



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Sunset Review

Department of Revenue— Sunset Factors

OCTOBER • 2005
REPORT NO. 05 – 16



Debra K. Davenport
Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.

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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

October 13, 2005

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Gale Garriott, Director
Department of Revenue

Transmitted herewith is a report of the Auditor General, A Sunset Review of the Department of Revenue. This report is in response to a November 20, 2002, resolution of the Joint Legislative Audit Committee and was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq.

Included with this report is a written response from the Department of Revenue.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on October 14, 2005.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

PROGRAM FACT SHEET

Arizona Department of Revenue

Services:

The Arizona Department of Revenue (Department) is responsible for licensing, processing, collecting, and enforcing most taxes for the State of Arizona. The Department's responsibilities include providing tax-related information to the general public and government officials, processing incoming tax documents and refunds, and ensuring compliance with Arizona tax laws.

Facilities:

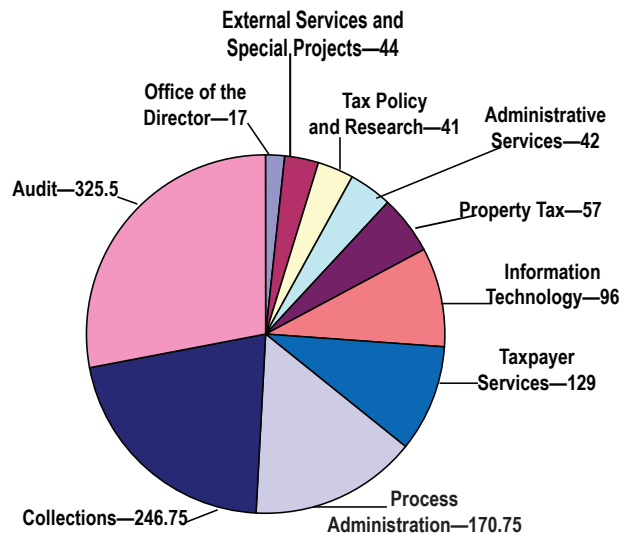
The Department's staff are located in three offices state-wide. Specifically, department staff are located in the agency headquarters, a state-owned building at 1600 West Monroe in Phoenix, and in a state-owned building complex at 400 West Congress in Tucson. Finally, staff are located in a privately owned facility at 3191 North Washington Street in Chandler. The Department also leases a privately owned warehouse in Phoenix, which is used primarily for document storage. The lease cost for these two privately owned facilities is \$418,115 annually, plus operating costs.

Equipment:

The Department has typical office equipment, such as office furniture, computers, and printers. Additionally, some divisions within the Department use specialized equipment. For example, both the Collections Division and the Taxpayer Services Division use an Automated Call Distribution System that manages and processes incoming phone calls. Additionally, the Process Administration Division uses three Kodak scanners to image the transaction privilege tax returns, which allows easier retrieval for staff who are working to resolve an issue with a review or assist a taxpayer with a question. Finally, the Department reports acquiring over \$12 million in hardware and software over the past 2 years to support the implementation of the Business Reengineering/Integrated Tax System (BRITS) project.

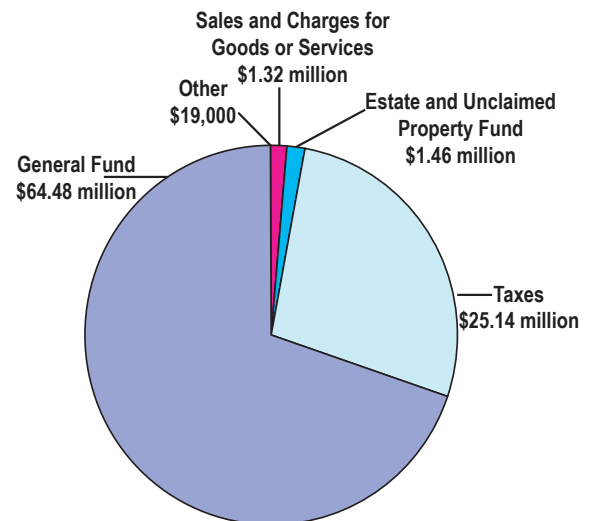
Department staffing by division:

1,169 FTEs (as of April 29, 2005, which included 149 vacancies)



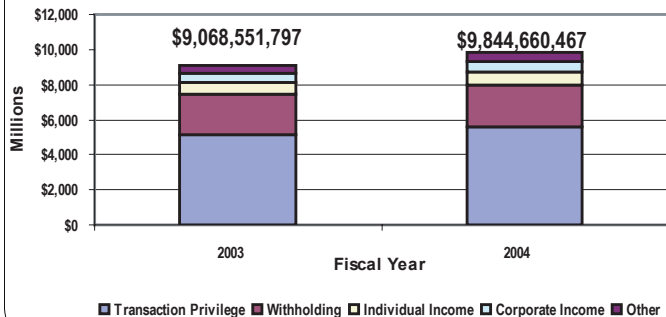
Department revenue:

\$92.4 million (fiscal year 2005)



Tax revenue collected:

Total gross revenues collected in fiscal years 2003 and 2004



Mission:

To administer tax laws fairly and efficiently for the people of Arizona.

Agency goals:

The Department has adopted the following three goals:

1. To maximize its return on investment.
2. To maximize customer and stakeholder satisfaction.
3. To maximize employee satisfaction.

Adequacy of goals and performance measures:

The Department's goals and performance measures appear to be generally aligned with its mission. Additionally, the Department has a variety of performance measures, including output, outcome, quality, and efficiency measures. The Department's performance measures include division-specific measures, as well as department-wide measures that are used to track the efficiency and effectiveness of a variety of departmental functions and services. For example, in order to maximize customer and stakeholder satisfaction, the Department is striving to more quickly get tax refunds out to taxpayers and therefore tracks the average turnaround time on refunds. Additionally, to maximize the Department's return on investment, the Department tracks the amount of revenue deposits received per total dollars spent. Lastly, in the Department's efforts to maximize employee satisfaction, the Department tracks employee turnover, career training, and grievances filed.

- Source: Auditor General staff analysis of Arizona Financial Information Systems (AFIS) *Revenues and Expenditures by Fund, Program, Organization, and Object*; AFIS *Trial Balance by Fund Report*; and the *State of Arizona Appropriations Report* for the years ended June 30, 2003 through 2005; the Department's *2004 Annual Report* and *Fiscal Year 2005 Strategic Plan*; and other information provided by the Department.

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♦ concluded

INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a review of the Arizona Department of Revenue (Department) using the 12 criteria in Arizona's sunset law. The analysis of the 12 sunset factors was conducted pursuant to a November 20, 2002, resolution of the Joint Legislative Audit Committee and prepared as part of the sunset review set forth in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

The sunset review of the Department also included a series of three performance audits. The audited areas covered the Department's Audit Division, the Department's Collections Division, and the Business Reengineering/Integrated Tax System (BRITS) project.

The Department is responsible for licensing, processing, collecting, and enforcing most taxes for the State of Arizona. In fiscal year 2004, the Department collected more than \$9.8 billion in state and local revenues to pay for many public services, including education, health, and public safety.

Department organization and responsibilities

The Department is divided into nine divisions in addition to the Office of the Director. As of April 29, 2005, the Department had 1,169 FTEs, which included 149 vacancies.¹

- **Office of the Director (17 FTEs, 4 vacancies)**—The director is responsible for the direction, operation, and control of the Department. The Office of the Director includes the deputy director as well as the Department's problem resolution officer, who acts as the taxpayer advocate within the Department.
- **Administrative Services Division (42 FTEs, 8 vacancies)**—The Administrative Services Division is responsible for the oversight of the Department's financial and employee services, such as accounting, budget, payroll, human resources, and purchasing. The Division is also responsible for taxpayer services, including problem resolution assistance and audit due process.

¹ According to the Department's fiscal year 2005 position vacancy report summaries by pay period, of the 1,169 total FTEs, 1,133 FTEs are General Fund positions and 36 FTEs are non-General Fund positions.

- **Audit Division (325.5 FTEs, 34 vacancies)**—The Audit Division is responsible for auditing taxpayer returns and identifying those taxpayers who did not file a return. The Division educates taxpayers, discovers and corrects differences between taxpayers' obligations and what they report, and encourages compliance with tax laws. The Division includes four sections, which are dedicated to auditing the major tax types, as well as licensing and enforcing bingo laws and tobacco and liquor tax.
- **Collections Division (246.75 FTEs, 30 vacancies)**—The Collections Division has the primary responsibility of collecting tax monies owed on delinquent accounts. The Division has the authority to take several enforcement actions, such as placing liens and levies, as well as several options for negotiating account resolution, such as negotiating payment plans. The Division includes three sections that have varying levels of enforcement authority: office collections, field collections, and bankruptcy and litigation.
- **External Services and Special Projects Division (44 FTEs, 9 vacancies)**—The External Services and Special Projects Division is responsible for a variety of areas, including criminal and civil investigations, the Office of Economic Research and Analysis, and the agency public information officer. Additionally, the Division handles special projects, such as the tax amnesty program and the implementation of the Ladewig class action lawsuit.¹
- **Information Technology Division (96 FTEs, 18 vacancies)**—The Information Technology Division is responsible for managing the Department's information technology. The Division provides application services, internal customer service, data center support, and enterprise network support. The Division is also providing support for the implementation of the agency's new integrated tax system.
- **Process Administration Division (170.75 FTEs, 18 vacancies)**—The Process Administration Division is responsible for individual income and business tax processing, as well as records management and mail services. This Division also houses the agency comptroller's office, which is responsible for providing the Department's revenue accounting services.
- **Property Tax Division (57 FTEs, 9 vacancies)**—The Property Tax Division plays a significant role in administering the property tax system in Arizona. The Division's responsibilities include assessing the value of utilities, railroads, mines, and other geographically dispersed properties, ensuring the application of uniform appraisal methods used by county assessors, and preparing tax code maps of taxing jurisdictions.

¹ According to the Department, from 1933 through 1990, the Arizona tax code allowed individuals to subtract from gross income dividends received from corporations doing more than half of their business in Arizona. In 1991, the estate of a taxpayer (Ladewig) filed a refund claim on non-Arizona dividends, asserting that Arizona was violating the commerce clause of the U.S. Constitution. The refund was denied and a class action lawsuit followed. The Arizona Supreme Court found in favor of the taxpayer, certified the class, and a settlement was reached in December 2002 in Tax Court. This settlement was for more than \$300 million and impacted hundreds of thousands of taxpayers.

- **Taxpayer Services Division (129 FTEs, 15 vacancies)**—The Taxpayer Services Division is responsible for taxpayer information and assistance and community outreach and education. Additionally, the Division processes applications for transaction privilege, use, severance, and withholding taxes and manages the Department's unclaimed property unit.
- **Tax Policy and Research Division (41 FTEs, 4 vacancies)**—The Tax Policy and Research Division provides administrative tax policy for the Department, legal and interpretive support, case resolution, and advocacy for the various divisions. The Division also acts as liaison to the Attorney General's Tax Section and coordinates the defense of litigation with the Tax Section attorneys.

Department budget

The Department was appropriated approximately \$64.5 million in fiscal year 2005 (see Table 1, page 4). The Department also received approximately \$27.9 million in other monies, of which \$25.1 million was from taxes, \$1.5 million was from the Estate and Unclaimed Property Fund, \$1.3 million was from the sale and charges for goods and services, and \$19,000 was from other sources.

Scope and methodology

The Department's performance was analyzed in accordance with the 12 statutory sunset factors. The following audits were completed:

- Audit Division (Auditor General Report No. 05-06).
- Collections Division (Auditor General Report No. 05-14).
- Business Reengineering/Integrated Tax System (BRITS) (Auditor General Report No. 05-15).

Various methods were used to study the issues addressed in this report. Specifically, to develop this report, auditors conducted interviews with department and division management and staff, and compiled information from state laws and regulations, unaudited information from the Department's 2004 Annual Report, the Department's position tracking list, the Department's Web site, the 2003-2005 Master List of State Government Programs, and other information provided by the Department. Additionally, auditors conducted interviews with staff from the Arizona Secretary of State's Office and the Governor's Regulatory Review Council.

**Table 1: Department of Revenue Administration
Schedule of Revenues and Expenditures, in Thousands
Years Ended June 30, 2003, 2004, and 2005
(Unaudited)**

| | 2003 | 2004 | 2005 |
|---|---------------|-----------------|---------------------|
| Revenues: | | | |
| State General Fund appropriations ¹ | \$65,622 | \$63,650 | \$64,478 |
| Estate and Unclaimed Property Fund ² | 1,370 | 1,373 | 1,460 |
| Taxes: | | | |
| Corporate income ³ | | 6,031 | 3,194 |
| Transaction privilege ³ | 629 | 2,866 | 15,246 |
| Individual income ³ | 16 | 2,067 | 4,410 |
| Income withholding ³ | | 775 | 1,858 |
| Tobacco ⁴ | 404 | 414 | 428 |
| Sales or charges for goods or services ⁵ | 1,279 | 1,098 | 1,315 |
| Other | 12 | | 19 |
| Total revenue | <u>69,332</u> | <u>78,274</u> | <u>92,408</u> |
| Expenditures: ⁶ | | | |
| Personal services and employee related | 42,585 | 46,352 | 48,671 |
| Professional and outside services | 9,875 | 6,879 | 19,633 ⁷ |
| Travel | 529 | 795 | 822 |
| Other operating | 13,948 | 13,342 | 12,786 |
| Equipment | 2,230 | 10,436 | 10,399 |
| Total expenditures | <u>69,167</u> | <u>77,804</u> | <u>92,311</u> |
| Excess of revenues over (under) expenditures | 165 | 470 | 97 |
| Net operating transfers in (out) | <u>(45)</u> | <u>4</u> | <u>(13)</u> |
| Excess of revenues and operating transfers in over (under) expenditures and operating transfers out | 120 | 474 | 84 |
| Fund balance, beginning of year | 622 | 742 | 1,216 |
| Fund balance, end of year ⁸ | <u>\$ 742</u> | <u>\$ 1,216</u> | <u>\$ 1,300</u> |

¹ Includes approximately \$8.6, \$3.7, and \$2.2 million for 2003, 2004, and 2005, respectively, appropriated for administering the Ladewig settlement.

² Amount is the Department's portion of the Estate and Unclaimed Property Fund used to administer the program.

³ Beginning in 2003, the Department retained these monies to pay for the Business Reengineering/Integrated Tax System (BRITS) project. The amounts retained are based on the benefit-sharing contract terms and vary significantly each year as BRITS generates additional enforcement revenues.

⁴ Consists of amounts retained by the Department for tobacco tax enforcement.

⁵ Amounts include monies collected from county assessors for data processing services, fees collected from taxpayers and agencies for administering the liability setoff program, and receipts from the sale of tax-related publications.

⁶ Includes administrative adjustments from prior years.

⁷ Over \$16.2 million of this amount relates to payments made for the BRITS program.

⁸ Amounts are reserved primarily for the liability set-off, BRITS, and county equipment capitalization programs.

Source: Auditor General staff analysis of Arizona Financial Information Systems (AFIS) *Revenues and Expenditures by Fund, Program, Organization, and Object*; AFIS *Trial Balance by Fund* report; and the *State of Arizona Appropriations Report* for the years ended June 30, 2003, 2004, and 2005.

The report was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the director and staff of the Department of Revenue for their cooperation and assistance throughout the development of this report.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Department of Revenue (Department) should be continued or terminated. The three performance audits identified areas that the Department has operated efficiently and effectively, as well as opportunities for the Department to improve operations. The evidence assembled under these 12 factors indicates the continued need for the Department.

1. The objective and purpose in establishing the Department.

The Department was established by Laws 1973, Ch. 123, which transferred the powers and duties of the Department of Property Valuation and the Estate Tax Commissioner and certain functions of the State Tax Commission to the Department.

The Department defines its mission as follows:

“To administer tax laws fairly and efficiently for the people of Arizona.”

In support of this mission, the Department’s nine divisions perform the following general functions:

- **Tax Service**—The Department is responsible for meeting the needs of Arizona taxpayers by providing answers to their questions regarding licensing, filing requirements, and application of the State’s tax laws. The Department also provides revenue statistics to the Governor’s Office, the Legislature, and the public to aid in making revenue projections and performs economic impact projections and other tax policy determinations. Additionally, the Department seeks to ensure fair, accurate, and uniform property valuations and property tax services for all Arizona counties as prescribed by Arizona statutes.
- **Tax Processing**—The Department is responsible for processing all incoming electronic and paper tax documents and associated revenues,

processing tax refunds, and executing the mailing of tax documents to Arizona taxpayers in a timely and efficient manner. The Department also ensures the accuracy of taxpayer accounts within the Accounts Receivable system and provides services to satisfy debts owed by taxpayers to other government agencies.

- **Tax Education and Compliance**—The Department is responsible for ensuring compliance with Arizona tax laws, department regulations, and policies through education, auditing and assessing, and collections and enforcement activities. This includes conducting taxpayer outreach, audit selection, and office and field collections, investigating tobacco retailers, and providing various legal services. Through a variety of activities, the Department helps ensure that taxpayers pay their fair share of tax.

2. **The effectiveness with which the Department has met its objectives and purposes and the efficiency with which it has operated.**

The Department has generally operated effectively and efficiently in performing its functions. For example, the Department reported that in fiscal year 2004, it collected over \$9.8 billion in gross revenues from all tax types and \$490 million in net tax revenues through its enforcement efforts. The 2004 revenues reflect almost an 8.5 percent increase in the Department's return on investment since 2002. In 2002, the Department reported a return on investment of \$151 for each dollar spent, and in fiscal year 2004 a return on investment of \$164. The Department also reported processing approximately 6 million tax returns in fiscal year 2004 and issuing nearly 1.4 million income tax refunds, which is an increase of over 20 percent from 2002. During this same period, the Department reported reducing the average time it takes to issue a refund from 18 days in 2002 to 8 days in 2004.

The three performance audits of the the Audit Division, the Collections Division, and the Business Reengineering/Integrated Tax System (BRITS) project highlighted other ways the Department has operated efficiently. Specifically:

- **The Audit Division audit** (see Auditor General Report No. 05-06) focused on ways the Audit Division could improve its resource allocation decisions and audit selection processes. Findings 1 and 2 found that the Division has developed business plans for each of the Division's sections, as well as audit selection criteria for individual income tax audits and corporate income tax field audits.
- **The Collections Division audit** (see Auditor General Report No. 05-14) focused on ways the Collections Division can improve its productivity. Finding 1 found that the Division is appropriately developing matching

programs, such as wage and bank matching programs, in order to more efficiently identify potential levy sources.

- **The BRITS audit** (see Auditor General Report No. 05-15). This audit focused on the BRITS project. In August 2002, the State entered into a contract with Accenture, a global management consulting firm, to reengineer its core business processes and implement an integrated tax system. Accenture is paid through additional enforcement revenue that results from the BRITS project. Finding 2 found that the Department is increasing some types of enforcement revenues, such as identifying nonfiling taxpayers and unlicensed businesses, which appear to be the result of enhancements created by BRITS.

However, the three audit reports also identified several ways the Department can improve its effectiveness and efficiency:

- **The Audit Division audit** (see Auditor General Report No. 05-06, Finding 1) found that the Division needs to take additional steps to better manage its limited resources. Although the Division's sections developed initial audit plans in 2004, the plans lack return-on-investment information for all types of audits, as well as the basic data needed to analyze how audit resources are used. The audit found that capturing and analyzing such information can aid the Division in meeting its objectives of maximizing revenues, audit coverage, and compliance rates. However, the Division is implementing a new automated audit system that should help it gather meaningful data. The audit found that once this new system is implemented, staff training will be key to ensuring the correctness and completeness of the data entered into the system.

The audit also found that the Division should further improve its audit selection processes (see Auditor General Report No. 05-06, Finding 2). Although the Division has improved some of its processes for deciding which taxpayers and businesses to audit, it should take steps to ensure continued improvements. For example, while the Division has taken steps to ensure that it focuses its audit selection techniques on high-liability and noncompliant taxpayers, it has not developed written criteria for doing so in all tax types.

- **The Collections Division audit** (see Auditor General Report No. 05-14) found that the Division should take additional steps to improve its ability to help it find and seize the wages and bank accounts of taxpayers who have not paid their taxes (see Finding 1). For example, the Department should consider expanding the number of accounts it matches against an unemployment insurance database, and requesting a legislative change to enable the use of a more up-to-date database. Auditors also found that the Division should consider new matching opportunities with entities such as

Arizona banks and take steps to establish a matching program with the State Lottery.

The audit also found that the Division could further improve some of the automated tools it has added to enhance collections (see Finding 2). For example, the Division is in the process of implementing debtor profiling for all tax types. However, the Division should ensure that it periodically assesses the effectiveness and outcomes of these tools. Auditors noted that the Division should next consider evaluating and possibly adjusting its staff distribution in office and field collections, which use different levels of enforcement action to bring about case closure.

Lastly, the audit found that the Division should take steps to provide taxpayers additional options to pay their debts (see Finding 3). First, the Department should continue working toward accepting credit cards from taxpayers, including those with collections accounts. To do so, the division should consider requesting a statutory change to broaden its authority to accept credit card payments for non-Web-based transactions. Second, the Division should consider seeking the legislative authority to accept automatic withdrawals from taxpayers similar to practices used in other states and at the Internal Revenue Service. Finally, the Division should consider allowing low-risk taxpayers to set up payment plans through automatic telephone or Web-based systems.

- **The BRITS audit** (see Auditor General Report No. 05-15, Finding 1) found that the Department could do more to ensure it effectively manages the BRITS project. For example, BRITS implementation problems have impacted the Department's ability to collect tax monies because taxpayer bills had to be manually reviewed and corrected before they could be mailed. Auditors found that these problems may have been minimized if the Department had hired an outside project advisor as outlined in the contract and involved a greater number of knowledgeable department staff sooner in the implementation process. Although the audit found that the Department is taking steps to more effectively manage the project, such as involving a greater number of experienced staff and working with the vendor to define in detail the Department's system needs, it should still consider hiring an outside advisor to help oversee the remaining phases of the project. Further, the Department can make additional improvements in a number of areas, ranging from better planning and training to more thorough testing of new functions.

The audit also found that BRITS is not generating additional revenue as expected, resulting in negative financial implications for the State (see Auditor General Report No. 05-15, Finding 2). Although BRITS appears to be generating some types of enforcement revenues, one type of enforcement revenue has been as much as \$27.3 million less than

expected. However, the Department and the vendor are taking steps to improve enforcement revenue. For example, the Department has developed a special team charged with increasing enforcement revenue by improving existing BRITS discovery programs and creating and implementing new ones. The Department needs to continue these efforts and should also continue to include information about each type of enforcement revenue in its monthly status report, which it began doing in June 2005 in response to auditor recommendations.

3. The extent to which the Department has operated within the public interest.

The Department has operated in the public interest in many of its activities. For example, the Department:

- Administers and enforces state tax laws, which generate revenue essential to the operation of state government. The Department's activities affect all programs that rely on state general funds, such as education, public health, public safety, and entitlement programs. In fiscal year 2004, the Department reported collecting \$9.8 billion in revenue, depositing \$5.9 billion into the General Fund, and distributing the remaining \$3.9 billion to cities, counties, special funds, and taxpayer refunds.
- Helps ensure that taxpayers pay their fair share of tax. Department enforcement activities, such as audit and collections, help to ensure taxpayer compliance with Arizona tax laws and department regulations and policies. The auditing function assists taxpayers in complying with tax laws and filing correct returns as well as identifies and licenses unlicensed businesses, and the collections function secures the payments of delinquent taxes.
- Provides comprehensive tools and information to the public via its Web site. Specifically, the Web site includes Department of Revenue locations and telephone numbers, forms, and instructions for the various tax types, electronic services, small business information, various publications, and forms and instructions pertaining to refunds and credits. Additionally, the Web site provides links to the Internal Revenue Service, Arizona Revised Statutes, and the Arizona Administrative Code.

4. The extent to which rules adopted by the Department are consistent with the legislative mandate.

According to the staff of the Governor's Regulatory Review Council (GRRC), the Department has consistently been timely and thorough in its mandated reviews.

The Department has a total of nine 5-year rule reviews, because of a large number of rules, which address all the rules in Title 15 of the Arizona Administrative Code (Code). According to the Department, it has 404 administrative rules in Title 15 of the Code. The Department also reports that, through the review process, it has identified approximately 146 rules needing amendment, and 25 rules in various stages of the formal GRRC review process, as well as 10 rules in the internal drafting review/comment stage.

5. The extent to which the Department has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Department uses several avenues to keep the public informed of its actions, such as its Web site, newsletters, and programs. However, the Department has not fully complied with open meeting law requirements.

The Department's Web site includes a link called draft documents for public comment, which includes three sections: proposed rules; proposed rulings, procedures, other miscellaneous documents; and the annual regulatory agenda. The Web site gives specific instructions on submitting public comment. It also provides a link that provides the public with information regarding departmental rulings, decisions, and procedures. The Department reports that, with a few exceptions, it posts all proposed rules, rulings, and procedures on its Web site in order to receive input from the public and interested taxpayers before promulgating rules, rulings, and procedures. Two exceptions include the rules addressing alternative fuel credits, which were written in conjunction with the Attorney General's Office, and the tax amnesty rules, which were specifically exempted from the rule-making process by the Legislature. The Department also reports that it e-mails or faxes proposed rules, rulings, and procedures to practitioners who work in the State and local tax area.

According to the Department, it also uses other avenues to keep the public informed of its actions, such as publishing a monthly newsletter, regularly mailing inserts, and offering programs, classes, and educational seminars. The Department also reports that it organizes focus group meetings with stakeholders in order to assess needs, identify opportunities to improve tax forms and processes, and develop new or revised tax education programs and classes.

The Department of Revenue also supports four committees that are subject to open meeting law requirements: the Education, Training, and Certification Committee; the Debt Oversight Commission; the Property Tax Oversight Commission; and the Economic Estimates Commission. However, until August 26, 2005, the Department had not notified the Secretary of State's Office

regarding where public meeting notices are posted for meetings of three of these committees, as required by A.R.S. §38-431.02. The Secretary of State's Office reports having information only on the Education, Training, and Certification Committee.

6. **The extent to which the Department has been able to investigate and resolve complaints that are within its jurisdiction.**

The Department has processes in place to investigate and resolve complaints within its jurisdiction. Several divisions are involved with the process:

- **A.R.S. §42-2051** established the Arizona Taxpayer Assistance Office (Office), which reports directly to the Director of the Department of Revenue. The Office is staffed by the Department's problem resolution officers. Statutorily mandated responsibilities and authority include assisting taxpayers in obtaining tax information, negotiating with department personnel on complex taxpayer problems, and receiving and evaluating complaints of improper or inefficient service by department employees. The Department reports that the Office averages 60 to 80 complaints per month, the majority of which involve assisting taxpayers with tax-based issues.
- **The External Services and Special Projects Division houses the Criminal Investigations Section**, which investigates complaints of tax fraud and tobacco luxury tax fraud. This section reported receiving approximately 17 complaints in fiscal year 2005. The Department may also investigate instances of illegal taxpayer conduct and seek criminal indictments and prosecution through the Arizona Attorney General's Office.
- **The Audit Division** reports investigating bingo-related complaints from players who allege bingo rule violations; for example, minors in the bingo hall, players with duplicate bingo cards, players not understanding that the last ball called wins the game, and tipping of bingo workers. According to the Division, most complaints are minor rule violations; however, the Division occasionally receives complaints alleging a theft or embezzlement of bingo funds. In fiscal year 2005, the bingo section received 28 complaints.
- **The Division of Taxpayer Services** reports receiving thousands of routine complaints annually about processes, such as using the Department's Web site, problems with the paper licensing process, billing notices, and business tax forms.
- **The Collections Division** reports receiving and investigating complaints regarding accounts in collections or bankruptcy. According to the Division, the complaints come from either the Governor's Office or the Director's Office. The Division reported receiving 14 such complaints in fiscal year 2005.

7. **The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under the enabling legislation.**

According to statute, the Attorney General has the authority to take all actions necessary to enforce the Department's prescribed duties in titles 42 and 43, including collections, contested audits, appeals of denied refunds and property valuations, and criminal violations of the Arizona tax revenue laws. The Attorney General may also defend all actions brought against the State arising under these titles. Additionally, statute also allows the Attorney General to delegate the prosecuting authority to any county attorney for prosecution in that county.

8. **The extent to which the Department has addressed deficiencies in its enabling statutes, which prevent it from fulfilling its statutory mandate.**

According to the Department, although it has not sought legislation to amend its enabling statutes, it has sought numerous technical and administrative changes and additions to agency statutes over the years. Over the last 6 years, the Department has implemented the following legislative changes:

- **Laws 2004, Chapter 337**—Modified the statute dealing with Transaction Privilege Taxes on telecommunication services by creating a new methodology for businesses to reasonably identify taxable and nontaxable charges on bundled transactions.
- **Laws 2003, Chapter 52**—Amended the statute that deals with tax preparer penalties, including specifying when a penalty is imposed on a tax preparer.
- **Laws 2002, Chapter 237**—Provided modifications to the Enterprise Zone program by narrowing definitions, capping the amount of tax credits, increasing reporting requirements, and assuring that double credits could not be taken when a business is in an enterprise zone and another zone.
- **Laws 2001, Chapter 261**—Enabled Arizona to participate in the Federal Refund Offset Program.
- **Laws 2000, Chapter 184**—Revised Arizona's Unclaimed Property Act by adopting many of the provisions from the 1995 Uniform Unclaimed Property Act. This change included establishing new time limits to determine when unclaimed property becomes abandoned and providing for an administrative hearing process for contested cases.
- **Laws 1999, Chapter 250**—Modified and expanded the Taxpayers' Bill of Rights.

9. **The extent to which changes are necessary in the laws of the Department to adequately comply with the factors listed in this subsection.**

Audit work identified several areas where changes may be needed to the department and/or other state statute, as follows:

The Collections Division audit found that the Division could benefit from a legislative change that would provide the authority for the Department to match its collections accounts with the Department of Economic Security (DES) child-support new-hire database (see Auditor General Report, No. 05-14—Finding 1). Currently, the Division matches with the DES unemployment insurance tax database, which provides quarterly wage information. Access to the DES new-hire database would give the Division more up-to-date employment information to aid in earlier enforcement action. The audit report also found that the Department could benefit from a legislative change, which would give the Department the authority to establish a financial institutions data match in order to access Arizona account holder information. The purpose of all these legislative changes is to more quickly identify levy sources for delinquent taxpayers.

The Collections Division Audit also found that in order to make it easier for a delinquent taxpayer to pay his or her debt, the Division should seek the statutory authority to accept credit card payments for non-Web-based transactions (see Finding 2). Additionally, the Department should seek the legislative authority to accept automatic withdrawal for payment plans.

Additionally, the Department reviewed unimplemented recommendations made in the Auditor General's 1995 sunset report and provided the following updates:

Recommendation:

- The Legislature should consider amending A.R.S. §42-141(C) to replace the current property valuation standard with the International Association of Assessing Officers (IAAO) recommended valuation standard of 0.90 to 1.10 of full market value (Auditor General Report No. 95-15).

Status of recommendation:

- A.R.S. §42-141 was repealed by Laws 1997, Ch. 150, §9, effective January 1, 1999. A.R.S. §42-11054.C, which replaced §41-141, still requires the Department to apply the ratio standard guidelines issued for tax year 1993. According to the Department, the valuation standard is 74 to 90 percent of nominal selling price. Department management opined that a valuation standard of 90 to 110 percent would be problematic for assessors and

taxpayers because half of all properties would be overvalued, which would result in an increased number of tax appeals.

Recommendation:

- The Legislature should consider providing DOR with additional authority to enforce equalization orders (Auditor General Report No. 95-15).

Status of recommendation:

- According to the Department, the Legislature has not changed the Department's equalization authority. The Department reports that it has the authority to prohibit assessors from issuing Notices of Value to taxpayers in areas that are out of compliance with statutory valuation standards. The Department also reports having the authority to request the Attorney General to bring actions to enforce the property taxes. Additionally, according to the Department, it is working closely with county assessors to improve valuations in each county, and has implemented computer-assisted programs that allow county assessors to identify areas that need improvement.

Recommendation:

- The Legislature should consider providing DOR with the authority to order reappraisals based on inconsistent property values (Auditor General Report No. 95-15).

Status of recommendation:

- The Legislature has not provided the Department with the authority to order reappraisals; however, it has given the Department authority to request an assessor to conduct field appraisals when valuation discrepancies are identified.¹ According to the Department, such field appraisals would constitute reappraisals.

Recommendation:

- The Legislature should consider amending A.R.S. §§42-179.01(D) and 42-179.03(E) to provide the Department with statutory authority to assess back taxes, penalties, and interest on centrally valued properties whether the taxpayer intentionally or unintentionally underpaid (Auditor General Report No. 95-15).

¹ A.R.S. §42-13005(B).

Status of recommendation:

- The Legislature has not amended A.R.S. §§42-179.01(D) and 42-179.03(E), which are now A.R.S. §§42-16252 and 42-16254.

Recommendation:

- The Legislature should consider amending A.R.S. §42-1451 to allow DOR to charge an administrative fee for collection and administration of local taxes (Auditor General Report No. 95-16).

Status of recommendation:

- A.R.S. §42-1451 is now A.R.S. §42-6001 and has not changed to allow the Department to charge an administrative fee.

10. The extent to which the termination of the Department would significantly harm the public health, safety, or welfare.

Termination of the Department would harm the public health, safety, and welfare because it collects the taxes that help fund the continued operation of essential state health- and safety-related services. In fiscal year 2004, the Department's gross revenue collections were more than \$9.8 billion. Over \$5 billion of this revenue went into the State's General Fund. In addition, terminating the Department would eliminate enforcement and compliance programs that help to ensure that all taxpayers pay their fair share of the tax burden.

11. The extent to which the level of regulation exercised by the Department is appropriate and whether less or more stringent levels of regulation would be appropriate.

The Department reports that it exercises an appropriate level of regulation in the areas in which it has been given regulatory authority. Although the Department's primary function is administering and collecting taxes, the Department has regulatory authority in the areas of licensing and registration, property tax administration, and tobacco and bingo code enforcement and regulation.

The Department reports issuing guidelines, conducting workshops, providing training, issuing valuation manuals, and providing valuation assistance to counties in an effort to ensure the accuracy and uniformity of values. Sales ratio studies are used to monitor assessor valuation performance.¹

¹ According to the Department, sales ratio studies comply with International Association of Assessing Officers standards.

12. The extent to which the Department has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

The Department has made several efforts to use private contractors.

- In August 2002, the Department entered into a contract with Accenture, a global management consulting firm, to reengineer its core business processes and implement an integrated tax system—BRITS. This 10-year contract uses a benefits-sharing funding approach, whereby the vendor pays the upfront cost and is repaid through additional enforcement revenue the BRITS project generates. Specifically, the BRITS contract provides that Accenture will be paid 85 percent of the additional enforcement revenue generated by BRITS, and the State receives the remaining 15 percent. This process continues until the total cost of the contract, \$122.65 million plus an estimated \$9 to \$13 million in interest, is paid.
- The Department reports contracting with off-site data entry firms and hiring seasonal help from temporary service agencies for years. According to the Department, it hires hundreds of clerical staff during peak tax season (January to June). The seasonal workers open and distribute mail, handle taxpayer phone calls, and provide data entry services and other clerical tasks. The Department also reports hiring temporary staff for year-long work, but only 1 week a month for the processing of Transaction Privilege Tax forms and payments. The Department considers these hires cost-effective because the Department can increase or decrease the number of staff required to do the job in a short time frame and can release these employees with little or no advance notice. According to the Department, it is careful to train vendors and ensure that they understand the Department's confidentiality and disclosure policies. The Department reports that, like its permanent employees, temporary vendors or service provider employees in direct contact with taxpayers or taxpayer information are required to be fingerprinted, view an IRS video, and sign the Department's confidentiality statements.
- According to the Department, it recently began outsourcing its outgoing mailroom activities, including printing and mailing various notices and warrants. The Department reports that it is still assessing the cost-effectiveness of this project.
- Department staff also reported that it began outsourcing its microfilming operations in fiscal year 2004. The Department reports planning to assess the cost-effectiveness of this outsourcing.

Audit work did not identify other uses for private contractors by the Department.

AGENCY RESPONSE

STATE OF ARIZONA

Department of Revenue
Office of the Director
(602) 716-6090



October 5, 2005

Janet Napolitano
Governor

Gale Garriott
Director

Debbie Davenport, Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Mrs. Davenport:

The Department of Revenue has reviewed the September 29, 2005 Sunset Review Performance Report on the Department. As has been stated in our previous responses to the Audit, BRITS and Collections Reports, we want to extend our thanks to you and your staff for the understanding and professionalism displayed throughout this process. The reviews have been stringent but fair, and all discussions have been productive and mutually satisfactory.

The following comments are provided as our response to the Sunset Factor analysis contained in the Report.

1. The objective and purpose in establishing the Department.

The Department agrees with the analysis.

2. The effectiveness with which the Department has met its objectives and purposes and the efficiency with which it has operated.

The Department agrees with the analysis and would refer readers to the Department's response to each of the three performance audits for further explanation of that agreement and implementation of each recommendation.

3. The extent to which the Department has operated within the public interest.

The Department agrees with the analysis.

4. The extent to which rules adopted by the Department are consistent with the legislative mandate.

The Department agrees with the analysis and takes pride in our commitment to maintain the Administrative Code in Title 15. Taxpayers rely upon these rules for clear advise on tax policy matters and through vigorous monitoring for updates due to legislative or judicial changes, the public is better able to comply with the tax statutes.

5. The extent to which the Department has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Department agrees with the analysis with the following comments. The Department takes the open meeting laws very seriously. Meetings for the committees subject to the open meeting law requirements were properly noticed by timely posting such notices at the Department of Administration. What the Department inadvertently failed to do was to file a statement with the Secretary of State which simply indicated where those public notices were posted. In the future the appropriate statement will be provided to the Secretary of State.

6. The extent to which the Department has been able to investigate and resolve complaints that are within its jurisdiction.

The Department agrees with the analysis.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under the enabling legislation.

The Department agrees with the analysis. The Department values the working relationship with the Attorney General's Office, Civil and Criminal Divisions, and the excellent support they provide in all areas of tax law.

8. The extent to which the Department has addressed deficiencies in its enabling statutes, which prevent it from fulfilling its statutory mandate.

The Department agrees with the analysis and seeks to have a good working relationship with the Legislature, the public, private business, and other stakeholders in Arizona's tax structure.

9. The extent to which changes are necessary in the laws of the Department to adequately comply with the factors listed in this subsection.

The Department agrees with the analysis and will complete the necessary research, work with stakeholders, and pursue the appropriate legislation to implement the recommendations of the Auditor General from the 2005 Reports.

As to the unimplemented recommendations from the 1995 sunset report referred to in this report, the Legislature on several occasions elected to provide alternative remedies for enforcement, which the Department supported. The final two recommendations were not supported during exploratory discussions with key legislators.

10. The extent to which the termination of the Department would significantly harm the public health, safety, or welfare.

The Department agrees with the analysis.

11. The extent to which the level of regulation exercised by the Department is appropriate and whether less or more stringent levels of regulation would be appropriate.

The Department agrees with the analysis.

12. The extent to which the Department has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

The Department agrees with the analysis and continues to seek effective, efficient and practical areas for use of private contractors.

The Department appreciates the opportunity to respond to the sunset report.

Sincerely,

Gale Garriott
Director

Performance Audit Division reports issued within the last 24 months

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| 04-L1 | Letter Report—Arizona Medical Board | 05-L1 | Letter Report—Department of Health Services—Ultrasound Reviews |
| 04-L2 | Letter Report—Gila County Transportation Excise Tax | 05-01 | Department of Economic Security—Division of Employment and Rehabilitation Services—Unemployment Insurance Program |
| 04-L3 | Letter Report—Department of Economic Security—Population Estimates | 05-02 | Department of Administration—Financial Services Division |
| 04-01 | Arizona Tourism and Sports Authority | 05-03 | Government Information Technology Agency (GITA) & Information Technology Authorization Committee (ITAC) |
| 04-02 | Department of Economic Security—Welfare Programs | 05-04 | Department of Economic Security—Information Security |
| 04-03 | Behavioral Health Services' HB2003 Funding for Adults with Serious Mental Illness | 05-05 | Department of Economic Security—Service Integration Initiative |
| 04-04 | Department of Emergency and Military Affairs and State Emergency Council | 05-06 | Department of Revenue—Audit Division |
| 04-05 | Department of Environmental Quality—Water Quality Division | 05-07 | Department of Economic Security—Division of Developmental Disabilities |
| 04-06 | Department of Environmental Quality—Waste Programs Division | 05-08 | Department of Economic Security—Sunset Factors |
| 04-07 | Department of Environmental Quality—Air Quality Division | 05-09 | Arizona State Retirement System |
| 04-08 | Department of Environmental Quality—Sunset Factors | 05-10 | Foster Care Review Board |
| 04-09 | Arizona Department of Transportation, Motor Vehicle Division— State Revenue Collection Functions | 05-11 | Department of Administration—Information Services Division and Telecommunications Program Office |
| 04-10 | Arizona Department of Transportation, Motor Vehicle Division—Information Security and E-government Services | 05-12 | Department of Administration—Human Resources Division |
| 04-11 | Arizona Department of Transportation, Motor Vehicle Division—Sunset Factors | 05-13 | Department of Administration—Sunset Factors |
| 04-12 | Board of Examiners of Nursing Care Institution Administrators and Assisted Living Facility Managers | 05-14 | Department of Revenue—Collections Division |
| | | 05-15 | Department of Revenue—Business Reengineering/Integrated Tax System |

Future Performance Audit Division reports

Governor's Regulatory Review Council

Arizona Health Care Cost Containment System—Healthcare Group