

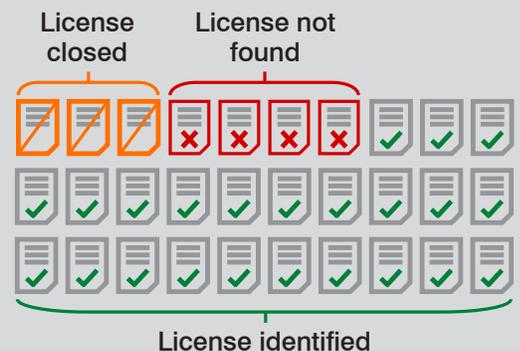
Arizona Department of Revenue Transaction Privilege Tax Administration and Enforcement

CONCLUSION: The Arizona Department of Revenue (Department) is responsible for administering the transaction privilege tax (TPT) on behalf of the State, counties, and cities and towns. TPT is a tax imposed on a seller for the privilege of doing business in the State and is commonly referred to as a sales tax because it is usually passed on to the buyer. The Department collected approximately \$10.9 billion in TPT revenue in fiscal year 2018, of which approximately \$3 billion was on behalf of cities and towns. We identified several areas where the Department should improve its administration of TPT. These include ensuring that businesses have active and accurate TPT licenses, detecting potential underreporting and misreporting of TPT owed and correcting errors on TPT returns, enforcing statutory filing requirements, correctly distributing TPT collected on behalf of cities and towns, and collaborating with cities and towns on TPT audits and collections efforts.

Department should take actions related to TPT licensure

Ensure businesses are licensed—Statutes require that all businesses subject to TPT have a TPT license, and the Department relies on these licenses to efficiently process, distribute, and enforce TPT payment. However, some businesses are likely operating without a TPT license and not paying TPT. The Department is required to enforce TPT licensure requirements, which helps ensure TPT is appropriately paid. However, the Department gradually discontinued its license-compliance program between fiscal years 2015 and 2018 and had stopped performing any license-compliance work by April 2018. Consequently, the number of businesses that should have a TPT license that were subsequently brought into compliance through Department efforts declined considerably. The Department implemented a new license-compliance program in October 2018 to identify unlicensed businesses.

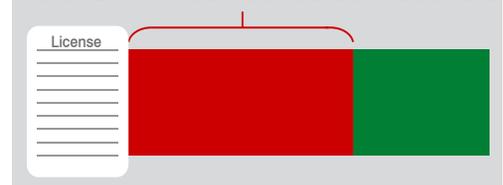
Department could not identify active TPT licenses for **7 of 30** operating businesses



Improve its nonfiler program—Through this program, the Department periodically identifies and cancels TPT licenses for businesses that have not filed a return for 13 consecutive months (i.e., nonfilers). However, some nonfilers may be operating but not complying with TPT filing requirements. The Department lacks an effective process for verifying a business' status before canceling its license and has inappropriately canceled some active businesses' licenses, potentially resulting in lost TPT revenues. In 2018, the Department collaborated with 10 cities and towns who volunteered to review nonfiler licenses it intended to cancel, and the cities and towns indicated that a considerable number of these nonfiler licenses should potentially remain active. Without an effective process to routinely verify the status of nonfilers located throughout the State, the Department remains at high risk of canceling nonfilers' licenses.

Ensure TPT licenses have accurate address information—We found inaccurate address information in TPT licenses we reviewed, such as incorrect street addresses, zip codes, or cities. We also identified several instances of unstandardized address information in the Department's tax system. Inaccurate and unstandardized addresses hinder the Department's ability to effectively administer and enforce TPT. The Department lacks information technology (IT) controls that could validate and standardize address information in its tax system and has not engaged in targeted taxpayer education efforts on how to correctly enter and update address information. Additionally, the Department's weekly process for manually reviewing newly issued licenses for errors, including address errors, is inefficient and error prone.

15 of 24 TPT licenses had address errors



Recommendations

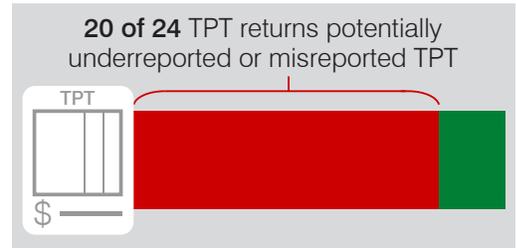
The Department should:

- Continue implementing its new license-compliance program, including its planned use of data analytics to identify and license potentially unlicensed businesses.
- Improve its nonfiler program by addressing deficiencies in the license-cancellation notice sent to nonfilers and implementing a process to verify a business' status before canceling its license.
- Implement address-standardization controls and a targeted taxpayer education campaign and look for ways to automate its new-license review process.

Department should take actions related to TPT filing

Better identify and address TPT underreporting or misreporting—

The Department uses some IT controls to identify certain types of errors when processing TPT returns in its tax system, but these controls are not designed to identify all errors. We identified instances where the taxpayer potentially underreported or misreported TPT owed, such as not reporting for all business locations or reporting taxes owed to the wrong jurisdiction.



For example, a taxpayer with multiple stores across Arizona did not report activity for 2 of its 6 stores in Avondale and 1 of its 3 stores in Queen Creek for the filing period we reviewed. The taxpayer may have underreported sales in these instances, which would have resulted in the Department not collecting an estimated \$12,129 owed to Avondale, \$4,205 owed to Queen Creek, and \$31,259 owed to the State/county. Data analytics could help the Department detect potential underreporting or misreporting, but the Department would need to first address inaccurate TPT license information in its tax system.

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Ensure staff accurately correct identified errors on TPT returns—TPT returns are suspended when the tax system's existing IT controls identify certain types of errors on the returns. Department staff then research the taxpayers' accounts and use the best information available to correct the errors and process the returns. Because the Department prioritizes processing returns quickly, staff may not always verify the accuracy of their corrections with taxpayers, which increases the risk of TPT reporting and distribution errors. During the audit, the Department implemented an informal quality control process to review corrections staff make to TPT returns, but this process was not effective.

Improve tax correction notices—The Department's tax system automatically generates tax correction notices to inform taxpayers of overpayments, underpayments, and filing errors on TPT returns. The Department generates thousands of these notices each month. According to Department staff, notices are intended to correct filing errors and educate taxpayers to reduce future incorrect filings. However, we reviewed 9 notices and found that they did not always accurately reflect or adequately explain the errors and/or did not provide adequate instruction to taxpayers to correct the issues, which could lead to continued filing errors and inefficiencies. The Department's prior efforts to improve the notices have not been effective.

Enforce statutory TPT filing requirements—We identified 3 statutory TPT filing requirements that the Department did not implement by their statutory effective dates and that had not been implemented as of November 2018. As a result, the

Session law and effective date	Requirement
Laws 2017, Ch. 60, §15 January 1, 2018	Requires taxpayers with an annual tax liability of \$20,000 or more to file their TPT return electronically beginning January 1, 2018. Tax liability threshold will continue to be lowered according to the following schedule: \$10,000 on January 1, 2019 \$ 5,000 on January 1, 2020 \$ 500 on January 1, 2021
Laws 2016, Ch. 208, §11 January 1, 2018	Requires property management companies to use an electronic consolidated return form the Department developed to file on behalf of multiple property owners
Laws 2017, Ch. 60, §3 August 9, 2017	Requires the Department to impose late-filing penalty of 4.5% of tax owed or \$25, whichever is greater, on taxpayers who do not file their TPT returns on time

Department has allowed taxpayers who are statutorily required to electronically file their TPT returns to continue to file more error-prone paper returns. In addition, the Department has underassessed late-filing penalties. For example, as of May 2018, the Department underassessed taxpayers approximately \$73,000 in TPT penalties for the September 2017 filing period.

Recommendations

The Department should:

- Reduce the risk of underreported or misreported TPT by implementing additional IT controls and data analytics and addressing inaccurate licensing information in its tax system.
- Consult with taxpayers when making corrections to TPT returns and develop and implement policies and procedures for its quality control process for reviewing corrected returns.
- Ensure tax correction notices are accurate and provide adequate taxpayer instruction to address the issues.
- Complete the necessary programming changes to its tax system to comply with statutory TPT-filing and penalty assessment requirements.

Department should address issues affecting city/town TPT distributions

The Department distributes the TPT it collects on behalf of cities and towns and prepares various TPT weekly distribution reports for them. However, the complexity of the Department's manual record-keeping process for TPT distributions and the potential for inaccurate tax system data increases the risk of distribution errors. For example, we identified 2 errors where the Department overdistributed \$53,000 to a town and \$25 to a city, which the Department later corrected. In addition, the tax system has functional limitations that impact its ability to correctly calculate and distribute city/town TPT in certain circumstances.

Recommendations

The Department should identify and implement opportunities to streamline or automate its weekly city/town TPT distribution process and finish resolving the functional limitations in its tax system that affect those distributions.

Department should further collaborate with cities and towns on TPT enforcement efforts

The Department can improve its collaboration with cities and towns by:

- Enhancing its audit planning efforts through collaboration with cities and towns.
- Collecting and analyzing data from its collections pilot project with cities and towns.
- Informing cities and towns of taxpayers' requests to compromise on a TPT debt (called offers in compromise).
- Analyzing its process to place liens—or legal holds—on taxpayer assets until a TPT debt is paid and developing staff guidance based on that analysis.



Department should improve its collaboration with cities and towns in 4 enforcement areas

Recommendations

The Department should:

- Continue to implement its plan to increase the number of TPT audits it performs and discuss opportunities to leverage available audit resources with cities and towns.
- Assess the effectiveness of its collections pilot project with cities and towns.
- Ensure it obtains city/town input on offers in compromise that include city/town TPT.
- Collaborate with cities and towns to establish a process for determining when to issue liens.