collect, track, and maintain settlement data, the Division has effectively placed this information beyond the reach of such independent review and oversight.

#### The Division is Making Progress Towards Improvement

Settlement agreements are now kept in a central file, but there is no policy to ensure that settlement files contain bill copies and taxpayer account histories. The Division Director stated that although there was no formal policy, audit bills are now required to be maintained in the settlement file, while settlement agreements and related memoranda reside in a central file. Without the development and implementation of effective policies and procedures, it will remain impossible for independent evaluators to determine amounts billed, adjustments made, and interest and penalties calculated by reviewing settlement files.

During 2001, the Division began using a protest resolution software program (PRP) that allows review officers to store settlement information in an electronic format. PRP serves as an electronic case activity log. Effective use of this technology will help the division track settled cases more efficiently.

Although using a system like PRP is a positive development, the Division should track, calculate, and report assessment and settlement amounts. For example, PRP should calculate interest and penalties, and display the user billings or assessment letters. The system should also have the capability to generate reports on settlement data. Without software applications that allow for detailed settlement tracking and data analysis, it will remain difficult for the Division to undertake meaningful and timely analysis or review of collected settlement data. According to Revenue officials, PRP currently is not able to do this type of tracking.

#### The Division Files are Not Properly Organized or Maintained

The Division has no written policies or procedures for file organization and maintenance. Sales and use tax case files are often not filed accurately. Many file drawers were too full to allow for easy retrieval of a file. In addition, files that could not fit in the filing cabinets were stacked on top of cabinets. This condition does not adequately safeguard important taxpayer files.

We found corporate tax case files to be even more difficult to access than sales and use tax case files. The sales and use tax case files contained only information relevant to the protested audit assessment. However, the corporate files were a mixture of both audit and historical materials. In addition to the documentation pertaining to the recent audit protest, files included historical information such as past tax returns, correspondence, supporting documentation, and meeting transcripts from previous cases.

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## Chapter 2

### Findings and Recommendations

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This practice has resulted in files that are cumbersome at best and inaccessible at worst. Some of the files contained little more than old tax returns dating back to the late 1970s and early 1980s. Many of the files are filled far beyond capacity, and most were extremely dilapidated.

According to Revenue officials, it is important for the current corporate audit files to contain historical information because the audit may focus on issues in past tax returns and schedules. One official noted that given the nature of corporate taxes, multiple auditors from the IRS and Revenue might need access to the files.

Even though we agree that the historical information should be kept in close proximity to the current audit files, it is important for the corporate files to be better organized. For example, dividers could be used for each corporate file to separate the current audit information from the historical information. Additional file folders could also be used to make sure that existing files are not filled beyond their capacity. Because outside entities such as the IRS and Auditor of Public Accounts may need to review the files, they should be logically ordered.

#### The Division Could Not Produce Timely and Complete Information for the Corporate Settlement Files

The Division was unable to produce complete documentation in a timely manner for the corporate files we reviewed. Most of the missing information related to dollar amounts of tax, interest, and penalties. To complete the performance audit, we requested billings and taxpayer account histories for 46 corporate case files, however despite repeated requests, the Division was unable to produce this information in a timely manner. According to staff from Revenue's Department of Information Technology, all taxpayer account histories and billings may have not been converted to CARS when the system was implemented in 1995.

We were unable to gain a complete perspective on corporate settlements for the years in question because of the absence of billings and taxpayer account histories. Likewise, other independent evaluators such as internal auditors would be unable to confirm the validity of settlement presumptions and conclusions in these corporate cases. Corporations are a significant source of state revenue through their remittance of income and licensing taxes. The absence of essential documentation, coupled with the physical difficulty in accessing corporate files is troubling.

#### CARS Data is Unreliable and Inaccurate Because Adjustments Are Not Made Consistently

The Division's review officers do not make necessary adjustments to CARS. The accounts receivable balance may therefore be inaccurate. According to Division staff, review officers may update the bills in CARS to accurately reflect adjustments to a taxpayer's account or they may simply enter the notation "Part Pay Accepted" once the final settlement is reached. The latter option will effectively close out the protest.

We learned that review officers consider it much easier to bypass CARS maintenance in favor of the "Part Pay Accepted" approach. Since there are no written guidelines requiring review officers to enter the adjustments, the shorter and easier method is usually followed, resulting in misstatement of accounts receivable.

Using CARS data for the three-year sampling period, we calculated a maximum accounts receivable amount of \$63,373,145. This figure contrasted sharply with the approximately \$16 million that Revenue actually collected through these settlement agreements. Concerned about the large disparity between the two figures, Division officials examined some of the settlement files in detail and discovered that the maximum receivable amount was deceptively high because one taxpayer's assessment was billed under two separate sets of notice numbers. This means that CARS contained the data for both billings and taxpayer account histories. Prior to settlement, CARS reflected overstated receivables by at least \$36 million.

## **Recommendations**

### **Agency Recommendations**

We recommend:

1. The Division develop and implement detailed policies and procedures for negotiating, drafting, and executing settlement agreements.
2. The Division clearly define "hazards of litigation" and the resulting calculations of the settlement value.
3. Revenue assign an additional attorney to the Division to review proposed settlements. In addition, Revenue should provide training in protest and settlement resolution.
4. Revenue, in consultation with the Personnel Cabinet, review minimum education requirements for review officer job classifications to ensure that officers possess appropriate skills and training.
5. Revenue ensure that review officers are made aware of new tax case law immediately upon conclusion of court proceedings.
6. The Division take immediate steps to improve the condition and accessibility of its files, including the development and implementation of policies and procedures on file contents, organization, and maintenance.
7. Revenue develop or purchase software applications that will capture settlement data, generate detailed reports for analysis, and properly archive information.
8. The Division develop and implement written policies and procedures to ensure the proper archiving of electronic records.
9. The Division require review officers to update bills in CARS, to ensure that all adjustments are currently reflected in the system.
10. Revenue internal auditors routinely test and verify the validity of the accounts receivable.

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### Scope

We conducted our audit in accordance with *Government Auditing Standards* promulgated by the Comptroller General of the United States. The purpose of the audit was to accomplish the following objective:

**Evaluate the efficiency and effectiveness of the Kentucky Revenue Cabinet’s tax protest settlement process.**

KRS 131.110 sets forth the right of a taxpayer to protest any assessment resulting from a Revenue audit or the Cabinet’s denial of a claim refund. We reviewed settlement cases related to protests resulting from Revenue audits.

After careful consideration of all the categories of taxes administered by Revenue we decided to focus on settlement cases involving sales and use tax, corporate tax, and individual income tax for the three (3) year period 1998-2000. These tax categories constitute the majority of the cases handled by the Division. Also, these were the only three categories of files that contained sufficient documentation to assess the tax settlement process.

Although we reviewed applicable agency policies and procedures and cases to better understand the settlement process, we did not determine whether each settlement was evaluated based on the “hazards of litigation” as required by KRS 131.030. Because of a lack of written criteria for determining “hazards of litigation” and because of case file deficiencies, it was impossible to determine how the “hazards of litigation” were evaluated or how settlements were computed. In addition, we did not assess the reliability of computer-based data or management controls since these areas were not significant to our audit objective.

We were able to document what appeared to be inflated receivables in our population of 319 cases. According to Revenue’s technology staff, CARS identifies the “Part Pay Accepted” entries as amounts not to be included in overall accounts receivable report numbers. We did not conduct additional work to verify this. We are identifying this area as requiring further study.

### Methodology

We conducted interviews with staff from the following agencies to ascertain their involvement with tax protest settlement process:

- Revenue’s Division of Protest Resolution
- Revenue’s Department of Information Technology

We reviewed Kentucky’s tax protest settlement statutes and regulations, focusing on the areas of sales and use, corporate, and individual income taxes.

### Documenting the Tax Settlement Process

We reviewed documents and reports from various agencies and associations to document the tax protest settlement process in Kentucky. These documents included the following:

- Revenue’s Protest and Appeal Guidelines
- Division Monthly Reports for 1998, 1999, and 2000

- Settlement Agreements from all 1998, 1999, and 2000 settlements of sales and use tax, corporate tax, and individual income tax protests
- Sample Protest Resolution Settlement Memorandum
- Revenue Collection Division Offer in Settlement Forms
- American Bar Association Legislative Recommendation 1983-85

### Review of Settlement Files

To evaluate Kentucky's tax protest settlement process, we interviewed responsible officials from the Division to obtain a general understanding of the pertinent policies and procedures. Then we obtained all the review officers' monthly reports from 1998, 1999, and 2000. We examined each of the monthly reports and listed all the cases that were marked "settled and paid." We pulled all of these corresponding files from the various file storage areas. Each file was individually reviewed. Files were retained if they contained a settlement agreement. Files that did not were refiled. We identified a population of 272 sales and use tax settlements, 46 corporate settlements, and one individual income tax settlement, for a total of 319 cases.

Although we reviewed 46 corporate files, we included information for only 36. We excluded four refund cases, as well as six others that were part of a unitary case consisting of 20 separate files. The tax assessed for the unitary case was \$12,873,719 and the amount collected was \$11,388,210. This information was not included in our report because of time constraints associated with reviewing the additional files.

After assigning a number to each file, we then compiled a cross-referencing list to identify each file by taxpayer name and identification number. This step was performed to meet Revenue's confidentiality requirements; which precluded the use of any identifying information in working papers or reports. We also requested the correlating billings and taxpayer account histories from the Division.

Excel spreadsheets were created for each category of tax. The following information was entered into the spreadsheets: original assessment, final assessment, interest, penalty, maximum amount receivable, settlement amount, existence of settlement memo, assessment date, settlement date, name of review officer, and any auditor notes.

Auditors examined all the settlement files for the three tax categories and entered the appropriate information for each file using documentation in the files and the billings and taxpayer account histories provided by the Division. After the data entry phase of the project was completed, another auditor tested every fifth file to ensure that the data entered into the spreadsheets was reliable.

Auditors then reviewed the spreadsheet data with the Division. The Division was given an opportunity to explain any discrepancies and provide additional case information. In addition, the Division reviewed cases with more than 50% difference between the maximum amount assessed and the settled amount. They communicated any changes in the amounts to our auditors.

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During this time, auditors also surveyed the Division’s review officers about their experiences and opinions pertaining to the tax protest settlement process and their jobs. Surveys were sent to all nineteen (19) review officers, and fourteen (14) were returned, for a response rate of 74%.

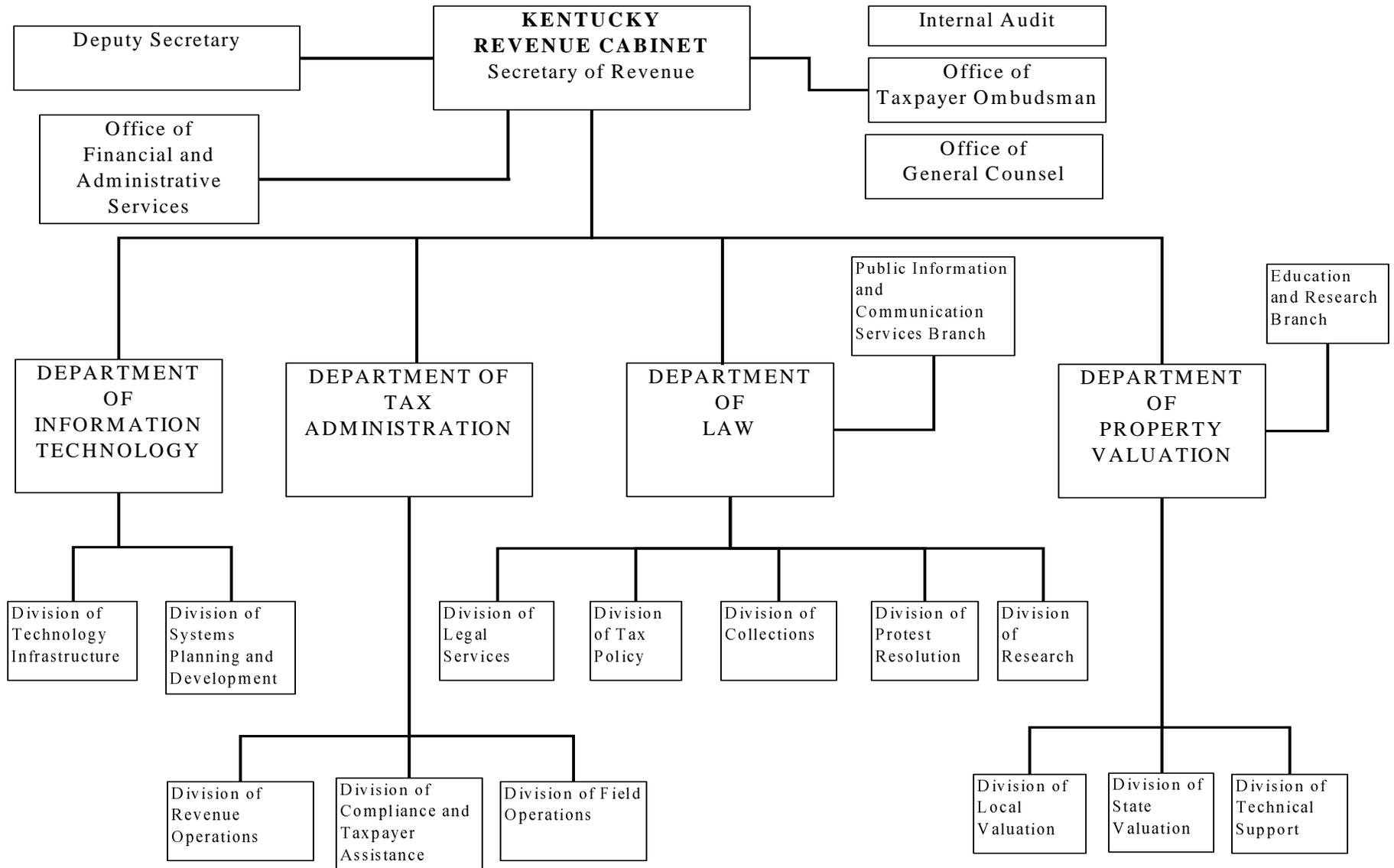
## Benchmarking With Other States

To develop an understanding of tax protest settlement procedures in other states, we interviewed officials from the following five states:

- Illinois
- Indiana
- Virginia
- Ohio
- Tennessee

# Revenue Cabinet's Organizational Chart

Source: Tax Facts: A Digest of Kentucky Tax Laws.



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# Divisional Expenditure and Personnel Data

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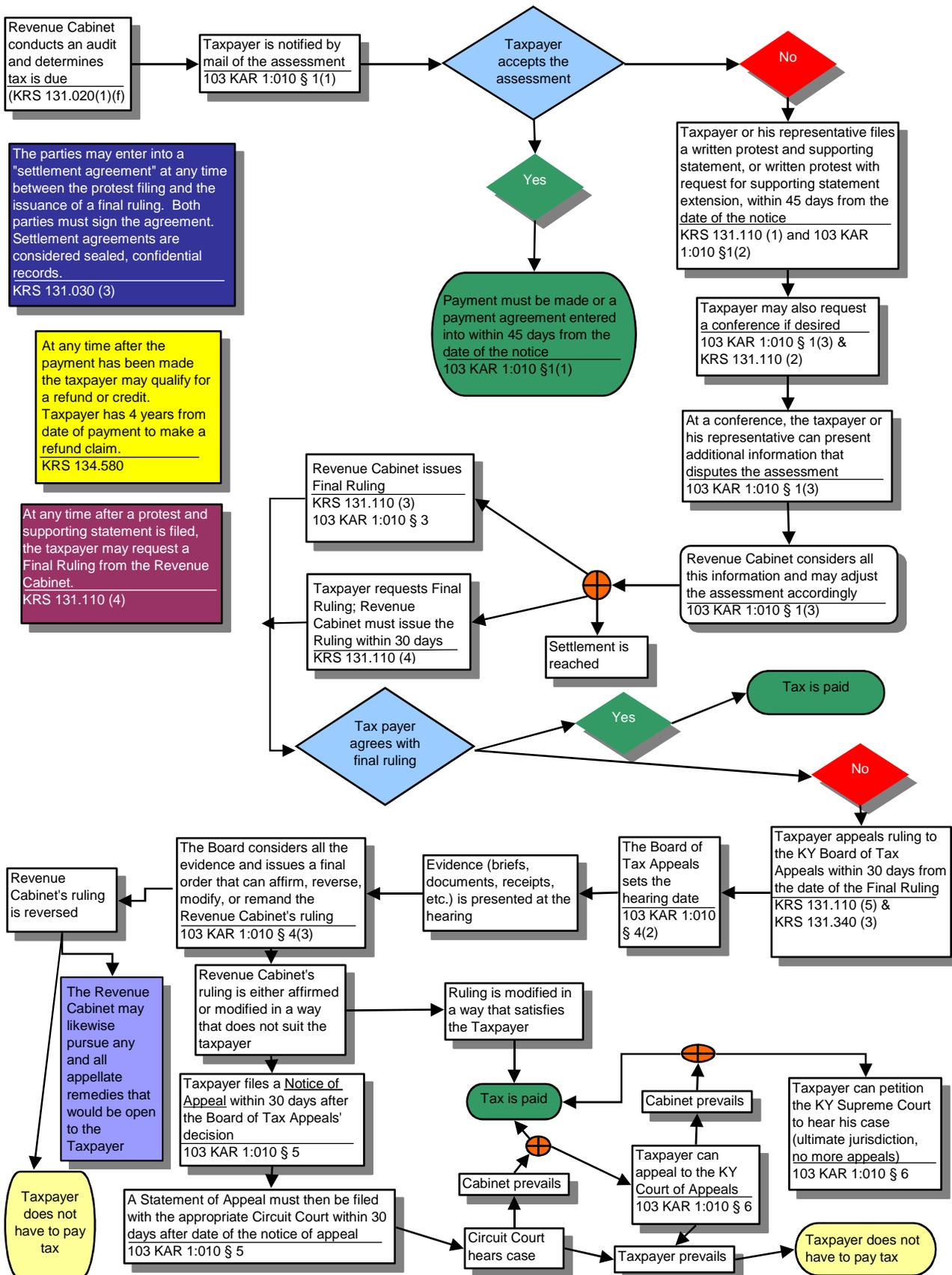
Appendix III

## Division of Protest Resolution's Staffing Levels and Expenditures for Fiscal Years 1999, 2000, and 2001

	FY 1999	FY 2000	FY 2001
<b>Staffing Level</b>	24	23	24
<b>Expenditure Category</b>			
Personnel Costs	\$1,174,948	\$1,368,813	\$1,298,446
Operating Expenses	13,727	10,532	17,423
<b>Total Expenditures</b>	<b>\$1,188,675</b>	<b>\$1,379,345</b>	<b>\$1,315,869</b>

Source: Auditor of Public Accounts, from information provided by the Division of Protest Resolution.

# Tax Protest Process Flowchart



## Sales and Use Tax

Sales and Use Tax account for the majority of tax protests that are handled by Division. For the privilege of making “retail sales” in Kentucky, a sales tax is imposed upon the seller’s gross receipts from retail sales of tangible personal property sold in the regular course of business. The lease and rental of tangible personal property for a consideration is considered a sale or purchase, the receipts of which are also subject to the sales and use tax. KRS 139.200 mandates the collection of this tax. The current tax rate for sales tax is 6% of gross receipts.

For the privilege of storing, using, or consuming tangible personal property in Kentucky, a use tax is imposed if sales tax has not already been paid. KRS 139.310 mandates the collection of this tax. The current tax rate for use tax in Kentucky is 6% of the sale price of the property.

Because filing frequencies are determined by the amount that a retailer remits each year, most sales and use taxes are collected from retailers on a monthly basis. Monthly filing is required of all retailers that remit amounts greater than \$1,200 per year.

## Corporate Tax

Corporate taxes are twofold in Kentucky in that corporations are subject to both a corporate income tax (KRS 141.040) and a corporate license tax (KRS 136.070). Although many exemptions exist, the majority of corporations (a) organized under the laws of Kentucky, (b) having its commercial domicile in Kentucky, (c) owning or leasing property in Kentucky, (d) having one or more individuals employed or subject to unemployment insurance tax in Kentucky, or (e) which is a partner in a partnership doing business in Kentucky shall pay for each taxable year a tax to be computed by the taxpayer upon the taxable net income of the corporation.

The annual corporate income tax is imposed on a sliding scale, as detailed in the table below.

<b>Tax Rate</b>	<b>Taxable Net Income</b>
4%	First \$25,000
5%	Next \$25,000
6%	Next \$50,000
7%	Next \$150,000
8.25%	Excess over \$250,000

Source: *Tax Facts: A Digest of Kentucky Tax Laws*.

Exemptions also exist for the corporate license tax; however, a Kentucky License Tax Return must be filed for every corporation (a) organized under the laws of Kentucky, (b) having its commercial domicile in Kentucky, (c) owning or leasing property in Kentucky, or (d) having one or more individuals employed or subject to unemployment insurance tax in Kentucky. The corporate license tax rate is set at \$2.10 for each \$1,000 of capital employed in the business. However, corporations with gross incomes of less than \$500,000 are entitled to a tax credit on the first \$350,000 of their capital. The corporate license tax is due on a yearly basis. The minimum tax due is \$30.

## Individual Income Tax

KRS 141.020 levies the individual income tax. Under this statute, each Kentucky resident must pay an annual tax on his or her net income. Individual income taxes must also be remitted from nonresidents on the portion of their income that is derived from Kentucky sources, fiduciaries on that portion of an estate or trust not distributed or distributable to

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# Description of Tax Categories Reviewed

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beneficiaries, and self-employed individuals with gross income of at least \$5,000. The individual income tax is imposed on a sliding scale as detailed in the table below.

## Individual Income Tax Rates

<b>Tax Rate</b>	<b>Net Income</b>
2%	Less than \$3,000
3%	Between \$3,000 and \$4,000
4%	Between \$4,000 and \$5,000
5%	Between \$5,000 and \$8,000
6%	In excess of \$8,000

Source: *Tax Facts: A Digest of Kentucky Tax Laws*.

PAUL E. PATTON  
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February 18, 2002

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RE: Revenue Cabinet's Response to the Performance Audit Report for the  
Division of Protest Resolution

Dear Auditor Hatchett:

We have reviewed the final draft report entitled "Kentucky's Tax Protest Settlement Process". We appreciated the opportunity to work closely with your staff during this performance audit and believe that the final product is more accurate as a result. The following comments are provided for your inclusion in the final report.

While the focus of this performance audit was the settlement process within the Division of Protest Resolution, it is important to note that this Division not only handles taxpayer protests for the Cabinet, but provides the central review and billing of the field audits originating from the 10 taxpayer service centers located around the state. The Auditor has reviewed 319 audits in which settlements were reached in calendar years 1998, 1999, and 2000 and noted that the Cabinet had reduced the assessments in these audits by \$12 million. When viewed in isolation, \$12 million is a significant figure. The Cabinet believes, however, that this number must be viewed within the context of the Division's entire operation.

During these three calendar years, this Division also prepared and sent tax bills in 5,179 audits for a total billing of tax, exclusive of interest and penalties, in the amount of \$170,354,203. During this three-year period, the Division also collected a total amount of \$124,293,724 from either protests completed in those years or from unprotested bills paid in those years. In fact 3,253 protests were resolved during this three-year period. In other words, the \$12 million dollar figure is only 9.65% of the total amounts collected by this Division during those three years, and less than 2/10 of a percent of the more than \$7 billion collected by this



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Cabinet in each of those years. It is also noteworthy that while the performance audit covers a three-year period, in the final year covered by the audit, year 2000, there were significant changes made within the Division. Then Secretary Mike Haydon and I, as the Commissioner of the Department of Law, determined that it would be beneficial to have an attorney in charge of the Division's operations on a full-time basis. Prior to that change, the non-attorney Division Director had reported to the Commissioner of Law who was an attorney and the Commissioner of Law had reviewed and approved all settlements over \$100,000. There was, however, no full-time involvement by an attorney within the Division.

With the appointment of an attorney as Division Director beginning in year 2000, all settlements in the Division have been reviewed and approved by at least one attorney. The attorney Director has also developed a new settlement approval form for the review officers to complete which requires more explanation and detail than was previously required. The new PRP software program was also developed and installed to better track the issues and settlements within the Division. These changes occurred prior to the commencement of the performance audit. Soon after the Auditor's staff began the audit, the Division began maintaining a central settlement file of all settlements (As Commissioner, prior to that I had maintained a central file of settlements over \$100,000 that I had approved.) The staff was also directed to begin maintaining copies of the bills within the files as suggested by the Auditor.

The Revenue Cabinet agrees with the Auditor's finding that prior to year 2000, the Division did not collect, track or analyze settlement data. As noted above, in year 2000, steps were taken to begin collecting and tracking this information with the PRP software. The Cabinet is in the process of further developing its reporting capabilities so as to comply with the Auditor's recommendation that more detailed information about the settlements be retained in a database for future review and analysis. The Cabinet also agrees with the recommendation that timely adjustments should be made in CARS and steps will be taken to correct this problem.

Finally, the Cabinet agrees with the recommendation that the Division staff would benefit from additional training concerning the settlement process and the "hazards of litigation" standard set forth in the statutes. As a point of clarification, however, such training cannot be provided by an outside company as suggested by the report. The Division Director did begin looking in year 2000 for an outside negotiations training seminar which would provide staff with additional general insight into the art of negotiation. While this training is too costly at this point in time, the Director is planning the more important settlement process training for both the Division of Legal Services and the Division of Protest Resolution in March.

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The Division Director, the staff attorneys and myself (as I am a licensed attorney as well) have met and reviewed a new settlement approval form which will be used by each Division in the future and which will serve as the basis for the training. This form provides a checklist of "hazards" to be considered. During this training, the attorneys will thoroughly review and discuss with staff the settlement process and the concept of "hazards of litigation". The new form will have a formal approval sheet where each supervisor in the chain of command can review and note their comments and there will be documentation by the review officer as to whom he or she has met with to discuss the proposed settlement. The new settlement procedures will be set forth in a formal policy as suggested by the Auditor.

As for the general recommendations concerning the Revenue Cabinet's maintenance of files, and the review of the accounts receivable system by the Internal Auditor, both of these recommendations will be considered and appropriate changes implemented. We would note that the State Auditor's office currently conducts an annual review of the Revenue Cabinet's accounts receivable system and performs a check of those accounts in the Division of Protest Resolution's control as well.

The Cabinet disagrees with the Auditor's apparent finding that the review officers are the ones who are evaluating the hazards of litigation in each instance or are the ones who are authorized to settle cases. The Cabinet further disagrees with the apparent finding that review officers are making initial determinations about the hazards of litigation and should, therefore, have formal legal training. We believe that the review officer's task in the settlement process has always been one of gathering information, particularly factual information about the case, from various sources. This information comes from the staff attorneys with whom they discuss proposed settlements and who may have been involved in the taxpayer conference; from the tax consultants in the Division of Tax Policy who have historical information about each tax; and, from the auditors in the field who know about the factual issues in the case. Once this information is gathered, the review officer must consider it and offer a preliminary recommendation as to the proposed settlement.

While this information gathering may not have been adequately documented in the past, it was never the intent for the review officer to make a legal determination on his own as to the hazards of litigation involved in the protest. It is fair to say that most of the survey responses of the review officers would support the notion that their job was to gather the information. This will remain the review officer's task in the future. There will, however, be much better documentation as to the source of the information gathered. Thus, the Cabinet does not agree that the review officer has to have legal training or that the review officer should be replaced with an attorney. The Cabinet does agree that the

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review officer needs to have settlement process training. So long as an attorney is thoroughly reviewing the approval form and the case file, we believe that a sufficient legal review of the matter will have been conducted. In fact, under the new procedures, two attorneys will be reviewing each proposal—a staff attorney will review the matter along with the Division Director.

In summary, the Cabinet agrees with most of the findings and recommendations in the report and primarily takes exception with the mischaracterization of the review officers' duties and their need for legal training. The Cabinet appreciates the cooperation and thoroughness of the Auditor's staff who have worked on this audit, often on site, for approximately one year. As noted above, the Revenue Cabinet's senior management recognized in 2000 that changes needed to be made within this Division and much progress has been made since that time. We welcomed the further suggestions for change made by the Auditor's staff during this past year and as described above, the Division has already begun implementation of many of these suggested changes.

Thank you for the opportunity to respond to your report.

Sincerely,



Dana B. Mayton

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### General Questions

General questions should be directed to Harold McKinney, Intergovernmental Liaison, at (502) 564-5841 or the address above.