
Follow-Up Audit of the Department of Taxation

A Report to the
Governor
and the
Legislature of
the State of
Hawaii

Report No. 96-9
April 1996

THE AUDITOR
STATE OF HAWAII

Follow-Up Audit of the Department of Taxation

A Report to the
Governor
and the
Legislature of
the State of
Hawaii

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 96-9
April 1996

Foreword

This is a report of our follow-up audit of the Department of Taxation for the period from July 1, 1994 to February 1996. The audit focused on the findings and recommendations contained in our 1994 Report No. 94-20, *Financial Audit of the Department of Taxation*. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State.

We wish to express our appreciation for the cooperation and assistance extended by the officials and staff of the Department of Taxation.

Marion M. Higa
State Auditor

Table of Contents

Chapter 1 Introduction

Background	1
Objectives of the Follow-Up Audit	2
Scope and Methodology	2

Chapter 2 Findings and Recommendations

Summary of Findings	5
Department Has Improved Its Collection Procedures	5
Cooperation With Other Agencies Yields Collection Potential	6
Electronic Funds Transfer Is Being Implemented	7
System Replacement Project Is Being Planned	7
Vacancies in Collection and Audit Divisions Have Not Been Filled	8
A Formal Training Program Has Not Been Fully Implemented	8
Other Actions that the Department Is Taking	9
Conclusion	9
Recommendations	9

Notes	11
-------------	----

Response of the Affected Agency	13
---------------------------------------	----

Chapter 1

Introduction

This is a report on our follow-up audit of the *Financial Audit of the Department of Taxation*, Report No. 94-20. The report describes actions taken by the department with respect to the findings and recommendations contained in Chapter 2 of our 1994 report.

Both the current and prior audits were performed pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

Background

In 1994, the Office of the Auditor and the certified public accounting firm of Deloitte & Touche LLP conducted a financial audit of the Department of Taxation for the fiscal year July 1, 1993 to June 30, 1994. The audit reported that the combined financial statements of the department were presented fairly. It also reported that, with respect to items tested, the department had complied with applicable laws and regulations and that no material weaknesses in the department's internal control structure were noted. The report pointed out, however, that the department could improve its ability to collect taxes by strengthening its internal control and administrative practices and resources.

Prior audit findings and recommendations

We found that the procedures for collecting unpaid taxes could be strengthened in a number of ways. The department's computers could be better utilized to identify nonfilers and payment plans for delinquent taxes should have documented approvals by responsible officials. We also noted that the department did not pursue collections through foreclosure proceedings. It also did not actively monitor taxpayers' financial condition to determine when tax liens should be enforced through foreclosure proceedings. We recommended that the department's computer systems be re-programmed to identify nonfilers and that approvals of delinquent tax payment plans be documented. We also recommended the department re-examine its practice of not initiating foreclosure proceedings and actively monitor the financial condition of taxpayers to determine when liens should be enforced through foreclosure proceedings.

We found that processing mail-in general excise and state withholding tax payments was time-consuming and recommended the department

implement a depository system so that taxpayers would not have to mail in payments, but rather could deposit them directly at their respective banks.

We also found that the department's income tax computer system was too limited to provide efficient tax processing and other functions. We recommended the department consider acquiring a new income tax computer system. Additionally, we found that letter ruling responses to taxpayers' inquiries were not timely and inactive agency accounts were not closed. We recommended that letter ruling responses to taxpayers' inquiries be prepared on a timely basis and that inactive agency accounts be closed.

With regard to staffing, we found that unfilled vacancies in the department's collection and audit divisions may have a negative impact on overall collections and taxpayer compliance. We also found that after their initial basic tax auditor training program, much of the training for auditors was on an informal, unstructured basis. We recommended that the department be allowed to fill vacant positions in its collection and audit divisions and that the department establish a formal training program for its auditors.

Agency response

In its response to our audit report, the department generally concurred with our findings and recommendations. However, it believed that an electronic funds transfer system would be more efficient than a depository system. It agreed to revise its procedures for letter rulings, consider the acquisition of a new tax computer system, implement better training for its auditors, and close its inactive agency accounts.

The department also agreed to implement a suggested procedure to process payments received on delinquent accounts. The department responded to our recommendation to enforce collections through foreclosure proceedings by stating it would use foreclosure proceedings when warranted.

Objectives of the Follow-Up Audit

1. Review the extent to which findings and recommendations contained in our prior audit are being addressed by the department.
2. Make recommendations as appropriate.

Scope and Methodology

We conducted our review of actions taken for the period from July 1, 1994 to February 1996. We ascertained the extent to which the department has implemented our prior recommendations. We examined

relevant forms and records and interviewed key department officials. We sampled case files to assess the changes made to increase collections.

Our work was performed from December 1995 through March 1996 in accordance with generally accepted government auditing standards.

Chapter 2

Findings and Recommendations

In 1995, the new director of the Department of Taxation updated our office on actions taken to implement recommendations contained in our prior audit.¹ These actions have included efforts to strengthen collection procedures, plans to improve the computer system, implementation of an electronic funds transfer system, development of an auditor training program, and the closure of inactive agency accounts. Our follow-up audit assessed the accuracy of the director's update.

Summary of Findings

We are pleased to note that the new director of taxation is taking positive steps, not only to implement our recommendations, but also to initiate additional actions to improve tax collections and enforce compliance with tax laws.

The department did use foreclosure proceedings to enforce a tax lien. It is implementing electronic funds transfer for certain taxpayers and has begun an income tax computer system replacement project. It has also begun working with other government agencies to identify nonfilers. It has started a training program for its auditors, and has taken actions to close its inactive agency accounts. The department, however, has not been able to fill vacant positions in its audit and collection divisions.

Department Has Improved Its Collection Procedures

The department has begun to improve its collection practices and procedures by revising a procedures manual which now sets clear timetables and specific collection actions which must be initiated. In addition, the collection division is adhering to the policies in the manual. The department also has been aggressively using compromise settlements to improve collections.

Revised procedures provide clearer guidance to field collectors

In 1994, the department revised its collection procedures manual to provide uniform standards of procedures and strict deadlines for enforced collection measures. The manual indicates prompt actions will ensure the State's tax claims receive high priority. Field collectors are required, within 10 days of referral, to send a notice informing a delinquent taxpayer of the legal consequences of not making timely payment. Collectors are also required to file liens and levies within prescribed periods.

The new manual also elaborates on the structuring of payment plans, clarifies default procedures, and adds guidelines on other collection procedures.

Prompt actions are being carried out by field collectors

We found that field collectors are complying with the new procedures. For example, collectors send notices to delinquent taxpayers within the required time period and file tax liens as required.

Compromise of tax liability is being utilized as a collection tool

Section 231-3(10), Hawaii Revised Statutes (HRS), authorizes the department to initiate, with the governor's approval, compromise agreements with taxpayers. These agreements allow taxpayers to pay taxes, penalties, and interest at a lesser amount than the total claim through a "compromise" with the State. In certain instances, such as when the department expects that the entire amount due to the State cannot be collected, or when there is a legitimate dispute as to how much is owed, the department has entered into compromise agreements. By this process the department has effectively increased collections.

The department adopted administrative rules covering these procedures. Because there is a potential for abuse and allegations of favoritism, the department should ensure that strict controls are placed on how and when compromise settlements are reached.

In 1995, the department entered into nine compromise agreements to settle outstanding delinquent balances totaling \$3,175,000. The State agreed to settle for \$846,000 of that amount. We found that the department is following procedures protecting the State's interest in reaching the compromise agreements.

Cooperation With Other Agencies Yields Collection Potential

We are pleased to note that the department has begun cooperative efforts with the Internal Revenue Service (IRS) and the Department of Accounting and General Services (DAGS) to improve collections and identify nonfilers. These actions were part of the department's initiative to improve collections and not a direct response to our prior recommendations.

Department works with IRS to identify nonfilers

The department initiated a "Schedule C Project" to identify taxpayers who fail to file general excise tax returns. The IRS compared department information with its database to identify taxpayers who might have failed to file state general excise tax returns for self-employment income. As of February 1996, this project has yielded additional tax assessments totaling \$9,075,000, of which the department

has collected \$600,000. The department continues to investigate possible nonfilers identified by the project and even more tax assessments may be forthcoming.

Department works with DAGS to identify non-filing state workers

Incredibly, the department did not have the ability to identify State employees who have not filed income tax returns. A “Fact of Filing Project,” cooperatively undertaken with DAGS and the IRS, was initiated to identify these employees. The department and DAGS provided the IRS with payroll and income tax information which the IRS used to identify taxpayers who have failed to file state income tax returns. In turn, the department proceeded to collect from these nonfilers. As of February 1996, this project resulted in almost \$42,000 in assessments, collections of almost \$12,000, and refunds due to nonfilers of more than \$19,000.

Electronic Funds Transfer Is Being Implemented

We recommended that the department consider using a depository system to improve the processing of general excise tax and state income withholding tax payments. The department responded that it would rather pursue electronic funds transfer which is the transfer of funds between bank accounts without the need for written checks. Act 121, Session Laws of Hawaii 1995, amended Chapter 231, HRS, to authorize the Department of Taxation to require taxpayers whose tax liability in any year exceeds \$100,000 to pay their taxes via electronic funds transfer. The department feels this payment process is more efficient, less error-prone, and less costly than a depository system. We agree that it has advantages if properly managed.

The department feels comfortable with its progress in converting to electronic funds transfer and has started to notify taxpayers who might be subject to the new law. Electronic funds transfer became operational in March 1996. The department informed us some taxpayers are confused about the procedure but the first month of operation went smoothly.

System Replacement Project is Being Planned

The department’s tax computer system has two major components: the Comprehensive Net Income Tax system (CNIT) and the General Excise and Withholding Taxes/Transient Accommodation Tax system (GEW/TAT). Our prior report found the computer system to be limited and recommended the department consider acquiring a new one. The department has begun plans to replace the old system.

Department initiates a comprehensive overhaul

The department has launched a Systems Replacement Project and has decided that using a performance-based contract approach will assure the replacement system achieves the results desired. A performance-based contract allows the department to pay the vendor based on the new system's level of performance rather than its installation. Under the new approach, payments would be geared to improved tax collections attributable to the new system. To this end, the department has initiated a bill to obtain legislative authority to proceed with performance-based contracting.

The department expects the new system to enhance collection capabilities through more efficient allocation of resources, improved information databases, and the use of cross-functional applications. Cross-functional applications can access all tax information on any taxpayer. The new system would also improve and expand tax audit selection criteria, automate tax filing and processing, and expand the department's research capability.

Vacancies in Collection and Audit Divisions Have Not Been Filled

In our prior report, we pointed out that tax collections are the result of voluntary compliance with tax laws and the department's collection of delinquent taxes. Tax audits ensure compliance with tax laws and collectors are responsible for collecting delinquent accounts.

We recommended the department be allowed to fill vacancies in its collection and audit divisions: the costs of these positions could be more than offset by the increased revenues brought in by new staff. During this follow-up, we found that the department is still unable to fill vacancies in these divisions because of budget restrictions. The department intends to continue working with the Department of Budget and Finance to ease the restrictions and begin to fill these vacancies.

A Formal Training Program Has Not Been Fully Implemented

In 1994, we recommended that the department initiate formal staff training programs for its auditors. Such programs would enhance the department's ability to examine more complex tax issues and increase assessments. In May 1995, the department instituted a training policy that requires each division to implement a training plan which provides all employees at least 20 hours of training per year.

In this follow-up, we focused on the training provided to the Audit Division staff and found the division is providing staff training. While the training follows a plan that is more in line with the new director's initiatives, it is still somewhat informal. In other words, the plan still does not have a formal structure to ensure that auditors are provided standardized training consistent with their responsibilities.

Other Actions that the Department Is Taking

In our 1994 audit, we recommended that the department close its inactive agency accounts, deposit delinquent checks in a more timely manner, and expedite its letter rulings. The department is in the process of addressing these recommendations.

The department, with the assistance of the attorney general, has taken steps to close its inactive agency accounts in compliance with state statutes. To expedite its response to taxpayer inquiries, the department is exploring the possibility of using Post-itTM responses on correspondence that do not require a full reply.

In response to our recommendation to improve the timeliness of deposits, the department maintains that it has taken actions to identify and deposit large checks in a more timely manner. It feels that, because checks are being processed within one month of receipt, a suspense account is not needed.

Conclusion

Under the leadership of its new director, the department has addressed our recommendations and initiated other actions to improve collections and compliance. We are pleased with the progress and believe that further improvements can be achieved.

Recommendations

1. We recommend the department continue to follow its new collection procedures and initiatives and that it continue to pursue implementation of a new income tax computer system.
2. We again recommend the department be allowed to fill vacancies in its audit and collections divisions.
3. We recommend the department continue its training initiatives and develop a formal training program for its auditors.

Notes

Chapter 2

1. Letter to Marion M. Higa, State Auditor, from Ray K. Kamikawa, Director of Taxation, November 17, 1995.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Taxation on April 3, 1996. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2.

The department generally concurs with our findings and recommendations. While our report provided information on increased tax assessments and collections to February of this year, the department provided additional statistics through March from two of its initiatives.

The department commented that it has received the governor's approval to fill some of the vacancies in the audit and collections divisions, it is working with the Department of Commerce and Consumer Affairs and the Public Utilities Commission on joint tax compliance projects, and it plans to establish a Technical Training & Development Office to handle formal training for its employees. The response also includes a status of tax payments received through electronic funds transfer.

BENJAMIN J. CAYETANO
GOVERNOR

MAZIE HIRONO
LT. GOVERNOR



RAY K. KAMIKAWA
DIRECTOR OF TAXATION

SUSAN K. INOUE
DEPUTY DIRECTOR

DEPARTMENT OF TAXATION

STATE OF HAWAII
P.O. Box 259
Honolulu, Hawaii 96809

RECEIVED

APR 9 3 05 PM '96

OFF. OF THE AUDITOR
STATE OF HAWAII

April 8, 1996

The Honorable Marion Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Mrs. Higa:

Thank you for the opportunity to review and respond to the Follow-Up Audit of the Department of Taxation. We are pleased to note that the auditor has recognized that we are taking positive steps, not only to implement our recommendations, but also to initiate additional actions to improve tax collections and enforce compliance with our tax laws. The comments which follow address the specific audit recommendations and comments in Chapter 2 of the report.

Page 6, Cooperation With Other Agencies Yields Collection Potential:

In addition to the agencies listed in the draft, the Department of Taxation is also working with the Department of Commerce and Consumer Affairs (DCCA) and the Public Utilities Commission (PUC) on joint compliance initiatives. The Memorandum of Understanding between TAX and DCCA addresses compliance problems with real estate brokers and salespersons. (Please see attached.) Basically, a person must be cleared with TAX before obtaining or renewing their licenses. The Department and PUC have entered into an arrangement whereby applicants for a PUC license are required to obtain a tax clearance as a condition to any license transfer.

Page 6, Department works with IRS to identify nonfilers:

Attached is an updated worksheet showing that the Schedule C Project has yielded as of March 1996 tax assessments totaling \$10,275,681.02 of which the department has collected \$1,076,099.95. (Copy of worksheet attached.)

Hon. Marion Higa
Page 2

Page 6, Department works with DAGS to identify nonfiling state workers:

Attached is an updated worksheet showing that the nonfiling state workers project has yielded almost \$54,000 in assessments, collections of \$21,145, and refunds due to nonfilers of more than \$21,000. The disparity between these numbers and those in your draft report is explained by the fact that your figures were based on a sample, only ten percent (10%), of the total cases involved.

Page 7, Electronic Funds Transfer Is Being Implemented:

The electronic funds transfer (EFT) program was implemented on March 4, 1996. The program initially involves general excise/use, withholding, transient accommodations, and rental motor vehicle/tour vehicle surcharge taxes. Taxpayers continue to register for participation. Tax payments via EFT totalled \$28.4 million in March 1996 with partial participation. Approximately 4,000 tax payments will be made using EFT in April 1996. When fully implemented, we estimate receiving over \$500,000,000 in EFT payments annually for these tax types. The remaining tax types (e.g. public service company tax, franchise, liquor, tobacco, fuel, income) will be phased in over two years.

Page 8, Vacancies in Collection and Audit Divisions Have Not Been Filled:

To date the Department has requested and has received approval from the Governor to fill 3 positions in the Audit Division, 3 positions in the Collection Division, and 3 positions in the Tax Service and Processing Division.

Page 8, A Formal Training Program Has Not Been Fully Implemented:

The Department has just sent a request to Budget & Finance to reorganize the Department. Included in this request is to establish a Technical Training & Development Office. During our reorganization process, the Department will try to identify a vacant position for this office to start a formal training program for our employees. In the interim, we will continue to pursue our training plan initiatives.

Thank you for your favorable response to our initiatives and procedures.

Sincerely,



RAY K. KAMIKAWA
Director of Taxation

Attachments

Memorandum of Understanding

THIS MEMORANDUM OF UNDERSTANDING (this "MOU") is made this 6th day of February, 1996, by and between the DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS, STATE OF HAWAII, by its Director, Kathryn S. Matayoshi ("DCCA"), the DEPARTMENT OF TAXATION, STATE OF HAWAII, by its Director, Ray K. Kamikawa ("TAX"), and the REAL ESTATE COMMISSION, an agency attached to DCCA, by its Chairperson, Barbara Dew ("COMMISSION")

WHEREAS, TAX has experienced compliance problems with real estate brokers and salespersons licensed by DCCA ("Licensees")

WHEREAS, DCCA, TAX, and COMMISSION believe that it is in their mutual best interests and the interests of the State of Hawaii (the "State") to cooperate in improving compliance by Licensees with the State's tax laws.

NOW, THEREFORE, in consideration of the foregoing recitals, the undertakings of the parties herein, and the mutual covenants hereby, DCCA, TAX, and COMMISSION shall adopt the following procedures with respect to Licensees.

1. TAXPAYER EDUCATION.

DCCA and COMMISSION shall make available to TAX adequate space in its quarterly Real Estate Bulletin for a message pertaining to tax information applicable to Licensees. DCCA and COMMISSION shall advise TAX on the publication deadlines and other particulars with respect to publication of said message. TAX may, but need not, submit a message for each bulletin.

2. APPLICATIONS FOR LICENSURE.

With respect to applications for licensure by persons desiring to become Licensees, DCCA, TAX and COMMISSION shall forthwith implement the following:

a. DCCA shall provide, on a weekly basis to TAX, a list of all persons applying for licensure as Licensees. TAX shall verify whether these persons are current in the filing of all applicable tax returns, are current in the payment of all tax liabilities, and have complied with the terms of a payment plan for the payment of delinquent taxes (if any taxes are delinquent and a payment plan is in effect with TAX).

b. TAX shall within 48 hours of receipt of said list notify DCCA in writing of any such persons who have failed to comply with their tax obligations stated in paragraph 2 a. above; and DCCA and COMMISSION shall immediately, within applicable laws and rules, take steps to deny applications for licensure with respect to such persons.

3. LICENSE RENEWALS.

Prior to the beginning of each real estate license renewal season applicable to Licensees (now December of every even-numbered year) DCCA, TAX AND COMMISSION shall forthwith implement the following

Run *COM* a. DCCA shall prepare on its letterhead a message (in a form mutually approved with TAX), signed by the Director of DCCA and the Chairperson of COMMISSION which shall explain ~~in detail~~ the new procedures adopted by DCCA and TAX relating to real estate license renewals by Licensees. The message shall include a statement that the Commission will initiate steps to deny renewal, within applicable laws and rules, if DCCA receives information from TAX of Licensees' failure to comply with the State's tax laws. DCCA shall provide said message to TAX in sufficient time for TAX to complete the procedures described below in paragraphs 3 b and 3 c. of this MOU.

b. The message shall be duplicated and mailed by TAX to those Licensees that TAX determines are not current in the filing of any tax return, who have failed to pay any taxes due, or who have failed to satisfy the terms of a payment plan for the payment of delinquent taxes

c. In the first week of November during each license renewal season, TAX shall provide DCCA with a written list of Licensees who received the message described in the preceding paragraph 3 b. Upon receipt of a renewal application from Licensees on TAX's list, COMMISSION shall immediately, within applicable laws and rules, take steps to deny renewal of applications for licensure with respect to such Licensees.

4. CONTINUING COMPLIANCE.

Upon notification by TAX that any Licensee has failed to comply with the State's tax laws, DCCA and its Regulated Industries Complaint Office shall initiate an investigation for disciplinary or other action as deemed appropriate with respect to said Licensees.

5. MISCELLANEOUS.

a. This MOU shall be in force until terminated by either party in writing given to the other party.

b. COMMISSION shall adopt rules providing that applications for licensure and renewals for licensure shall, within applicable laws and rules, be denied when the person applying for licensure or Licensee applying for renewal is determined by TAX as not being in compliance with the State's tax laws. Similarly, COMMISSION shall adopt rules requiring that a Licensee's license shall, within applicable laws and rules, be subject to disciplinary action for failure to comply with the State's tax laws..

c TAX, in its discretion, may share information relating to tax delinquencies of Licensees and persons applying for Licensure with the Internal Revenue Service.

d TAX will withdraw its 1996 legislative proposal to impose a tax clearance procedure on Licensees subject to execution of this MOU, but reserves the right for future introduction.

WHEREFORE, the parties hereto have entered into this MOU as of the date first above written.

Department of Commerce and Consumer Affairs
State of Hawaii

By: 
Kathryn Matayoshi
Its Director

Department of Taxation
State of Hawaii

By: 
Ray K. Kamikawa
Its Director

Real Estate Commission
Department of Commerce and Consumer Affairs
State of Hawaii

By: 
Barbara Dew
Its Chairperson

rkk-172c agt

Schedule C Project
Prepared 3/23/96

	Assmt		Returns		Penalty & Interest	Total	Amount Collected
	# of Accts	Dollars	# of Accts	Dollars			
Office Audit	1072	2,353,217.93		570,894.90	1,420,192.66	4,344,305.49	558,157.99
Field Audit	6	518,141.94				518,141.94	
Maui District	143	688,055.92		111,913.95	384,723.26	1,184,693.13	16,836.49
Hawaii District	35	371,913.60	20	199,928.23	272,270.53	844,112.36	133,170.75
Kauai District	19	69,024.84	5	20,824.36	45,407.69	135,256.69	41,845.98
First 100	39	1,728,180.66	20	406,919.97	1,114,070.78	3,249,171.41	326,088.74
TOTAL	1,314	5,728,534.69	45	1,310,481.41	3,236,664.92	10,275,681.02	1,076,099.95

Hilo, Hawaii
March 28, 1996

TO: Mr. Melvin Wakumoto
Returns Classifying Officer

THROUGH: Mr. Richard Chiogioji *RC*
Tax Audit Administrator

FROM: Ronald T. Yabe *RY*
Hawaii District Tax Assessor

SUBJECT: SEFF PROJECT STATUS REPORT FOR WEEK ENDING MARCH 22, 1996

	1993 Week 03/22/96	1993 TO-DATE	OTHER YEARS TO-DATE	TOTAL
1. Total No. of Taxpayers Referred:		264		
2. No. of Letters Sent:		192		
3. No. of Responses from Taxpayers:	0	80		
4. No. of Tax Returns Received:	0	50	60	
5. No. of Taxpayers Assessed:	0	1	-0-	
6. No. of Taxpayers with Taxes Due State:	0	32	13	
7. Amount Due State:	\$0.00	\$27,171.49	\$26,638.54	\$53,810.03
8. No. of Taxpayers with Refunds:	0	17	13	
9. Amount to be Refunded:	\$0.00	(\$12,554.14)	(\$9,192.31)	(\$21,746.45)
10. No. of Taxpayers who paid:	0	19	10	
11. Amount Collected:	\$0.00	\$9,557.81	\$11,587.85	\$21,145.66

No changes for week of March 18-22, 1996.

We are presently awaiting information from the IRS to prepare assessments on those taxpayers who failed to respond to our inquiries. Therefore, our weekly status report will be suspended until then.

COPY