STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

A PERFORMANCE AUDIT
OF THE

DEPARTMENT OF REVENUE
SALES TAX PROGRAM

FEBRUARY 1981

A REPORT TO THE
ARIZONA STATE LEGISLATURE

REPORT 81-2

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

February 6, 1981

Members of the Arizona Legislature
The Honorable Bruce Babbitt, Governor
Mr. J. Elliott Hibbs, Director
Department of Revenue

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Revenue, Sales Tax Program. This report is in response to the June 19, 1979, resolution of the Joint Legislative Budget Committee.

The blue pages present a summary of the report; a response from the Department of Revenue is found on the yellow pages preceding the appendices.

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

Respectfully submitted,

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Enclosure

OFFICE OF THE AUDITOR GENERAL

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ARIZONA STATE LEGISLATURE

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SUMMARY

The Office of the Auditor General has conducted a performance audit of the Department of Revenue - Sales Tax Program in response to a June 19, 1979, resolution of the Joint Legislative Budget Committee. The performance audit report presented herein was prepared under the authority vested in the Auditor General by Arizona Revised Statutes (A.R.S.) §41-1279 et seq.

The authority to administer the sales tax program was transferred from the now-defunct State Tax Commission to the Department of Revenue (DOR) when DOR was formed on July 1, 1974. The sales tax program, as administered by DOR, includes the collection of six separate taxes. In addition to transaction privilege, education excise and special excise tax for education, which are commonly referred to as sales taxes, DOR also collects use, bingo and rental occupancy taxes.

In 1979, DOR's administration of the Sales Tax Program received a great deal of public criticism and, since then, DOR has made a concerted effort to improve the program. Nevertheless, additional improvements are still needed and are addressed in seven major findings:

1. The Department of Revenue has not fulfilled its statutory responsibility to establish adequate procedures for safeguarding and processing sales tax payments. As a result, the State may have lost an estimated $1.1 million a year in interest income, and a significant amount of money is exposed to loss through defalcation or accident. (page 13)

2. DOR has not developed a systematic audit selection procedure similar to those of other tax administration authorities. As a result, DOR may not be maximizing revenues from its sales and use tax audit function. In addition, DOR has overstated revenues generated by its audit function in budget documents submitted to the Legislature. (page 27)

3. The DOR sales and use tax appeals process is fragmented and uncoordinated. As a result, the process is excessively long, and not properly documented or monitored. (page 41)

4. DOR is not consistently imposing penalties on late payments of sales taxes as required by statute. As a result, DOR is not complying with State law or treating taxpayers equally, and a substantial amount of State revenue is lost. (page 61)

5. DOR collection procedures are inefficient. (page 71)

6. Improvements are needed in DOR's financial transaction controls and documentation. (page 91)

7. Because Arizona does not tax the construction of power-generating facilities as other states do, by 1986 Arizona will lose substantial sales and use taxes related to the construction of the Palo Verde nuclear generating facility and other power-generating facilities. (page 105)

It is recommended that:

- The Legislature approve DOR's request for funds to purchase electronic payments processing equipment.

- DOR implement additional security precautions, including: 1) storage facilities that provide safeguards to prevent loss from theft, fire, sprinkler-system damage and other accidents, and 2) restrict access to areas in which returns and payments are processed.

- During the time required to implement electronic processing, it is recommended that DOR either:
  - o Provide for the deposit of all checks with the State Treasurer within 24 hours of receipt by separating checks from returns at the time returns are opened and sorted, or
  - o Adopt the use of lockbox services.

In addition, it is recommended that:

- DOR expedite the implementation of an audit selection system similar to those currently used in Texas and California.

- The Legislature consider amending A.R.S. §§41-1327.E and 42-1414.F to allow for full 36-month audits as conducted by the cities of Scottsdale and Phoenix.

- DOR increase its efforts to coordinate its audit activities with those of the five largest cities in Arizona.

- DOR maintain more accurate records of audit assessments and report such information to the Legislature in a manner which will more accurately reflect actual revenues generated by its audit activities.

It is further recommended that DOR:

- Establish a time limitation for each specific step in the appeals process by adopting rules and regulations similar to A.C.R.R. R16-3-107 of the State Board of Tax Appeals or Rule 12(a) of the Rules of Civil Procedure.

- Adopt rules and regulations directing the Hearing Officer to schedule hearings for taxpayers who have postponed, without good cause, a hearing beyond the established time.

- Document appeals according to A.R.S.§§42-1338, 42-1415 and 41-1009 (Administrative Procedure Act).

- Fully implement centralization of the appeals process in the Hearing Office, as outlined in the Director's September 19, 1980, memorandum.

- Prepare monthly management reports on the status of protested audit assessments including explanations for excessive delays.

Additionally, we recommended that:

- The Legislature amend A.R.S. §§42-1322 and 42-1327 to provide clear statutory guidelines on the imposition and waiver of penalty.

- DOR promulgate rules establishing specific criteria for the imposition of the ten and 25 percent penalties provided in A.R.S. §§ 42-1322.D, 42-1327.B and 42-1327.C.

- DOR impose a penalty and interest on all taxpayers who fail to pay their taxes when due.

- Subject to the three-year statute of limitations, DOR assess penalties and interest which it failed to assess in the past.

- DOR include in its annual report a summary of penalty abatements granted. The summary should include the amounts involved and reasons for the abatements.

With regard to DOR collection practices it is recommended that:

- DOR cease combining data on late taxes and current taxes collected for budget information reports.

- The special collections section generate, at the minimum, the same types of service measurements as the collections section.

- DOR mail nonfiling notices 25 days after a taxpayer becomes delinquent.

- DOR refer nonfiled accounts to a collector before the account becomes over two months old.

- DOR bill accounts receivable taxpayers monthly.

- DOR mail a second notice to a nonfiling taxpayer within 55 days after the due date.

- DOR refer accounts receivables of more than $100 to collectors as soon as an account is due and payable.

- All accounts receivable of less than $100 be referred to a collector within three to four months after they are due and payable.

- DOR collection supervisors monitor accounts referred to collectors, actions taken against taxpayers and the dates action is taken.

- Collectors contact all of the taxpayers assigned to them provided it is cost effective to do so, and DOR establish time limits for making such contacts.

- DOR establish guidelines for when specific collection actions should be taken and establish procedures to ensure the guidelines are followed.

- DOR standardize part pay procedures within the collections section. Once procedures are standardized, collection supervisors should monitor employees and determine that part pay agreements are fulfilled by taxpayers.

- The DOR collection section require its collectors to use the telephone as the primary mode of taxpayer contact. Travel to the taxpayers' places of business should be kept to a minimum and be used only when taxpayers are unresponsive to letters and telephone calls.

- DOR evaluate the opportunities to expand collector duties so that all collectors can use the collection techniques of each.

Regarding DOR's recording of financial transactions we recommended that DOR:

- Establish an internal audit staff, reporting to the DOR Director.

- Conduct an indepth review of current accounting procedures and develop written policies and procedures which are in compliance with State statutes and good accounting procedures.

- Prior to entering accounts receivable into the new automated system:
  - Determine the collectibility of all receivables more than a year old and purge those accounts deemed to be uncollectible.

  - Determine the error rate in collectible receivables by conducting an indepth review of a statistically valid sample of the receivables,

  - If the error rate established through the review exceeds an acceptable level, review and correct all collectible receivables, and

  - Report the results of this review, including the acceptable error rate established by the Department, to the Joint Legislative Budget Committee and/or the Special Committee on the Department of Revenue.

We also recommended that the Legislature consider statutory changes to allow for a full independent audit of the Department of Revenue.

Finally, it is recommended that:

- The Legislature evaluate the agreement among the Attorney General, DOR and APS to determine if it is consistent with legislative intent. If expansion of the exemption is deemed appropriate, A.R.S. §§42-1312.01 and 42-1409 should be revised to define the conditions under which buildings may be subject to exemption. If the expansion of the exemption is considered inappropriate, DOR should initiate corrective measures to ensure timely assessment and collection of taxes due.

- The Legislature review exemptions currently granted by the statutes and DOR rules and regulations.

- DOR include information regarding the audits of suppliers and contractors of the Palo Verde project in its annual report.

INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Department of Revenue - Sales Tax Program in response to a June 19, 1979, resolution of the Joint Legislative Budget Committee*. The performance audit report presented herein was prepared under the authority vested in the Auditor General by Arizona Revised Statutes (A.R.S.) §41-1279 et seq.

The authority to administer the sales tax program was transferred from the now-defunct State Tax Commission to the Department of Revenue (DOR) when DOR was formed on July 1, 1974. The sales tax program, as administered by DOR, includes the collection of six separate taxes. In addition to transaction privilege, education excise and special excise tax for education, which are commonly referred to as sales taxes, DOR also collects use, bingo and rental occupancy taxes.

The Transaction Privilege Tax is levied on those engaged in business activity in Arizona, and is assessed on gross receipts, less certain deductions, as set forth by the Legislature. The privilege tax came into being in 1935. Effective in 1959, an Education Excise Tax was imposed and, in 1968, a Special Excise Tax for Education was added. Table 1 presents a summary of the distribution of current sales tax rates.

* The performance audit of the sales tax program was delayed because the Office of the Auditor General was statutorily denied access to the sales tax records. House Bill 2003, signed by the Governor on January 10, 1980, granted the Auditor General access to sales tax records.

TABLE 1
SUMMARY OF THE DISTRIBUTION
OF CURRENT SALES TAX RATES

Taxable Activities	Privilege Tax Percentage	Education Excise Tax Percentage	Special Excise Tax for Education Percentage	Combined Tax Percentage
Mining - oil and gas production	1%	1/2%	1%	2 1/2%
Transporting and towing	1	1	2	4
Utilities	1	1	2	4
Communications	1	1	2	4
Railroads and aircraft	1	1	2	4
Publishing	1	1	2	4
Printing and advertising	1	1	2	4
Private car/pipelines	1	1	2	4
Contracting	1	1	2	4
Timbering	1	1/2	-	1 1/2
Restaurants and bars	2	2	-	4
Amusements	2	2	-	4
Rentals of real property	2	1	-	3
Rentals of personal property	2	2	-	4
Feed, wholesale	1/4	1/8	-	3/8
Retail	2	2	-	4

The Use Tax applies to the use, storage or consumption in this State of tangible personal property unless the purchaser can prove that the tax has been collected by an authorized retailer. The Use Tax rate is four percent.

Rental Occupancy Tax is imposed on a tenant for the privilege of occupancy of real property when the right to occupy the property resulted from a written lease entered into before December 1, 1967 (pre-existing lease). The amount of this tax is two percent of rent paid to the landlord.

The Bingo Tax imposes a two-and-a-half percent tax on the net profits derived from bingo games.

Table 2 presents a summary of the gross sales taxes collected, by type, for fiscal years 1975-76 through 1979-80.

TABLE 2

SUMMARY OF GROSS SALES TAX
COLLECTIONS BY TYPE
FOR FISCAL YEARS 1975-76 THROUGH 1979-80

Type	1975-76	1976-77	1977-78	1978-79	1979-80
Transaction Privilege	$187,536,545	$216,049,456	$247,838,898	$302,812,573	$344,755,193
Education Excise	181,085,020	208,981,016	240,826,672	292,999,847	335,360,847
Special Excise Tax for Education	59,996,809	69,778,747	81,151,553	98,985,428	121,759,143
Use	7,204,281	8,997,174	8,647,600	10,657,575	15,267,048
Bingo	82,788	96,394	118,114	127,072	142,458
Rental Occupancy	194,752	179,845	169,562	155,854	147,904
Total	$436,100,195	$504,082,632	$578,752,399	$705,738,349	$817,432,593

The Department of Revenue is authorized to administer the sales tax program of any Arizona city or town by entering into a written contract with the incorporated community to receive payment of local sales taxes, perform local audits, make collection calls on delinquent city accounts, return amounts collected to the city or town weekly and suggest changes in city ordinances. These activities are performed by the Department without charge. During 1979-80 the Department collected, on behalf of 52 cities and towns, a total of $24,024,045.

The five largest cities in Arizona - Mesa, Phoenix, Scottsdale, Tempe and Tucson - do not have DOR collect their local sales taxes.

The Office of the Auditor General expresses its gratitude to the Director and employees of the Department of Revenue and the officials of numerous Arizona cities for their cooperation, assistance and consideration during the course of this audit.

FINDING I

THE DEPARTMENT OF REVENUE HAS NOT FULFILLED ITS STATUTORY RESPONSIBILITY TO ESTABLISH ADEQUATE PROCEDURES FOR SAFEGUARDING AND PROCESSING SALES TAX PAYMENTS. AS A RESULT, THE STATE MAY HAVE LOST AN ESTIMATED $1.1 MILLION A YEAR IN INTEREST INCOME, AND A SIGNIFICANT AMOUNT OF MONEY IS EXPOSED TO LOSS THROUGH DEFALCATION OR ACCIDENT.

The Department of Revenue (DOR) is responsible for collecting and processing approximately $800 million a year in sales taxes. Our review of DOR procedures for safeguarding and processing payments revealed that: 1) the timeliness of DOR's deposit of sales tax payments is not in compliance with statutory requirements and is deficient in contrast to other public and private entities, and 2) millions of dollars of unprocessed sales tax payments are left unprotected on shelves in DOR's mailroom. As a result, the State may have lost an estimated $1.1 million a year in interest income, and a significant amount of money is exposed to loss through defalcation or accident.

TIMELINESS

DOR has a statutory responsibility to deposit sales tax payments with the State Treasurer on the day they are received. Our analysis revealed that: 1) statutory requirements notwithstanding, DOR has taken as long as eleven days to deposit sales tax payments with the State Treasurer, and 2) other public and private entities make same-day deposits of payments collected. Although substantial improvements have been made recently,* if DOR were in compliance with statutory law or on a par with other entities, the State could earn an estimated $1,089,222 a year in additional interest income.

* Appendix I contains a memorandum from DOR officials outlining recent improvements in the payments-processing function.

Statutory Requirements

Arizona Revised Statutes (A.R.S.) require that sales tax revenues be deposited daily with the State Treasurer. A.R.S. §42-1341.02(B) states:

> "...the department shall each day remit all revenues collected...to the state treasurer..."

According to a Legislative Council Opinion dated October 2, 1980:*

> "...in the face of an apparent intent to require prompt processing and transfer of the monies to the treasurer the processing and transfer of payments to the treasurer's office should be completed prior to the close of the next calendar day."

Analysis of Sales Tax Processing

Analysis of DOR payment-processing procedures revealed that the Department is not in compliance with A.R.S. §42-1341.02(B), since it has taken up to eleven days for DOR to deposit payments with the cashier. In addition to untimely processing, current procedures lack sufficient internal controls, because negotiable instruments are handled by numerous individuals prior to deposit.

At the Phoenix DOR facility, the mail is picked up twice each day from the post office and brought to the mailroom, where it is opened and sorted. Returns accompanied by checks are separated from those without checks and all of them are placed in bundles in mail trays. The trays are flagged to indicate if checks are included with the returns and the date the mail was opened. All trays are stored on open shelves in the mailroom.

* Appendix II contains the full text of this opinion.

The DOR documents processing section is responsible for verifying the mathematical accuracy of a return, determining that all applicable sections of a return have been completed and agreeing the amount of the check with the amount due as indicated on the return. If the amounts do not agree, the amount due is deleted on the return by placing a blank sticker over it, and the amount of the check is written on the sticker. Checks then are separated from returns, batched and sent to the cashier, accompanied by a calculator tape indicating the dollar total of each batch. The cashier verifies tape totals, and the tape produced by the cashier is sent back to the documents-processing area, where it is attached to the corresponding returns. The returns and tape are then sent to data processing, where the information from the returns is entered into the computer system. The cashier's tape then is balanced against the dollar total of the returns entered by data processing.

The DOR office in Tucson receives sales tax remittances by mail and from individuals who choose to pay in person. The payments are deposited daily with the State's servicing bank. The returns, deposit slip and a memo itemizing dollars received, by taxpayer's account, are sent daily to the DOR cashier's office in Phoenix, where they are balanced against each other. The returns are then sent to the documents-processing area.

The procedures followed for depositing and processing payments received in the Tucson office illustrate that retaining checks with returns through the entire review process is not essential. Separation of checks from returns prior to entry of all returns into the documents-processing flow would expedite the deposit of monies and reduce the opportunity for loss or defalcation by limiting access to checks.

DOR receives an average of 52,000 sales tax returns a month. Approximately 30,000 returns, or 60 percent, are received during the five working days preceding the sales tax due date and the five calendar day grace period following it. This heavy volume of sales tax returns during a relatively short time creates a processing backlog.

Processing Delays

Audit staff inventoried the number of trays of unprocessed mail stored in the DOR mailroom four times over an eight-day period which the DOR Assistant Director for Administration characterized as "...representative in terms of mail receipts..." There was an average of 18 trays of unprocessed sales tax returns, 12 of which contained checks. During our review it was observed that some tax payments remained in the DOR mailroom for as long as eleven days.

In July 1980, DOR established a document processing unit by consolidating three functional units. This reorganization resulted in significant personnel changes, as noted in an October 20, 1980, letter* from the Assistant Director of the Division of Administration:

> "Only two employees in the Document Processing Unit are continuing to perform the function they did prior to July 1 as the 'pre-audit' unit in the Revenue Control Section. That function is serialization. The other eighteen have taken on the duties of editing all returns (sales, income, corporate, partnerships, etc.) and making necessary corrections for processing, including some decision making, which was not previously part of their function. In addition, prior work experience was limited to sales documents and did not include either the adjustment or handling of trouble documents. It had been expected that in the transfer of the function and some personnel from Taxation that the expertise of this processing would also come with the unit, this did not prove so due to promotions, resignations, etc., in that unit prior to its transfer. In actuality, only one employee from the unit in Taxation has been assigned on a limited basis to assist in training.

* Appendix III contains the full text of this letter.

"With reference to actual vacancies experienced in the unit, I have supplied a recap below for July, August and September.

"Month	Authorized FTE*	Vacant FTE*
July	20	7
August	20	3
September	20	1

"We have found that the use of temporaries is not a feasible alternative; because of the complexity of the task and the high turnover rate in temporary employees, a high error rate results on documents."

In addition to the reorganization, the change in the due date for the monthly sales and use tax returns from the 15th of the month to the first of the next month has had an impact on the document processing unit's workload. In a September 9, 1980, letter,** the Assistant Director commented:

"Normally we will receive between 60 and 70 percent of the sales tax returns in a one week period, the week after the required postmark date. Our practice has been to employ temporaries for such peak filing periods to handle this type of influx. In August the due date for sales tax returns changed from the 15th of August to September 1. We anticipated that a larger percentage of our taxpayers would recognize the later due date and thus planned for temporary help to bolster document processing in the last week of August and the first week of September.

"In actual practice most taxpayers continued filing at the old due date and we thus had a larger than anticipated workload develop in August..."

* Full time equivalent positions.
** Appendix IV contains the full text of the letter.

Additional Income Lost

A tray of unprocessed sales tax returns with checks, which was stored in the DOR mailroom, was selected randomly and the checks were totaled. The tray contained 857 checks totaling $1,129,280. The 857 checks remained unprocessed for at least seven days. For each day that these checks remained unprocessed and undeposited, the State lost interest revenues of $303, based on the State Treasurer's average rate of return earned on investments of 9.81 percent during fiscal year 1979-80.* Thus the State lost a minimum of $2,126 in interest revenues for the seven-day period during which this $1,129,280 in tax payments remained unprocessed. Because DOR resorts and rebatches checks during processing, the exact date DOR actually deposited these 857 checks with the State Treasurer and the resultant total dollars in lost interest revenues could not be determined.

During fiscal year 1979-80, DOR collected $814,676,135 in sales tax revenues, net of refunds. Of this amount, $4,143,774 was deposited on the day received by the DOR office in Tucson. The remaining $810,532,361 was received and processed by the Phoenix mailroom and documents processing section and was, therefore, subject to processing delays prior to deposit with the State Treasurer. For each day that these tax payments were not processed and deposited with the State Treasurer, the State lost approximately $218,000 in interest revenues. As previously noted, our analysis revealed processing delays of up to eleven days. Elmination of delays in making deposits would produce significant additional interest revenues. Table 3 shows the interest income which would be earned if processing delays were eliminated.

* The rate of return of 9.81 percent applies to the types of investments tax payments are used to purchase. These investments are repurchase agreements.

TABLE 3

ADDITIONAL INTEREST INCOME THAT WOULD BE EARNED EACH YEAR IF DELAYS IN PROCESSING AND DEPOSITING SALES TAX PAYMENTS WERE ELIMINATED*

Days of Processing Delays Eliminated	Additional Interest Income that Would Be Earned Each Year
1	$ 217,844
2	435,689
3	653,533
4	871,378
5 **	1,089,222
6	1,307,067
7	1,524,911
8	1,742,756
9	1,960,600
10	2,178,445
11	2,396,289

It should be noted that several trays containing income and withholding tax returns and checks were also stored in the mailroom. Because access to withholding tax information by Auditor General staff is precluded by law, we were unable to determine the dollar loss associated with processing delays for these tax payments.

* Based on revenues collected during the 1979-80 fiscal year.

** Average processing delay since reimplementation of special-handling procedures. (See page 23)

Other Entities

During the course of our audit we reviewed payment-processing procedures used by the following corporations and cities: American Express, Valley National Bank (VNB), the City of Scottsdale and the City of Phoenix. These entities are able to process and deposit all payments within 24 hours of receipt. A comparison of the efficiency of these entities and DOR is presented in Table 4.

TABLE 4

COMPARISON OF THE EFFICIENCY OF
DOR'S PAYMENT-PROCESSING DURING
FISCAL YEAR 1979-80, WITH OTHER ENTITIES

Entity	Number of Payments Received Per Month	Average Time to Deposit (Days)
American Express	1,500,000-2,500,000	1
Valley National Bank	250,000	1
City of Phoenix*	20,000	1
City of Scottsdale*	5,000	1
DOR	52,000	5

As shown in Table 4, American Express processes approximately 1,500,000 to 2,500,000 payments each month using an automated payments-processing system. The system includes magnetic encoding of the check amount on the bottom of both the payment card and check to allow electronic capture and verification. The use of an encoding machine provides economies by eliminating manual agreement of payment documents and checks and by simultaneously producing a tape total of each batch.

VNB manually agrees the amount of a remittance to the amount due. The review and agreement function is performed by the employee who opens the mail, thereby reducing the number of persons who handle checks. Account posting and encoding, balancing, endorsing and microfilming of checks are automated.

* These cities use lockbox services for processing payments. Payments received represent sales tax only.

The cities of Phoenix and Scottsdale use lockbox services offered by VNB for processing sales tax returns. A lockbox arrangement involves collection and processing of payments by a third party. VNB picks up mail from post office boxes rented in the cities' names and processes it according to the specifications of the city. The purchaser of the services defines types of payments which may be accepted, how documents are to be batched and the means by which data is to be recorded and reported. Both cities have requested that if the amount due indicated on the return differs from the amount remitted, both the document and the check are to be returned to the city for in-house processing.

VNB does, however, have the capability to process payments for which the remittance differs from the amount due. Differences would be noted on a sales tax return and the document would be returned to the city so that differences could be noted on internal records. Data recording and reporting alternatives include capture on magnetic tape, used by the City of Scottsdale, and summary reports of total numbers and dollar value of payments processed, used by the City of Phoenix.

Security

DOR's security over tax payments is deficient in comparison to other entities' security. Our analysis revealed that adequate protection has not been afforded unprocessed documents and remittances, thereby creating a potential for significant loss through defalcation or accident.

DOR collects approximately $68 million in sales tax each month. The payments are stored on open shelves in DOR's mailroom for up to eleven days and are not additionally secured at night or on weekends. During working hours, the mailroom and document-processing area doors are not only unlocked but, on occasion, are left open as well. Although specific instances of malfeasance or theft were not detected during our audit, allowing unlimited access to tax payments by DOR employees and unauthorized individuals increases the possibility of such occurrences.

Additionally, storage facilities for sales tax returns and payments are not afforded adequate protection against fire, water damage from sprinkler systems or other accident.

By way of contrast, visitors are required to sign in, obtain badges and be accompanied by authorized personnel to enter American Express' Western Regional Operations Center and Valley National Bank's central payments processing area. Doors are locked at both facilities at all times, with access limited to authorized employees and persons accompanied by authorized employees. At American Express, payments not in process are stored in a locked area.

Finally, according to a Legislative Council memorandum dated October 7, 1980,* a loss of tax returns and checks from the DOR mailroom, prior to deposit with the State's servicing bank, would result in additional delays and costs in that DOR would have to exert additional effort to collect the taxes due. The opinion states, in part:

> "The tax is paid...if by negotiable instrument such as a check, when the drawee (bank) charges the amount of the instrument to the account of the drawer (taxpayer)...If the loss occurs before the tax is paid, the taxpayer's debt is not discharged and the department has the duty to pursue the collection of the taxes..." (Emphasis added)

Recent DOR Improvements In the Processing of Sales Tax Payments

During and subsequent to our review DOR made a number of significant improvements in processing sales tax payments. The following is a chronology of those improvements:

* Appendix V contains the full text of this memorandum.

September 1980

In September 1980 DOR reinstituted special handling procedures whereby checks in excess of $50,000 were batched separately and expedited through the documents processing system. According to the Administrator of DOR's Management Services, such a procedure had been used previously but was "(i)nadvertantly discontinued in the shift to the new procedures (instituted in July 1980)..."

According to a DOR management analyst study, by reimplementing the above special-handling procedures DOR has reduced the delay in depositing payments. Our analysis of the DOR management study revealed that, since reimplementation of special-handling procedures, DOR now takes an average of five calendar days to deposit checks with the Treasurer, with delays of up to ten calendar days.

November 1980

In November 1980, DOR revised its special-handling procedures to include all checks in excess of $10,000. This change was prompted by a November 1980 DOR management analyst study which indicated that, while only two percent of the sales tax returns filed with DOR indicated a tax due in excess of $10,000, these returns accounted for 64 percent of total sales tax dollars.

In addition to prioritizing checks based upon dollar value, DOR has also: 1) completed staffing, 2) begun tracking work to identify backlogs, assist in forecasting workloads and anticipate temporary staffing needs and 3) initiated studies of various processing alternatives such as lockbox services and automated in-house processing.

Alternative Processing Procedures

Arizona statutes allow for the use of lockbox services by providing for the appointment of agents. A.R.S. §42-1303 states, in part:

> "C. The department shall appoint, as necessary, such agents, clerks and stenographers authorized by law, who shall perform such duties as may be required...and who shall be authorized to act for the department as it prescribes..."

Further, a Legislative Council memorandum dated October 17, 1980* concludes:

> "The department of revenue may appoint a bank as its agent and contract with it for its lockbox services for processing sales tax payments. The bank would be subject to the confidentiality provisions of A.R.S. §42-1307."

It should be noted, however, that if DOR used a lockbox for sales tax payments, personnel still would be required for processing quarterly withholding tax payments and annual income tax payments, for which processing with lockbox services is not feasible because of timing and volume of receipts. DOR has requested $62,100 in the 1981-82 budget for the first year of a seven-year lease-purchase agreement to acquire an electronic payments-processing system similiar to that used by American Express. A December 1980 memorandum** from the Administrator of DOR's Management Services concludes that automated in-house processing, when compared with other alternatives, has among its advantages:

"a) Lower costs.

"b) Document balancing.

"c) Improved audit trail on documents and checks.

"d) Front end locator capabilities before data entry.

"e) Check encoding which could improve correspondent bank bids for service.

"f) Microfilming of checks.

"g) Internal versus external operations."

* Appendix VI contains the full text of this memorandum.
** Appendix I contains the full text of the memo.

While it appears that implementation of the system proposed by DOR would increase processing costs, electronic processing would provide for same-day deposit of payments. Thus the State would realize additional revenues because of the elimination of delays in depositing remittances. Table 5 shows the additional interest revenues, net of the additional cost of the electronic equipment requested by DOR, which would be earned if the current average processing delay of five calendar days for sales tax payments were eliminated.

TABLE 5

ADDITIONAL NET REVENUE PER YEAR WHICH COULD BE EARNED IF THE ELECTRONIC PROCESSING EQUIPMENT REQUESTED BY DOR WERE ACQUIRED

Year during which Additional Net Revenue Would Be Earned	Additional Net Revenue Per Year
First year of Acquisition	$1,030,193*
Second to 7th year after acquisition	$1,060,689
After 7th year of acquisition	$1,079,863

Based on the information in Table 5, it appears that the acquisition of the equipment requested by DOR would be cost effective. Particularly in view of the fact that the additional revenue shown in Table 5 does not include the additional interest earnings that would accrue from faster processing of withholding and income tax payments.

CONCLUSION

DOR does not process sales tax payments efficiently. As a result: 1) DOR is not in compliance with statutory requirements concerning the timeliness of depositing monies with the State Treasurer, and 2) the State may have lost an estimated $1.1 million in interest income annually. In addition, DOR does not fulfill its responsibility to safeguard sales tax payments, and a potential exists for significant losses through defalcation or accident.

* The first-year expenses include a ten percent down payment ($10,372) and the cost of application programming ($20,124) in addition to the expenses for years two through seven.

RECOMMENDATIONS

It is recommended that:

1. The Legislature approve DOR's request for funds to purchase electronic payments processing equipment.

2. DOR implement additional security precautions, including: 1) storage facilities that provide safeguards to prevent loss from theft, fire, sprinkler-system damage and other accidents, and 2) restrict access to areas in which returns and payments are processed.

3. During the time required to implement electronic processing, it is recommended that DOR either:
   - Provide for the deposit of all checks with the State Treasurer within 24 hours of receipt by separating checks from returns at the time returns are opened and sorted, or
   - Adopt the use of lockbox services.

FINDING II

DOR HAS NOT DEVELOPED A SYSTEMATIC AUDIT SELECTION PROCEDURE SIMILAR TO THOSE OF OTHER TAX ADMINISTRATION AUTHORITIES. AS A RESULT, DOR MAY NOT BE MAXIMIZING REVENUES FROM ITS SALES AND USE TAX AUDIT FUNCTION. IN ADDITION, DOR HAS OVERSTATED REVENUES GENERATED BY ITS AUDIT FUNCTION IN BUDGET DOCUMENTS SUBMITTED TO THE LEGISLATURE.

Department of Revenue (DOR) budget documents reported that during fiscal year 1979-80 DOR's 41 sales and use tax auditors completed approximately 758 sales and use tax audits. According to the documents, the direct cost of these audits was $537,338, and the audits generated $13,107,482 in additional State revenues. In 1979, DOR's audit function received a great deal of public criticism and, since then, DOR has made a concerted effort to improve that function. However, based on our review additional improvements still are needed in the following areas:

- The selection of taxpayers for sales tax audits is not based on demonstrated audit assessment potential. As a result, DOR may not be maximizing the return on expended audit resources.

- Because of the current wording of the Arizona statute of limitations on sales and use tax audit assessments, DOR is not able to audit taxpayers for a full 36-month period. As a result, the State may have lost approximately $3.2 million in additional audit assessments during the three fiscal years from 1977-78 through 1979-80.

- The Department has not coordinated effectively its audit program with those of the five largest Arizona cities, which also conduct sales and use tax audits. As a result, substantial revenues may be lost, and an apparently significant amount of audit effort has been duplicative.

- DOR has overstated substantially the return on its sales and use tax audit function in budget information submitted to the Legislature. Consequently, analysis based on the data is unreliable.

AUDIT SELECTION

During fiscal year 1979-80, DOR assigned 41 auditors to conduct approximately 646 sales and 102 use tax audits.* Unlike other entities that conduct such audits, DOR has not developed a system of audit selection that is designed to prioritize sales taxpayers based on historical probability of a large audit assessment relative to the audit resources expended. Instead of using such a system, DOR relies almost exclusively on auditor recommendations for selecting future auditees. As a result, DOR may not be maximizing its rate of return on audit resources expended.

Audit selection procedures was a primary topic discussed at an August 16, 1979, hearing of a special State legislative committee established to study DOR. At the hearing, a DOR official listed the primary goals of sales tax audits as:

- Maximizing revenue generated, and
- Promoting taxpayer compliance and education.

Based on our analysis of DOR's audit selection procedures and the resultant taxpayers selected for audit, it appears that the goal of maximizing revenue generated from audits is not realized.

Our analysis of DOR records revealed that during fiscal year 1977-78 through 1979-80, DOR completed more than 2,700 sales and use tax audits. The 2,700 audits resulted in additional tax assessments of approximately $32 million. Table 6 presents a summary of the audits.

* Our analysis of DOR records revealed that during fiscal year 1979-80 DOR completed 748 sales and use tax audits (see page 37).

TABLE 6
A SUMMARY OF SALES AND USE TAX AUDITS COMPLETED BY DOR DURING FISCAL YEARS 1977-78 THROUGH 1979-80

Fiscal Year	Use Tax		Sales Tax		Total	
	Number of Audits	Additional Assessments	Number of Audits	Additional Assessments	Number of Audits	Additional Assessments
1977-78	71	$1,190,491.80	918	$ 6,656,953.71	989	$ 7,847,445.51
1978-79	53	948,366.42	938	10,546,948.60	991	11,495,315.02
1979-80	102	1,916,683.87	646	10,450,686.26	748	12,367,370.13
Total	226	$4,055,542.09	2,502	$27,654,588.57	2,728	$31,710,130.66

The procedure DOR used to select the taxpayers who were subjected to the 2,728 audits shown in Table 6 primarily was auditor recommendation. Such a procedure is in sharp contrast to the much more sophisticated audit selection procedures used by other tax administration authorities.

For example, the California State Board of Equalization* has developed a system for selecting sales tax accounts for audit that is designed to produce additional tax assessments equal to or greater than the cost of the audit. In the California system, sales tax accounts first are gathered into 740 industry-tax interval groupings. Historical audit results for each of these groupings are accumulated, and criteria for audit selections are developed. Based on the probability of a productive audit and the time required to conduct it, each of the 740 industry-tax interval groupings are placed into one of 16 audit selection cells. This system allows California officals to identify potentially productive audits readily, based on prior audits of similar firms.

Other examples are the Texas Comptroller of Public Accounts** and the City of Scottsdale, which have developed audit selection systems similar to the California system. Further, it took Scottsdale approximately 200 staff hours to implement the system because California provided Scottsdale with its historical probability data.

One consequence of DOR's not selecting its sales tax audit assignments based on demonstrated audit results is that revenues resulting from audits may not be maximized. Such a conclusion is based on our analysis of the taxpayer accounts that DOR audited during fiscal years 1977-78 through 1979-80, summarized in Table 7.

* The California State Board of Equalization is responsible for administering California's sales tax program.

** The Texas Comptroller of Public Accounts is responsible for administering the Texas sales tax program.

TABLE 7

ANALYSIS OF DOR SALES TAX AUDITS COMPLETED
DURING FISCAL YEARS 1977-78 THROUGH 1979-80

Tax Payments* Made during the Year for which DOR Performed an Audit	1977-78		1978-79		1979-80	
	No.	%	No.	%	No.	%
Less than $1,000	182	21.6%	189	21.1%	132	21.2%
$1,001 to $5,000	236	28.0	201	22.5	99	15.9
$5,001 to $25,000	274	32.4	293	32.7	140	22.5
$25,001 to $50,000	63	7.4	97	10.9	57	9.1
$50,001 to $100,000	38	4.5	59	6.6	48	7.7
$100,001 to $200,000	24	2.8	29	3.2	73	11.7
$200,001 to $300,000	9	1.1	8	.9	19	3.0
$300,001 to $400,000	5	.6	6	.7	11	1.8
$400,001 to $500,000	3	.4	3	.3	8	1.3
$500,001 to $1,000,000	5	.6	2	.2	18	2.9
$1,000,001 to $1,500,000	1	.1	1	.1	3	.5
More than $1,500,000	4	.5	7	.8	15	2.4
Total	844	100%	895	100%	623	100%

As shown in Table 7, DOR audits substantially more small firms than large firms. For example, from fiscal years 1977-78 through 1979-80, 74 percent of the DOR audits completed were of firms who paid $25,000 or less during the year of the audit. This suggests a less than optimal usage of sales tax audit resources, in view of the fact that in fiscal year 1979-80 the 15 audits of taxpayers who paid more than $1.5 million generated more than 40 percent of the audit assessments that resulted from the 371 audits of taxpayers who paid less than $25,000. It should be noted that the audit hours expended for each category on Table 7 are not shown. DOR records regarding audit hours are recorded and maintained in such a manner as to preclude such a presentation for all practical purposes.

* Tax payments were obtained from the sales tax year-to-date payments file. Since use tax payments are not maintained in this file, use tax auditees were excluded from the analysis. In addition, a few sales tax auditees did not have corresponding records in the file and were similarly excluded. (See Finding VI regarding problems associated with the year-to-date payments file.)

Improvements Made During 1980

DOR's sales and use tax audit function received a considerable amount of public criticism during 1979. Since that time, DOR has made a concerted effort to improve the function. According to a December 1980 memorandum from the Director of DOR,* major improvements accomplished during 1980 included:

- A comprehensive training program for new auditors was initiated covering such subjects as law, audit techniques and policy and procedures.
- A management information system was implemented to measure, classify and monitor audits.
- An audit selection unit was created to develop methods for random and cost effective audit selection.
- A separate audit review unit was created to provide independent quality control on audits.
- A procedure was initiated to issue "tax rulings" on topics which need clarification and to establish and/or delineate the Department's official position on various issues.

It should be noted, however, that some of the improvements still are in the formative stage and, in the case of the management information system, it appears that a thorough review of the data in the system is in order. According to the Chief Auditor for the sales tax audit section, as of September 1980 DOR audit selection procedures had not changed materially.

AUDIT PERIOD

Once a taxpayer is selected, DOR normally audits only a 33-month period. This is despite the fact that the statute of limitations on sales and use tax audits provides for a 36-month period. However, because of the wording of the statute, DOR is effectively limited to 33-month audits. As a result, the State may have lost an estimated $3.2 million** in sales and use tax audit assessments during fiscal years 1977-78 through 1979-80.

* Appendix VII contains the full text of this memorandum.

** This amount is based on the assumption that the audits could have been expanded to full 36-month audits using existing audit staff.

Arizona Statutes

Arizona statutes impose a three-year statute of limitations on sales and use tax audits. Arizona Revised Statutes (A.R.S.) §42-1327.E provides the limitation for sales taxes:

> "Except in the case of a fraudulent return, failure or refusal to make a return, every notice of a determination of an additional amount due shall be mailed within three years after the fifteenth day of the calendar month following the period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later."

Similarly, A.R.S. §42-1414.F contains the limitation for use tax audits:

> "Except in the case of a fraudulent return or the case of a failure or refusal to make a return, every notice of a determination of an additional amount due shall be mailed within three years after the fifteenth day of the calendar month following the period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later."

According to a Legislative Council memorandum dated December 5, 1980*, the purpose of the limitations is to protect the taxpayers. The memorandum states:

> "The purpose of a statute of limitations is primarily to protect the defendant and the court from the litigation of stale claims where evidence may have been lost or witnessess' memories may have faded. Brooks v. Southern Pacific Company 466 P. 2d 736, 105 Ariz. 442 (1970)."

* Appendix VIII contains the full text of this memorandum.

Because the Department is required to provide "...every notice of a determination of an additional amount due" within three years of the original due date of the tax, it cannot audit a full 36 months because some of those months are consumed in processing the audit. For example, if DOR begins an audit on January 1, 1981, it audits the following returns:

Sales Months	Sales Tax Return Due Date
March 1978 through November 1980	April 15, 1978 January 1, 1980*

Thus, DOR audits only 33 months of sales tax returns because it anticipates that the audit will be completed and the taxpayer notified of additional assessments by April 15, 1981, or 36-months after the due date of the March 1978 return.

The cities of Phoenix and Scottsdale have similar three-year statutes of limitations. However, they conduct full 36 month audits because their statutes of limitations are based on the notification of intent to conduct an audit, not the notification of additional assessments. For example, Scottsdale City Code §6-219.A, states in part:

> "Collection of back privilege taxes by the city shall be limited to a period of three years prior to the date when the tax collector gave notice to the taxpayer of the city's intention to perform an audit of the taxpayer's books, wrote to the person through use of ordinary mail concerning an apparent violation of the article, or took some other recorded action to require a privilege tax permit application or other compliance with the article. (Emphasis added)

* During the 1980 Legislative session, A.R.S. §42-1322 was amended to extend the filing date for sales tax returns from 15 days after the sales month to the first day of the second month after the sales month.

As previously noted, during the last three fiscal years the Department assessed additional taxes amounting to $31,710,130.66 as the result of sales and use tax audits based on the 33-month audit period. Had the audit periods been 36 months, the State may have earned an estimated $3.2 million in additional assessments. Finally, it appears that if A.R.S. §§42-1327 and 42-1414 were amended to use notification of intent to audit as the operative date for the statute of limitations, taxpayers still would be afforded the protections intended in present statutes.

COORDINATION OF AUDIT ACTIVITIES

In conjunction with its own audits, DOR also conducts audits for cities that participate in the State's sales tax collection program. The five largest cities in the State, however, have independent sales tax programs and conduct their own audits. In 1977 DOR formed a Unified Audit Committee including representatives from the cities not participating in the State's sales tax collection program. A primary objective of this group was the coordination of audit activities but, as of November 1980, audit activities of the various entities have not been coordinated effectively. As a result, the State has lost tax revenues that could be generated by the city audits, and an apparently significant duplication of audit work exists.

Cities' Audit Programs

The five largest cities in Arizona - Mesa, Phoenix, Scottsdale, Tempe and Tucson - each conduct their own sales tax audits. During fiscal year 1979-80, the five cities employed a combined total of 56 auditors. These auditors completed in excess of 1,600 audits during the year.

To better assess the potential impact of the cities' audits, we reviewed in detail the sales tax audit program of the City of Scottsdale. According to a city official, Scottsdale has completed more than 1,000 sales tax audits during the three fiscal-year period from 1977-78 through 1979-80. The audits resulted in more than $1 million in additional tax assessments, based on Scottsdale's one percent tax rate.

Also with assistance from Scottsdale officials, we compared the taxpayers audited by the city with the taxpayers audited by the State during the same three-year period. We found that 98 of the taxpayers were audited by both DOR and the City of Scottsdale during the same period. The 98 audits resulted in additional assessments of $258,646 for the City of Scottsdale. The remaining 935 Scottsdale audits, which were not also audited by DOR, resulted in audit assessments of $750,769.

At the present time there is no mechanism by which DOR can use the results of the cities' audits automatically. If such a mechanism had existed, it appears the State could have assessed up to an additional $3 million* based on the 935 Scottsdale audits which the State did not duplicate.

Unified Audit Committee

In an attempt to establish better cooperation beteen the cities and DOR, the Department formed a Unified Audit Committee in November 1977. The Department invited all cities not participating in the State sales tax collection system to send representatives to the committee's monthly meetings. In addition to DOR officials, the primary participants have been representatives from the cities of Flagstaff, Mesa, Phoenix, Prescott, Scottsdale, Tempe and Tucson. The main topics addressed by the committee have been audit issues and problems or differences encountered between the cities and DOR in the general administration of their respective sales tax programs.

According to a DOR official the work of the committee has resulted in improved cooperation between the cities and the State. During fiscal year 1979-80, DOR and the cities coordinated their audit activities for selected audits - especially out-of-State audits. It was estimated that for at least 15 out-of-State audits during the last year, DOR and city auditors worked together on the audits.

* The $3 million is based upon a four percent tax rate for the State. In 1978-79, 88 percent of all State sales taxes were paid at the four percent rate.

The DOR official added that a fully coordinated audit program, one which would eliminate duplication of audit work and allow the cities and DOR to use each other's work as a basis for additional assessments, would require a concerted effort by all parties and is a long-term project. The DOR official pointed out that differences between State and local sales tax laws and their interpretation of these laws, audit techniques, audit schedules and the length of audit periods complicate the development of a fully coordinated system.

City officials support the concepts of coordinated system. They point out, however, that only the State (DOR) can institute such a coordinated effort effectively. Further, concern was expressed over the slow rate at which progress is being made.

REPORTED RESULTS HAVE BEEN OVERSTATED

DOR has overstated the return on its sales and use tax audit function substantially in budget information submitted to the Legislature. Consequently, the results of analysis based on such data is unreliable.

During the last three fiscal years, DOR has reported in budget documents a total "return" on sales and use tax audits of $38,517,641. Our review of DOR records revealed that the "returns" presented in the budget documents have been overstated in that:

- DOR records do not support the reported returns on audits in any of the three years, and
- The "return" amounts are based on audit assessments, many of which are appealed and subsequently reduced or eliminated.

In its annual budget requests submitted to the Legislature, DOR presents the number of audits conducted and the "average return per audit". Total return on sales and use tax audits must be derived from these amounts. Table 8 presents the results as presented in the budget requests and the derived total results.

TABLE 8
DOR'S REPORTED RESULTS OF SALES AND USE TAX AUDITS
AND DERIVED TOTAL RESULTS FOR FISCAL YEARS
1977-78 THROUGH 1979-80

Description	Reported Results: Return Per Audit	Reported Results: Number of Audits	Derived Results	
1977-78 audits:				
In-State	$ 6,308	954	$ 6,017,832	
Out-of-State	37,734	130	4,905,420	
				$10,923,252
1978-79 audits:				
In-State	10,566	874	9,234,684	
Out-of-State	42,701	123	5,252,223	
				14,486,907
1979-80 audits:				
In-State	13,494	648	8,744,112	
Out-of-State	39,667	110	4,363,370	
				13,107,482
Total		2,839		$38,517,641

As shown in Table 8, DOR reported that the sales and use tax audits yielded a "return" of $38,517,641 for the last three fiscal years. Our review of DOR records, however, revealed that the audits completed in those three fiscal years yielded a "return" of only $31,710,131. Table 9 presents a comparison of the DOR reported results and the total assessment as shown in our review of DOR records.

TABLE 9

A COMPARISON OF DOR'S REPORTED RESULTS OF SALES AND
USE TAX AUDITS FOR FISCAL YEARS 1977-78 THROUGH 1979-80
AND THE TOTAL ASSESSMENTS RECORDED IN DOR RECORDS

Fiscal Year	DOR's Reported Results	Total Assessments Per DOR Records
1977-78	$10,923,252	$ 7,847,446
1978-79	14,486,907	11,495,315
1979-80	13,107,482	12,367,370
Total	$38,517,641	$31,710,131

As shown in Table 9, the reported returns on DOR sales and use tax audits are overstated in comparison to the Department's records of assessments resulting from sales and use tax audits completed during the same periods.

A further analysis of the audit assessment amounts revealed that the presentation of these amounts as returns on audits is a substantial overstatement of actual returns. In fact, our analysis showed that a high percentage of the dollar value of the assessments may never be realized.

As part of our review of DOR's audit function, we reviewed all audits that had substantial audit assessments for the last three fiscal years. According to DOR records, 30 audits were completed during the last three years that resulted in audit assessments greater than $200,000. In the aggregate these audit assessments totaled $14,334,796, or 45 percent of the $31,710,131 in total audit assessments for the period. As of June 30, 1980, the status of these 30 audits was as follows:

Status of Assessment	Number of Audits	Original Audit Assessment	Amount Paid or Collectible
Paid or due	4	$ 1,529,950.44	$1,529,950.44
Appealed assessments for which a decision has been rendered	8	3,148,547.22	1,003,753.80*
Assessments still in appeals process	18	9,656,298.07	**
Total	30	$14,334,795.73	$2,533,704.24

It should be noted that the DOR has implemented an Audit Management Information System which will automate the record-keeping function for the sales and use tax audits. Hopefully, the system will improve the accuracy of DOR's budget information regarding audit activities.

* These amounts may be subject to future appeals to the State Board of Tax Appeals or Superior Court.

** These amounts will be determined when the appeals are resolved.

CONCLUSION

Since August 1979, DOR has made a concerted effort to improve the sales and use tax audit function. However, as of November 1980, additional improvements still are needed in the following areas:

1) Audit selection procedures,

2) Expansion of the statute of limitations for audits,

3) Coordination of DOR's and Arizona cities' sales tax audit activities,

4) Recording and reporting of sales and use tax audit results.

Therefore, DOR may not be maximizing revenues generated by the sales and use tax audit function. In addition, DOR has overstated revenues earned from audit functions reported in budget documents submitted to the Legislature.

RECOMMENDATIONS

It is recommended that:

1. DOR expedite the implementation of an audit selection system similar to those currently used in Texas and California.

2. The Legislature consider amending A.R.S. §§41-1327.E and 42-1414.F to allow for full 36-month audits as conducted by the cities of Scottsdale and Phoenix.

3. DOR increase its efforts to coordinate its audit activities with those of the five largest cities in Arizona.

4. DOR maintain more accurate records of audit assessments and report such information to the Legislature in a manner which will more accurately reflect actual revenues generated by its audit activities.

FINDING III

THE DOR SALES AND USE TAX APPEALS PROCESS IS FRAGMENTED AND UNCOORDINATED. AS A RESULT, THE PROCESS IS EXCESSIVELY LONG, AND NOT PROPERLY DOCUMENTED OR MONITORED.

The Department of Revenue (DOR) conducts approximately 800 sales and use tax audits each year, generating approximately $10 million in additional tax assessments. Under Arizona law those taxpayers who are assessed additional taxes may petition for a hearing, correction or redetermination. During the three-year period which ended June 30, 1980, an indeterminate number of appeals resulted in 277 hearings involving $18.2 million in sales and use tax assessments. Our review of the 277 hearings revealed that the sales and use tax appeals process is fragmented among several divisions within DOR, without sufficient formalized procedure. As a result, DOR is:

1. Not processing appeals in a timely manner,
2. Not documenting the appeals process properly, and
3. Not properly monitoring the appeals process.

APPEALS PROCEDURES

The formal appeals procedure begins when the sales and use tax audit section of the Taxation Division sends a taxpayer an assessment letter stating the amount of additional tax or refund due from DOR and asking the taxpayer to inform DOR in writing within 30 days if the audit assessment is accepted or protested.

When a protest letter is received by the audit section, it is given to the Chief Auditor to review. The protest letter, audit assessment and audit file are:

- Returned to the auditors for correction of mathematical or technical errors, and/or
- Sent to a tax analyst, who prepares a brief for the Taxation Division for an administrative hearing.

Occasionally the audit section schedules an informal conference with the taxpayer to resolve the issues.

Receipt of a brief is the first official notice the Administrative Hearing Office receives of a request for a hearing. The secretary at the Hearing Office schedules a hearing and notifies the taxpayer.

Since July 1980, the Administrative Hearing Officer writes and signs the administrative decision and sends it to the taxpayer and copies to the Taxation Division and the Director of DOR. The taxpayer and the Division have 30 days in which to appeal to the Director, or the Director may opt to review the decision of the Hearing Officer. At the end of the 30-day period, the Hearing Officer notifies the taxpayer that the administrative decision has become the final order of the Department. The taxpayer then has 30 days from receipt of this letter to appeal to the State Board of Tax Appeals, Division Two* or the decision becomes final and any additional assessments become due.

TIMELINESS OF APPEALS PROCESS

According to available records at DOR for the three-year period ended June 30, 1980, an indeterminate number of protested audit assessments resulted in 277 hearings. An analysis of these hearings revealed that the time from initial taxpayer protest to a hearing decision is excessive, in that:

1. The average time to reach a hearing decision is 14.4 months,
2. Time delays may place cases in violation of legislative intent, and
3. DOR takes much longer than the State Board of Tax Appeals to conduct and conclude hearings.

* Division Two of the State Board of Tax Appeals is separate from DOR and conducts hearings on appeals from DOR dealing with income, sales, use, estate and luxury taxes.

Processing Delays

Our analysis of the hearings conducted during the period from July 1, 1977, through June 30, 1980, revealed that the Department took an average of 14.4 months to render a decision on a protested audit assessment. Cases in which a decision was rendered were completed in an average of 13.9 months, while pending cases have been outstanding for an average of 15.2 months. Table 10 presents a summary of our analysis of the delays experienced in processing contested audit assessments over a three-year period.

TABLE 10

DELAYS EXPERIENCED IN PROCESSING CONTESTED
AUDIT ASSESSMENTS FROM JULY 1, 1977 TO JUNE 30, 1980*

Decision Rendered			Cases Pending			Total Decisions Rendered and Cases Pending**		
Number of Months from Assessment to Hearing Decision	Number of Hearings	Tax Assessment	Number of Months Outstanding	Number of Hearings	Tax Assessment	Number of Months to Hearing Decision or Outstanding	Number of Hearings	Tax Assessment
1-3	4	$ 42,193	1-3	2	$ 38,957	1-3	6	$ 81,150
4-6	18	180,174	4-6	11	1,953,904	4-6	29	2,134,078
7-9	32	1,092,293	7-9	14	744,357	7-9	46	1,836,650
10-12	25	816,046	10-12	20	1,792,568	10-12	45	2,608,614
13-15	25	1,298,620	13-15	17	467,406	13-15	42	1,766,026
16-18	14	402,794	16-18	13	1,623,014	16-18	27	2,025,808
19-21	8	1,255,530	19-21	12	2,401,127	19-21	20	3,656,657
22-24	5	272,131	22-24	5	179,536	22-24	10	451,667
25-30	5	238,199	25-30	2	17,914	25-30	7	256,113
31-36	2	256,182	31-36	3	953,274	31-36	6	1,209,456
37-42	2	656,706	37-42			27-42	2	656,706
43-48			43-48	1	99,388	43-48	1	99,388
49-60	1	14,193	49-60	1	2,150	49-60	2	16,343
61-113	1	110,458	61-87	1	315,287	61-113	2	425,745
Total	142	$6,635,519		102	$10,588,882		244 **	$17,224,401
Average 13.9			15.2			14.4		

* From information at Hearing Office, sales and use tax audit section and State Board of Tax Appeals.

** The total does not equal 277 cases because assessment dates or decision dates were unavailable or missing for 33 cases.

As shown in Table 10, of the 142 hearings held in the three-year period ended June 30, 1980, for which a decision was rendered, 38 decisions took longer than 15 months and one case took 113 months or more than nine years to decide. Of the 102 cases pending on June 30, 1980, 38 cases had been pending for longer than 15 months and one case had been pending for 87 months. The cases taking 16 months or longer represent $5.6 million or 53 percent of the audit assessments pending administrative review on June 30, 1980.

Our analysis revealed that a primary cause for the lengthy hearing process is the time DOR takes to get ready for a hearing. For example, of the hearings for which the date of assessment and date of the hearing were available, more time was spent on getting the protest ready for hearing than was spent in rendering the decision. The average time between assessment date and hearing date was 8.5 months, whereas the total average elapsed time was 14.4 months. Thus 59 percent of the hearing process time was spent preparing a protested audit case for hearing.

Several of the hearing files at DOR document time delays encountered in the hearing process. The following is a synopsis of three noteworthy cases.

Examples of Excessive Delay at Audit Division

CASE I

The taxpayer was assessed $315,286 for the period October 1967 through September 1970. The taxpayer was allowed eight years, instead of 30 days, to protest. On March 8, 1979, the protest was made formally and hand-delivered to the audit section. A hearing was held and the case was still pending on June 30, 1980.

CASE II

The taxpayer was assessed $2,150 on August 15, 1975. In this case the taxpayer did respond within 30 days. It took the audit section 47 months to get the brief to the Hearing Office. In October 1979, 50 months after the assessment, the hearing was held. The case was still pending on June 30, 1980.

CASE III

The taxpayer was assessed $244,331 on November 15, 1977. A hearing was held nine months later on August 25, 1978. The case was still pending at June 30, 1980, 22 months after the hearing. (A decision was mailed September 9, 1980, and has been appealed to the Director.)

Arizona Public Service - Palo Verde Guidelines Cases

There have been a number of appealed audit assessments pending since Arizona Public Service Palo Verde guidelines were worked out among various taxpayers, DOR and the Attorney General. The guidelines indicate items used in the construction of Palo Verde Nuclear Generating Station that will be partially or totally exempt from sales or use tax. These guidelines were sent to the Director on August 15, 1979, and were accepted by the Director August 16, 1979. The guidelines became effective on October 15, 1979.*

According to records at the sales tax audit section and the Hearing Office, through June 30, 1979 there were 17 appealed audit assessments related to construction at Palo Verde. One taxpayer waived oral hearing, two cases never reached the Hearing Office and 14 taxpayers received a hearing. Although the guidelines became official on October 15, 1979, not one decision had been rendered by June 30, 1980, eight-and-a-half months later. By October 22, 1980, a year after the guidelines were adopted, only two decisions had been rendered.

* See Finding VII for a discussion of these guidelines.

Legislature Did Not Contemplate Unreasonable Delay in Resolution of Tax Appeals

A.R.S. §§42-1415 and 42-1338 provide the means to appeal a use or sales tax assessment. §42-1415 states:

> "Appeal to department; petition for redetermination; finality of order
>
> . . . . . .
>
> "A. Any person from whom an amount is determined to be due under the provisions of this article may apply to the department by a petition in writing within thirty days after the notice required by §42-1414 is received by him, or within such additional time as may be allowed by the department, for a hearing, correction or redetermination of the action taken by the department. The petition shall set forth the reasons why such hearing, correction or redetermination should be granted and the amount in which any tax should be reduced. The department shall promptly consider the petition and shall grant a hearing, if requested." (Emphasis added)

Arizona statutes impose few deadlines for hearing tax appeals and do not establish what constitutes reasonable delays on the part of the taxpayer, the Division or the Department. A Legislative Council Memorandum of August 15, 1980,* states:

> "The only statutory provisions relating to the time in which the department must rule on appeals are A.R.S. §§42-1338, subsection A and 42-1415, subsection A which require that, after the appeal is received, 'the department shall promptly consider the petition and shall grant a hearing, if requested.' It may be argued that this is a requirement for the department to promptly take up the matter but does not relate to the speed of disposing of the matter. The statutes do not specifically prescribe any time limit for making a decision on appeals." (Emphasis added)

* Appendix IX contains the full text of this memorandum.

"Nevertheless, a requirement for reasonable promptness in resolving the appeal may be implied from the nature of the appeal and hearing before the department. The legislature in writing and adopting this statute intended it to facilitate the collection of taxes due or to determine that taxes were not due. The legislature did not contemplate unreasonable or arbitrary delay in resolution. For such to occur would be an interference with personal and property rights and would inhibit the further appellate relief afforded by other statutes. To inhibit or delay these further hearings is a denial of due process of law under the United States Constitution. Due process requires both a prompt hearing and a prompt conclusion." (Emphasis added)

The administrative rules and regulations of DOR in effect June 30, 1980, are no more specific than the statutes as to what constitutes prompt consideration of a taxpayer petition.

According to Legislative Council, the administrative procedure was intended to facilitate the resolution of disputed tax assessments. A taxpayer may be deprived of due process by unnecessary delays in the appeals procedures and thus the whole proceeding may be void. The August 15, 1980, Legislative Council Memorandum states:

"There is little conceivable state interest in delaying the decision on an appeal of sales or use taxes. On the contrary, it would be in the interest of both the state and the taxpayer to provide for a timely and reasonably prompt resolution of the matter in order to either collect the tax or move the action on to the next forum. Moreover, if due process is not afforded by the hearing and appeal, the whole proceeding may be void." (Emphasis added)

Time Limitations within which Other State Entities Conduct Administrative Hearings

Although the statutes governing the State Board of Tax Appeals, Division Two* do not prescribe specific time limitations, the rules and regulations adopted by the Board set limitations for specific steps in the process, stating:

* Division Two of the State Board of Tax Appeals conducts hearings on appeals of DOR administrative hearing decisions regarding protested sales and use tax audit assessments.

"R16-3-107. Memoranda
"A. The appellant may file a memorandum in support of the appeal within thirty (30) days of filing the notice of appeal. The Department will be allowed thirty (30) days from the date of receipt of appellant's memorandum to respond. In the event that appellant does not file a memorandum, the Department will be allowed thirty (30) days to file its memorandum from the time appellant's memorandum would have been due. The appellant will then be allowed thirty (30) days from receipt of the Department's memorandum to respond. Appellant's reply memorandum shall be limited to a reply to the issues of law or fact raised in the Department's memorandum. Reasonable extensions of time for the filing of memoranda may be granted upon written request from either party. The Board will transmit a copy of any memorandum filed to the opposing party. Both or either party to the appeal may waive the filing of memorandum."

Further, our review of Division Two records revealed that its decisions are rendered in a more timely fashion. During the past three fiscal years, Division Two has rendered decisions on an average of 1.5 months from their hearing dates. In fact, 35 percent of its decisions were rendered on the same day as the hearing.

It should be noted that statutory and administrative time limitations have been established for other State entities. For example,

- Rule 12(a) of the Rules of Civil Procedure* states:

"A defendant shall serve and file his answer within twenty days after the service of the summons and complaint upon him, except when service of process is made pursuant to Rule 4(e) (1), (2), (3), (4), or 5. A party served with a pleading stating a cross-claim against him shall serve and file an answer thereto within twenty days after the service upon him. The plaintiff shall serve and file his reply to a counterclaim in the answer within twenty days after service of the answer or, if a reply is ordered by the court, within twenty days after service of the order, unless the order otherwise directs. The service of a motion permitted under this Rule alters these periods of time as follows, unless a different time is fixed by order of the court: (Emphasis added)

* The Rules of Civil Procedure govern the procedure in the superior courts of Arizona in all suits of a civil nature.

"1. If the court denies the motion or postpones its disposition until the trial on the merits, the responsive pleading shall be served within ten days after notice of the court's action.

"2. If the court grants a motion for a more definite statement the responsive pleading shall be served within ten days after the service of the more definite statement."

- Under the provisions of A.R.S. §32-2157, the Department of Real Estate conducts administrative hearings regarding written complaints. The statutes require the defendant to file a verified response within ten days after notice of charges is served. The statutes further require that proceedings regarding the complaint be "...promptly instituted and determined." In carrying the statutory mandate for prompt determination, the Department has adopted Rule A.C.R.R. R4-28-41 which requires the Hearing Officer to issue a written opinion within 45 days after the conclusion of a hearing.

- Arizona Revised Statutes §32-1157.B requires the Registrar of Contractors to issue a written decision within 15 days of the conclusion of administrative hearings.

DOCUMENTATION OF APPEALS PROCESS

Our review of DOR administrative hearing files revealed that the sales and use tax appeals process is not adequately documented in that:

1. The files do not consistently contain statutorily required records,
2. Some files contain conflicting versions of the same decision, and
3. The files do not adequately document the receipt of written protests from taxpayers.

As a result, the absence of required records may preclude the collection of additional taxes due to the State. Further, the basis for a timely appeal from the taxpayer cannot always be established.

Documentation Required for Contested Cases

According to a Legislative Council Memorandum dated August 15, 1980,* the record-keeping requirements for contested cases contained in the Administrative Procedure Act apply to administrative hearings conducted by DOR. In the memorandum, Legislative Council stated:

> "A sales or use tax protest or appeal would become a contested case if a hearing is requested under section 42-1338, subsection A or section 42-1415, subsection A. Once the proceeding becomes a contested case, the administrative procedure act applies to prescribe the rules and procedures for the hearing, there being no procedural statutes specifically applicable to sales and use tax appeals. The rules and procedures are prescribed by A.R.S. sections 41-1009, 41-1010 and 41-1011..."

A.R.S. §41-1009.E is specific in mandating what the records of a contested case shall include:

> "E. The record of a contested case shall include:
>
> "1. All pleadings, motions, interlocutory rulings.
>
> "2. Evidence received or considered.
>
> "3. A statement of matters officially noticed.
>
> "4. Objections and offers of proof and rulings thereon.
>
> "5. Proposed findings and exceptions.
>
> "6. Any decision, opinion or report by the officer presiding at the hearing.
>
> "7. All staff memoranda, other than privileged communications, or data submitted to the hearing officer or members of the agency in connection with their consideration of the case."

* Appendix IX contains the full text of this memorandum.

DOR Administrative Hearing Records

When contrasted with Administrative Procedure Act requirements, DOR hearing records are seriously lacking. For more than one-third of the cases resolved during the last three years, no record of the resolution could be found in the Hearing Office.

Of 277 hearings held in the three-year period ending June 30, 1980, the Auditor General's staff found that 102 hearings were still pending. Presumably there had been decisions rendered or some resolution of the remaining 173 hearings.* A search of decisions-rendered binders and hearing files at the Hearing Office on August 7, 1980, located only 111 decisions. Thus, from records at the Hearing Office, 62 decisions could not be located. Further, in many closed files there was no indication of case disposition and many presumably closed cases had no files at the Hearing Office. Several cases had as many as three different decision letters in the file, so it was impossible to determine which decision, if any, had been mailed to the taxpayer.

An April 1980 DOR internal management report regarding the administrative hearing process recommended that "Complete decision reference files should be established in the Hearing Office..." By November 18, 1980, great improvements were noted in the decisions records at the Hearing Office; however, the April 1980 recommendation had not been fully implemented. Auditor General staff still could not find documentation for 23 decisions.

* An additional two cases had been heard but were in active files to be reheard.

Documentation of Taxpayer Protests

The audit section's assessment letter of June 30, 1980, states:

> "The results are effective upon receipt of this notice. However, if you wish to apply for an administrative review, correction or redetermination of the action taken, you are required under the law to present a petition in writing within thirty (30) days of your receipt of this notice. Such petition must set forth the reasons why such administrative review, correction or redetermination should be granted and the amount by which this tax should be reduced or increased. If not filed within the required time, this audit will become final and you shall be deemed and treated as having waived and abandoned any rights to question said amount. Upon finalization, additional tax assessments will begin to accrue interest at the rate of 1/2 of 1 percent per month." (Emphasis added)

The assessment letter clearly states that the taxpayer who wishes to appeal assessment must:

1. Present a petition in writing, and
2. Do so within 30 days of receipt of the assessment.

Thus, to ensure that the audit division allows timely protests only, appeals should be properly documented. The documentation should include:

1. The date the assessment was received by the taxpayer, evidenced by a green return-receipt card received by DOR from the post office;
2. The taxpayer's written petition, and
3. The date the written appeal was received by DOR.

An analysis of 88 audit files at the Hearing Office on June 30, 1980, revealed that only 59 files contained documentation that the taxpayer filed an appeal within the 30-day statutory limitation.

IMPROPER MONITORING OF THE APPEALS PROCESS

The sales and use tax appeals process is fragmented among several DOR divisions, and formalized procedures have not been established or specific responsibilities assigned to ensure that appeals are processed in an appropriate and timely manner. In addition, meaningful management reports are not prepared for DOR officials regarding tax appeals in process. The lack of monitoring fosters an uncoordinated, inefficient and poorly controlled appeals process.

Fragmentation of Appeals Process

The Hearing Office has not been the recipient or processor of petitions for review, redetermination or correction. The audit section has controlled: 1) acceptance of appeals, 2) documentation of their timeliness, and 3) progress of petitions through the audit section to the point at which they may reach the Hearing Office. No audit section deadlines exist regarding the processing of appeals, amending audits or preparing briefs for hearings.

In addition, the Hearing Office accomplished little in the way of monitoring the status and progress of cases during most of the three-year period ended June 30, 1980. As in the audit section, there are no guidelines or established deadlines to expedite the scheduling of a hearing or to render a decision. Until May 1980, cases were neither logged nor assigned a number to aid in tracking or identifying the age of an appeal. Cases were lost in alphabetical files with no followup to remind the Hearing Officer of an appeal's existence or status and thus to ensure compliance with stipulated time requirements.

It should be noted that DOR established new appeals procedures in the summer of 1980, and a memorandum from the Director on September 19, 1980, called for control of the appeals process by centralization in the Hearing Office. However, as of November 20, 1980, the new procedures had not been implemented.

The absence of monitoring and the lack of established guidelines allow for inefficiency and inequity in the appeals process, as demonstrated in the following cases:

CASE I

The taxpayer requested that an oral hearing be rescheduled. He was assured by DOR that the hearing date would be changed. The taxpayer heard nothing more from DOR until a year later, when he received a copy of the Hearing Officer's decision letter. The case had been heard without the taxpayer's presence. The taxpayer appealed the decision to the State Board of Tax Appeals.

CASE II

Incongruously, another taxpayer was notified in advance of a hearing to be held September 12, 1979. He failed to appear. In a letter dated December 12, 1979, DOR notified the taxpayer that he had failed to: 1) appear for the scheduled hearing, or 2) notify DOR of the reason for his nonappearance. The letter from DOR states:

> "Please be advised that unless you request within 15 days that a hearing be rescheduled, I will be forced to decide your protest without having orally heard your position."

Thus, the second taxpayer was given two opportunities by DOR to present his protest while the taxpayer in Case I was given no opportunity to present his protest. As of June 30, 1980, no decision had been reached for Case II.

CASE III

The audit file indicated that the taxpayer had been extremely uncooperative with DOR auditors, had no sales tax license number and was assessed $33,947 on November 5, 1979. The taxpayer had requested and had been granted two hearing postponements. In April 1980, DOR asked the taxpayer to let the Hearing Office know the date and time he conveniently could appear for administrative review. The taxpayer did not respond. In June 1980, DOR requested by certified mail that the taxpayer respond within 15 days or the Hearing Officer would set a date for hearing. Subsequently, the taxpayer's representative notified DOR that his client would be out of the State until at least January 1981.

It should be noted that the State Board of Tax Appeals does not permit such delaying tactics by taxpayers. A five-day grace period may be given for good cause, but if the taxpayer or DOR exceeds that grace period, a hearing is scheduled automatically.

Accountability for Monitoring
Appeals Process Does Not Exist

In the summer of 1980, DOR established a formalized appeals process including assignment of specific responsibility for the entire process.* In a memorandum dated September 19, 1980, the Director recognized "...that taxpayer protests are not immediately being forwarded to the hearing officer." Furthermore, the memorandum stated:

> "To properly handle taxpayer appeals, the hearing officer should be the only individual in the department to determine whether a protest is proper and shall decide whether to accept or dismiss a protest. To assist the hearing officer in handling this function, all protests should be forwarded to the hearing officer upon receipt. (Emphasis added)

* Appendix X contains a December 15, 1980, memorandum from DOR officials which outlines improvements made in the administrative hearing function.

As of November 20, 1980, the memorandum had not been implemented in that: 1) according to the Chief Auditor, the DOR audit section still receives and screens protest letters from taxpayers, 2) the assessment letter had not been revised to advise taxpayers to send their protests to the Hearing Office, 3) the Hearing Office had received no sales and use tax protest letter directly from the taxpayer or from the audit section, and 4) the Hearing Office had received eight briefs on taxpayer protests, but all eight protests had been received by the audit section before June 30, 1980. Thus, procedures that have been established by the Director of DOR to monitor the appeals process have not been implemented and the appeals process still is fragmented.

In addition, DOR does not produce management reports on all appealed audit assessments. As a result, DOR management is unsure and cannot verify:

1. How many and which audits have been protested,
2. Whether assessments were amended before hearing,
3. How many assessments were corrected for mathematical or technical errors,
4. The time required to process assessments through current procedures,
5. The identity of each outstanding audit,*
6. The age of each outstanding audit, and
7. The causes for long-outstanding cases.

When Auditor General staff requested the DOR audit section to provide a list of audits protested in the last three fiscal years, and their resolution, DOR furnished a list for the nine-month period from October 1979 to June 1980 only.

* An outstanding audit is one which has been assessed but not paid in full.

It should be noted that in accordance with an April 1980 DOR management study recommendation, the Hearing Office has been preparing a monthly Administrative Review Status Report, which lists caseloads, hearings held, decisions rendered and cases appealed. However, the report does not include monthly appeals volume or the number of cases more than 30 days old, also recommended in the study. Without such information, the Director has no knowledge of the numbers of cases, on a month-to-month basis, more than 30, 60 or 90 days or two or three years old.

CONCLUSION

Our review of 277 hearings revealed that the sales and use tax appeals process is fragmented among several sections in DOR without sufficient formalized procedures. As a result, DOR: 1) does not process appeals in a timely manner, 2) does not document the appeals process adequately, and 3) does not monitor the appeals process properly.

Although improvements were made in DOR's administrative hearing process during the summer of 1980, many problems still exist. Procedures developed to consolidate the appeals process have not been fully adopted.

RECOMMENDATIONS

It is recommended that DOR:

1. Establish a time limitation for each specific step in the appeals process by adopting rules and regulations similar to A.C.R.R. R16-3-107 of the State Board of Tax Appeals or Rule 12(a) of the Rules of Civil Procedure.

2. Adopt rules and regulations directing the Hearing Officer to schedule hearings for taxpayers who have postponed, without good cause, a hearing beyond the established time.

3. Document appeals according to A.R.S.§§42-1338, 42-1415 and 41-1009 (Administrative Procedure Act).

4. Fully implement centralization of the appeals process in the Hearing Office, as outlined in the Director's September 19, 1980, memorandum.

5. Prepare monthly management reports on the status of protested audit assessments including explanations for excessive delays.

FINDING IV

DOR IS NOT CONSISTENTLY IMPOSING PENALTIES ON LATE PAYMENTS OF SALES TAXES AS REQUIRED BY STATUTE. AS A RESULT, DOR IS NOT COMPLYING WITH STATE LAW OR TREATING TAXPAYERS EQUALLY, AND A SUBSTANTIAL AMOUNT OF STATE REVENUE IS LOST.

Arizona law provides that taxpayers who do not pay the proper amount of sales taxes when due must pay a penalty and interest. However, our review revealed that DOR 1) currently does not always assess penalties on late payments and previously did not always assess interest, 2) does not always assess the proper penalty when it does assess a penalty, and 3) in conjunction with the Office of the Attorney General, abates penalties even though DOR itself has no statutory authority to do so. As a result, DOR is not complying with State law or treating taxpayers equally, and a substantial amount of State revenue is lost.

Penalties and Interest Not Always Assessed

Arizona Revised Statutes (A.R.S.) §§42-1322.D, 42-1327.B and 42-1327.C provide that taxpayers who do not pay the proper amount of sales tax when due are to be assessed a penalty of 10 percent or, in cases of fraud or intent to evade the statutes, 25 percent of the total tax due and interest at the rate of one percent per month,* or fraction thereof, on unpaid amounts.

As part of our DOR audit we reviewed the 30 largest sales and use tax audit assessments between July 1977 and June 1980 to determine if penalties and interest were properly assessed. We found that DOR did not impose penalties and interest on 14 of the 30 audit assessments and that approximately $1.5 million in penalties and interest that should have been assessed were not. Table 11 summarizes the 14 sales and use tax audit assessments.

* Prior to August 1, 1980, interest was assessed at the rate of one-half of one percent per month, or fraction thereof, on unpaid amounts.

TABLE 11

SUMMARY OF 14 OF THE LARGEST SALES AND USE TAX AUDIT ASSESSMENTS FROM JULY 1977 TO JUNE 1980 FOR WHICH DOR DID NOT IMPOSE PENALTY OR INTEREST

Notification Date	Audit Assessment	Amounts Assessed		Amounts That Should Have Been Assessed		
		Penalty	Interest	Minimum Penalty*	Estimated Interest**	Combined
3/27/79	$ 214,514.84	0	0	$ 21,451.48	$ 15,552.33	$ 37,003.81
5/02/79	1,379,744.80	0	0	137,974.48	113,828.95	251,803.43
9/10/79	358,053.21	0	0	35,805.32	29,539.39	65,344.71
5/08/78	495,371.05	0	0	49,537.10	42,106.54	91,643.64
2/23/79	868,398.07	0	0	86,839.81	65,129.85	151,969.66
11/23/77	326,211.68	0	0	32,621.17	27,727.99	60,349.16
8/09/77	204,330.87	0	0	20,433.09	18,389.78	38,822.87
10/31/78	1,511,343.46	0	0	151,134.35	124,685.83	275,820.18
3/16/78	458,146.58	0	0	45,814.66	36,651.73	82,466.39
10/04/78	651,255.00	0	0	65,125.50	52,100.40	117,225.90
9/22/78	649,821.13	0	0	64,982.11	45,487.48	110,469.59
2/01/79	399,603.68	0	0	39,960.37	33,966.31	73,926.68
12/08/78	542,837.28	0	0	54,283.73	44,784.08	99,067.81
5/19/78	213,025.52	0	0	21,302.55	18,639.73	39,942.28
				$827,265.72	$668,590.39	$1,495,856.11

* Calculated using a ten percent penalty, which is the minimum.
** Calculated using an interest rate of one-half of one percent.

For audits initiated after June 1, 1979, DOR adopted a new policy regarding penalty and interest assessment. Since that time, the policy has required the assessment of interest for all additional taxes owed. The Chief Auditor of the sales and use tax audit section stated that a ten percent penalty is levied automatically if it is discovered through an audit that a taxpayer did not file a return. If it is determined that a taxpayer did file a return but the reported tax was insufficient, a penalty is imposed only if the Chief Auditor feels there was an intent to deceive the Department. Such a policy is not only totally discretionary but is not in compliance with A.R.S. §42-1322.D, which states:

> "Any taxpayer who fails to pay such tax (transaction privilege tax) within five days from the date upon which the payment becomes due shall be subject to and shall pay a penalty of ten percent of the amount of the tax..."

Legislative Council Criticizes DOR's Penalty Assessment Policy

A Legislative Council memorandum dated November 28, 1980*, criticizes DOR's penalty assessment as being contrary to statutes. It states, in part:

> "The instances stated as the department's criteria do not meet the statutory requirements...
>
> "According to the stated facts, the department collects the 10% penalty if (a) the taxpayer did not file a return or (b) the chief of the audit division feels the imposition of a penalty is appropriate. The former instance is so broad that it could include cases which should properly be subject to a 25% penalty. In order to comply with the statute, the department's first criterion for a 10% penalty should exclude those circumstances. The department's second criterion is likewise inappropriate as seemingly permitting an abuse of administrative authority through arbitrary and capricious rulings which should instead be determined on the basis of promulgated rules.

* Appendix XI contains the full text of this memorandum.

"The department's criterion for no penalty again is a substitution of the department's standards for the statutory standards. The department's practice is invalid on at least three points: (a) As stated in the facts, too much discretion is given to the chief of the audit division. There should at least be a requirement of evidence upon which to make an objective finding. (b) The practice does not recognize the statutory requirements that, if the deficiency was fraudulent or due to an intent to evade, a 25% penalty must be imposed or, if the deficiency was due to negligence or intentional disregard, a 10% penalty must be imposed. Stated another way, the department's practice is that the taxpayer escapes a penalty unless the chief feels that the taxpayer intentionally deceived the department. This does not follow the statutory mandate in any respect. (c) The criterion does not recognize the 'residual' provision of A.R.S. section 42-1322, subsection D that any taxpayer who fails to pay the tax within five days of becoming due is subject to and shall pay a 10% penalty." (Emphasis Added)

As stated in the Legislative Council memorandum, DOR's penalty assessment policy is improper in that: 1) taxpayers who do not file a return may not be subject to a 25 percent penalty at the discretion of the Chief Auditor of the sales and use tax audit section, and 2) taxpayers who owe additional taxes should always be assessed at least a ten percent penalty. In addition, DOR should promulgate rules regarding penalty assessments.

DOR May Collect Penalty And Interest It Failed to Assess Earlier

The Department of Revenue may assess and collect penalties and interest it neglected to impose originally. The assessment and collection of penalties and interest are, however, subject to a three-year statute of limitations.

A Legislative Council memorandum dated December 5, 1980*, states "The department may assess and collect the interest and penalty it failed to impose on taxpayers who owed additional taxes, subject to the three year limitation on tax assessments for sales and use taxes."

* Appendix VIII contains the full text.

In addition, the Legislative Council memorandum states that "interest should be assessed on the amount of taxes due and owing from the original filing date to the date when the taxes were paid." Thus taxpayers against whom DOR originally failed to assess interest should be assessed interest between the time the tax was originally due and the time the tax was paid.

DOR Abates Penalties

DOR abates penalties in conjunction with the Office of the Attorney General even though the Department has no statutory authority to do so. DOR has developed a set of written guidelines to determine when penalties on late payment of sales and use taxes may be abated. Following are the guidelines DOR uses for penalty abatements.

"1. Honest mistakes or errors.

"a. A new company or firm makes a mathematical error on the timely filed tax form.

"b. A new company or firm is late the first time with its tax return. However, the return should not be more than 10 days late.

"c. An established firm hires a new or inexperienced employee who is directly responsible for timely and accurate filings of tax reports. This should only be granted for the first such incident. Further, the Department should be notified promptly upon discovering the deficiency.

"d. Implementation of a new accounting or computerized report system which has caused a delay or mathematical error in filing. This should be a one-time abatement.

"e. Breakdown of mechanized accounting system (e.g., computer) just prior to the filing deadline.

"2. Unexpected illness or absence of responsible authority for timely filing of tax reports.

"3. Weather conditions or acts of God which are causally related to late filing of the tax return.
"a. Blizzards, storms, etc.

"b. Other disasters caused by weather or acts of God.

"4. Forms sent to another agency, when a taxpayer can provide proof (copy of envelope with postmark) that tax forms were mailed to another agency such as DES or IRS. Original envelope must indicate timely postmark. (This should be a "one time only" abatement.)

"5. Postmark.
"a. When a taxpayer states he has mailed the return timely, but the Post Office did not mark the envelope on the same date (maximum 3 day allowance), penalty may be abated if:

First request - Taxpayer will prepare an affidavit stating that said return was mailed timely.

Second request - Taxpayer will prepare an affidavit stating that return had been timely filed along with a witness affidavit stating taxpayer had filed timely.

Third request - Taxpayer will have to go to court to get penalty abated.

"6. The late filing was attributable to fraud by a person who is directly responsible for filing of tax returns.

"7. Department of Revenue erroneous mailings (Sales Tax only):
"a. Where a taxpayer has advised the Department of an address change, but said change had not been processed prior to the next form mailing to taxpayer, such that the return is sent to the wrong address.

"b. Where a taxpayer does not get a return mailed to the business address."

The guidelines state that requests to abate penalty must be received within a reasonable length of time and that a taxpayer's history of filing promptly may be considered in granting penalty abatement.

When DOR receives an abatement request that does not involve questions of filing timeliness, it fowards the request to an Assistant Attorney General, who recommends approval or disapproval. DOR then reviews the Assistant Attorney General's recommendations.

According to a Legislative Council memorandum dated August 15, 1980*:

> "The penalties and interest which are assessed for delinquent sales and use taxes are mandatory...In order to abrogate the mandatory imposition of a penalty or interest there must be either specific statutory authority for the abatement or a finding that the tax was not, in fact, due.
>
> A search of the statutes and annotations thereunder has not disclosed any authority for abrogating or abating sales or use tax penalties or interest which are assessed, other than through the protest and appeal procedures prescribed in A.R.S. sections 42-1338, 42-1338.01, 42-1339, 42-1340, 42-1415, 42-1415.01, 42-1421 and 42-1422. Refunds of excess taxes paid may occur under A.R.S. sections 42-1326 and 42-1413. Otherwise, the statutes do not appear to authorize abatement in the case of mistake or difficulty in payment of sales and use taxes."

In other words, DOR does not have authority to abate penalties other than through the protest and appeal procedures. However, the Office of the Attorney General claims that the Attorney General, in conjunction with DOR, can abate penalties. A letter from an Assistant Attorney General** states:

* Appendix XII contains the full text of this memorandum.
** Appendix XIII contains full text of this letter.

"The Attorney General has the obligation to safeguard the legal interests of the State in the most economical fashion possible. As a consequence, the Attorney General is authorized to compromise claims in an appropriate case. A.R.S. §41-192(B)(4). In the absence of legislative guidelines, it is clear the Attorney General has the discretion to determine the likelihood of prevailing on any claim.

The procedure, devised in conjunction with the Department of Revenue, is designed to compromise only in cases where the Attorney General and the Department of Revenue believe no penalty would be upheld by the courts. The procedure, to the extent it involves the Attorney General, only applies to penalties applied under A.R.S.. §42-1322. Penalties determined under other provisions of the tax law may be redetermined by the Department of Revenue prior to becoming final. We do not attempt to compromise claims where legal liability is unclear. In these instances, we will settle only after the claimant files suit and then only when appropriate." (Emphasis added)

Thus the Assistant Attorney General opines that he may abate penalties through this authority to compromise claims against the State.

However, in a memo dated April 22, 1980, the Attorney General's Chief Counsel of the Tax Division said penalty abatement requests that involve questions of timeliness are DOR's responsibility. The memo states that abatement requests that "fall within the category of items where the taxpayer has claimed that they have filed the return timely, i.e., the return was placed in the mail on or before the due date...is an administrative decision for the Department of Revenue."

Between August 30, 1979 and August 18, 1980, there were 265 abatement requests, of which 119 dealt with questions of timeliness. According to a memorandum from the Office of the Attorney General, between March 5, 1980, and September 10, 1980, 92 requests were sent to the Assistant Attorney General for review. The remaining 146, according to a memorandum from the Office of the Attorney General to the Auditor General, were sent to the Assistant Attorney General for review.

Of these 92 requests for abatements, the Assistant Attorney General recommended that 57 be approved and 35 denied. The 57 abatements that the Assistant Attorney General recommended be approved totaled $17,811.68.

DOR could not provide us with a complete list of penalty abatements involving questions of timeliness which were granted. However we identified two penalty abatements concerning questions of timeliness for $11,041.14 and $43,837.74 respectively. Thus the dollars involved in penalty abatements that are the sole responsibility of DOR could be significant.

It should be noted that in its 1978-79 Annual Report, DOR requested the following legislative changes:

> "Overhaul A.R.S. §42-1322 to provide clear statutory guidelines on: 1) imposition and waiver of penalty; 2) imposition of interest; 3) the validity of and causes for extensions of time to file a return and pay the tax.
>
> "PURPOSE:
>
> "To provide clear direction as to exactly how the sales tax should be administered. The present law is vague and results in confusion and misinterpretation on the part of both the public and the Department."

CONCLUSION

The Department of Revenue is not consistantly or properly imposing statutorily mandated penalties against audited taxpayers who are found to owe additional sales or use taxes. In addition, in conjunction with the Office of the Attorney General, DOR abates penalties even though it is not authorized by statute to do so.

RECOMMENDATIONS

It is recommended that:

1. The Legislature amend A.R.S. §§42-1322 and 42-1327 to provide clear statutory guidelines on the imposition and waiver of penalty.

2. DOR promulgate rules establishing specific criteria for the imposition of the ten and 25 percent penalties provided in A.R.S. §§ 42-1322.D, 42-1327.B and 42-1327.C.

3. DOR impose a penalty and interest on all taxpayers who fail to pay their taxes when due.

4. Subject to the three-year statute of limitations, DOR assess penalties and interest which it failed to assess in the past.

5. DOR include in its annual report a summary of penalty abatements granted. The summary should include the amounts involved and reasons for the abatements.

FINDING V

DOR COLLECTION PROCEDURES ARE INEFFICIENT.

As of July 1, 1980, the Department of Revenue (DOR) had 17 collectors who collected unreported and unremitted taxes. Our review of DOR collection procedures revealed that:

- DOR statistics have been inflated, raising questions regarding the accuracy of budget information on collection activities that DOR reports to the Legislature and precluding a determination as to how cost effective those procedures are.

- In contrast to other Arizona taxing authorities, DOR is decidedly deficient in that collection proceedings are not initiated in a timely manner, causing an indeterminable loss of State revenue.

- DOR has not established sufficient controls to monitor the activities of collectors adequately. Thus, opportunities exist for fraudulent activities and for noncompliance by collectors even with DOR's limited collection policies and procedures.

- DOR collection procedures are inefficient and wasteful in that some collectors regularly travel to taxpayer premises instead of telephoning the taxpayer.

As a result, DOR collection procedures are insufficient, tax revenues may have been lost and tax collectors are afforded needless opportunity to engage in fraudulent activities.

DOR'S COLLECTION STATISTICS HAVE BEEN INFLATED

DOR collectors file activity reports which include the amount of money they collect each day. From these reports, DOR calculates, on the average, how much a collector collects per visit.

Two siginificant statistics regarding the cost effectiveness of its collection activities are: 1) the dollars collected per visit to taxpayers by DOR collectors, and 2) the ratio of collection cost to average dollars collected per taxpayer visit.

DOR management uses these statistics to demonstrate its cost effectiveness in budget information presented to the Legislature.

However, our review of the statistics revealed that they are misleading. As a result, the accuracy of budget information on collection activities reported to the Legislature is questionable, and a determination of the cost effectiveness of collection procedures cannot be made.

Before August 1, 1980, collectors and special collectors* recorded on their activity reports back taxes collected from taxpayers as well as current returns filed by those same taxpayers. As a result, collectors took collection credit not only for late taxes but also for taxes paid on time.

* DOR's special collections section handles hard-to-collect accounts.

When Auditor General staff apprised DOR administrators of this practice, it was amended on August 1, 1980,* so that collectors no longer could take credit for current monthly returns except if the money is collected from a taxpayer who has not filed a tax return. According to DOR, it is appropriate to give collectors credit for collecting taxes paid on current monthly returns in such cases, because a taxpayer who has failed to file one return is likely not to file other returns. It should be noted, however, that collectors do not initiate collection procedures against nonfiling taxpayers until six months after the return is due.** As a result, the following situation could occur:

- A taxpayer did not file a return for January 1980. The sales tax due is $1,000.

- The same taxpayer files returns on time for February 1980 through January 1981.

  In January 1981, a DOR collector collects the $1,000 due for January 1980.

- The collector gets credit for collecting both the $1,000 due for January 1980 and the $1,000 paid by the taxpayer for his current return filed for January 1981.

It should be noted that, in addition to dollars collected per taxpayer visit and the ratio of cost to average dollars collected per taxpayer visit, DOR produces the following statistics regarding the activities of its regular collectors:

1. Number of taxpayer visits by DOR collectors,
2. Number of payments collected by collectors, and
3. Cost per taxpayer visit.

* As of August 22, 1980, special collectors still were allowed to claim credit for collecting taxes paid on time if a collection effort was made.

** See page 74 for further information on account types collectors handle.

The only statistics DOR produces regarding the activities of its special collectors, however, is the amount of money collected. In fiscal year 1980-81, this statistic was used to justify a budget request of $98,790 for special collections.

DOR COLLECTION PROCEDURES ARE TARDY

DOR initiates collection activities against two categories of taxpayers:

> Nonfiling Taxpayers - those who fail to file tax returns.
>
> Accounts Receivable Taxpayers -those who: 1) file returns but do not pay the full amount of tax due, 2) owe penalties and/or interest on late tax payments, and/or 3) owe additional monies as a result of a DOR audit.

In contrast to other Arizona taxing authorities, DOR is decidedly deficient in that collection proceedings are not initiated in a timely manner, causing an indeterminable loss of State revenue.

As part of our review of DOR we analyzed current collection procedures for nonfiling taxpayers and account receivable taxpayers. The procedures are summaried below:

Collection Procedures
for Nonfiling Taxpayer

Every other month DOR mails to nonfiling taxpayers notices that their tax return was late and should be filed, advising them of the proper tax, penalty and interest due. DOR sends the first nonfiling notice when the return is 35-65 days past due. A second notice is sent when the return is 95-125 days past due and a third notice if the return becomes 155 days past due. The account is referred to the collection section if the return is 185-215 days past due.

Collection Procedures For
Accounts Receivable Taxpayers

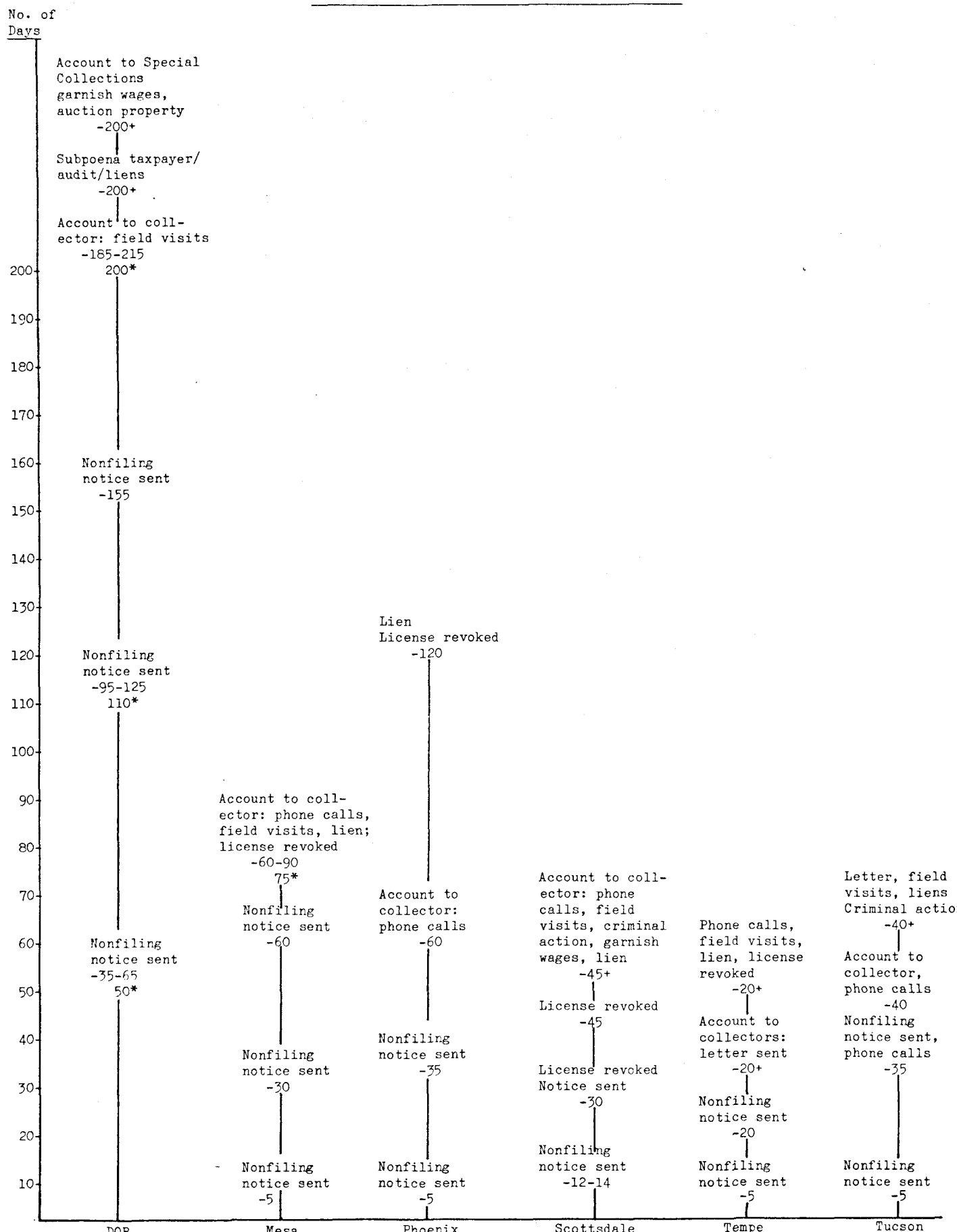
During the period from January to August 1980, DOR sent payment notices to accounts receivable taxpayers at 90- and 105-day intervals. Also at 90- and 105-day intervals accounts of more than $500 were turned over to collectors. For amounts less than $500, DOR simply continued to send taxpayer notices. It should be noted that DOR intends to reduce the elapsed time to a maximum of 60 days between the date an account receivable becomes due and the date it sends initial payment notice. In addition, DOR is in the process of hiring 13 more collectors to handle some of the accounts receivable of less than $500.

DOR's collection procedures, as outlined above, are untimely in contrast to those of the five largest cities in Arizona. As a result, a probable significant amount of State revenue is lost.

As part of our DOR review, we surveyed the Arizona cities of Phoenix, Tucson, Tempe, Scottsdale and Mesa to ascertain their collection procedures for nonfiling and accounts receivable taxpayers. Each of these cities levy and collect sales taxes. The results of our survey are summarized in Tables 12 and 13.

TABLE 12

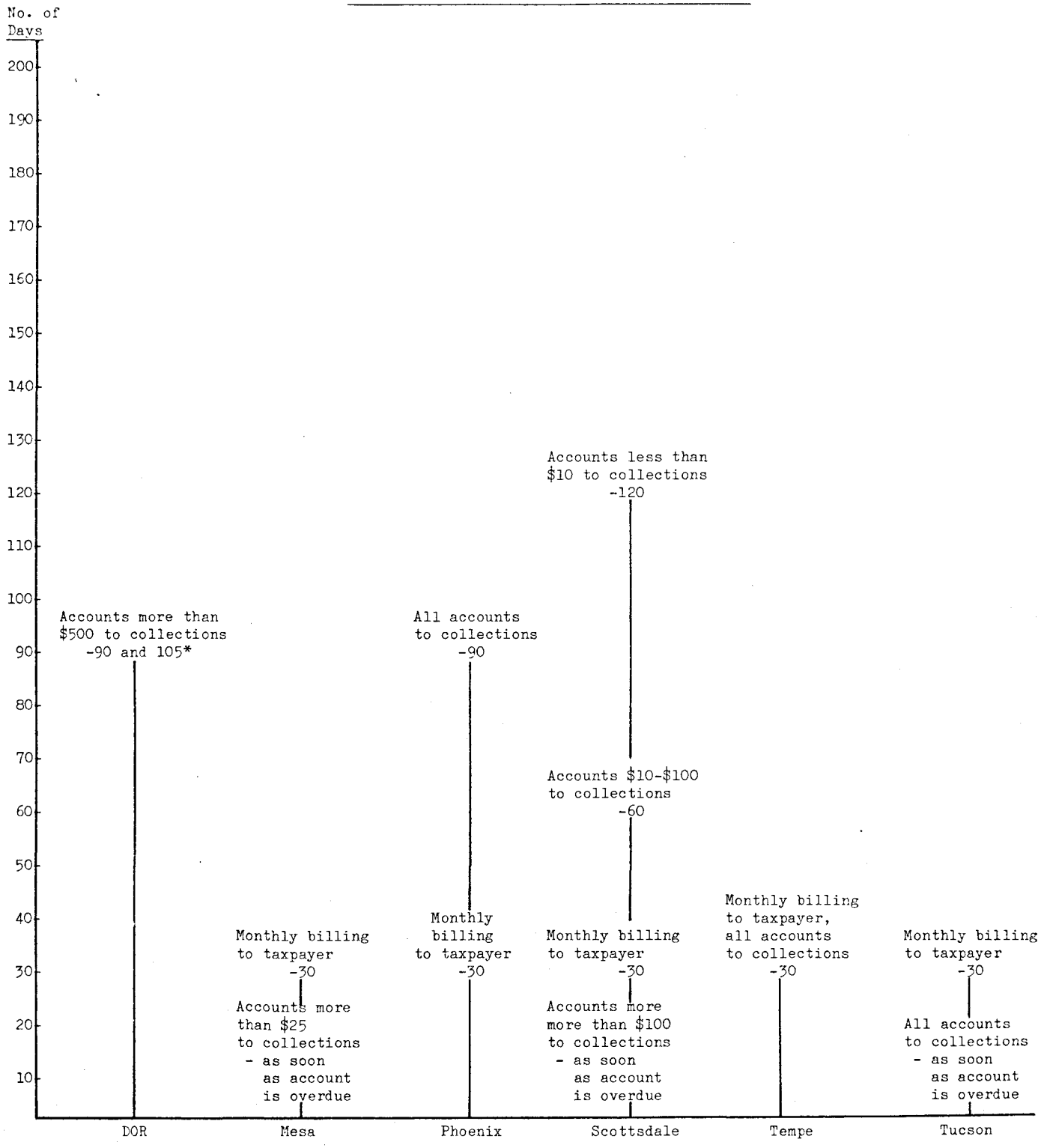
COMPARISON OF COLLECTION PROCEDURES USED FOR NONFILING TAXPAYERS BY DEPARTMENT OF REVENUE AND THE FIVE LARGEST CITIES IN ARIZONA



* Average.

TABLE 13

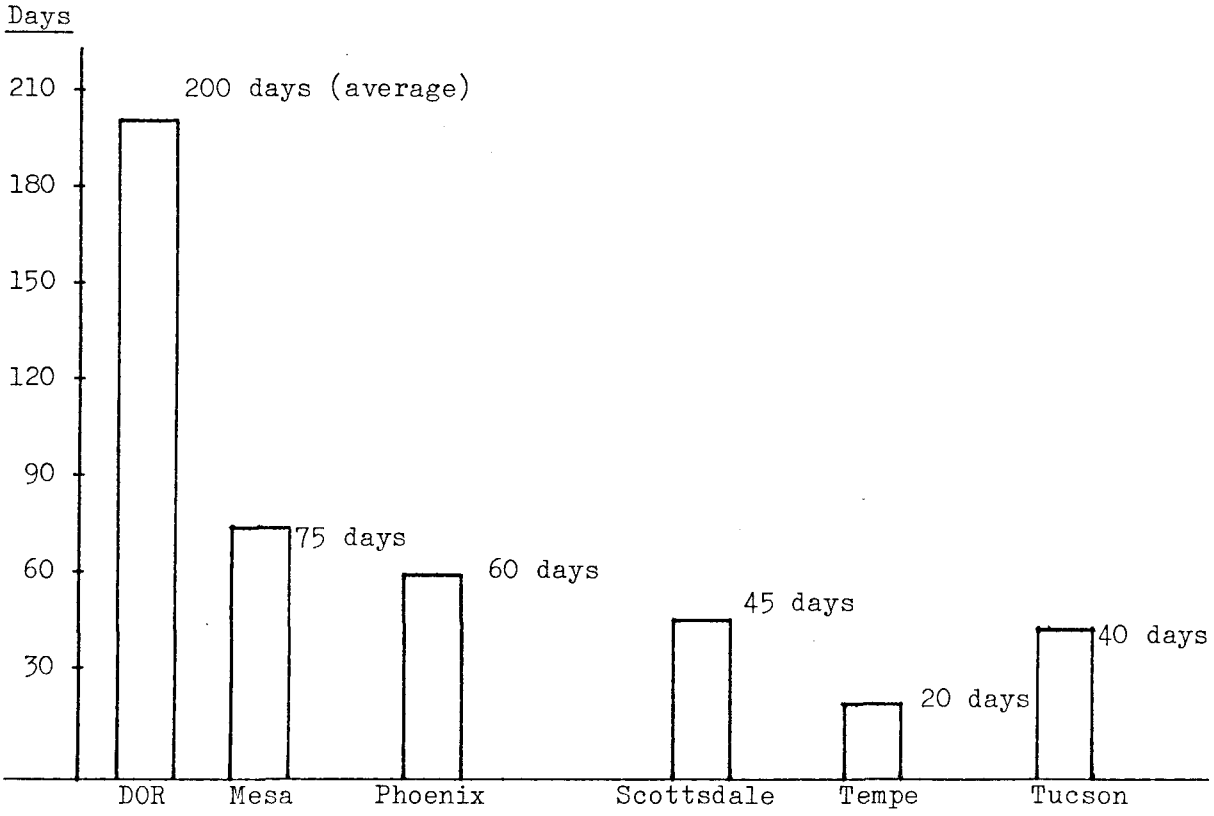
COMPARISON OF COLLECTION PROCEDURES USED FOR ACCOUNTS RECEIVABLE TAXPAYERS BY DEPARTMENT OF REVENUE AND THE FIVE LARGEST CITIES IN ARIZONA



* Accounts receivable billings were sent by DOR on January 1, April 15 and August 1, 1980. According to a DOR administrative official, accounts receivable billings were not generated prior to 1980.

As shown in Table 12, Mesa, Phoenix, Tempe and Tucson mail a first nonfiling notice five days after the taxpayer's return is late, while Scottsdale waits 12-14 days. In comparison, DOR waits 35-65 days before sending a first notice to a nonfiling taxpayer. Thus, by the time DOR mails a first notice to nonfiling taxpayers, the other cities already have initated two or three collection actions and by the time DOR mails a second nonfiling notice, most of the other cities have assigned the account to a collector. The comparison is displayed graphically below.

Number of Elapsed Days before a Nonfiling Account Is Assigned to a Collector:



As shown above, DOR's nonfiling taxpayers are not contacted by a collector until 200 days (average) after the return is due. In contrast, the other cities turn accounts over to a collector 20 to 75 days after they are due.

In addition, as shown in Table 13 DOR sends account receivable notices at 90 and 105 days. Therefore, DOR takes approximately three times as long as the other cities to send accounts receivable notices to taxpayers.

A final marked difference between the collection procedures of DOR and the surveyed cities is that DOR does not refer accounts to collectors if they are for less than $500. By way of contrast, Phoenix, Tucson, Tempe and Scottsdale eventually refer all accounts to collectors and Mesa eventually refers all accounts of more than $25 to a collector.

Consequences of DOR's Tardy Collection Procedures

Authoritative literature agrees that taxpayers are more apt to pay their tax liabilities if prompt, aggressive collection action is taken after the liability becomes due. Therefore, DOR's delay in initiating and pursuing collection proceedings results in an indeterminable loss of State revenue.

According to Moak and Cowan, authors of Administration of Local Sales and Use Taxes*:

> "...delinquency notices should be issued as promptly as possible after determination of delinquency in filing...A mailing of delinquency notices should be a firm element of the routine schedule and not left to spasmodic processing.
>
> "The psychological effect of an immediate follow-up should not be overlooked. Taxpayers who have skipped the due date would thus be made aware that their oversight has not been ignored by the taxing authorities.
>
> "The taxpayer should be notified of delinquency as soon as possible after the due date for filing and payment has passed. A prompt follow-up by the taxing agency conveys the impression to the taxpayer that his delinquency has not been overlooked...The experience in most taxing districts indicates that the longer the follow-up is delayed, the harder the tax is to collect." (Emphasis added)

* Moak, Lennox L., and Cowan, Frank Jr., Administration of Local Sales and Use Taxes. Municipal Finance Officers Association of the United States and Canada, Chicago, 1961.

The California State Board of Equalization, responsible for collecting California sales taxes, further underscored the need for prompt collection action in its collections manual.

> "Prompt, aggressive collection action is necessary...Failure to take prompt and aggressive action encourages some taxpayers to procrastinate when future payments become due since failure to act gives the impression that little will happen except that the taxpayer will be required to pay additional penalty and interest."

DOR HAS NOT ESTABLISHED SUFFICIENT CONTROLS OVER THE ACTIVITIES OF ITS COLLECTORS

DOR has not established sufficient control over taxpayer accounts once they are assigned to collectors in that: 1) adequate records are not maintained regarding the number or dollar amounts of taxpayer accounts assigned to collectors, 2) collectors are not aware of formal collection policies and procedures, and 3) there is collector noncompliance with those formal procedures that have been established.

Inadequate Records

DOR collection supervisors assign delinquent taxpayer accounts to collectors. However, after an assignment is made, DOR does not maintain adequate records and control over collectors in that:

- No records are kept of which accounts are assigned to which collectors.
- Records are kept of the accounts worked by collectors each day, but no comparisons are made of the accounts given to collectors and the accounts worked.
- Supervisors do not track accounts to determine when and how collectors work them.
- Supervisors cannot determine if, or why, collectors do not work some accounts.

As a result, DOR supervisors are effectively precluded from monitoring collectors' activities, allowing collectors to avoid working some accounts quickly, or not at all, and to engage in inappropriate activities without detection.

Collectors Are Not Aware of Formal Collection Policies

The first step a collector takes in attempting to collect an account is to make a personal visit to the taxpayer. Next, the collector may:

1. Visit the taxpayer again,

2. Recommend that subpoenas be issued against nonfiling taxpayers,

3. Recommend that liens be filed against account receivable taxpayers,

4. Recommend that accounts receivable taxpayers be referred to the DOR special collections section, and/or

5. Recommend that the taxpayer be audited.

Guidelines governing when these procedures should be used exist; however, collectors have not received the guidelines. As a result, it is a matter of the collectors' personal discretion as to which, if any, collection procedures are used.

For example, one DOR collector stated he automatically files a lien if he has determined that a taxpayer's tax liability cannot be paid within six months. Another DOR collector files liens only against taxpayers who agree to pay their tax liability in 12 or more monthly installments. Once the lien is filed the collector has the option of pursuing or dropping collection procedures against the taxpayer.

In addition, DOR does not have sufficient guidelines regarding the special collections section in that:

- No formal guidelines are followed in determining when a collector should turn an account over to special collections.

- Special collectors use procedures not used by regular collectors, such as garnishing wages and bank accounts and seizing and selling property. DOR has not provided special collectors with formal guidelines as to when such procedures should be applied.

By way of contrast, the manual used by the California State Board of Equalization states:

> "Control of collection assignments is a responsibility of each compliance supervisor. Controls should permit the supervisor to refer to one collection activity file and from that determine the exact status of a case as well as determine to whom it is assigned and for how long. The control system should provide for automatic progress reports after a certain period of time from fieldmen who are charged with assignments.
>
> Under no circumstances should a fieldman be given an assignment and allowed to carry it indefinitely without making progress reports. Fieldmen should also be encouraged to discuss their more difficult cases with their supervisors.
>
> Fieldman should be fully informed as to the extent of their authority and what to do when the action they have taken has reached the limit of that authority." (Emphasis added)

Noncompliance with Procedures
that Have Been Established

The Administrator of the collectors section provided the Auditor General staff with a memo dated August 21, 1979, listing collection guidelines. However, discussions with DOR collectors revealed that as of October 15, 1980, there was general noncompliance with the guidelines. For example:

- Field collectors are supposed to be assigned a maximum of 150 cases. DOR collectors estimate their case load at between 380-450 cases.

- Collectors are supposed to submit a list of assigned accounts to their supervisors. No lists exist.

- Collectors are required to make contact on assigned cases within a month. In actuality some accounts never get worked.

- A time and action sequence has been devised, detailing when specific collection steps should be taken. Collectors still work accounts discretionarily.

- Special collections is suppose to work all accounts referred to it. Special collectors still pick and choose the accounts they wish to work.

In addition, during our review of DOR we identified instances of noncompliance with DOR policies regarding partial-payment agreements.

DOR allows taxpayers with accounts receivables to pay back taxes in monthly installments; this is called a part pay agreement.

According to a DOR subject memo, Procedure For Part Pay Agreements:

> "A part pay agreement...is to be initiated only after payment in full within 60 days cannot be accomplished.
>
> "The collector is authorized to establish a payment agreement to a maximum of six months without any supervisory approval. If the part pay is to exceed six months, a complete financial statement...is to be provided. Immediate supervisor approval is required and, if the balance warrants, a lien is to be filed.
>
> "Any part pay exceeding twelve months will require additional approval from the Collection Supervisor."

Attached to the memo was a standardized form to be completed when part pay agreements were made.

While the memo clearly outlines guidelines for part pay agreements the following departures were identified:

- Collectors do not consistently obtain supervisory approval for payment agreements exceeding six months.

- The Assistant Supervisor of Collectors, who is in charge of dealing with subpoenaed taxpayers, does not require supervisory approval for part pay agreements exceeding six months.

- Special collectors do not use the standardized DOR form for part pay agreements. Instead, they either use their own "customized" form for each taxpayer or ignore the use of a written form all together and accept verbal part pay agreements.

- No guidelines exist as to how collectors should determine if a taxpayer cannot make payment in full within 60 days. This allows for unequal treatment of taxpayers.

Finally, we identified the following violations of part pay agreements:

- Taxpayers do not always pay the minimum down payment required to enter into a part-pay agreement*.

- Taxpayers do not always pay according to their part pay agreement schedules. For example, one taxpayer failed to make a payment for six months.

- Control over part pay payments is poor. For example, a $3,300 check from a part pay taxpayer was discovered in an accounts receivable clerk's desk three weeks after the date on the check and before the payment was credited to the taxpayers' account. Further, part pay taxpayers sometimes send payments directly to collectors instead of DOR's cashier. The practice not only delays the deposit of checks (see Finding I), but affords collectors an opportunity to engage in fraudulent activities.**

* There was some disagreement within DOR as to what amount the required down payment should be. The Deputy Administrator for Collections stated that it should be 20 percent of the amount owed, while the Supervisor of Collections said it should be interest and penalty due. DOR subsequently issued a memo stating that the down payment should be 20 percent of the amount owed. We identified instances of down payments in amounts less than interest and penalty due or 20 percent of the amount owed.

** During the course of our audit DOR proposed establishment of a part pay desk through which all part pay agreements consisting of three or more monthly payments would be submitted. However, as of October 22, 1980, the part pay desk had not been established.

INEFFICIENT COLLECTION PROCEDURES

Unlike other tax collecting authorities, DOR relies heavily on person-to-person contact between collectors and taxpayers. As a result, DOR collections are inefficient and wasteful in that collectors travel by automobile to the taxpayer's place of business instead of telephoning in order to make a collection effort.

As of July 1980, DOR collectors contacted assigned accounts by driving to the taxpayers' places of business. The visits were not preceded by a telephone call to ensure that a taxpayer was available. In fiscal year 1979-80 DOR collectors and special collectors drove approximately 238,000 miles to visit taxpayers.

By way of contrast, the cities of Tucson, Tempe, Scottsdale and Mesa rely extensively on the use of telephones to collect taxes, and Phoenix never uses field visits to taxpayers' places of business as a means to collect taxes.

As a result, the average collector for the city of Phoenix is able to make more taxpayer contacts, at less cost per contact than the average collector for DOR as shown below.

	DOR	City of Phoenix*	Ratio of DOR to the City of Phoenix
Average Number of Yearly Contacts per Collector	2,470	7,588	1:3
Average Contacts per Work Day per Collector	9.84	30.54	1:3
Average Cost per Contact	$8.10	$1.63	5:1

* The City of Phoenix had data available. Data was not available from other Arizona cities.

As previously indicated, DOR's use of visits to taxpayers' places of business instead of telephone calls to contact taxpayers increases significantly the cost of each taxpayer contact, limits the number of contacts each collector can make and reduces the number of accounts collected each year.

Further, when contacted by Auditor General staff, a spokesperson for the American Collectors Association, a professional association for private collection agencies, commented that field visits are not used very often to contact taxpayers as such visits are not economical. Most private collection agencies rely on phone calls and written notices.

As of August 25, 1980, DOR was in the process of hiring 13 additional collectors. The new collectors will not make field visits, but will contact taxpayers by telephone. The phone collectors will be assigned accounts of more than $100 but less than $500. Accounts of more than $500 will be assigned to collectors who will continue to contact taxpayers at their places of business.

While DOR's use of telephones to collect accounts less than $500 is commendable, the continued practice of driving to taxpayers' places of business does not appear to be a cost effective way to collect delinquent taxes.

It should be noted that a practical problem exists with having current field collectors use telephone calls to make collection. Current DOR field collectors are Grade 13 in the State personnel classification system, while the new phone collectors are Grade 9. Thus, if current field collectors use telephones instead of visiting taxpayers to make collections, there is a disparity in pay scales without corresponding disparity in duties.

There are three apparent solutions to the dilemma.

1) Red-lining - Current field collectors would be dropped to the grade of phone collectors (Grade 9). Their salaries would remain the same but they would not be eligible for promotion.

2) Reduction in force - Field collectors could apply for other available DOR positions for which they are qualified. Vacant field collector positions thus could be downgraded to phone collector positions.

3) Upgraded collector positions - Phone collector position classifications could be upgraded by adding duties such as those handled by DOR field and special collectors.

DOR's Collections Administrator endorses the third option.

Recent Improvements

In a memorandum dated December 15, 1980,* DOR officials outlined improvements they claim have been made in the sales tax collection function.

The improvements include:

1) Emphasis on clearing large-dollar taxpayer accounts first.

2) Referring complete accounts to collectors instead of partial work as in the past.

3) Implemention of the phone collector unit.

4) Development of formal training for collectors.

5) Establishment of an interagency information exchange with the Department of Liquor Licensing and Control and the Office of the Registrar of Contractors.

6) Time limits for collection actions.

* Appendix XIV contains the full text of the memorandum.

Since many of the improvements were made after our review, we were unable to verify that they were, in fact, implemented or to assess the results of their implementation.

CONCLUSION

DOR produces data on collection activities that is unreliable and insufficient, does not initiate collection proceedings in a timely manner, has not established sufficient controls to monitor the collector activity adequately, and does not collect delinquent taxes in an efficient manner.

As a result DOR collection procedures are inefficient, tax revenues may have been lost, and tax collectors are afforded an opportunity to engage in fraudulent activities.

RECOMMENDATIONS

It is recommended that consideration be given to the following:

1. DOR cease combining data on late taxes and current taxes collected for budget information reports.

2. The special collections section generate, at the minimum, the same types of service measurements as the collections section.

3. DOR mail nonfiling notices 25 days after a taxpayer becomes delinquent.

4. DOR refer nonfiled accounts to a collector before the account becomes over two months old.

5. DOR bill accounts receivable taxpayers monthly.

6. DOR mail a second notice to a nonfiling taxpayer within 55 days after the due date.

7. DOR refer accounts receivables of more than $100 to collectors as soon as an account is due and payable.

8. All accounts receivable of less than $100 be referred to a collector within three to four months after they are due and payable.

9. DOR collection supervisors monitor accounts referred to collectors, actions taken against taxpayers and the dates action is taken.

10. Collectors contact all of the taxpayers assigned to them provided it is cost effective to do so, and DOR establish time limits for making such contacts.

11. DOR establish guidelines for when specific collection actions should be taken and establish procedures to ensure the guidelines are followed.

12. DOR standardize part pay procedures within the collections section. Once procedures are standardized, collection supervisors should monitor employees and determine that part pay agreements are fulfilled by taxpayers.

13. The DOR collection section require its collectors to use the telephone as the primary mode of taxpayer contact. Travel to the taxpayers' places of business should be kept to a minimum and be used only when taxpayers are unresponsive to letters and telephone calls.

14. DOR evaluate the opportunities to expand collector duties so that all collectors can use the collection techniques of each.

FINDING VI

IMPROVEMENTS ARE NEEDED IN DOR'S FINANCIAL TRANSACTION CONTROLS AND DOCUMENTATION.

The Department of Revenue (DOR) has developed a sales tax accounts receivable system to monitor $24 million in sales and use tax receivables and a payments system that records and reports approximately $800 million in sales taxes collected annually. Our review of these systems revealed that: 1) control over accounting transactions is not adequate, 2) no regular reviews are made of the information in either system, and 3) both systems contain inaccurate or inappropriate information.

ACCOUNTS RECEIVABLE SYSTEM

During fiscal year 1979-80, DOR developed an accounts receivable system that was designed to consolidate available information and to aid in the collection of approximately 19,000 sales and use tax accounts amounting to $24 million. The development of the current system represents a substantial improvement in that, prior to August 1979*:

1. Accounts receivable information regarding one taxpayer could have been distributed among eleven different files.
2. The Department did not have the capability to produce a consolidated accounts receivable billing for sales or use taxpayers.
3. The Department was not able to tally the total amount of sales and use tax accounts receivable.

* Appendix XV contains a complete list of the improvements that the Department reports have been made in the accounts receivable function during the last year.

Despite the new system, as of October 1980, improvements still needed to be made in accounts receivable information:

1. Individual account balances may be unreliable because of a high error rate.
2. The accounts receivable system is burdened unnecessarily with accounts for which there is no hope of collection.

Unless these problems are eliminated, the State may lose significant sales and use tax revenues, DOR's collection function will continue to be impaired and anticipated benefits of the Department's planned automated accounts receivable system may not be fully realized.

High Error Rate

As a part of our audit of DOR's sales and use tax accounts receivable system, we reviewed 71 individual account balances to ascertain if they were recorded correctly. We found that the incidence of error in the account balances we reviewed was high enough to raise serious questions regarding the accuracy of all individual account balances in the system and the accuracy of the $24 million total sales and use tax accounts receivable recorded by DOR.

We selected 71 individual accounts randomly from the approximately 19,000 individual accounts in sales and use tax accounts receivable as of August 1980. We compared the entries on the 71 accounts receivable cards with documents located in the taxpayer master files.* Differences between the information in the taxpayer master file and the accounts receivable system were considered errors, based on the assumption that the information in the master file was correct.** Table 14 presents the results of our review of the accounts receivable.

* Appendix XVI contains a list of information that should be in the taxpayer master files.

** One DOR official stated that some of the information in the taxpayer master files might not be complete or accurate. We were unable to verify that statement.

TABLE 14

SUMMARY REVIEW RESULTS FOR DOR'S
SALES AND USE TAX ACCOUNTS RECEIVABLE

Description of Results	Number of Accounts	Total Recorded Liability
Information not available to verify the correctness of individual balances	25	$ 8,960
Individual balances agreed with information in taxpayer master files	23	5,024
Individual balances did not agree with information in taxpayer master files	23	60,763
Totals	71	$74,747

As shown in Table 14, we were not able to verify the accuracy of 25 of the individual balances reviewed because documentation could not be located in the taxpayer master files. Table 14 also shows that for the 46 individual balances for which documentation was available, the recorded balance for 23 of the accounts did not coincide with information found in the taxpayer master files. The difference between the information in the taxpayer files and the recorded balances for these 23 accounts was that the recorded balances were understated by $5,995, or approximately ten percent of the recorded liability of $60,763. While no statistical inference can be drawn from our sample size, if the error rate experienced in our sample is representative of the error rate for approximately $24 million* in sales and use tax accounts receivable, then DOR's financial statements may be misstated materially.

* This amount is net of the $795,835 due to taxpayers (page 96).

Based on our review, it appears that the major cause of the errors noted lies in the original determination of individual account balances. This is not surprising, given that 16 people worked from July through September 1979, consolidating accounts receivable information from eleven different sources to determine the individual account balances we reviewed. The work of these employees was reviewed only on a sample basis, and no subsequent formalized review of the accounts receivable records has been conducted. In addition, DOR does not have an internal financial audit function to perform regular reviews of financial data.

Finally, it should be noted that, since the establishment of DOR in 1974, the Office of the Auditor General has not been able to conduct a full financial audit of DOR because of Federal and State statutory limitations on access to certain DOR taxpayer information.

Overburdened With Essentially Uncollectible Accounts

As part of our review of accounts receivable, we established an aging schedule for the 71 account balances sampled. The aging revealed that a high percentage of the accounts was more than a year old and, therefore, of doubtful collectibility. In addition, DOR records indicated that almost two-thirds of $20 million* in sales and use taxes receivable is similarly more than a year old. Finally, our review of accounts receivable revealed that many of the individual balances in the accounts receivable system actually represent monies owed to taxpayers.

The ages of the 71 randomly selected accounts receivable were established through DOR's master file documents, when they were available, or from the accounts receivable cards. Table 15 shows that 46 percent of the accounts for which an age could be established were more than a year old.

* The amount excludes approximately $4 million in interest and penalties that are part of the total accounts receivable.

TABLE 15

SUMMARY OF THE AGING OF RANDOMLY
SELECTED ACCOUNTS RECEIVABLE

Age	Number of Accounts	Percentage
Less than 1 month	1	1 %
1 to 2 months	0	0
2 to 3 months	8	12
3 to 6 months	11	16
6 months to 1 year	17	25
1 to 2 years	16	24
2 to 3 years	4	6
3 to 4 years	1	1
4 to 5 years	0	0
5 years and older	10	15
Total	68 *	100 %

In addition, a DOR report dated August 1, 1980, indicates that nearly two-thirds and one-third, respectively, of the $20,384,238** in sales and use taxes due to the State are at least two years and four years old, respectively. Table 16 presents the aging shown in the report.

TABLE 16

AGING OF SALES AND USE TAX RECEIVABLES
PREPARED BY DOR AS OF AUGUST 1, 1980

Date Liability Originated	Dollar Amount** (Tax Only)	Percentage	Cumulative Percentage
1976 and earlier	$ 6,935,679	34%	34%
1977	2,125,057	10	44
1978	4,303,423	21	65
1979 and 1980	7,020,079	35	100
Total	$20,384,238	100%	

* We were unable to determine the age of three of the 71 randomly selected accounts receivable.

** The amount excludes $4 million in interest and penalties that are part of the total accounts receivable.

Our review of the 71 sampled accounts receivable also revealed that a significant number of balances in the accounts receivable system are not receivables at all, but rather are amounts owed by the State to the taxpayer. According to our analysis, in eleven of the 71 sampled accounts, the State owed money to taxpayers. Further, the previously mentioned August 1, 1980, DOR report indicated that $795,835 in monies owed to taxpayers was carried in the accounts receivable system.

It should be noted that as of July 1, 1980, DOR instituted procedures which allow for the removal of uncollectible and Due to Taxpayer accounts from the accounts receivable system. According to DOR records, as of December 1, 1980, 108 uncollectible accounts, amounting to $1,037,079, have been removed from the system since adoption of the new procedures.

The new procedures notwithstanding, a significant number of individual balances in the accounts receivable system: 1) still have been long outstanding and, therefore, are of doubtful collectibility, or 2) still actually represent monies owed to taxpayers. These accounts not only overburden the system, but retention of the uncollectible accounts may also result in the overstatement of monies owed to DOR and ultimately impact on the accuracy of DOR's financial statements. As a result, DOR needs to adopt additional procedures to remove uncollectible accounts and accounts that represent monies owed to taxpayers from the accounts receivable system.

Automated System Is Expected to Help

DOR is developing an automated accounts receivable system that will interface with its other automated sales tax systems. The system is scheduled to be implemented in October 1981. According to DOR officials, system development was on schedule as of November 1980, and the major improvements expected from the automated accounts receivable system are:

"a) The system will provide math and data checks on the computer which are not now available. Any math check that is currently performed is being manually accomplished in the edit cycle. Since time constraints prohibit extensive edit time, the math check is not as comprehensive as the automated system will be.

"b) Single entry of documents for both revenue distribution and A/R (Accounts Receivable). Currently these are separate systems requiring redundant entry.

"c) Regular billing of all receivables which is integrated with delinquency runs. In addition, billings will be more complete and will be on data processible forms.

"d) Automatic allocation of payments. Currently, clerks must allocate partial payments of receivable monies.

"e) Automatic lien generation and lien release production. This will allow for a significant increase in the number of liens filed and the speed of filing as clerks will only have to perform quality control checks.

"f) Automatic generation of liquor and contractor complaints.

"g) The ability to generate a number of reports not currently feasible such as

- "• Total number of accounts and dollars in the system each month.
- "• Stratification of accounts by multiple levels for each in assignment to collection staff.
- "• Aging of receivable.
- "• Prompt reaction to delinquent part-pay accounts.
- "• Interaction of receivables, delinquency and licensing programs.
- "• Terminal access to A/R (Accounts Receivable) to increase flexibility of staff in receivables, collections and taxpayer assistance to access the data.

"h) Substantially improved processing time. All receivables will be posted in the normal cycle, a period of days rather than weeks, thus improving the accuracy and credibility of the data."

Such benefits appear to be promising, but the high error rate in individual account balances we observed during our sample of individual accounts may forestall many of the anticipated benefits of the new system. Quite simply, if misinformation is entered into the new automated system, it will be difficult to determine if errors generated by the new system are the result of problems with the new system or problems with the data input into the system. Further, it is important that errors in individual accounts receivable balances be corrected before DOR incurrs the costs of transferring those account balances to the new system.

YEAR-TO-DATE PAYMENTS FILE

During fiscal year 1979-80, DOR collected in excess of $800 million from more than 70,000 sales tax licensees. The Department uses an automated system to record the sales tax payments in a year-to-date payments file which includes a record of total taxes remitted by each taxpayer for fiscal years 1977-78, 1978-79 and 1979-80. As a part of our audit, we reviewed the file and found a significant number of individual accounts that showed negative tax payment balances for an entire fiscal year, which is impossible. When audit staff brought this to the attention of Department officials, they were able to explain reasons for tax credits, but were unable to justify accounting entries which caused the negative tax payment balances to show up on the year-to-date payments file.

Through use of our generalized audit software package, we reviewed all 134,381 licensees contained in the year-to-date payment file as of June 30, 1980, and extracted all licensee accounts which showed negative tax payment balances during fiscal years 1977-78, 1978-79 or 1979-80. Table 17 tabulates the results of this analysis.

TABLE 17

SUMMARY OF DOR'S SALES TAX YEAR-TO-DATE PAYMENT FILE
RECORDS WHICH SHOWED NEGATIVE TAX PAYMENT BALANCES FOR LICENSEES
DURING FISCAL YEARS 1977-78, 1978-79 OR 1979-80

Fiscal Year	Number of Licensees	Total of the Negative Tax Payment Balances
1977-78	251	($ 313,633)
1978-79	529	($ 722,159)
1979-80	542	($1,578,061)

As shown in Table 17, the sales tax year-to-date payment file as of June 30, 1980, contained 542 licensee accounts with $1,578,061 in negative tax payment balances for fiscal year 1979-80. In order to determine the nature of negative tax amounts, we reviewed in detail all licensee accounts with negative tax payment balances in excess of $25,000 for fiscal year 1979-80. The ten accounts amounted to $1,015,398, or almost two-thirds of $1,578,061 in total negative tax payment balances for that fiscal year. Table 18 presents the results of this analysis.

TABLE 18

ANALYSIS OF TEN TAXPAYERS ACCOUNTS WITH NEGATIVE TAX PAYMENTS IN EXCESS OF $25,000 IN THE YEAR-TO-DATE PAYMENT FILE DURING FISCAL YEAR 1979-80

Case Number	Total Sales Tax Payments Recorded in Year-to-Date Payment File			Reason for Negative Tax Payment Balances
	1979-80	1978-79	1977-78	
1	$ (28,691)	$38,886	$117,039	A 12/79 refund of $30,535 resulting from a DOR audit.*
2	(84,687)	49,240	53,192	A 1/80 transfer of $110,765 in tax payments previously remitted for the period 1/77-7/79 under a different taxpayer license number.
3	(69,743)	46,875	22,868	A 12/79 transfer of $69,743 in tax payments previously remitted for the period 8/77-2/79 under a different taxpayer license number.
4	(59,516)	0	0	An 8/79 transfer of $59,516 in tax payments previously remitted for the period 9/76-9/79 under a different taxpayer license number.
5	(36,469)	15,601	17,563	A 12/79 transfer of $41,063 in tax payments previously remitted for the period 12/76-9/79 under a different taxpayer license number.
6	(29,251)	0	0	A refund of $29,251 resulting from a DOR audit* for the period 1/76-5/77.
7	(243,090)	484	0	An 8/79 refund of $243,090 resulting from a DOR audit* for the period 1/73-9/75.

* These audits were performed by DOR's sales and use tax audit staff. (See Finding II)

Case Number	Total Sales Tax Payments Recorded in Year-to-Date Payment File			Reason for Negative Tax Payment Balances
	1979-80	1978-79	1977-78	
8	$(399,807)	0	0	An 11/79, 1/80 and a 4/80 transfer of $1,737,087 in tax payments previously remitted for 7/79, 8/79 and 9/79 under a different taxpayer license number.
9	(38,252)	$49,240	$53,192	A 9/79 transfer of $43,801 in tax payments previously remitted for the period 1/79-4/79.
10	(25,891)	13,767	8,749	A 12/79 refund of $29,531 in tax payments for a period between 7/76 and 7/79. Payments were based on a related court case. No DOR audit was conducted.

As shown in Table 18, six of the ten negative tax payment balances were the result of transfers from one taxpayer license number to another, three were the result of DOR sales tax audits and one case was a refund based on a related court decision. Five of the six transfers from one taxpayer license number to another involved tax payments received in one or more prior fiscal years, as did the four refunds.

It should be noted that taxpayer license numbers are changed for a number of reasons, such as changes in legal ownership, addition of new location without filing a consolidated return or changing to a consolidated filing status for a multiple-location taxpayer. Finally, we were not able to verify the negative tax payment balance shown for Case 8 in Table 18. It appears that the State portion of the taxpayer's July 1979 sales tax remittance was incorrectly transferred twice. Staff auditors reported the error to DOR officials, who promised to take corrective action.

There are two primary consequences of current DOR recording procedures for refunds and transfers. First, when audit refunds or transfers include prior fiscal years' payments, current-year tax payments for a licensee are understated and, in the case of tax payment transfers to a new license number, current-year tax payments are grossly overstated for the new license number.

Second, improper recording of transfers could result in improper distributions of sales tax funds to Arizona counties and cities. One of the transfers we reviewed involved a taxpayer with locations in several counties. DOR transferred tax payments from one county only, when the transfer should have been allocated from two counties. As a result, one county's base for sales tax distribution during three months was understated while the other county's base was overstated.

According to DOR officials, transfers from one taxpayer license number to another frequently are made when the collections or audit sections discover that a taxpayer has been remitting tax payments under an old taxpayer license number after a new number was established. DOR does not review regularly the contents of the year-to-date payments file primarily because it does not have an internal audit function. A regular review appears to be in order because 1) DOR's collection and audit staffs may initiate such transfers without presenting supporting documentation and 2) DOR officials cannot explain why prior-year tax payments were transferred against current-year tax payments.

It should be noted that the fiscal year 1980-81 DOR appropriation included funds to establish a fiscal affairs administrator position. During November 1980, DOR was in the process of hiring a person to fill the new position as controller. One of the primary responsibilities of the controller will be to establish accounting policies for the Department. This appears to be a positive step because DOR has had no centralized control over departmental accounting policies.

CONCLUSION

The Department of Revenue collects in excess of $800 million annually in sales taxes. DOR has an accounts receivable system and a year-to-date payment system that aid in the collection, recording and distribution of sales tax payments. Despite the large number of transactions and the associated millions of dollars processed by the Department each year, DOR's accounting policies, procedures or records have not been thoroughly reviewed since the Department was created in 1974, because of the lack of an internal audit staff and statutory limitations imposed on outside auditors.

RECOMMENDATIONS

The Department of Revenue should:

1. Establish an internal audit staff, reporting to the DOR Director.

2. Conduct an indepth review of current accounting procedures and develop written policies and procedures which are in compliance with State statutes and good accounting procedures.

3. Prior to entering accounts receivable into the new automated system:

   - Determine the collectibility of all receivables more than a year old and purge those accounts deemed to be uncollectible.

   - Determine the error rate in collectible receivables by conducting an indepth review of a statistically valid sample of the receivables,

   - If the error rate established through the review exceeds an acceptable level, review and correct all collectible receivables, and

- Report the results of this review, including the acceptable error rate established by the Department, to the Joint Legislative Budget Committee and/or the Special Committee on the Department of Revenue.

The Legislature consider statutory changes to allow for a full independent audit of the Department of Revenue.

FINDING VII

BECAUSE ARIZONA DOES NOT TAX THE CONSTRUCTION OF POWER-GENERATING FACILITIES AS OTHER STATES DO, BY 1986 ARIZONA WILL LOSE SUBSTANTIAL SALES AND USE TAXES RELATED TO THE CONSTRUCTION OF THE PALO VERDE NUCLEAR GENERATING FACILITY AND OTHER POWER-GENERATING FACILITIES.

As of July 1980, Arizona was one of only four states that allows sales and use-tax exemptions for machinery or equipment used directly in the production of electrical power. The exemption will cost the State a significant amount in sales and use taxes related to the construction of the Palo Verde nuclear generating facility and other power-generating facilities.

Sales and Use Tax Exemptions

Arizona Revised Statutes (A.R.S.) §§42-1312.01.A.4 and 42-1409.B.4 provide specific exemptions from sales and use taxes, respectively, for certain types of electrical generating and transmission equipment. A.R.S. §42-1312.01.A.4 states in part:

> "...the following categories shall also be exempt:
>
> "Tangible personal property consisting of machinery, equipment or transmission lines used directly in the production or transmission of electrical power..." (A.R.S. §42-1409.B.4 is nearly identical.)

Our review revealed that: 1) Arizona is one of only four states providing that exemption, and 2) a Department of Revenue (DOR) interpretation of A.R.S. §§42-1312.01.B.7 and 42-1409.C.7 has resulted in an expansion of that exemption to include facilities not previously exempted.

Other States' Statutes

Our review of the exemptions provided by the 45 states which levy sales and use taxes revealed that Arizona is one of only four states which allow exemptions for machinery and equipment sold to privately owned utility companies. Massachusetts, New Jersey and Virginia do not tax the sale of machinery and equipment used directly in the production of electrical power. As in Arizona, the statutory exemptions provided by the three states do not include materials used in the construction of buildings.

Interpretation of Arizona Statutes

A.R.S. §§42-1312.01.B.7 and 42-1409.C.7 include a provision that buildings are not exempted from sales and use taxes:

> "The exemptions...shall not include:
>
> "Shops, buildings, docks, depots and all other materials of whatever kind or character not specifically included as exempt." (Emphasis added)

However, Arizona Public Service Company (APS) contended that buildings at the Palo Verde nuclear generating facility are unique by virtue of their essentiality to the operation of the facility, and that a substantial number of those buildings should be exempt from sales and use taxes. An agreement was reached in August 1979 among APS, the Office of the Attorney General and DOR that provided for the exemption of certain buildings at the Palo Verde nuclear generating facility from sales and use taxes.

As a result of the agreement, Arizona is the only state that exempts buildings such as those at the Palo Verde facility from sales and use taxes. The other three states that allow sales and use-tax exemptions for machinery and equipment purchased for power-generating facilities have not extended that exemption to buildings at nuclear generating facilities. A Massachusetts utility company currently is challenging the Massachusetts Department of Revenue's refusal to allow such an exemption on the same grounds used by APS to have its sales and use-tax exemption extended. However, that state's Department of Revenue intends to continue disallowing the exemption pending a decision of the Massachusetts Appellate Tax Board.

The Arizona agreement provides, in effect, guidelines which establish the tax status of materials incorporated into buildings at the Palo Verde facility. Tax status is dependent on the purpose served by the structure. APS argued that because of the essential nature of some buildings, without which the facility could not operate, the structures should qualify for exemption. Therefore, materials used in buildings considered vital to the generation of electrical power are exempt from sales and use taxes.

The guidelines also are designed to facilitate auditing the numerous contractors and suppliers involved in the construction of the Palo Verde installation. However, as of October 1980, only one of 12 major suppliers had been audited by DOR. The Chief Auditor for DOR said that the agency plans to audit the other contractors and suppliers when the opportunity to maximize revenues from such audits is best.

The guidelines provide tax-exempt status for 27 of 46 permanent buildings and partially exempt status for six permanent structures. Determination of the portion of a building subject to exemption is based on the time during which the building will be used in the power-generating operation and the area of the building occupied by power-generating equipment. The Palo Verde nuclear generating station buildings which are totally or partially tax exempt and the purpose served by each are shown in Table 19.

TABLE 19

PALO VERDE NUCLEAR GENERATING STATION BUILDINGS TOTALLY OR PARTIALLY EXEMPT FROM SALES AND USE TAXES

Structure*	Percentage of Structure Exempt from Sales and Use Tax	Purpose of Structure
Containment	100%	Houses reactor vessel and two steam generators.
Auxiliary	100	Houses safeguard system, chemical and volume control system, cooling water and ventilation systems, maintenance access control.
Fuel	100	Houses used fuel pool and new fuel storage.
Turbine	100	Houses turbine generator, condensor, components of main steam system, main and auxiliary feedwater systems, secondary chemical control system.
Radioactive waste	100	Houses liquid, solid and gaseous radioactive waste systems, boron (safeguard) system.
Cooling towers and intake	100	Cools water used in condensor-cooling process.
Switchyard facility and associated bulk transmission towers	100	Transfers power to transmission lines.
Water reclamation facility	100	Houses equipment used to purify effluent to be used in cooling system.
Main steam support	100	Houses pipes which carry steam to turbine.
Reservoir, spray ponds and evaporation ponds	100	Provide water for refueling and emergency core cooling system.
Containment building's permanently affixed work platforms	53.14	Allow personnel to inspect and repair within the containment building.
Control	75	Houses control, computer and cable-spreading rooms, switchgear and battery rooms.

* The following are not exempt: diesel-generating structure; water reclamation operations, equipment and storage buildings; sewage treatment plant; water demineralization structure; fire station; guardhouse; service structure; maintenance structure; calibration shop; meterological tower; administration building and the maintenance shop annex. Eleven temporary buildings used during construction are fully taxable.

APS has estimated that costs incurred in the construction of the Palo Verde facility, excluding interest on funds used during construction, transmission lines, switchyards, taxes, nuclear fuel, start-up costs, operating and maintenance expenses and capitalized training, will total $3.607 billion at completion in 1986. However, because APS cannot furnish current or projected costs associated with each structure, we were unable to determine the tax revenue the State will lose because of the exemptions.* It should be noted that if the construction of the Palo Verde project were fully taxed, the State would realize $144,288,000** from this project. Therefore, it is reasonable to assume that the exempt sales tax status of the 33 buildings, the largest at the Palo Verde facility, will cost the State a substantial amount in sales and use taxes by 1986. Appendix XVII depicts the completed project and identifies the tax status of each structure.

APS shares ownership of the Palo Verde facility with four other utility companies. The participants and the percentage of the project owned by each are shown in Table 20.

TABLE 20

PARTICIPANTS IN THE PALO VERDE NUCLEAR GENERATING FACILITY AND PERCENTAGE OF PROJECT OWNERSHIP

Participant	Percentage of Ownership
APS	29.1%
Salt River Project (SRP)	29.1
Southern California Edison Company	15.8
El Paso Electric Company	15.8
Public Service Company of New Mexico	10.2

* Appendix XVIII contains all correspondence between Auditor General staff and APS or its representatives concerning requests for cost information.

** $144,288,000 is the maximum sales tax that could be realized and is shown for illustrative purposes only. In actual practice, an unknown portion of the total cost would represent labor costs and as such would not be subject to sales tax.

It is noteworthy that the tax exempt status of the Palo Verde facilities will allow Southern California Edison Company, El Paso Electric Company, and Public Service Company of New Mexico to pass along lower costs to their customers. Thus, by not imposing sales taxes on a significant portion of the Palo Verde facility, Arizona will, in effect, subsidize out-of-State users of Arizona-generated power.

Further, the practice of subsidizing out-of-State utility users is not restricted to the Palo Verde facility. As shown in Table 21, two major projects, built in Arizona between 1967 and 1980, involved out-of-State participants with significant interests in the facilities.

TABLE 21

COST OF POWER-GENERATING FACILITIES
CONSTRUCTED IN ARIZONA BETWEEN
JANUARY 1, 1967 AND DECEMBER 31, 1979

Facility*	Participants	Percentage Owned	Number of Units	Cost (Thousands of Dollars)
Agua Fria (Glendale)	SRP	100.0%	3	$ 22,281**
Apache (Cochise County)	Arizona Electric Power Cooperative	100.0	3	N/A
Cholla (Holbrook)	APS	100.0	2	N/A
Coronado (St. Johns)	SRP	70.0	1	343,986****
	Los Angeles Department of Power & Water	30.0		N/A
Horse Mesa Dam	SRP	100.0	1	12,876**
Kyrene (Tempe)	SRP	100.0	4	22,064**
Mormon Flat Dam	SRP	100.0	1	11,066
Navajo (Page)	SRP	21.7	3	166,005****
	APS	14.0		N/A
	Los Angeles Department of Power & Water	21.2		N/A
	Nevada Power Co.	11.3		N/A
	Tucson Electric	7.5		N/A
	Western Area Power Administration	24.3		N/A
Roosevelt Dam	SRP	100.0	1	11,234**
Santan (Gilbert)	SRP	100.0	4	59,011**
Total				$648,523

* APS also installed eleven gas turbines and three combined-cycle units during this period. The location and costs of these facilities were not available. Appendix XVIII contains all correspondence between Auditor General staff and APS or its representatives concerning requests for cost information.

** Represents total investment, including improvements, through December 1979. Labor costs, funds used during construction (interest), property and payroll taxes, insurance, administrative and general expenses, and "...several others [costs] which would not be subject to sales and use taxes..." are capitalized and, therefore, included in the cost information provided by SRP. Appendix XIX contains the full text of a letter from SRP.

*** Represents cost to SRP only.

Ironically, reciprocal benefits do not accrue to Arizona residents. None of the neighboring states from whom Arizona utilities either purchase electricity or with whom they participate in the construction of power-generating facilities offers a sales or use-tax exemption such as that granted by Arizona.

In addition, four other power-generating facilities will be completed in Arizona by 1986 at a currently projected cost of at least $663.7 million. Table 22 details the proposed projects, the participants in each and estimated costs to complete.

TABLE 22

CONSTRUCTION PLANNED BY ARIZONA UTILITIES
(EXCLUSIVE OF PALO VERDE FACILITY)
1980-1986

Project	Participant	Units	Cost
Coronado (St. Johns)	SRP (70%)*	1	$431,000,000**
Coronado (St. Johns)	SRP	1	
Cholla (Holbrook)	APS	1	$232,700,000
Springerville	Tucson Electric	1	N/A

The cost projections in Table 22 do not include: 1) the cost of facilities under construction that will not be completed by 1986, or 2) the cost of the Springerville project, which Tucson Electric declined to provide.

* 30% owned by Los Angeles Department of Water and Power.
** Total cost to SRP of both units at Coronado.

Because exact cost figures were not provided for: 1) power-generating facilities constructed or to be constructed in Arizona between 1967 and 1986, and 2) the buildings granted exempt status at the Palo Verde Nuclear Generating Station* by DOR and the Attorney General, it is not possible to assess the impact of A.R.S. §§42-1312.01 and 42-1409 and interpretations of those statutes on sales and use taxes. However, given the billions of dollars in construction costs involved, it seems reasonable to assume that the impact is significant.

Still More Tax Exemptions

In addition to the exemption of machinery and equipment used to generate electrical power, other Arizona statutes and DOR rules and regulations permit numerous deductions and exemptions from sales and use taxes. A Legislative Council opinion dated October 31, 1980,** details 15 deductions in computing sales tax liability and 103 exemptions from sales, rental occupancy and use taxes. The deductions and exemptions are granted to a number of industries, some of which also are subject to sales tax rates lower than the four percent rate applicable to most industries. For example, the mining industry, which by definition includes oil and gas production, is taxed at a rate of two and one-half percent, is subject to five sales-tax exemptions and three use-tax exemptions in which the exemption specifically identifies mining or oil and gas production, and may claim certain tax credits for fiscal years 1980-81 through 1982-83. The mining industry also may qualify for other, more general, exemptions. These exemptions also may have a significant impact on sales and use taxes.

* Appendix XVIII contains the full text of a letter from APS in response to the audit staff request for cost information.

** Appendix XX contains a full text of the opinion.

CONCLUSION

Arizona is one of only four states that allow sales and use tax exemptions for machinery and equipment sold to privately owned utility companies. In addition, an agreement among the Attorney General, DOR and APS has expanded that exemption to include certain buildings at the Palo Verde nuclear generating facility. The impact of exemptions on sales and use taxes cannot be determined, but it appears to be substantial. Finally, Arizona statutes provide numerous other exemptions which also may have a significant impact on sales and use-tax revenues.

RECOMMENDATIONS

It is recommended that:

1. The Legislature evaluate the agreement among the Attorney General, DOR and APS to determine if it is consistent with legislative intent. If expansion of the exemption is deemed appropriate, A.R.S. §§42-1312.01 and 42-1409 should be revised to define the conditions under which buildings may be subject to exemption. If the expansion of the exemption is considered inappropriate, DOR should initiate corrective measures to ensure timely assessment and collection of taxes due.

2. The Legislature review exemptions currently granted by the statutes and DOR rules and regulations.

3. DOR include information regarding the audits of suppliers and contractors of the Palo Verde project in its annual report.

J. ELLIOTT HIBBS
DIRECTOR

BRUCE BABBITT
GOVERNOR

Arizona Department of Revenue

CAPITOL BUILDING
1700 W. WASHINGTON
PHOENIX, ARIZONA 85007

February 3, 1981

Mr. Douglas R. Norton
Auditor General
State Capitol
Suite 200 F
Phoenix, Arizona 85007

Dear Mr. Norton:

The Department of Revenue has completed its review of the preliminary draft of the performance audit of our Sales Tax Program.

Our comments concerning each finding are attached for your information and inclusion in the final report. We appreciated the cooperation of the members of your staff who conducted the audit. The views and recommendations expressed have assisted us in improving our administration of sales tax in a number of important ways.

If you have any questions concerning our written reply, please contact me.

Sincerely,

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

blm

DEPARTMENT OF REVENUE COMMENTS
PRELIMINARY REPORT OF THE AUDITOR GENERAL
PERFORMANCE AUDIT - D.O.R. SALES TAX PROGRAM

The following comments are offered to express our agreement or disagreement with the findings and recommendations of the performance audit of our sales tax administration functions. By and large we concur with the results of the performance audit and have already adopted, are in the process of implementing or are planning future implementation of many of the recommendations. We take issue with only two findings, both dealing with legal interpretations of existing statutes, and have included herein our interpretations and those of the Assistant Attorneys General representing the department to help clarify the issues.

We noted no findings or recommendations in the report concerning our licensing/registration activities in spite of considerable hours spent in evaluation. We trust this indicates that the unit is performing satisfactorily and at least as efficient as other licensing agencies with which we were compared during the audit.

The remainder of the comments are offered in the sequence of the findings in the draft report.

FINDING I

THE DEPARTMENT OF REVENUE HAS NOT FULFILLED ITS STATUTORY RESPONSIBILITY TO ESTABLISH ADEQUATE PROCEDURES FOR SAFEGUARDING AND PROCESSING SALES TAX PAYMENTS. AS A RESULT, THE STATE MAY HAVE LOST AN ESTIMATED $1.1 MILLION A YEAR IN INTEREST INCOME, AND A SIGNIFICANT AMOUNT OF MONEY IS EXPOSED TO LOSS THROUGH DEFALCATION OR ACCIDENT.

1. The legislature should appropriate funds to the Department of Revenue to purchase electronic payment processing equipment. The Department of Revenue has included the electronic payment processing equipment in its 1981/82 budget and concurs with the recommendation. This equipment will greatly enhance the department's ability to reach its goal of 24 hour deposit of receipts.

2. The Department of Revenue implement additional security precautions, including storage safeguards and restricting access to work areas.
We generally concur and have already implemented a number of actions to restrict access to sensitive areas. These include the following:

- Instituted employee I.D. badge program;
- Reduced to one the number of entrances to each area;
- Installed and enforced sign-in/sign-out procedures for sensitive processing areas;
- Assigned an employee as security officer to test off hour security;
- Enforced locking of doors after hours; and,
- Moved all public contact offices out of the basement processing areas.

The Department of Revenue has recognized for some time the security limitations of its existing facility. These offices were not originally designed to provide document and check security and we have previously requested improvements to the building and security procedures from the Department of Administration, Public Building Division. These requests have included:

- Additional sensors;
- Video camera surveillance;

- Screening of false ceiling area;
- Installation of a door in the basement hall to limit access, particularly from the main elevator and cafeteria areas;
- Locking of back stairway and elevator during off-hours; and,
- Restricting the use of the back elevator.

As of this date, the rear elevator and stairwell doors are locked during off-hours and it is our understanding sensors have been ordered. It must be recognized, however, that the ultimate solution is to provide the Department of Revenue with a facility properly designed to give security and protection from natural disasters to documents and checks. Such a facility should provide limited access to all processing areas and the computer as well as proper safeguards against fire, water or other such disasters, while continuing to permit an efficient work flow.

3. Until implementation of electronic processing, the Department of Revenue should either provide for 24 hour deposit or adopt lockbox services. While we concur the law requires 24 hour deposit and our stated goal is to achieve this requirement, it is not practical to achieve it now, nor is a lock box service the answer.

The department had started its own move to identify key processing problems and implement solutions to them prior to this audit. Document and revenue processing was the second major study which was completed in late fiscal year 1979/80. The recommendations from that

study were implemented in July 1980 and refined over the last seven months, right in the middle of the performance audit. While the potential interest loss as noted in the finding might have occurred in the past, as a result of improvements now fully implemented, we believe it is not a present phenomenon.

As of December, average deposit time for sales tax receipts was under two calendar days. This improvement was due to continued refinement of procedures and use of night shifts. As we have fought to reduce deposit time, it became apparent a 24 hour average deposit time is impossible to attain because of factors beyond our control. The Treasurer's Office is not open evenings or weekends. This means Friday mail will be processed on Monday (Three calendar days); so the best average deposit would be 1.4 days, or .4 days beyond the statutory requirement. We feel with future improvement in handling procedures and in the cashiering equipment, we can meet the 24 hours requirement for all mail except that received on Friday. Our own achievements at getting the deposit time to 2 days have greatly reduced the need for exploring alternative deposit methods, such as lockbox operations. However, the Department of Revenue has been exploring the use of lockbox services since last summer. In November, we asked Valley National Bank and First National Bank to make formal proposals on what portion of the Department of Revenue processes they can perform. They have as yet not responded. When they complete their evaluation, we will review it thoroughly, compare it to our own current and expected future situation and determine the cost effectiveness. If the result reveals more efficiency we will move in that direction. However, the department will move cautiously in this area.

While the finding alleged the department operation was inefficient in comparison to two city programs using lockboxes, the comparison was not totally valid.

First, while it is claimed that Scottsdale and Phoenix deposit all checks in one day via lockbox operations, it was also noted that trouble documents were set aside to be processed by the cities and presumably deposited at a later date. Since up to 40% of the Department of Revenue's sales tax returns require editing before processing such an operation might be slower in aggregate than in-house processing.

Secondly, the evaluation of efficiency totally ignored the economics resulting from the joint state/city collection vis-a-vis separate city programs. While the department concurs it should strive to be more efficient, there is no doubt this combined process is more efficient for Arizona taxpayers than separate state and individual city programs would be.

Finally, the danger of defalcation of checks mentioned in the report is at best minimal. Cash is removed and deposited immediately upon opening envelopes and the probability of a bank or third party cashing

a check addressed to the State of Arizona or the Department of Revenue is remote. Documents with payments are balanced to deposits and there are no known cases of checks addressed to the Department of Revenue which have been cashed outside the system.

FINDING 2

THE DEPARTMENT OF REVENUE HAS NOT DEVELOPED A SYSTEMATIC AUDIT SELECTION PROCEDURE SIMILAR TO THOSE OF OTHER TAX ADMINISTRATION AUTHORITIES. AS A RESULT, THE DEPARTMENT OF REVENUE MAY NOT BE MAXIMIZING REVENUES FROM ITS SALES AND USE TAX AUDIT FUNCTION. IN ADDITION, THE DEPARTMENT HAS OVERSTATED REVENUES GENERATED BY ITS AUDIT FUNCTION IN BUDGET DOCUMENTS SUBMITTED TO THE LEGISLATURE.

1. Audit Selection. We fundamentally agree that the Department of Revenue does not have a sophisticated audit selection system and that, for the most part, audits have been selected on the basis of referrals. However, one of the goals of the Department of Revenue is the creation of better audit selection systems. Towards that end, our current development plans in Data Processing include the development of such an audit selection system for sales tax based in part on California's model.

These plans have been prioritized along with other development projects, such as the creation of a fully computerized sales tax accounts receivable system and a five year license renewal system. Further, new development priorities have been placed on the agency such as the repeal of the state sales tax on food, that have required shifting of resources. Therefore, while we may not be talking about a great amount of time to incorporate a selection system similar to that of the State of California, it is still time that would be taken away from other priorities of the department. As soon as the resources are available to allocate to the development of an audit selection system, the department will be evaluating successful systems not only like California's, but other states as well. While it may be some time before the department is able to fully develop a sales tax audit selection system, the department is compiling information as a result of its management information system, as referenced in the report, that will show such data as the average assessment per audit, broken down by industry groupings. Information such as this, when compiled over time, will give indications as to which particular industry groupings provide the most return per audit expended. While this information system is not completed, it represents in our opinion, the genesis of an audit selection system.

It should also be noted the department undertook during the fiscal year 1979/80, a project to concentrate audit resources on accounts that paid over $100,000 per year in tax. That project is reflected in Table 7 on Page 27 of your report. This table shows that, of the 623 audits shown, 147, or 23.6% were in the higher tax paid category as compared to only 6.3% in that category in 1978/79. Thus, there is a perceptible change in the use of our auditing resources toward auditing the larger tax accounts.

3. Coordination of Audit Activities. We also wholeheartedly agree with and support the concept of joint and coordinated auditing which is contemplated by A.R.S. 42-1451. In this regard, it is clear the department's effort in establishing the unified audit committee has not yet lived up to its full potential.

The department also concurs that a formal mechanism should exist by which results of city and state audits can be automatically used at the other government level. That idea has been proposed and is presently under study by the unified audit committee. It was discussed at some length at the July 1980 meeting of the unified audit committee that was attended by a representative of the Auditor General's office. This exchange of information and audit results can and should be established on a similar basis by which the department now exchanges audit results with the Internal Revenue Service.

It is the department's feeling that while progress of the committee has been slow in the joint and coordinated audit area, there has been a marked improvement in overall state/city relations according to feedback from the cities involved. There has been an excellent dialogue on audit related problems, such as tax law interpretations, which has helped make sales tax administration more uniform and coordinated at the state and city levels. None of the city officials have ever expressed concern to myself or other members of the department over the slow rate of progress being made to coordinate efforts.

4. Reported Results Have Been Overstated. We agree the best measure of the success of our audit programs is actual collections instead of audit assessments. Unfortunately, the information system that has existed to measure audit performance has remained unchanged for years and has simply not provided the information needed to adequately

determine the true productivity of the audit programs. Our current efforts towards a management information system are designed to provide information about collections to eliminate this gap and to allow ourselves more ability to evaluate agency performance in the enforcement area.

Reported audit results have not been deliberately overstated. The service measurements as indicated in the department's budget document have been provided only because that is the only information available by which any analysis can be made concerning the audit effort. This gap will be closed when the management information system is completed and tested and will begin producing the data to evaluate performance more accurately.

FINDING 3

THE DEPARTMENT OF REVENUE SALES AND USE TAX APPEALS PROCESS IS FRAGMENTED AND UNCOORDINATED. AS A RESULT, THE PROCESS IS EXCESSIVELY LONG, AND NOT PROPERLY DOCUMENTED OR MONITORED.

1. Time Limitation for Steps of Appeals Process. There is no question the department has an excessive backlog of cases that are at some stage in the appeals process. This backlog has been allowed to build up over a number of years and must be eliminated. We do agree it is in the best interests of taxpayers and tax administration to establish time limitations for each step in the appeal process to help resolve appeals more quickly at the administrative level.

One of the problems has been a lack of information concerning the number of appeals in process, as you properly noted in your report. Before the department can adequately assess the situation with appeals and

determine objectives on how the problems may be resolved, it was necessary to fully understand the current situation. Our analysis of the appeals files has resulted in the closing of files that had been resolved many months ago; the recording of all of the necessary information concerning the status of an appeal; and, controls to determine at what level appeals exist so the director can establish objectives and standards of performance for the hearing officers of the department to timely move taxpayer appeals through the administrative process.

For the first time, the department is getting written rules and regulations concerning the appeals process. These are ready to be filed with the Secretary of State. There are some time limitations presented in these rules but they will be reviewed and additional time limitations inserted that might aid in timely handling of an appeal.

The proper method of evaluating the responsiveness of the hearings section is through the management reports and the standards of performance that are written for the hearing officers and I would continue to advocate these as the ultimate method of control. With the existing backlog, rigid time limitations on setting hearing and issuing orders would require many additional hearing officers or inadequate attention to the issues on individual appeals. We feel we can gradually eliminate the backlog while reducing the overall amount of time before a decision of the department is issued by adopting some time constraints on actions, and allowing the flexibility for the department to handle its current caseload.

As a final note in this area, we feel that comparison of the appeals process and procedure at the Department of Revenue level as compared to Division Two is not totally valid. They do not handle nearly the volume of appeals of the department. Further, the background work of each of the parties at the Appeals Board is basically completed during the Department of Revenue Administrative Appeal Process. The facts are known and the reasoning for the position of each party is clearly established. As any attorney will agree, it is much less expensive and time consuming to prepare an appeal than it is to prepare the initial action in a protest.

2. Grant the hearing officer authority to reschedule hearings for taxpayers who have postponed, without good cause, a hearing beyond the established time. We are not clear as to the exact nature of this recommendation. If the recommendation is to keep the hearing process moving by not allowing delaying tactics of taxpayers, we certainly agree with the recommendation. In the interest of providing every taxpayer, large or small, due process, we have tried to be somewhat lenient in scheduling hearings for the convenience of the taxpayer. It is our belief this is still good public policy as long as postponements do not drag a matter beyond a "reasonable" time. We will develop rules regarding the rescheduling of hearings to make it clear for the hearing officers and taxpayers under what conditions a hearing will be rescheduled and within what time frame a rescheduled hearing will be required to be held.

3. Document appeals according to statutes. Again, we agree with the premise of the recommendation of your study. We feel the recent improvements, once fully implemented, will provide the documentation

necessary not only to monitor the status of appeals in the department but also provide a clear and complete record of every case.

4. Centralize appeals process in the hearing offices. As outlined in my memorandum of September 19, 1980, it is obvious there is agreement on the need to centralize control of the appeals process in the hearing office. Reasons this has not been completed mainly fall on the lack of management information concerning the progress of the implementation. We will shortly conduct a follow-up study to determine in what respects centralization has not been completed, if any, and see that the process as outlined for handling of appeals is being fully used in the department.

5. Prepare monthly management reports. It goes without saying the accountability for the handling of protested assessments can only be made if sufficient information is available to management to determine the status and progress. As was noted, we have begun preparing monthly management reports, but the validity of the reports has been questionable due to the condition of many of the files. It was necessary to completely review each and every protest file and often times study the content of the file to determine a true status from which monthly management reports could be based. This was completed in January of 1981 with the first full reports issued on the status of individual protests as well as a summary of the condition of our appeals. From these reports we expect to be able to monitor more closely the resolutions of individual protests and to determine whether we are making the inroads into resolving the backlog. To accomplish this, specific objectives will be established with the hearing officers to identify

the time limitations under which appeals are to be handled and the order in which existing matters are to be resolved.

FINDING 4

THE DEPARTMENT OF REVENUE IS NOT CONSISTENTLY IMPOSING PENALTIES ON LATE PAYMENTS OF SALES TAXES AS REQUIRED BY STATUTE. AS A RESULT, THE DEPARTMENT OF REVENUE IS NOT COMPLYING WITH STATE LAW OR TREATING TAXPAYERS EQUALLY, AND A SUBSTANTIAL AMOUNT OF STATE REVENUE IS LOST.

By in large we disagree with many of the interpretations that lead to the above-stated finding. Legislative council is misinterpreting A.R.S. 42-1322 and 42-1327 which has led to erroneous conclusions of inconsistent and improper imposition of penalties. My experience as a tax administrator agrees with the interpretations of the Arizona Attorney General's office that Section 42-1322 applies to the filing of tax returns and that 42-1327 applies to audit situations where an underpayment is determined. In other words, when a taxpayer files and pays late, penalty and interest is imposed under the provisions of 42-1322. If on the other hand, a deficiency is discovered during the course of an audit, a 10% penalty is imposed if the deficiency is due to negligence or intentional disregard of tax law and/or regulations, as provided in 42-1327. If the deficiency is due to fraud, the penalty is 25%, as provided by statute.

The department has also established guidelines for recommending the abatement of penalties assessed under Section 42-1322 which are presently distributed in Policy Memo 81T-002 (copy attached). Guidelines for imposing penalties under 42-1327 are presently distributed in Policy Memo 80T-007 (copy attached).

We feel, based on the guidelines established and the present department practices, that we are in fact consistently imposing penalties on late payments of sales taxes as required by statute and we are treating taxpayers equally. We certainly do not disagree that there was a time when interest was not being assessed, but this practice was discontinued some time ago. Audits after July 1, 1979 have had interest computed correctly.

Suffice it to say, in this one area we disagree with your interpretations and would request a discussion concerning this finding between the legislative council, Attorney General's office, members of your staff and Department of Revenue personnel.

1. Provide clear guidelines on the impositions and waiver of penalty.

We agree with this recommendation in regard to Section 42-1322. We feel the present procedure of the Department of Revenue receiving requests for abatement of penalty when a return has been received late and referring the request to the Attorney General's office is cumbersome and is inconsistent with similar procedures of other states. The guidelines we have established for forwarding abatement requests are those in use in most other states and we feel could be administered properly within the Department of Revenue without having to involve the Attorney General's office.

We see no need to amend Section 42-1327 unless the legislature wishes to define what it means by negligence or intentional disregard of the statutes or regulations.

2. Establish criteria for imposition of penalties. As mentioned above, the department has guidelines for imposing penalties under Section 42-1327 and would not be opposed to placing these in rule form. It is unnecessary to establish criteria for the imposition of the penalty under A.R.S. 42-1322 (D) as there is no discretion allowed the department in this area. The only discretion allowed is the Attorney General's abatement of such a penalty. The department has chosen not to place into rule form reasons why penalties may be abated since taxpayers would become familiar with the reasons and request abatement based on a criteria they know would result in an abatement, rather than reporting the actual facts that may have led to a late filing.

3. The Department of Revenue impose a penalty and interest on all taxpayers who fail to pay their taxes when due. As stated above, since mid 1979, interest has been routinely assessed on all audit deficiencies uncovered. Similarly, since approximately July 1980, a 10% penalty has been routinely assessed on all audits where, pursuant to the statutory standard, negligence or intentional disregard of statute or regulation was involved. This fact is essentially reflected in your table 11, where it indicates that, although your analysis runs through June 1980, the most recent case in which you found no penalty or interest assessed is in 1979.

Also, as mentioned above, according to our interpretation of 42-1322, your presumption that a 10% penalty is automatic on audits is incorrect. The findings that the manner in which the Department of Revenue imposes penalty is arbitrary and capricious seems to be based on the assumption

that A.R.S. 42-1322 applies to audit situations. It is the interpretation of the department, the Attorney General's office and similarly interpreted by other states having like statutes, that penalties and interest applied by A.R.S. 42-1322 are only applied to the late filing and/or late payment of tax on the monthly sales tax return. In Arizona's case, such penalties and interest are to be applied routinely in all such cases, subject to abatement only if the cause for the late filing/late payment falls within the guidelines that we have developed.

4. The Department of Revenue assess penalties and interest which it failed to assess in the past. We understand the position that the legislative council advances, but question whether it would be a wise course of action, even if proper under the law, to now subject taxpayers who thought a tax obligation had been resolved to an additional assessment. Many of the taxpayers may have been able to show their failure to pay the proper amount was not due to negligence or intentional disregard of the statutes or regulations, but any documentation to prove a claim may no longer be available. Further, the legality of reopening an audit a taxpayer has "paid" would need to be reviewed by the Attorney General's office before any such actions were taken. Under similar circumstances in other states, the courts have found the tax administrator cannot reopen an audit to which the taxpayer and department have reached agreement. Obviously, the state may be challenged if the Department of Revenue should try to reopen and assess penalties and interest not previously assessed and we should be clear of our legal position before acting. Another consideration might be that we could better use our time to conduct other productive audits rather than pulling out old files and trying to impose penalty and interest. This

is especially true in light of the fact that many taxpayers may claim that negligence or intentional disregard was not present.

5. The Department of Revenue include in its annual report a summary of penalty abatements granted. The department has no difficulty with this recommendation. We can certainly provide the amounts and reasons for abatements if the legislature would feel it necessary to separately account for this particular activity of the department over and above the performance and financial audits conducted by your office. It seems unnecessary to single out this one particular function, but it is certainly possible and agreeable for us to do so.

FINDING 5

DEPARTMENT OF REVENUE COLLECTION PROCEDURES ARE INEFFICIENT

1. The Department of Revenue cease combining data on late taxes and current taxes collected for budget information reports. We have changed our report procedures to stop the recording of collection of current month taxes with past due monies, although we believe it is proper for a collector to take this action. While we can understand the auditor's concern in reflecting, for budget evaluation, only collection of past due monies, we believe arguments in favor of continuing this practice have merit. Taxpayers who are delinquent or in arrears at the time of contact have already demonstrated a propensity to avoid timely payments. It is thus prudent for a collector to ask for this current payment as well as late payments. When collectors collect the taxes, they feel justified in claiming credit for it. Prior to implementing this practice, a number of accounts were found in which the taxpayers were making payments on old receivables while ignoring current tax liabilities.

2. Special Collections should generate the same types of service measurements as the collections section.

We agree. Action will be taken immediately to implement this recommendation.

3. The Department of Revenue mail nonfiling notices twenty-five days after a taxpayer becomes delinquent.

We agree and are aiming our efforts toward achieving this desired result.

4. The Department of Revenue refer nonfiled accounts to a collector before the account becomes over two months old.

Again we agree and our goal is to refer the account to a phone collector shortly after the initial delinquency notice is issued. The obvious problem right now is that the ratio of accounts to collectors does not allow this response time.

5. The Department of Revenue should bill accounts receivable taxpayers monthly.

This is another goal of the agency; one that can be achieved when the automated system is developed. It is not currently feasible under our semi-automated system because of the time necessary to issue billings and update accounts for payments received. The monthly billings are also subject to the availability of sufficient funds for postage and printing of bills.

6. The Department of Revenue should mail a second notice to nonfiling taxpayers within 55 days after the due date.

We agree this would be an ideal situation when combined with our other

collection improvements. It also depends on postage and printing funding being available.

7 & 8. The Department of Revenue should refer accounts receivables of more than $100 to collectors as soon as an account is due and payable. All accounts receivables of less than $100 be referred to a collector within three to four months after they are due and payable.

We agree in principle, but do not believe this is feasible with current staffing. The department has too many large dollar accounts assigned to its current staff to meet this suggestion. If accounts are going to be referred this quickly and collectors must also handle withholding and income tax receivables, we would have to assign 5,132 accounts per collector. This is an unreasonable number to expect a collector to handle. The collections management assigns accounts based on dollar size to make the most efficient use of collectors' time. Through implementation of phone power staff the level has been dropped to $300 and it is believed can soon reach $100. However, it would take 315 additional staff to individually work all accounts.

9. The Department of Revenue collection supervisors should monitor accounts referred to collectors. Our reports have been revised to improve the monitoring process as recommended.

10. Collectors contact all taxpayers assigned to them who owe delinquent taxes within specified time limits.

We concur and revised our procedures to clearly require this action. Continual monitoring of the accounts assigned to each collector will reveal whether the contacts are being made as required and act as a control.

11. The Department of Revenue establish guidelines for when specific collection action should be taken.

We agree and will establish the specific guidelines in the near future.

12. The Department of Revenue standardize part pay procedures including those used by special collections. We standardized the procedures but controls to monitor their use were incomplete. Now we have established a part pay desk to ensure standards are being followed both in collections and special collections.

13 and 14. The Department of Revenue collection unit should require its collectors to use the telephone as a primary mode of contact. The Department of Revenue should evaluate expanding all collectors duties to the full realm of action from phone power to seizure.

We agree in principle that phone power should be used first. The question remains as to the optimum mix of field and phone personnel duties necessary to collect the taxes due. Ideally all accounts should go to phone power first (except jeopardy accounts which require immediate collection action) with only the accounts not responding assigned to a field collector for a personal contact. There is a question whether personnel should act as both a field and phone collector. We are evaluating the pros and cons of combined collectors versus phone and field specialists. Arguments can be made for each classification and careful evaluation of the alternatives should be made before establishing one approach over another.

In addition to the above comments concerning the individual recommendations, the following general comments should also be noted. The audit

finding alleges the Department of Revenue collection efforts are inefficient because:

. Other entities work accounts sooner;

. Other entities work smaller accounts; and,

. Other entities use phone power more than the Department of Revenue.

In general there is no question but that we can be more efficient. We asked for and partially received phone power personnel in our 1980-81 appropriation and we have converted some field collectors to phone collectors to become more efficient. However, care must be taken in jumping to a conclusion of inefficiency based on a comparison of timing and account size. The comparisons in the report are primarily a function of account numbers relative to numbers of collectors and do not reflect the efficiency of the resources available. In addition, it should be noted, the cities referred to in the report tax at 1/4 the state rate. By definition, then, that same delinquent account would have shown only 1/4 the size of the state liability. Thus, if a city works the same percentage of accounts as the Department of Revenue, it will naturally be working smaller accounts. This, then, does not mean they are more efficient, only that they have relatively smaller accounts. Finally, since there is no comparison of costs per dollar collected (the only real measure of efficiency) between the Department of Revenue and other entities, the inference that the Department of Revenue is less efficient than the cities is unwarranted.

FINDING 6

IMPROVEMENTS ARE NEEDED IN THE DEPARTMENT OF REVENUE FINANCIAL TRANSACTION CONTROL AND DOCUMENTATION

1. The Department of Revenue should establish an internal audit staff.

The Department of Revenue agrees such a unit is needed and would be

beneficial if it were funded by the legislature. We recognize, however, the need to keep the size of government down and have limited our requests to FTE's necessary to retain and enhance service levels while depending on occasional performance audits, management studies and consulting services to provide internal audit results.

2. The Department of Revenue should conduct an in depth review of current accounting procedures and develop written policies and procedures for it. We agree and are presently negotiating with a CPA firm to assist in this analysis. Correlated revisions to Data Processing Programs, once the analysis is complete, will be slow in developing as they must wait in line for completion of more critical programs such as the sales tax receivable system, on line error resolution and information retrieval systems. As much work as can be done to upgrade and standardize procedures will be completed even without the revised systems.

3. Prior to entering accounts receivables into the new automated system

- Review and remove uncollectible accounts from the active file;
- Determine the error rate of the file;
- If the error rate exceeds allowable limit audit the file and correct; and,
- Report findings of the analysis.

We have been and are working to remove uncollectibles. We agree it is prudent to analyze the error factor of our receivables file before conversion from the semi-automated to a computerized system and will do so, taking corrective action as necessary. A test will be conducted shortly to help us plan the conversion. If the Joint Legislative Budget Committee wishes the Department of Revenue to advise them of our test findings, we will do so.

4. The legislature should consider statutory changes to allow for a full independent audit of the department.

We would welcome a complete audit as long as it meets the federal confidentiality requirements so the federal/state exchange agreement for tax administration purposes is not jeopardized. We are aware of most of the agency problems and have goals and objectives to review and upgrade our activities, but an independent audit would help identify any problems of which we are unaware.

In addition to the above, the following comments are offered. First, in spite of the sample results of the audit, care was taken to set up accurate receivable accounts. Files were reviewed by staff auditors in 1979 and these in turn were quality checked on a sample basis. Detailed billings were sent to taxpayers who were invited to challenge receivables. Since then, five billings have been made. Thousands of payments were received and accounts were audited. Corrections required were few, as a percentage of accounts. While statistics were not kept, the number of complaints from taxpayers about errors was not large enough to cause alarm or invalidate the system.

Secondly, we disagree that the treatment of adjustments in the period in which the adjustments are made is irregular or violates accounting principles. In state accounting, transactions are recorded when they occur, not to the period to which they relate. Thus receivables due in fiscal 1979/80, but paid in 80/81 are recorded in the fiscal 80/81 statistics. We feel adjustments should be similarly treated.

Finally, while we concur the current accounts receivable system is burdened with uncollectible accounts, care must be taken in removing them. Procedures were established for collectors to recommend accounts be removed. Special

actions must be taken to ensure accounts are worked before they are removed from active status. This is a slow process and the 317 largest uncollectibles have been weeded out. The process should accelerate as smaller accounts are worked.

FINDING 7

BECAUSE ARIZONA DOES NOT TAX CONSTRUCTION OF POWER GENERATING FACILITIES AS OTHER STATES DO, BY 1986 ARIZONA WILL LOSE SUBSTANTIAL SALES AND USE TAXES RELATED TO THE CONSTRUCTION OF THE PALO VERDE NUCLEAR GENERATING FACILITY AND OTHER POWER-GENERATING FACILITIES.

The department does not concur in the findings or recommendations relating to the circumstances surrounding the transaction privilege and use tax situation at the Palo Verde Nuclear Generating Station (PVNGS). While it may appear an "agreement" has been struck between the Department of Revenue and A.P.S., with approval of the Attorney General, this is not a valid conclusion. The documents and facts demonstrate a recognition by the Department of Revenue of, not only what the present state of the statutory and decisional law is, but also the potential likelihood of successfully challenging the position of A.P.S. in what would unquestionably be an exceedingly complex and drawn-out lawsuit. The Department of Revenue, relying upon advice from its legal counsel as to the state of the law, seeks to cooperate with any taxpayer in the correct calculation of tax liability arising from a profoundly complex business activity. To the extent there is any cooperation, it is only through recognizing any and all statutory exclusions and there has been no attempt to "expand" an exemption or deplete the state treasury in developing the Palo Verde guidelines. The present guidelines reflect existing statutory exemptions and court interpretations applicable

thereto. Only if the legislature is desirous of altering the effects of applicable court decisions can the exemptions in this situation be expanded or limited. Until and unless there is legislative action, the Department of Revenue does not feel it can alter its present interpretation, especially based on expected fiscal effects. To assist the Auditor General's Office in fully understanding the background of the documents and facts relating to the transaction privilege and use tax applicability at the Palo Verde Nuclear Generating Station, a brief discussion of the applicable law and court decisions is presented below.

At the outset, it must be noted that the exemptions in question arise under A.R.S. §§ 42-1312.01 and/or 42-1409(B). There is no intent by the Department of Revenue to exempt from taxation those construction activities which would be subject to A.R.S. § 42-1310(2)(i).

The starting point for the analysis is the decision of the Arizona Court of Appeals in DUVAL-SIERRITA CORP. v ARIZONA DEPARTMENT OF REVENUE, 116 ARIZ. 200, 368, P2d 1048 (CT. APP. 1977) (review denied September 15, 1977). There, it was held that machinery and equipment which was essential to the operation of the copper mining business was exempt from use taxation per A.R.S. § 42-1409(B). The rationale of the Court was that the "integrated rule" under the concept of "direct use" was the proper test. The same standard would apply to A.R.S. § 42-1312.01.

Under the integrated rule, if an item in question is necessary to the operation, is physically and causally close to the finished product and functions harmoniously with other items to form an integrated system, it is "directly used" and therefore exempt. The leading case on the point, in the Arizona Court's view, is NIAGRIA MOHAWK POWER CORP. v. WANAMAKER, 286 APP. DIV. 446, 144 N.Y.S. 2d 458 (1955). This case specifically holds that, in proper circumstances structures and supports which house, steady and protect machinery and equipment used to generate electric power are essential to the operation and, for that reason, exempt.

With respect to the question of whether the items in question are tangible personal property, it is essential to remember that the exemptions under A.R.S. §§ 42-1312.01 and 42-1409(B) are confined to those items which at the time of the taxable event, are tangible personal property. Thus, when an item is purchased from a retailer for subsequent incorporation by a contractor into a structure, the taxable event is the business transaction between the retailer and the contractor (i.e., the sale) and not the subsequent transformation of the item by the contractor from tangible personal property into real property. See A.R.S. § 42-1321(A)(3).

In the PVNGS situation, the purchase transaction is even one step further removed in view of the fact that APS, rather than the many contractors, purchases the tangible personal property to be later transformed by the contractors into an integrated nuclear power generating plant. SEE

EBASCO SERVICES, INC. v ARIZONA STATE TAX COMMISSION, 105 ARIZ. 94, 459 p.2d 719 (1969).

Thus, the determination of the nature of the items is to be made at the time of purchase by APS from the various suppliers of tangible personal property rather than at the time of the transformation of such by contractors into real property, at which time a separate taxable event occurs, that is, the engaging in business by the contractors under A.R.S. § 42-1310(2)(i).

On the issue of whether the items in question constitute machinery or equipment, the decision in the DUVAL case is controlling. In view of the fact that the Court equated the concept of "direct use" with "essentiality" under the WANAMAKER decision, it would be highly unlikely that the Court would now retreat from that position with respect to the items of tangible personal property involved in the Palo Verde guidelines.

Again, it is the nature of the property at the time of its acquisition by APS -- rather than its transformed nature at some later date following the contractors' incorporation of it into the PVNGS structures -- that is determinative.

In this regard, the term "equipment" is a very broad one, encompassing whatever is needed to accomplish a particular objective. In view of the fact that the Legislature has phrased the exemption in A.R.S. § 42-1312.01 (A)(4) in the disjunctive (i.e., "...machinery, equipment or transmission

lines..."(emphasis added)), the maximum of statutory construction which would suggest that the term "equipment" be limited to items like "machinery" is considerably weakened. Moreover, the taxpayer in the DUVAL case specifically pointed out to the Court numerous cases which stand for this proposition that "equipment", used in a disjunctive way, is to be broadly interpreted.

Thus, under the statutory exemption as it now exists, the items of tangible personal property in question seem clearly to fit within the exemptive language.

Perhaps the central point of controversy herein is the question whether or not the structures at the PVNGS constitute "buildings" for purposes of A.R.S. §§ 42-1312.01 and 42-1409(B). Again, the starting point is the DUVAL case and its reliance upon the WANAMAKER decision. While the Department of Revenue may not, for purposes of this discussion, totally agree with the Court's rationale, it is undeniably what the present state of the law actually is. The WANAMAKER case, in so many words, declares that the "...structures and supports which house and steady the machinery (at a steam power generating plant) are essential to production." The DUVAL case holds that such items are therefore directly used and thus exempt.

It should be noted that APS provided to the Department of Revenue documentation from the Maricopa County Board of Supervisors which exempted

the PVNGS structures in question from Maricopa County building code requirements upon the grounds that the structures were not buildings at all, but were, instead, integrated parts of the overall nuclear power generating function. Furthermore, many cases from other jurisdictions have held that specialized structures, while perhaps having the outward appearance of "buildings", may frequently be found to be something quite different. For example, it has been held that a massive cement cooling tower some 450 feet tall -- which tower, incidentally, cooled water to permit the operation of a nuclear power plant -- was properly exempted as machinery or equipment connected with the generation of electricity. SEE HEATH v RESEARCH-COTTRELL, INC., 529 S.W.2d 336 (ARK. 1975). Many other cases hold that specialized structures are not necessarily "buildings". SEE, e.g., YELLOW FREIGHT SYSTEM, INC. v UNITED STATES, 413 F. SUPP 357 (W.D. MO. 1975), (truck terminals not "buildings" for federal investment tax credit purposes); BROWN-FORMAN DISTILLERS CORP. v UNITED STATES, 499 F.2d 1263 (CT.CL.1974)(large structures with permanent floors, roof and walls used to age whiskey not "buildings" for federal investment tax credit purposes); THIRUP v COMMISSIONER OF INTERNAL REVENUE, 508 F.2d 915 (9th CIR. 1974) (400' x 200' greenhouses not "buildings" under 26 U.S.C. §48); WEST WHITELAND TOWNSHIP v EXTON MATERIALS, INC. 11 PA. COM 474, 314A,2d 43 (1974) (concrete plant where interior not suited for human use not a "building" for zoning purposes).

The foregoing are merely examples of other cases that could be found. Indeed, while APS is aware of most of these cases, it is not aware, so far as we know of all of them.

In view of these facts and the decision in the DUVAL case, the potential for successfully arguing that the structures in question are "buildings" within the meaning of A.R.S. §§ 42-1312.01 and/or 42-1409(B) are, at best, slim.

Based on the above, the department feels it has fairly and accurately established guidelines for use in determining transaction privilege and use tax liability in the development of the Palo Verde Nuclear Generating Station. We welcome legislative evaluation of the guidelines if they so choose. However, there is no need to revise the current statutory exemptions to conform to the guidelines, because the guidelines were established based upon the statutory exemptions and applicable court cases.

In like manner, the department would also be willing to assist the legislature in reviewing the myriad of exemptions granted by the tax statutes and department interpretations thereof. This would be a monumental task and I would question the results that might be obtained from such exercise versus the cost for both the legislative and executive branches. Perhaps the legislature may wish to assign members of its staff to review certain sections of the code each year to determine whether the exemptions allowed are still desired, a "sunset" approach to exemption statutes.

We also question the value of placing information regarding the audits of suppliers and contractors of the Palo Verde project in our annual

report. If under review the guidelines are found to be proper and within the current statutory provisions, I would question whether there is any legislative need for this type of information. It would be time consuming to compile the information by treating these audits separately from other audits. Suppliers and contractors do other work besides the Palo Verde project and audits would include all of their activities not just those related to Palo Verde. If this information were essential to an evaluation of the tax laws, I could see the worth, but by themselves they would reflect little as an information source to legislators.

J. ELLIOTT HIBBS
DIRECTOR

BRUCE BABBITT
GOVERNOR

Arizona Department of Revenue

CAPITOL BUILDING
1700 W. WASHINGTON
PHOENIX, ARIZONA 85007

POLICY MEMO 80T-007

October 23, 1980

TO: Administrators

FM: David P. Jankofsky
Assistant Director for Taxation

RE: Sales Tax Policies on Filing of Returns

1. Issue:

The statutes provide that sales tax returns are due and payable monthly on or before the 1st day of the 2nd month next succeeding the month in which the tax accrues (ARS 42 1322A). That same sub-section of law provided that the tax is delinquent 5 days thereafter. The issue needing resolution is: when a taxpayer files a return after the 6th of the 2nd month, does interest start accruing back to the 1st or does it begin on the 6th?

Department Policy:

The statute providing for interest (ARS 42 1322D) provides that interest shall accrue at the rate of 1% per month or fraction of a month from the time the tax was due and payable until paid. This implies that when a taxpayer fails to meet the 6th of the month deadline that interest should be calculated back to the 1st. Therefore, interest will be calculated from the 1st of one month to the 1st of the next month.

2. Issue

When is a sales tax return deemed to be received: the date on which it is post marked or the date on which it is received in the Department?

Current Department practices provide that the post-marked date is considered the date of receipt.

Department Policy:

Based upon a review of ARS 1-218, the post-marked date should be deemed the date of receipt of a sales tax document.

3. Issue

When calculating the interest, should the tax and a penalty be the base against which the interest rate is applied or should only the tax be the base against which the interest rate is applied?

Department Policy:

The interest should be calculated only upon the tax itself.

4. Issue

When an audit results in an assessment, should interest be charged on that additional tax from the date of the assessment or from the date the tax was actually due?

Department Policy:

ARS 42 1327 provides that when a deficiency is found as the result of an audit that those additional amounts should bear interest from the time the additional tax was due and payable until paid. Hence, given the fact that the additional tax was due and payable on the 1st day of the month following the month in which the tax accrued, (it was simply not discovered by the State until the audit date), interest on assessments should accrue from the date the original tax was due and not from the assessment date. (This brings up the additional fact that separate interest calculations will have to be made for each individual month's tax liability. During a normal audit this would result in 33 separate interest calculations.)

This issue also has implications for the Collections area since currently when a taxpayer is delinquent for a number of months only one interest calculation is made and applied to the "average" age of the account. Consistent with that discussed in the previous paragraph, separate interest calculations should be made for each individual month of delinquency.

5. Issue

Current Departmental practice is to not impose a penalty upon a return timely filed even if a subsequent audit discloses that a tax liability did indeed exist for the months in question.

Department Policy:

ARS 42 1327B and C provide for penalties to be assessed if any part of a deficiency is due to negligence or fraud. Hence, it seems reasonable that based upon the facts surrounding any particular return of this nature that a penalty of 0%, 10% or 25% could be imposed, upon the recommendation of the auditor, provided the Chief Auditor concurs.

Any account that the Chief Auditor believes should be assessed a 25% penalty for intent to evade or defraud, should be reviewed with the Attorney General's Office for the possibility of prosecution. If the Attorney General's Office stipulates that prosecution is not warranted or unlikely, then the Department shall proceed with assessing a 25% civil penalty.

6. Issue

When a taxpayer files under extension, does the additional time granted for filing begin on the 1st or 6th of the month?

Department Policy:

An extension of time will begin to run from the 1st of the month. Any return filed under an extension shall be due at the end of the extension period, and will be delinquent five days thereafter. For example, a taxpayer filing under a 15-day extension must have his ST-1 for January filed by March 21 to avoid the imposition of a penalty.

DPJ:dk

J. ELLIOTT HIBBS
DIRECTOR

BRUCE BABBITT
GOVERNOR

Arizona Department of Revenue

CAPITOL BUILDING
1700 W. WASHINGTON
PHOENIX, ARIZONA 85007

POLICY MEMO #81T-002

January 9, 1981

TO: Administrators
Division of Taxation

FROM: David P. Jankofsky
Assistant Director for Taxation

SUBJ: Guidelines for Penalty Abatement
(Late Filing/Late Remitting)

The following are general guidelines for abating penalties. Penalties may be imposed in certain circumstances for late filing of a tax return, for late remittance of taxes, or for under-reporting taxes.

Any taxpayer who believes he or she has good reason to object to any penalty imposed by the Department for failure to file returns timely or pay tax timely may submit a request for abatement seeking that penalty be abated. The request must be in writing and it must contain all facts and complete information alleged as reasonable cause for the taxpayer's delinquency.

The following are the proposed guidelines for recommending penalty abatements for Income and Sales Tax. Specifically, the guidelines are designated S, WH, C, I, if they apply to Sales, Withholding, Corporation Income Tax and Individual Income Tax, respectively. These examples are not all-inclusive, but offer basic guidelines:

1. Honest mistakes or errors!

   a. A first-time mathematical error on the timely filed tax form. (S, WH)

   b. A business is late the first time, according to our records, with its tax return. However, the return should not be more than 10 days late. (WH)

   c. Breakdown of mechanized account system (e.g., computer) just prior to the filing deadline. (S, WH, C, I)

2. Unexpected illness or absence of responsible authority for timely filing of tax returns. (S, WH, C, I)

   a. This includes the death of any member of the taxpayer's immediate family, or the sudden death or illness of the taxpayer's bookkeeper or practitioner.

b. Where the delay was caused by prolonged unavoidable absence of the taxpayer responsible for filing. In past situations, penalty has been waived where the taxpayer is out of the country or away on business, it does not include delay caused by vacations.

3. Weather conditions or other casualties which are causally related to late filing of tax return (S, WH, C,I)

   a. Blizzards, storms, or other Acts of God.

   b. Destruction by fire or other casualty of the taxpayer's records. The taxpayer should show that the destruction took place before the due date of the return.

4. Forms sent to another agency, when a taxpayer can provide proof (such as a copy of envelope with postmark) that tax forms were mailed to another agency such as DES or IRS. (This should be a "one time only" abatement.) (S,WH, C, I)

5. Postmark:

   When a taxpayer states he has mailed the return timely, but the Post Office did not mark the envelope on the same date; penalty may be abated if: (S, WH, C, I)

   First request - Taxpayer will prepare an affidavit stating that said return was mailed timely.

   Second request - Taxpayer will prepare an affidavit statin that return had been timely filed along with a witness affidavit stating taxpayer had filed timely.

   Third request - Taxpayer will have to go to court to get penalty abated.

6. The late filing was attributable to fraud by a person who is directly responsible for filing of tax returns for the taxpayer without the taxpayer's knowledge. (S, WH, C, I

7. Department of Revenue error:

   a. Where a taxpayer does not get a return mailed to the business or mailing address supplied by the licensee. (S, WH)

   b. The delay or failure to file a report properly was due to erroneous information given the taxpayer by an employee of the Department. (S, WH, C, I)

8. Special Rules/Considerations:

   The imposition of a 25% late remittance penalty on Withholding pursuant to 43-826 should be imposed upon chronic late remitters, e.g., where a taxpayer has been late more than once within the period of time covered by the Department's records, and where reasonable cause

for abating did not exist for both instances.

Abatement of penalty should take into account whether or not the taxpayer was following prudent business practices in his or her methods.

The following individuals have the authority to abate penalty (or, in the case of late filing of Sales Tax returns, recommend abatement to the Attorney General's Office):

- Collections Administrator - late filing/remitting for all taxes.
- Chief, Special Collections & Compliance Unit - late filing/remitting for all taxes.

DPJ:ld

APPENDIX I

MEMORANDUM FROM A DOR OFFICIAL
REGARDING IMPROVEMENTS IN
THE DOCUMENT AND REVENUE FLOW

MEMORANDUM

TO: Brian Dalton
Auditor General's Staff

December 1, 1980

FROM: Richard Milanese, Administrator
Management Services
Department of Revenue

SUBJECT: Improvement on Document and Revenue Flow

As you requested in our discussion 11/26/80, this memo summarizes the sequence of events which have occurred to improve our Department's document and revenue flow.

Prior to July 1980, the Department conducted a document processing study which found that a lack of standardization and a fragmentation of duties in the document flow process resulted in inadequate controls and excessively long processing times. New standardized procedures were developed to streamline the process and centralize the workload. Remodeling required to accommodate the centralized process was completed in late July and the new procedures were initiated.

As expected when staff is reassigned and procedures are significantly changed, initial production was low. This condition occurred at a cyclical peak workload period when your team audited the process.*

As separately noted by Paul Waddell in a memo to you, other factors which contributed to an excessively high backlog in early August included staff shortages, shifts in workload patterns due to legislatively changed due dates and the added workload of the food tax exemption program.

In the four months since installation of these procedures, the following factors have contributed to a substantially improved performance:

1. Reinstallation of a program to expedite large ($50,000 +) checks: Inadvertently discontinued in the shift to the new procedures, this was reinstituted as soon as the error was discovered.

2. Completion of staffing, fine-tuning of procedures, familiarization by staff of procedures and improved quality control which has resulted in a significant increase in production.

* **Note: Does not apply to the workload condition cited on page 17.**

3. Stabilization in Workflows: As the taxpayers' reaction to new due dates improved, so, too, has our ability to forecast workloads and temporary staffing needs. In October and November, the Withholding cycle was handled with a minimal impact on sales processing.

4. Documents are now date-stamped in and weekly reports track work in progress. By highlighting the front end workload or backlog, these have improved our responsiveness and minimized the chance for batches being bypassed.

5. Lowering the Level of Special Handling of Big Checks to $10,000: This change which doubles the number expedited will result in a further reduction in float by one day.

6. Continued Exploration of Alternatives to the Current Manual Process Including Lock Box, Electronic Register and Electronic Transfer Operations: While further study is in progress, the Department has requested funds in the 81-82 budget to implement an electronic register system similar to that used in Nebraska. This appears to have the potential of the following advantages over traditional lock box operations:

   a) Lower costs.
   b) Document balancing.
   c) Improved audit trail on documents and checks.
   d) Front end locator capabilities before data entry.
   e) Check encoding which could improve correspondent bank bids for service.
   f) Microfilming of checks.
   g) Internal versus external operations.

CC: P. Waddell

APPENDIX II

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

OCTOBER 2, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

October 2, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (0-80-45)

This is in response to a request submitted on your behalf by Gerald A. Silva in a memo dated September 24, 1980. No input was received from the Attorney General concerning this request.

FACT SITUATION:

The Department of Revenue (Department) picks up sales tax payments twice daily -- 5:30 a.m. and 4:30 p.m. It can take the Department up to ten days to process these payments and deposit them with the State Treasurer.

QUESTION PRESENTED:

Do the provisions of Arizona Revised Statutes (A.R.S.) section 42-1341.02, subsection B require the Department to deposit these payments:

1. On the same calendar day that they are collected (picked up)?

OR

2. Within 24 hours of collecting (picking up) the payments?

ANSWERS:

SEE DISCUSSION.

DISCUSSION:

A.R.S. section 42-1341.02 prescribes that:

> /T/he department shall each day remit all revenues collected pursuant to this article and articles 1.1 and 1.2 of this chapter to the state treasurer . . . .

As used in statutes, the term "day" normally means the twenty-four hour period from midnight to midnight, in other words, a calendar day. See State of Arizona ex rel. Conway v. Superior Court, 60 Ariz. 69, 131 P.2d 983 (1942); Black's Law Dictionary 357 (5th ed. 1979); 11 Words and Phrases

"day" (Supp. 1980). The term "collect" is defined to mean gathering together, assembling scattered things into one mass or fund or to receive payment. Black's Law Dictionary 238 (5th ed. 1979); Webster's Third New International Dictionary 444 (1976); 7A Words and Phrases "collect" (1952 and Supp. 1980).

An elementary rule of statutory construction is that each word of a statute will be given effect. Sutherland, Statutes and Statutory Construction section 46.06 (4th ed., Sands, 1972). State v. Superior Court for Maricopa County, 113 Ariz. 248, 550 P.2d 626 (1976).

Additionally, the words of a statute are to be given their common meaning unless it appears from the context or otherwise that a different meaning is intended. Ross v. Industrial Commission, 112 Ariz. 253, 540 P.2d 1234 (1975).

A review of A.R.S. section 42-1341.02, subsection B using the above-cited definitions and rules indicates that all revenues collected by the Department in each twenty-four hour period from midnight to midnight must be daily turned over to the State Treasurer.

However, in construing statutes, Arizona courts will attempt to give them a sensible construction which will accomplish the legislative intent and at the same time avoid an absurd result. A.R.S. section 1-211; State v. Valenzuela, 116 Ariz. 61, 567 P.2d 1190 (1977). A reasonable interpretation of A.R.S. section 42-1341.02 could find that the use of the term "collect" implies more than the mere act of receiving the money. Collect also means to put together in an orderly fashion, which presumably in this instance means recording the name of the taxpayer along with the amount and manner of payment prior to transmittal to the State Treasurer. Under this interpretation arguably the revenues collected would be those payments which are received and processed by the Department. It is understandable, especially with regard to payments picked up at 4:30 p.m., that processing and transfer to the treasurer's office would not be completed prior to midnight of that calendar day since normal office hours for state agencies would mean that work would usually cease at 5:00 p.m. (See A.R.S. section 38-401.) However, in the face of an apparent intent to require prompt processing and transfer of the monies to the treasurer the processing and transfer of payments to the treasurer's office should be completed prior to the close of the next calendar day.

You may wish to suggest corrective legislation to clarify the legislative intent with regard to processing the payments received.

cc: Gerald A. Silva
Performance Audit Manager

APPENDIX III

OCTOBER 20, 1980, MEMORANDUM
FROM A DOR OFFICIAL REGARDING
DOCUMENT PROCESSING

J. ELLIOTT HIBBS
DIRECTOR

BRUCE BABBITT
GOVERNOR

Arizona Department of Revenue

CAPITOL BUILDING
1700 W. WASHINGTON
PHOENIX, ARIZONA 85007

October 20, 1980

MEMORANDUM

TO: Brian Dalton, Auditor
Auditor General's Office

FROM: Paul Waddell, Assistant Director
Division of Administration

SUBJECT: Document Processing

In response to your inquiry made during our meeting of Wednesday October 8, 1980, I have reviewed the hiring/reorganization/reclassifying trends experienced in the Document Processing Unit and am providing the following information to you.

The Document Processing Unit was created in July 1980. It is a unit of the Revenue Control Section and is made up of twenty (20) positions. Of these twenty positions, four vacant positions required reclassification from Cashier to Clerk and subsequent advertising and recruitment. Of these four, one remains vacant and three were filled at the end of August and beginning of September. Recruitment was difficult in that these are night positions.

Another four of the twenty positions were transferred from the Taxation Division to Administration. Of these, three were new legislative allocations in the 1980-81 budget and required classification by Personnel effective July, 1980. These three positions were filled in August.

Only two employees in the Document Processing Unit are continuing to perform the function they did prior to July 1 as the 'pre-audit' unit in the Revenue Control Section. That function is serialization. The other eighteen have taken on the duties of editing all returns (sales, income, corporate, partnerships, etc.) and making necessary corrections for processing, including some decision making, which was not previously part of their function. In addition, prior work experience was limited to sales documents and did not include either the adjustment or handling of trouble documents. It had been expected that in the transfer of the function and some personnel from Taxation that the expertise of this processing would also come with the unit, this did not prove so due to promotions, resignations, etc., in that unit prior to its transfer. In actuality, only one employee from the unit in Taxation has been assigned on a limited basis to assist in training.

With reference to actual vacancies experienced in the unit, I have supplied a recap below for July, August and September.

Month	Authorized FTE	Vacant FTE
July	20	7
August	20	3
September	20	1

We have found that the use of temporaries is not a feasible alternative; because of the complexity of the task and the high turnover rate in temporary employees, a high error rate results on documents.

I have also included for your information a copy of our current organizational chart for the division.

If I may provide any additional information, please feel free to contact me.

jw

APPENDIX IV

SEPTEMBER 9, 1980, LETTER
FROM A DOR OFFICIAL REGARDING
DOCUMENT-PROCESSING WORKLOAD

J. ELLIOTT HIBBS
DIRECTOR

BRUCE BABBITT
GOVERNOR

Arizona Department of Revenue

CAPITOL BUILDING
1700 W. WASHINGTON
PHOENIX, ARIZONA 85007

September 9, 1980

Dawn R. Sinclair
Performance Audit Division
Office of the Auditor General
Legislative Services Wing
Suite 200
State Capitol
Phoenix, AZ 85007

Dear Ms. Sinclair:

I am responding to your letter of 9/2/80 because Pat Kelly, as supervisor of the Mail Room really cannot respond in regard to workloads which occur in Document Processing. Document Processing is an entirely separate section from the Mail Room and is under different supervision.

Normally we will receive between 60 and 70 percent of the sales tax returns in a one week period, the week after the required postmark date. Our practice has been to employ temporaries for such peak filing periods to handle this type of influx. In August the due date for sales tax returns changed from the 15th of August to September 1. We anticipated that a larger percentage of our taxpayers would recognize the later due date and thus planned for temporary help to bolster document processing in the last week of August and the first week of September.

In actual practice most taxpayers continued filing at the old due date and we thus had a larger than anticipated workload develop in August. We were not able to respond with temporary help fast enough to keep the count down. Since then temporary help has been brought in, and as of yesterday's target closing date of September 8, all sales tax monies received by then were deposited.

We are working with Personnel to develop a cadre of seasonal personnel who can be trained and on-call so we can respond more rapidly to the work fluctuation. In addition we will be monitoring the inflow over the next three to four months to develop revised time tables for planning for these peaks. It is anticipated that it will take that long before any kind of reliable forecast can be made on the new cycle as more and more taxpayers react to the new due dates.

In summary, while August was representative in terms of mail receipts compared to historical information, it would not have been typical if more taxpayers recognized the new due date and filed accordingly. As taxpayers recognize the opportunity to hang on to money longer, their filing practices will change.

Sincerely,

Paul Waddell
Assistant Director for Administration

jw

APPENDIX V

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

OCTOBER 7, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

October 7, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-80-46)

This is in response to a request submitted on your behalf by Gerald A. Silva in a memo dated September 24, 1980. No input was received from the attorney general concerning this request.

FACT SITUATION:

The department of revenue (department) does not provide adequate physical safeguards for sales tax returns and payments that are awaiting processing and deposit.

QUESTIONS:

1. If returns or payments within the department's possession are lost, stolen or destroyed, can the department require taxpayers to resubmit returns or payments?

2. What would be the consequences of such a loss?

ANSWERS:

1. The sales tax is a personal debt of the taxpayer which is not discharged until it is paid. Arizona Revised Statutes (A.R.S.) section 42-1331. The tax is paid, if by cash, when it is delivered to the department or an agent of the department or, if by negotiable instrument such as a check, when the drawee (bank) charges the amount of the instrument to the account of the drawer (taxpayer). If paid by check, for purposes of due dates and delinquencies the payment relates back to the date on which the check was received. General Petroleum Corp. of Cal. v. Smith, 62 Ariz. 239, 157 P.2d 356 (1945). If the loss occurs before the tax is paid, the taxpayer's debt is not discharged and the department has the duty to pursue the collection of the taxes from the taxpayer as in any other case. If the loss occurs after the tax is paid, the taxpayer's obligation has been extinguished and the department's only recourse with the taxpayer is to obtain copies of relevant administrative forms and returns.

2. The doctrine of sovereign immunity does not apply in Arizona. Stone v. Arizona Highway Commission, 93 Ariz. 384, 381 P.2d 107 (1963).

If the loss results in injury to the taxpayer, he may have a judicial remedy against the department or the responsible agent. If the state is injured it may also have a remedy against the responsible agent. In any case, a public officer is responsible only for his own misfeasance or negligence and not for that of employees or those working under him. Stone, supra.

Thus, under certain circumstances, the department or an employee of the department who causes injury to a taxpayer may be liable in tort for his negligence. In the case of a ministerial act, such as collecting tax revenues and depositing them with the state treasurer, the obligation to the general public can be narrowed to a specific duty to an individual and the duty to the individual may exist when the agency itself is an active wrongdoer or tort-feasor. State v. Superior Court of Maricopa County, 123 Ariz. 324, 599 P.2d 777 (1979); Industrial Commission v. Superior Court In and For Pima County, 5 Ariz. App. 100, 423 P.2d 375 (1967).

In addition, each agent of the department is required to execute a bond conditioned on the faithful discharge of his duties. A.R.S. section 42-1303. Such duties presumably include the safekeeping of public monies in their possession. In such a case and where no statute limits the agent's obligation, the obligation is absolute and the doctrine of strict liability applies, except perhaps for acts of God or public enemies, and the loss of funds without fault or neglect of the officer or by theft is not a defense to an action to recover the funds. Cecil v. Gila County, 71 Ariz. 320, 227 P.2d 217 (1951). It should be noted that, under A.R.S. section 38-260, the beneficiaries of bonds of department agents include the state and all persons who may be aggrieved by the wrongful act or default of the officer in his official capacity. Any person injured or aggrieved may bring an action on the bond in his own name.

There may be other legal theories, such as breach of a fiduciary duty, whereby a department agent would be held liable to the department or an injured taxpayer.

CONCLUSION:

1. If the tax has been paid in the legal sense, the department cannot require the taxpayer to pay again after a loss of the money. If the tax has not been paid, the department can require payment. In either case, the department may seek to obtain copies of returns and other administrative documents.

2. An agent who is responsible for the loss, theft or destruction of tax revenues or records may be held liable for resulting injuries under tort law, agency law or on his official bond.

cc: Gerald A. Silva
Performance Audit Manager

APPENDIX VI

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

OCTOBER 17, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

October 17, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Informal Request for Research and Statutory Interpretation (O-80-47)

This is in response to an informal request submitted on your behalf by Dawn Sinclair on October 9, 1980.

FACT SITUATION:

Arizona Revised Statutes (A.R.S.) provide confidentiality for sales tax information. A.R.S. section 42-1307, subsection A, states:

> A. Unless required by judicial order or required pursuant to section 42-1451 for joint auditing functions or as otherwise provided by this article, the department, its agents, clerks or stenographers shall not divulge the gross income, gross proceeds of sales or the amount of tax paid by any person as shown by the reports filed as required by this article, except to employees of the department for the purpose of checking, comparing and correcting returns, . . .

Lockbox services for processing sales tax payments are available from a number of local banks. Under a lockbox arrangement the bank rents a post office box in the customer's name. Payments are picked up, opened, processed and deposited by bank personnel. The customer defines what type of payments may be accepted, the extent of processing by the bank, and the means by which data is to be recorded and reported.

The bank can review the return to ensure the amount due reported on the return agrees with the amount of the check and note any differences. The documents are returned to the customer for internal control purposes. Services can include further review of documents, such as verification of mathematical accuracy and determination that all applicable portions of the return have been completed. Data from the returns can be captured on tape or disc. The customer may elect to perform any of these functions, including processing of returns and checks which are not in agreement, review subsequent to the agreement process and electronic capture, on an in-house basis. The bank deposits the monies directly into the customer's account and provides the customer with a report detailing the number and dollar value of payments received, processed and deposited.

Payments received in the Tucson office of the department of revenue (department) are deposited in an account in the state treasurer's name at the state's servicing bank.

QUESTIONS PRESENTED:

1. Can the department utilize lockbox services for processing sales tax payments by making the bank an agent, subject to the confidentiality provisions of A.R.S. section 42-1307?

2. To what extent can lockbox services be used? Specifically, what services may be purchased and what must be performed in-house, based on the provisions of A.R.S. section 42-1307?

ANSWERS:

A.R.S. section 42-104, as amended by Laws 1980, second special session, chapter 8, section 37, sets forth the general powers and duties of the department and provides, in relevant part, that the department shall:

> 1. Formulate policies, plans and programs to effectuate the missions and purposes of the department.
> 2. Employ personnel subject to the provisions of title 41, chapter 4, articles 5 and 6, determine the conditions of employment and prescribe the duties and powers of administrative, professional, technical, secretarial, clerical and other personnel as may be necessary in the performance of its duties, and contract for the services of outside advisors, consultants and aid as may be reasonably necessary.
> 3. Make contracts and incur obligations within the general scope of its activities and operations subject to the availability of its funds.
>
> * * *
>
> 6. Provide information and advice within the scope of its duties subject to the laws on confidentiality of information and departmental rules and regulations adopted pursuant to such laws.
>
> * * *
>
> 9. Promulgate such rules and regulations as required by federal or state laws or regulations or as the department deems necessary to protect confidential information. No names or other information of any taxpayer, claimant or employer shall be made available for any political, commercial or other unofficial purpose except that the department shall, upon request of any person, provide the names and addresses of bingo licensees as defined in section 5-401 or 5-421 or verify whether or not a purchaser has a privilege tax license or state withholding tax number.
> 10. Provide an integrated, coordinated and uniform system of tax administration and revenue collection for the state.

In addition, A.R.S. section 42-1303, which relates to the administration of the sales tax provisions, states that:

> C. The department shall appoint, as necessary, such agents, clerks and stenographers authorized by law, who shall perform such duties as may be required not inconsistent with this article, and who shall be authorized to act for the department as it prescribes and as provided by this article. . . .

The above sections authorize the department to appoint a bank as its agent and to contract with a bank for its lockbox services for processing sales tax payments. The bank, as an agent of the department, would be subject to the confidentiality provisions of A.R.S. section 42-1307.

1. A.R.S. sections 42-104 and 42-1303 grant the department broad authority to contract for services as may be reasonably necessary in the performance of its duties. There are no apparent services which would have to be performed within the department by its own personnel.

However, the facts indicate that data from the sales tax returns can be captured on tape or disc. Although the department could contract with a bank to provide that service, A.R.S. section 42-1307, subsection A would probably confine the bank to using its own employees and facilities to perform the service. Any use of another company or sub-agent by the bank to provide that service would be divulging the gross proceeds of sales and the amount of tax paid in violation of A.R.S. section 42-1307.

CONCLUSIONS:

1. The department of revenue may appoint a bank as its agent and contract with it for its lockbox services for processing sales tax payments. The bank would be subject to the confidentiality provisions of A.R.S. section 42-1307.

2. The department of revenue may contract for all services as may be necessary in the performance of its duties.

RECOMMENDATIONS:

1. A.R.S. section 42-1303, subsection C, which authorizes the department to appoint agents, states that:

> Each agent shall execute a bond in the amount of five thousand dollars conditioned upon the faithful discharge of his duties, but the department may, in its discretion, bond all or any of its agents by a multiple or joint bond. The agents, clerks and stenographers may be removed by the department for cause and the department shall be the final judge of the sufficiency of the cause.

The requirement of execution of a $5,000 bond and the possibility of removal for cause by the department of revenue seem inadequate to impress upon an agent its duty to comply with A.R.S. section 42-1307 by maintaining the confidentiality of the sales tax returns and payments presented to it for processing. You may wish to recommend that the statutes be amended to provide that a person who violates the provisions of A.R.S. section 42-1307 is guilty of a crime.

2. If you recommend that the department of revenue utilize lockbox services for processing sales tax payments, you may also wish to recommend that the statutes be amended to provide safeguards, similar to those provided for federal income tax returns, for maintaining the confidentiality of the information supplied on sales tax returns and the amount of tax paid. See Internal Revenue Code (I.R.C.) section 6103 (p), paragraphs 4 through 6.

cc: Gerald A. Silva
Performance Audit Manager

APPENDIX VII

DECEMBER 15, 1980, MEMORANDUM
FROM THE DIRECTOR OF THE
DEPARTMENT OF REVENUE
REGARDING IMPROVEMENTS IN THE
SALES TAX AUDIT PROGRAM

M E M O R A N D U M

TO: Brian Dalton 12/15/80
Auditor General's Staff

FROM: J. E. Hibbs, Director JEH
Department of Revenue

SUBJECT: Sales Tax Audit Progress

The following summarizes the key changes we have made in the last year in Sales Tax Auditing:

1. A comprehensive training program for new auditors was initiated covering such subjects as law, audit techniques and policy and procedures.

2. A management information system was implemented to measure, classify and monitor audits.

3. Last month an audit selection unit was created which is developing methods for random and cost effective audit selection.

4. Last month a separate audit review unit was created to provide independent quality control on audits.

5. We have initiated a procedure to issue "tax rulings" on topics which need clarification. These will establish and/or delineate the Department's official position on various issues.

aw

APPENDIX VIII

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

DECEMBER 5, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

December 5, 1980

TO: Douglas R. Norton, Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-80-61)

This is a revision to an Arizona Legislative Council Memorandum dated November 28, 1980 in response to a request submitted by Mr. Randy Gross in a telephone conversation on December 3, 1980.

FACT SITUATION:

Until recently, the audit division of the department of revenue (department) did not consistently impose statutorily required interest and penalty assessments on taxpayers who owed additional taxes.

QUESTIONS PRESENTED:

1. Can the department assess and collect the interest and penalty it failed to impose on taxpayers who owed additional taxes?

2. If yes, are there any statutory restrictions on the imposition of such interest and penalty and which of the following is the proper time frame for calculating such interest on additional taxes owed:

(a) The original filing date to the date the taxpayer was notified by the department of the additional taxes due.

(b) The original filing date to the date the department notifies the taxpayer of the interest due?

ANSWERS:

1. Yes.

2. See discussion.

DISCUSSION:

1. Arizona Revised Statutes (A.R.S.) sections 42-1331 and 42-1418 state that the sales and use tax and all increases, interest and penalties on those taxes are a personal debt of the taxpayer to the state. At the request of the director of the department, both types of taxes and the increases, interest and penalty on the taxes may be collected in the superior court in an action instituted in the name of the state by the attorney general.

There is a three year limitation allowed for the tax assessment on the sales and use tax.

A.R.S. section 42-1327, subsections E and F provide in pertinent part:

* * *

> E. Except in the case of a fraudulent return, failure or refusal to make a return, every notice of a determination of an additional amount due shall be mailed within three years after the fifteenth day of the calendar month following the period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later.
>
> F. If the taxpayer makes an error in computing the tax assessable against him, the department shall correct the error or reassess the proper amount of taxes and notify the taxpayer of its action by promptly mailing to him a copy of the corrected assessment .... /N/o correction, assessment or reassessment shall be made for any month ... after the expiration of three years from the date upon which the taxpayer was obligated to file his return for such month under this article .... If a taxpayer fraudulently fails or refuses to file a return for any month, the department may assess the amount of taxes payable for that month at any time, or the department may cause an audit to be made of the taxpayer's records covering any period of time not specifically exempted by this section ....

* * *

Similarly, A.R.S. section 42-1414, subsection F provides:

> F. Except in the case of a fraudulent return or the case of a failure or refusal to make a return, every notice of a determination of an additional amount due shall be mailed within three years after the fifteenth day of the calendar month following the period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later.

See also, A.C.R.R. R-15-5-2236 and R-15-5-2426, a copy of which is enclosed.

The purpose of a statute of limitations is primarily to protect the defendant and the court from the litigation of stale claims where evidence may have been lost or witnesses' memories may have faded. Brooks v. Southern Pacific Company, 466 P. 2d 736, 105 Ariz. 442 (1970).

In this case, although A.R.S. sections 42-1327 and 42-1414 do not specifically state that the statute of limitations applies to interest and penalty, logic dictates that the notice of the "additional amount due" required by these sections include a notice of the interest and penalty due and owing for the deficiency determined by the department. Thus if the department, through neglect or mistake, fails to notify the taxpayer of any interest and penalty due, it would be patently unfair for the department to attempt to assess interest and penalty after the three year period on a deficiency which has already

been paid. However, since interest and penalty owed is a personal debt of the taxpayer, within the three year statute of limitations period, the department may properly assess and collect the interest and penalty on additional taxes owed and paid by the taxpayer. (For a discussion of when the statute of limitations on audit assessments begins to run, see "Arizona Legislative Council Memorandum" (O-80-22).)

2. There are additional statutory restrictions on the imposition of interest other than the statute of limitations restriction. Additional sales and use taxes bear interest "from the time the additional tax was due and payable until paid." A.R.S. section 42-1327, subsection A. Additional use taxes bear interest "from the date on which such amounts were required to be reported until paid." A.R.S. section 42-1414, subsection C. As stated in an Arizona Legislative Council Memorandum (O-80-22), the purpose of the imposition of interest is to prevent a taxpayer from the free use of what is rightly the state's monies.

For this reason and because of the requirements of A.R.S. sections 42-1327 and 42-1414, interest should only be imposed on those deficiencies which are due and payable until paid. Therefore, if the department attempts to assess interest on a deficiency which has already been paid, the interest should be calculated from the time of the original filing date to the date when the taxpayer actually paid the additional tax due. Computing the interest due from the date of the original filing to the date the department notifies the taxpayer of the interest due would penalize the taxpayer for the neglect or mistake of the department.

CONCLUSION:

1. The department may assess and collect the interest and penalty it failed to impose on taxpayers who owed additional taxes, subject to the three year limitation on tax assessments for sales and use taxes.

2. Interest should be assessed on the amount of taxes due and owing from the original filing date to the date when the taxes were paid.

cc: Gerald A. Silva
Performance Audit Manager

Encl.

APPENDIX IX

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

AUGUST 15, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

August 15, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-80-26)

This is in response to a request submitted on your behalf in a memo by Gerald A. Silva.

QUESTIONS PRESENTED:

1. Is the department of revenue (department) required to issue a decision allowing or disallowing a taxpayer's sales or use tax protest within a certain period of time? If the protest goes to an administrative hearing, is the hearing officer required to issue his decision within a certain period of time?

2. Is the department required to keep records of tax appeals decisions? In any particular place or form? Are records of these decisions required to be available to the public?

3. Do the statutes define what type of actions are appropriate for administrative hearings?

ANSWERS:

1. The statutes provide the following procedures for appealing or contesting sales and use taxes and associated charges. If a taxpayer feels that an amount determined to be due from him is incorrect in any way, he may apply to the department within 30 days of the assessment for a hearing, correction or redetermination. The department may extend the 30-day period. The department is required to "promptly consider" the application and grant a hearing if requested. If the appeal is not brought within 30 days or the extended period allowed by the department, the right to appeal is deemed waived regarding the amount due. The order or decision of the department on appeal is final 30 days after the taxpayer receives notice unless the taxpayer appeals to the state board of tax appeals. Arizona Revised Statutes (A.R.S.) sections 42-1338 and 42-1415.

If the taxpayer is not satisfied with the department's determination on appeal, he may, within 30 days of the decision, appeal to the state board of tax appeals. After the state board's decision, the taxpayer must pay whatever tax, penalties and interest are determined to be due. If he is still not satisfied, he must pay under protest in contemplation of a further challenge in superior court. A.R.S. sections 42-1338.01 and 42-1415.01.

A taxpayer may get into superior court only after paying the tax under protest. He need not appeal through the department and state board prior to filing an action in superior court. Any appeal from the superior court is in the same manner as other civil appeals. A.R.S. section 42-1339; J.H. Welsh & Son Contracting Co. v. Arizona State Tax Commission, 102 Ariz. 443, 432 P.2d 455 (1967).

The only statutory provisions relating to the time in which the department must rule on appeals are A.R.S. section 42-1338, subsection A and section 42-1415, subsection A which require that, after the appeal is received, "the department shall promptly consider the petition and shall grant a hearing, if requested." It may be argued that this is a requirement for the department to promptly take up the matter but does not relate to the speed of disposing of the matter. The statutes do not specifically prescribe any time limit for making a decision on appeals.

Nevertheless, a requirement for reasonable promptness in resolving the appeal may be implied from the nature of the appeal and hearing before the department. The legislature in writing and adopting this statute intended it to facilitate the collection of taxes due or to determine that taxes were not due. The legislature did not contemplate unreasonable or arbitrary delay in resolution. For such to occur would be an interference with personal and property rights and would inhibit the further appellate relief afforded by other statutes. To inhibit or delay these further hearings is a denial of due process of law under the United States Constitution. Due process requires both a prompt hearing and a prompt conclusion. Barry v. Barchi, 443 U.S. 55 (1979); Fusari v. Steinberg, 419 U.S. 379 (1975); Storer Broadcasting Co. v. U.S., 220 F.2d 204 (D.C. 1955), rev'd on other grounds 351 U.S. 192 (1955); Atlantic Greyhound Corp. v. Public Service Comm., 54 S.E.2d 169 (W. Va. 1949). There is little conceivable state interest in delaying the decision on an appeal of sales or use taxes. On the contrary, it would be in the interest of both the state and the taxpayer to provide for a timely and reasonably prompt resolution of the matter in order to either collect the tax or move the action on to the next forum. Moreover, if due process is not afforded by the hearing and appeal, the whole proceeding may be void. Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1949). Therefore, in order to be valid, the department must resolve its appeals without arbitrary, unreasonable or discriminatory delays. You may wish to recommend that A.R.S. sections 42-1338 and 42-1415 be amended to specifically incorporate a time limit for a decision. The due process requirements, however, apply without any amendment.

2. The general law on administrative hearing procedures is the administrative procedure act. A.R.S. title 41, chapter 6. The administrative procedure act applies to the department of revenue unless it is in conflict with statutes relating specifically to the department. Arizona State Tax Commission v. Phelps Dodge Corp., 116 Ariz. 175, 568 P.2d 1073 (1977), cert. den. 434 U.S. 1047; Didlo v. Talley, 21 Ariz. App. 446, 520 P.2d 540 (1974). The administrative procedure act applies in three broad areas: rule making, contested cases and licensing. A sales or use tax

protest or appeal would probably be considered a contested case, since it is a "proceeding . . . in which the legal . . . duties . . . of a party are required by law to be determined by an agency after an opportunity for hearing." A.R.S. section 41-1001, paragraph 2. A sales or use tax protest or appeal would become a contested case if a hearing is requested under section 42-1338, subsection A or section 42-1415, subsection A. Once the proceeding becomes a contested case, the administrative procedure act applies to prescribe the rules and procedures for the hearing, there being no procedural statutes specifically applicable to sales and use tax appeals. The rules and procedures are prescribed by A.R.S. sections 41-1009, 41-1010 and 41-1011 which are reproduced in their entirety in Appendix A.

Decisions or orders of the department after a hearing are to be in writing or stated in the record of the hearing and include findings of fact and conclusions of law, separately stated. A.R.S. section 41-1011. Otherwise there is no statutory requirement relating to the decision's content, form, storage or access. The decision could be considered a public record which would be available for inspection by any person under A.R.S. section 39-121. The supreme court of Arizona has described a public record as one:

> /M/ade by a public officer in pursuance of a duty, the immediate purpose of which is to disseminate information to the public, or to serve as a memorial of official transactions for public reference. or
>
> /R/equired by law to be kept, or necessary to be kept in the discharge of a duty imposed by law to serve as a memorial and evidence of something written, said or done. (Mathews v. Pyle, 75 Ariz. 76, 251 P.2d 893 (1952).)

A decision in a tax appeal could be deemed a record made by a public officer in pursuance of a duty, the immediate purpose of which is to serve as a memorial of official transactions for public reference or necessary to be kept in the discharge of a duty imposed by law to serve as a memorial and evidence of something done.

On the other hand, the department is specifically constrained by statute from divulging certain information. A.R.S. section 42-1307 provides:

> A. Unless required by judicial order or required pursuant to section 42-1451 for joint auditing functions or as othewise provided by this article, the department, its agents, clerks or stenographers shall not divulge the gross income, gross proceeds of sales or the amount of tax paid by any person as shown by the reports filed as required by this article, except to employees of the department for the purpose of checking, comparing and correcting returns, to the auditor general for purposes of section 41-1279.03 or to the governor, the attorney general or other authorized representative of the

state, in any action pertaining to the tax due under this article.

B. The department shall not disclose any information in any manner authorized by subsection A of this section if such disclosure would violate section 6103 of the United States Internal Revenue Code of 1954, as amended.

C. The auditor general shall maintain the confidentiality of any information he receives under this section, subject to the penalty prescribed by section 41-1279.05.

A.R.S. section 42-1406 is an essentially similar provision relating to the use tax. It should be noted that this prohibition on disclosure relates only to the department, not to the state board of tax appeals nor to the superior court. If a taxpayer appeals to either of those forums, he loses any protection afforded by these confidentiality statutes.

Because of the specific prohibition on divulging the amount of gross income, gross proceeds of sales or the amount of tax required under the sales and use tax laws, we must conclude that the appeal records and decisions of the department are closed to public access unless the decision contains only material not protected as confidential or unless access is permitted under the specific conditions of the statute.

We note the paradox that the appeal is public under the administrative procedure act but the records resulting from the appeal may be confidential. You may wish to suggest reconciling legislation.

3. Hearings are authorized by sales and use tax statutes in the following instances:

a. If a person fails to file a sales tax return, the department may conduct an investigation to obtain the information necessary to determine the tax due. When the department obtains the information, it must hold a public hearing to ascertain the amount of tax payable. A.R.S. section 42-1333. Note that this hearing is designated a "public" hearing and presumably outside the application of the confidentiality statute as discussed under question number 2.

b. If a person is assessed with a deficiency of either sales or use tax, he may appeal the assessment to the department and request a hearing, as described under question number 1. A.R.S. sections 42-1338 and 42-1415.

There is no other statutory provision for a hearing under the sales and use tax laws.

cc: Gerald A. Silva
Performance Audit Manager

41-1009. Contested cases; notice; hearing; records

A. In a contested case, all parties shall be afforded an opportunity for hearing after reasonable notice. Unless otherwise provided by law, the notice shall be given at least twenty days prior to the date set for the hearing.

B. The notice shall include:

1. A statement of the time, place and nature of the hearing.

2. A statement of the legal authority and jurisdiction under which the hearing is to be held.

3. A reference to the particular sections of the statutes and rules involved.

4. A short and plain statement of the matters asserted. If the agency or other party is unable to state the matters in detail at the time the notice is served, the initial notice may be limited to a statement of the issues involved. Thereafter upon application a more definite and detailed statement shall be furnished.

C. Opportunity shall be afforded all parties to respond and present evidence and argument on all issues involved.

D. Unless precluded by law, and except as to claims for compensation and benefits under chapter 6 of title 23, informal disposition may be made of any contested case by stipulation, agreed settlement, consent order or default.

E. The record in a contested case shall include:

1. All pleadings, motions, interlocutory rulings.

2. Evidence received or considered.

3. A statement of matters officially noticed.

4. Objections and offers of proof and rulings thereon.

5. Proposed findings and exceptions.

6. Any decision, opinion or report by the officer presiding at the hearing.

7. All staff memoranda, other than privileged communications, or data submitted to the hearing officer or members of the agency in connection with their consideration of the case.

F. Oral proceedings or any part thereof shall be recorded manually or by a recording device and shall be transcribed on request of any party, unless otherwise provided by law. The cost of such transcript shall be paid by the party making the request, unless otherwise provided by law or unless assessment of the cost is waived by the agency.

G. Findings of fact shall be based exclusively on the evidence and on matters officially noticed.

41-1010. Hearings; evidence; official notice; power to require testimony and records; rehearing

A. Unless otherwise provided by law, in contested cases the following shall apply:

1. A hearing may be conducted in an informal manner and without adherence to the rules of evidence required in judicial proceedings. Neither the manner of conducting the hearing nor the failure to adhere to the rules of evidence required in judicial proceedings shall be grounds for reversing any administrative decision or order providing the evidence supporting such decision or order is substantial, reliable, and probative. Irrelevant, immaterial or unduly repetitious evidence shall be excluded. Every person who is a party to such proceedings shall have the right to be represented by counsel, to submit evidence in open hearing and shall have the right of cross-examination. Unless otherwise provided by law, hearings may be held at any place determined by the agency.

2. Copies of documentary evidence may be received in the discretion of the presiding officer. Upon request, parties shall be given an opportunity to compare the copy with the original.

3. Notice may be taken of judicially cognizable facts. In addition, notice may be taken of generally recognized technical or scientific facts within the agency's specialized knowledge. Parties shall be notified either before or during the hearing or by reference in preliminary reports or otherwise of the material noticed including any staff memoranda or data and they shall be afforded an opportunity to contest the material so noticed. The agency's experience, technical competence and specialized knowledge may be utilized in the evaluation of the evidence.

4. The officer presiding at the hearing may cause to be issued subpoenas for the attendance of witnesses and for the production of books, records, documents and other evidence and shall have the power to administer oaths. Unless otherwise provided by law or agency rule, subpoenas so issued shall be served and, upon application to the court by a party or the agency, enforced in the manner provided by law for the service

and enforcement of subpoenas in a civil action. On application of a party or the agency and for use as evidence, the officer presiding at the hearing may permit a deposition to be taken, in the manner and upon the terms designated by him, of a witness who cannot be subpoenaed or is unable to attend the hearing. All provisions of law compelling a person under subpoena to testify are applicable. Fees for attendance as a witness shall be the same as for a witness in the superior courts of the state of Arizona, unless otherwise provided by law or agency rule.

B. Except when good cause exists otherwise, the agency shall provide an opportunity for a rehearing or review of the decision of an agency before such decision becomes final. Such rehearing or review shall be governed by agency rule drawn as closely as practicable from rule 59, Arizona rules of civil procedure, relating to new trial in superior court.

41-1011. Decisions and orders

Unless otherwise provided by law, any final decision or order adverse to a party in a contested case shall be in writing or stated in the record. Any final decision shall include findings of fact and conclusions of law, separately stated. Findings of fact, if set forth in statutory language, shall be accompanied by a concise and explicit statement of the underlying facts supporting the findings. Unless otherwise provided by law, parties shall be notified either personally or by mail to their last known address of any decision or order. Upon request a copy of the decision or order shall be delivered or mailed forthwith to each party and to his attorney of record.

APPENDIX X

DECEMBER 15, 1980, MEMORANDUM
FROM THE DIRECTOR OF THE
DEPARTMENT OF REVENUE
REGARDING IMPROVEMENTS IN THE
ADMINISTRATIVE HEARING PROCESS

M E M O R A N D U M

TO: Brian Dalton
Auditor General's Staff

12/15/80

FROM: J. E. Hibbs, Director
Department of Revenue

SUBJECT: Improvements in the Administrative Hearing Process

As you requested, this memo summarizes the efforts we have made to improve the Department's Hearing Process.

In October of 1979 an analysis was made of the Hearing Unit for the Interim Director. That analysis highlighted a number of problems which had to be corrected. In January, 1980 I, as the new Director, authorized a follow-up study to determine how to correct the process and improve its operations. As a result of those studies, the following actions were taken:

1. A temporary hearing officer was hired during the balance of FY 79/80 to help reduce the backlog of cases.

2. A permanent second hearing officer position was requested and approved in the FY 80/81 budget, and the position was filled. In doubling our staff, we materially increased our ability to respond to appeals.

3. A full-time hearing office secretary position was created and staffed. This position assumed the clerical duties which previously were a part-time additional duty of the director's secretary, who was not able to keep up with the work load.

4. The Hearing offices were remodeled to provide a better set of facilities, removed from the other distracting traffic of the Director's office. In addition to improving the Hearing office work environment, this move was designed to promote the image of independence of the Hearing office.

5. Procedures were written to both clean up the existing cases and provide a systematic process for the entire hearing activity. A review of existing cases was initiated to

    a) Clear completed hearings from the active case files.

    b) Schedule and complete decisions and hearings for older cases.

    c) Break the log jam for cases.

    d) Assign docket numbers to all cases.

The new procedures were designed to provide a systematic standardized process to expedite hearings through the system and to reduce the number of protests which ultimately go to litigation.

Since then, all cases have been catalogued, tickler files have been established, and most of the older cases have been cleared from the system. Additional clerical work is in progress to complete the system organization and reports will be generated to track what is happening. These reports will track the performance of the unit and be a tool to alert the Director as to the condition of the hearing process. In addition, they are designed to highlight cases which are getting old and will serve as a vehicle to cause corrective action before backlogs or delays get out of hand.

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APPENDIX XI

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

NOVEMBER 28, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

November 28, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-80-60)

This is in response to a request submitted on your behalf by Gerald A. Silva in a memo dated November 20, 1980. No input was received from the Attorney General concerning this request.

FACT SITUATION:

Arizona Revised Statutes (A.R.S.) section 42-1322, subsection D states:

> Any taxpayer who fails to pay such tax /transaction privilege tax/ within five days from the date upon which the payment becomes due shall be subject to and shall pay a penalty of ten per cent of the amount of the tax, plus interest at the rate of one-half of one per cent per month or fraction of a month from the time the tax was due and payable until paid.

(A.R.S.) section 42-1327, subsection B states:

> If any part of the deficiency for which a determination of an additional amount due is made is found to be due to negligence or intentional disregard of this article or authorized rules and regulations of the department /of revenue/, but without intent to defraud, a penalty of ten per cent of such amount shall be added, plus interest at the rate of one-half of one per cent per month or fraction of a month from the time the additional tax was due and payable until paid.

(A.R.S.) section 42-1327, subsection C states:

> If any part of the deficiency for which a determination of or additional amount due is made, is found to be due to fraud, or to have been done with an intent to evade this article, or authorized rules and regulations of the department, a penalty of twenty-five per cent of such amount shall be added, plus interest at the rate of one-half of one per cent per month or fraction of a month from the time the additional tax was due and payable until paid.

The department charges penalties of 0%, 10% and 25% for taxpayers which are determined to owe additional taxes as a result of an audit. A 25% penalty is charged if the department, with the concurrence of the attorney general, finds the taxpayer was fraudulent.

A 10% penalty is levied if: (a) the taxpayer did not file a return, or (b) the chief of the audit division feels the imposition of a penalty is appropriate.

No penalty is levied if the chief of the audit division feels that the taxpayer did not try to deceive the department when filing the return.

The department has not developed written guidelines governing the implementation of the above policies.

QUESTIONS PRESENTED:

1. Is the department's policy regarding penalty assessment in compliance with Arizona statutes?

2. Is it proper for the department to not charge a penalty when taxpayers are determined to owe additional taxes as a result of an audit?

3. Are A.R.S. section 42-1322, subsection D and A.R.S. section 42-1327, subsections B and C in conflict with each other regarding the imposition of penalties?

ANSWERS:

1. The 25% penalty for deficient taxes is authorized if the deficiency was due to (a) fraud or (b) "an intent to evade this article". A.R.S. section 42-1327, subsection C. The department's practice of charging the 25% penalty in instances of fraud is clearly within the statutory provision. The practice of obtaining the attorney general's concurrence is probably within the department's discretion. However, the department as outlined in the stated facts, does not impose the 25% penalty in the case of an intent to evade. This requirement is somewhat vague, especially when compared with the 10% penalty imposed for an "intentional disregard of this article". Nevertheless, we feel that a valid distinction may be drawn between an intent to evade and an intentional disregard. An example of the former might be a person who conceals the fact of his doing business in order to escape the imposition of the sales tax. An example of the latter is a person who simply delays filing his return and paying the tax because of critical business circumstances. Although the distinctions may be obscure, the department should attempt to meet the legislative mandate of collecting a 25% penalty for intent to evade, rather than ignore the mandate.

The 10% penalty should be collected if the delinquency was due to (a) negligence or (b) "intentional disregard of this article", A.R.S. section 42-1327, subsection B, or (c) any instance where the taxpayer fails to pay within five days of the due date not otherwise specifically provided for, A.R.S. section 42-1322, subsection D.

The instances stated as the department's criteria do not meet the statutory requirements. Negligence refers to the taxpayer's state of mind when he incurred the deficiency. Negligence may be identified by well-settled legal analysis. It is characterized by inadvertence, thoughtlessness, inattention and the like. The doctrine of negligence rests on the duty of every person to exercise reasonable care in his affairs, including the filing of tax returns and paying taxes. Negligence is routinely distinguished from other culpable states of mind such as recklessness or wilfulness. An intentional disregard of the sales tax is another standard state of mind. As discussed above, an intentional disregard may be confused with an intent to evade, but that fact does not

vitiate the requirement for the department to tailor its practices to the statutory mandates.

According to the stated facts, the department collects the 10% penalty if (a) the taxpayer did not file a return or (b) the chief of the audit division feels the imposition of a penalty is appropriate. The former instance is so broad that it could include cases which should properly be subject to a 25% penalty. In order to comply with the statute, the department's first criterion for a 10% penalty should exclude those circumstances. The department's second criterion is likewise inappropriate as seemingly permitting an abuse of administrative authority through arbitrary and capricious rulings which should instead be determined on the basis of promulgated rules.

The department's criterion for no penalty again is a substitution of the department's standards for the statutory standards. The department's practice is invalid on at least three points: (a) As stated in the facts, too much discretion is given to the chief of the audit division. There should at least be a requirement of evidence upon which to make an objective finding. (b) The practice does not recognize the statutory requirements that, if the deficiency was fraudulent or due to an intent to evade, a 25% penalty must be imposed or, if the deficiency was due to negligence or intentional disregard, a 10% penalty must be imposed. Stated another way, the department's practice is that the taxpayer escapes a penalty unless the chief feels that the taxpayer intentionally deceived the department. This does not follow the statutory mandate in any respect. (c) The criterion does not recognize the "residual" provision of A.R.S. section 42-1322, subsection D that any taxpayer who fails to pay the tax within five days of becoming due is subject to and shall pay a 10% penalty.

2. A.R.S. section 42-1327 prescribes the penalties which apply specifically to deficiencies determined by audits. There may be instances when a deficiency is determined by audit to result from causes other than fraud, an intent to evade, negligence or an intentional disregard. Nevertheless, A.R.S. section 42-1322, subsection D prescribes a 10% penalty in terms of strict liability, regardless of the taxpayer's state of mind and regardless of whether or not the deficiency was determined as a result of an audit.

An argument may be advanced that A.R.S. section 42-1322, subsection D merely states the general principle that penalties should be imposed if the taxes are not paid and that A.R.S. section 42-1327, subsections B and C prescribe the only specific circumstances in which the penalties should be collected. However, the department's practices, as stated in the facts, belie a reliance on this analysis as they do not follow the specific mandates of A.R.S. section 42-1327, subsections B and C.

It is our conclusion, therefore, that if taxes are in fact due and are not in fact paid within five days thereafter a penalty is imposed by statute and should be collected by the department.

3. As the preceding analysis shows, A.R.S. section 42-1322, subsection D and section 42-1327, subsections B and C are extremely confusing when read together. For this reason, a court might find the current general administrative practice of the department (as distinct from specific provisions) to be a reasonable interpretation of legislative intent. In cases of statutory ambiguity, a history of regulatory practice is persuasive of its validity. Swift & Company v. State Tax Commission, 10 Ariz. App. 10, 455 P. 2d 459, vacated on other grounds, 105 Ariz. 226, 462 P. 2d 775 (1969); City of Mesa v. Killingsworth, 96 Ariz. 290, 394 P. 2d 410 (1964).

It is possible, however, to analyze the language and the apparent intent of the cited statutes so as to avoid direct conflict among them. A penalty of 10% applies in all cases where a tax is due but unpaid within five days. A.R.S. section 42-1322, subsection D. In the case of an audit which discloses a deficiency due to the taxpayer's negligence or an intentional disregard of the statutes, the prescribed penalty is still 10%. A.R.S. section 42-1327, subsection B. However, if an audit discloses a deficiency due to fraud or an intent to evade the statutes, the penalty is 25%. A.R.S. section 42-1327, subsection C.

CONCLUSION:

The department's practices as stated in the fact situation do not comply with the statutes in all respects. If a tax is in fact due and not timely paid, a penalty should be assessed and collected. Nevertheless, the department's long-standing practice and interpretation may be accorded validity as a manifestation of the legislature's intent. Although the sales tax penalty statutes are confusing, they do not specifically contradict each other.

RECOMMENDATIONS:

In order to clarify the legislature's intentions and provide the department with meaningful guidance, the sales tax penalty statutes should be consolidated into a single section to correct the problems addressed in this and prior memoranda, including: (a) the instances in which a penalty applies (b) the criteria by which the severity of penalty is determined and (c) a reasonable penalty to serve the state's interest according to the severity of the violation.

cc: Gerald A. Silva
Performance Audit Manager

APPENDIX XII

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

AUGUST 15, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

August 15, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-80-22)

This is in response to a request submitted on your behalf in a memo by Gerald A. Silva.

QUESTIONS PRESENTED:

1. Are there any statutory guidelines concerning when sales and use tax penalties or interest should be imposed?

2. When can such penalties or interest be abated?

3. When should interest be charged?

4. When does the statute of limitations on audit assessments begin running?

5. Can the department of revenue (department) extend the thirty-day protest period?

6. Can the department defer audit assessments?

7. How far back can the department conduct an audit of a taxpayer who is suspected of operating without a sales tax or use tax license?

8. Can the department seize and auction off a taxpayer's liquor license for nonpayment of sales or use taxes?

9. May the department suspend the accrual of interest on delinquent sales taxes while the assessment of the taxes is on appeal?

10. If an assessment of delinquent sales taxes includes taxes which became due on different dates, how should interest be charged?

ANSWERS:

It should be pointed out initially that the department and its director have rather broad statutory authority to formulate policies, plans and programs and to make rules and regulations which are necessary to effectuate the missions and purposes of and effectively administer the department. Arizona Revised Statutes (A.R.S.) section 42-104, paragraph 1 and section 42-105, paragraph 1. In addition, as a general rule, courts will give validity to regulations of long standing, if not manifestly erroneous, as being an indication of legislative intent. In cases of clear conflict, statutory language is controlling, but in cases of ambiguity, a history of regulatory practice is persuasive of validity. Swift & Company v. State Tax Commission, 10 Ariz. App. 10, 455 P.2d 459, vacated on other

grounds, 105 Ariz. 226, 462 P.2d 775 (1969); City of Mesa v. Killingsworth, 96 Ariz. 290, 394 P.2d 410 (1964); Long v. Dick, 87 Ariz. 25, 347 P.2d 581 (1959); Koshland v. Helvering, 298 U.S. 441, 56 S.Ct. 767, 80 L. Ed. 1268 (1936). Thus, if a departmental practice is not authorized by statute, it may nevertheless be deemed valid if it is not in conflict with a statute. In such cases you may wish to suggest legislative confirmation of the practices by statutory enactment.

The department is aware of ambiguities in statute and discrepancies between statute and practice. One of the recommendations in their 1978-79 annual report was for the legislature to "provide clear statutory guidelines on: 1) imposition and waiver of penalty; 2) imposition of interest; 3) the validity of and causes for extensions of time to file a return and pay the tax." No legislative action was taken.

1. Unpaid sales and use taxes bear interest "from the time the tax was due and payable until paid." A.R.S. section 42-1322, subsection D, cf. section 42-1416. The taxes are deemed delinquent, a penalty may be assessed and interest begins to accrue five days after the due date. A.R.S. section 42-1322, subsection D and section 42-1412, subsection A, as amended by Laws 1980, chapter 70, section 2. If no return is filed or if, after audit, the department determines that additional taxes are due, the "deficiency" bears interest "from the time the additional tax was due and paybale until paid." A.R.S. section 42-1327, subsections A, B and C, cf. section 42-1414, subsection C. The "additional" sales taxes are due and payable, and thus bear interest and are subject to penalty, 30 days after the taxpayer receives notice and demand from the department or within ten days of an order or decision of the department on appeal. A.R.S. section 42-1327, subsection D. Use tax deficiencies bear interest and are subject to penalty "from the date such amounts were required to be reported until paid." A.R.S. section 42-1414, subsection C.

Although the foregoing statutory provisions are confusing and seem somewhat inconsistent, it is evident that the imposition of penalties and interest depends on whether a sales or use tax is due and payable. Whether or when a return is filed or gross income is declared is immaterial to the initial question of whether penalties or interest should be imposed. If a sales or use tax is in fact due and payable on a certain date and is not paid by a statutorially prescribed date thereafter, the penalty and interest should be imposed.

Normally a sales tax return is to be filed on or before the date the tax is due. A.R.S. section 42-1322, subsection C. The statutes provide for extensions of time for filing the return, A.R.S. section 42-1322, subsection G, but do not provide for extending the tax due date and are silent as to whether taxes which are not paid until the return is filed on the extended date are subject to penalty and interest. This is in contrast to the use tax statutes which allow an extension for both filing the return and paying the tax. A.R.S. section 42-1412, subsection C.

2. The penalties and interest which are assessed for delinquent sales and use taxes are mandatory. The law provides that if a tax is due and is not thereafter paid on the prescribed date, a penalty "shall" be added along with the interest which accrues. A.R.S. section 42-1322, subsection D, section 42-1327, subsections B and C, section 42-1414, subsections B and D and section 42-1416. In order to abrogate the mandatory imposition of a penalty or interest there must be either specific statutory authority for the abatement or a finding that the tax was not, in fact, due.

A search of the statutes and annotations thereunder has not disclosed any authority for abrogating or abating sales or use tax penalties or interest which are assessed, other than through the protest and appeal procedures prescribed in A.R.S. sections 42-1338, 42-1338.01, 42-1339, 42-1340, 42-1415, 42-1415.01, 42-1421 and 42-1422. Refunds of excess taxes paid may occur under A.R.S. sections 42-1326 and 42-1413. Otherwise, the statutes do not appear to authorize abatement in the case of mistake or difficulty in payment of sales and use taxes. You may wish to contact the department for clarification of the legal basis for their practice.

3. From the discussion under question 1 above, interest should be charged beginning five days after unpaid sales and use tax is due and payable. In the case of a "deficiency", the additional sales tax bears interest beginning 30 days after the taxpayer receives notice and demand from the department or ten days after an order or decision of the department on appeal has become final. A use tax "deficiency" bears interest from the date the deficiency is required to be reported.

If an assessment is appealed to the department and thence to the state board of tax appeals, and the tax is not paid until after the appeals are completed, interest should be assessed on the amount of the tax and from the time the tax was due and payable, as determined in the appeal, until paid. If the tax is paid under protest pending a challenge, no interest accrues if the tax was in fact timely paid. If the tax was not paid when due, interest would accrue until it was paid under protest.

The statutes do not provide for or preclude the use of a payment schedule for sales or use taxes, presumably with interest charged on the unpaid balance. If this is a current departmental practice, you may wish to suggest legislative action on this issue.

4. A.R.S. section 42-1327, subsections E and F provide in pertinent part:

> E. Except in the case of a fraudulent return, failure or refusal to make a return, every notice of a determination of an additional amount due shall be mailed within three years after the fifteenth day of the calendar month following the period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later.
>
> F. If the taxpayer makes an error in computing the tax assessable against him, the department shall correct the error or reassess the proper amount of taxes and notify the taxpayer of its action by promptly mailing to him a copy of the corrected assessment. . . . /N/o correction, assessment or reassessment shall be made for any month . . . after the expiration of three years from the date upon which the taxpayer was obligated to file his return for such month under this article . . . . If a taxpayer fraudulently fails or refuses to file a return for any month, the department may assess the amount of taxes payable for that month at any time, or the department may cause an audit to be made of the taxpayer's records covering any period of time not specifically exempted by this section. . . .

Thus, the statute of limitations begins to run on the fifteenth day of the calendar month following the period for which the tax is due or after the return is filed, whichever is later (except for fraudulent failure or refusal to file a return, in which case the statute of limitations does not apply). Note that the fifteenth day of the calendar month for

which the tax is due used to be the date the tax became due and payable. The 1980 regular session of the legislature changed the due date to the first day of the second month after the month in which the tax accrues. A.R.S. section 42-1322, subsection A, as amended by Laws 1980, chapter 70, section 1. You may wish to suggest a conforming change to the date the statute of limitations begins to run.

Similarly, A.R.S. section 42-1414, subsection F provides:

> F. Except in the case of a fraudulent return or the case of a failure or refusal to make a return, every notice of a determination of an additional amount due shall be mailed within three years after the fifteenth day of the calendar month following the period for which the amount is proposed to be determined or within three years after the return is filed, whichever period expires later.

A similar discrepancy exists for the use tax between the due date and the date the statute of limitations begins to run.

5. The department may allow additional time to protest an assessment beyond the initial 30 days, A.R.S. section 42-1338, subsection A, but no additional time is allowed to bring an action in superior court against the department after payment of a tax under protest. Failure to bring such an action within 30 days after the order or decision of the state board becomes final constitutes a waiver of the right to protest and a waiver of all other related claims. A.R.S. section 42-1339, subsection B. Similar provisions apply for the use tax. A.R.S. section 42-1415, subsection A, and section 42-1421, subsection B.

6. Any sales tax determined to be due after an audit "shall be paid" within 30 days after receipt of the assessment unless an appeal is taken to the department, in which case payment is due within ten days after the order or decision of the department has become final. A.R.S. section 42-1327, subsection G. There is no provision for extending or deferring the assessment. The use tax statutes do not contain a similar mandatory payment date which presumably allows the department some flexibility in collecting audit assessments.

7. Sales tax audits are conducted "if a taxpayer fails to file a return, or if the department is not satisfied with the return and payment of the amount of tax. . . ." A.R.S. section 42-1327, subsection A. This being the purpose of the audit and deficiencies being subject to a three-year statute of limitations, any incidental discovery of a sales tax license irregularity would have to be in connection with an examination of books relevant to the three-year period. Otherwise, an investigation into whether a person operated without a sales tax license would not be in the nature of an audit but would be an investigation into a criminal violation of the sales tax laws, cf. A.R.S. section 42-1308, subsection F.

Use tax audits are also conducted "if the department is not satisfied with the return and payment of the amount of tax required to be paid. . . ." A.R.S. section 42-1414, subsection A. Any discovery that a retailer is or was not registered under A.R.S. section 42-1407 would be incidental to the examination of the records relevant to the three-year statute of limitations period. The primary incidence of the use tax, however, is on the purchaser of tangible personal property, who is not required to have any use tax license or registration with the department. Moreover, most use tax retailers are outside the territorial jurisdiction of the department.

8. A.R.S. section 4-203, subsection H provides that "/n/o spirituous liquor license shall be assigned, transferred or sold except as provided for in this title. . . ." Title 4 does not provide for the transfer of a liquor license by seizure and sale for taxes.

Nevertheless, the legislature in the last regular session enacted new provisions for the seizure and sale of property for, among others, sales and use taxes. A.R.S. title 42, chapter 12, article 2, enacted by Laws 1980, chapter 220, section 17. This new law provides that "/n/otwithstanding any other law of this state, no property or rights to property shall be exempt from the levy provided in this article other than the property specifically made exempt by subsection A of the section." A.R.S. section 42-1834, subsection C. Liquor licenses are not specifically exempted under that section from seizure or sale and thus are apparently subject to the levy along with other property of the licensee.

9. The important consideration in the answer to this question is the date the sales tax becomes due and payable because that is the date which triggers the accrual of interest. Arizona Revised Statutes (A.R.S.) section 42-1322, subsection D. Because the answer to this question also involves a close analysis of A.R.S. section 42-1327, the text of subsections A, B, C and D is here set out in full:

> A. If a taxpayer fails to file a return, or if the department is not satisfied with the return and payment of the amount of tax required by this article to be paid to the state by any person, it may examine the return and recompute and re-examine the amount required to be paid, based upon the facts contained in the return or upon any information within its possession or which comes into its possession. All additional amounts determined to be due under the provisions of this section shall bear interest at the rate of one per cent per month or fraction of a month from the time the additional tax was due and payable until paid.
>
> B. If any part of the deficiency for which a determination of an additional amount due is made, is found to be due to negligence or intentional disregard of this article or authorized rules and regulations of the department, but without intent to defraud, a penalty of ten per cent of such amount shall be added, plus interest at the rate of one per cent per month or fraction of a month from the time the additional tax was due and payable until paid.
>
> C. If any part of the deficiency for which a determination of an additional amount due is made, is found to be due to fraud, or to have been done with an intent to evade this article, or authorized rules or regulations of the department, a penalty of twenty-five per cent of such amount shall be added, plus interest at the rate of one per cent per month or fraction of a month from the time the additional tax was due and payable until paid.
>
> D. The department shall give to the taxpayer written notice of its determination of a deficiency by mail, and such deficiency, plus penalties and interest, shall be due and payable thirty days after receipt of the notice and demand, or if an appeal is taken to the department, within ten days after the order or decision of the department has become final. (Emphasis added.)

A problem exists in trying to reconcile an apparent conflict among several subsections of A.R.S. section 42-1327 relating to sales tax deficiencies. Subsections A, B

and C state that interest accrues "from the time the additional tax (i.e., the deficiency amount determined by an audit) was due and payable until paid," (emphasis added) implying that the interest relates back to the date the tax should have been paid originally. On the contrary, subsection D states "such deficiency (i.e., the same deficiency amount determined by an audit), plus penalties and interest, shall be due and payable thirty days after receipt of the notice and demand, or if an appeal is taken to the department, within ten days after the order or decision of the department has become final."

The reconciliation of these seemingly contradictory due and payable dates lies in an analysis of the purposes underlying the imposition of penalties and interest. If on a particular day a tax is due, there should be an incentive for the taxpayer to pay. If there were no incentive, he could sit back and wait for the state to discover his delinquency and take affirmative steps to collect, meanwhile enjoying for himself the use of what is rightly the state's money. This result is obviously not what the legislature intended in drafting A.R.S. section 42-1327. With respect to the accrual of interest, subsections A, B and C indicate that interest applies from the date the taxes were originally due and payable. In other words, the taxpayer does not get the free use of the state's money during that time. Subsection D, in a confusing way, gives the deficient taxpayer thirty days in which to decide his course of action on the delinquent taxes, and the accumulated charges including the interest which has already accrued and is continuing to accrue. The taxpayer may:

a) Pay the deficiency, penalty and interest within thirty days of the notice and demand and the matter becomes closed.

b) Do nothing. Thirty days after the notice and demand, the department may commence collection proceedings for the deficiency, the penalty and the interest which has continuously accrued.

c) Appeal the deficiency assessment to the department within thirty days after the notice and demand. A.R.S. section 42-1338, subsection A. In the case of an appeal, the thirty-day deadline is stayed until ten days after the decision of the department has become final. Nevertheless, there is no provision allowing the suspension of the accrual of interest during the appeal process. The provisions continue to apply which mandate that the deficiency bear interest continuously from the date it was due and payable until paid. To find otherwise would allow the taxpayer at his option free use of public money.

10. To illustrate the answer to this question, consider the following hypothetical example involving taxpayer "T":

- A sales tax of $X for January 1978 became due and payable and was paid by T on February 15, 1978.

- A sales tax of $X for February 1978 became due and payable on March 15, 1978 but T only paid $1/2X on that date.

- A sales tax of $Y for March 1978 became due and payable on April 15, 1978. T paid the remaining $1/2X from the February tax period on April 15, plus the penalty and interest for one month at the current rate, but did not pay any portion of the March tax.

- A sales tax of $Z for April 1978 became due and payable on May 15, 1978 but T did not file a return or pay any portion of the tax.

- Thereafter, T regularly reported and paid his sales tax as required by law.

In January 1980, the department audits T under A.R.S. section 42-1327 and determines that he owes a deficiency of $Y from the March 1978 tax period and $Z from the April 1978 tax period. The department mails notice and demand for the payment of the deficiencies and T receives the notice on February 1, 1980. From that day, T has thirty days to decide whether to appeal, pay the tax and charges or do nothing.

According to A.R.S. section 42-1332, subsection D and section 42-1327, subsections A, B and C, as explained in the answer to question number 1, the March 1978 tax of $Y began to accrue interest on April 15, 1978 at the then current rate of 1/2% of the unpaid tax per month or fraction of a month and the April 1978 tax of $Z began accumulating interest on May 15, 1978. Both months' taxes each continue to accrue interest from those respective dates "until paid". There is no statutory allowance for combining the two taxes for the purpose of applying interest.

cc: Gerald A. Silva
Performance Audit Manager

APPENDIX XIII

LETTER TO AUDITOR GENERAL STAFF
FROM OFFICE OF ATTORNEY GENERAL
REGARDING PENALTY ABATEMENTS

Attorney General
STATE CAPITOL
Phoenix, Arizona 85007

Robert K. Corbin
255-4681

November 28, 1980

Auditor General
112 North Central
Suite 600
Phoenix, Arizona 85007

Attn: Randolph D. Gross

Dear Mr. Gross:

I am writing in response to your letter of November 5, 1980. From my reading of your letter, you may have some misconceptions of the powers and duties of the Attorney General with respect to compromising claims. The Attorney General has the obligation to safeguard the legal interests of the State in the most economical fashion possible. As a consequence, the Attorney General is authorized to compromise claims in an appropriate case. A.R.S. § 41-192(B)(4). In the absence of legislative guidelines, it is clear the Attorney General has the discretion to determine the likelihood of prevailing on any claim.

The procedure, devised in conjunction with the Department of Revenue, is designed to compromise only in cases where the Attorney General and the Department of Revenue believe no penalty would be upheld by the courts. The procedure, to the extent it involves the Attorney General, only applies to penalties applied under A.R.S. § 42-1322. Penalties determined under other provisions of the tax law may be redetermined by the Department of Revenue prior to becoming final. We do not attempt to compromise claims where legal liability is unclear. In these instances, we will settle only after the claimant files suit and then only when appropriate.

The procedure for compromising claims begins by the Department of Revenue reviewing all claims in relation to the Department's guidelines, which were devised as minimum standards for allowing a claim. Then, the Attorney General's Office reviews the claim to determine if other factors might increase the likelihood of prevailing on the claim. If there are no such factors present and, in our judgment based upon prior experience, we will be unable to prevail on the penalty, then the penalty is removed from the books of the Department of Revenue after approval by the Director's representative.

The application of this procedure has resulted in more stringent enforcement of penalties. Since the institution of this procedure, four legal actions challenging only the application of penalties have been filed, which constitute more suits on this issue than in the previous 50 years of experience of the transaction privilege tax. Furthermore, the results of these cases should give a better perspective for review of future claims for compromise.

Sincerely,

ROBERT K. CORBIN
Attorney General

EDWIN P. LEE
Chief Counsel
Tax Division

EPL:jh

APPENDIX XIV

DECEMBER 15, 1980, MEMORANDUM FROM
THE DIRECTOR OF THE
DEPARTMENT OF REVENUE
REGARDING IMPROVEMENTS IN THE
COLLECTION ADMINISTRATION

M E M O R A N D U M

TO: Brian Dalton
Auditor General's Staff

12/15/80

FROM: J. E. Hibbs, Director
Department of Revenue

SUBJECT: Improvements in Collection Administration

As you requested, this memo summarizes the efforts we have made to improve the operation of our collections activities.

Prior to June, 1979 DOR collections activities were separated into two distinct units that rarely spoke to each other, and each had widely divergent degrees of sophistication of operations. In addition to pure collections activities, each - to varying degrees - was responsible for accounts receivable activities for their respective taxes and numerous document processing, audit support and administrative functions for their particular tax grouping.

During the period FY 79/80 the Accounts Receivable activities of Sales Tax were consolidated and revised so that in July of 1980 the A/R activities of Sales and Withholding tax could be transferred to the Division of Administration. (Details of the A/R progress are presented in a separate memo on Receivables.)

Late in 1979 the activities of the two Collection Units were merged into one section, reporting directly to the Assistant Director for Taxation and under one supervisor. In addition to the reorganization, a number of other changes were made to improve the Collection Section's effectiveness. These include the following:

1. In conjunction with the Accounts Receivables rewrite, Sales tax accounts were stratified for work by collectors. Starting in July, 1979 the level has progressively been reduced as emphasis was placed on clearing up large dollar accounts first.

2. Again, in conjunction with the A/R clean up, the consolidation of the Sales and Use tax A/R files resulted in a complete account being referred to a collector instead of the partial data worked in the past.

3. The unit recognized from its own experience in income tax collections the effectiveness of phone collectors and requested in the 80/81 budget additional positions in Phone Collection. These were approved in the budget and, after some delays due to classification problems, a core of 13 telephone collectors was added to the existing staff and four field positions are being reclassified to phone power. Over the coming months as future field positions become vacant, they will be evaluated for possible conversion to phone power. These changes should result in an increase in case closures, collections and a lowering of the operating cost per case.

4. Collection of all taxes are assigned by geographic zone so that a collector can collect all taxes owed the Department in one step.

5. Formal training has been given to all collectors on Sales Tax rules and regulations. Regulation and Statute Books have been acquired for each section and written collection procedures and guidelines have been established to improve the quality of work performed.

6. Each collector is required to prepare daily activity reports which are consolidated into monthly management reports. Guidelines for collections have been established and have been reviewed with collectors so that they are aware of the Department's goals.

7. Interagency information exchange has been expanded to more fully utilize the powers of the Liquor Board and Registrar of Contractors to and in collecting DOR receivables.

8. The Tucson collectors were assigned to the Collection Unit under a local supervisor. Southeastern Arizona collections were coordinated in a similar manner to those accounts worked in Phoenix.

9. Clerical support and supervisory positions were restructured and new PDQs and PP&Es were written. The result has been an improvement in attendance, performance and morale.

10. Time limits for actions have been established and procedures were implemented to cause receivables to go to lien or other more stringent collection efforts sooner.

11. Contracts were awarded to write programs to produce an accounts receivable interface between the Burroughs system and our computer. Programs are now being tested that should be ready by the January billing period which will result in flagging delinquency listings with receivable information and to produce a more flexible statistical report and stratification of the receivables.

12. A program is being written to annotate on the delinquency reports historical average sales so that collectors can prioritize these accounts when working delinquencies.

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APPENDIX XV

DECEMBER 15, 1980, MEMORANDUM FROM THE DIRECTOR OF THE DEPARTMENT OF REVENUE REGARDING IMPROVEMENTS IN THE ACCOUNTS RECEIVABLE PROCESS

M E M O R A N D U M

TO: Brian Dalton
Auditor General's Staff

12/15/80

FROM: J. E. Hibbs, Director
Department of Revenue

SUBJECT: Improvements in the Accounts Receivable Process

The following summarizes the changes which have been effected, or are in progress, in regard to the Sales Tax Accounts Receivables.

As covered in greater detail in our collections study in early 1979, the accounts receivables in sales tax were very disorganized. There were multiple files with redundant information, infrequent and incomplete billings, and no concept of the extent of the receivable. Numerous other problems existed due to each of the procedures, training and incorrect policies such as estimated liens.

The following has occurred since that time:

1. A staff of auditors reviewed all sales tax receivable files and their associated main and lien files. They then produced composite and complete detailed account receivable ledgers for each account. These desk audited ledgers were then sent to the taxpayers as the first billing of the new consolidated system. Taxpayers were invited to respond to these and any challenge as to charges were researched and appropriate corrective action was taken.

2. These ledgers were then placed on Burroughs magnetic card machines where interest was updated at billing time. All accounts have been billed five times in the last year and a half.

3. The A/R system, in addition to producing aggregate billings, stratifies accounts for collectors and identifies delinquent part-pay accounts in the billing process.

4. In addition to initiating the semi-automated system, procedures were written to standardize document review and accounts receivable programs and the statutory due dates on filings were enforced. This resulted in an increase in approximately 7,000 transactions per month. In all, 28 problem areas were corrected.

5. Procedures were initiated to improve the speed in which audit assessments are released to accounts receivable after the appeal period.

6. The master files were improved by the return of all documents previously held in Collections.

7. The part-pay plan performance was improved by establishment of automatic referral of delinquencies at billing time and at posting time. Further refinements have been installed in November to improve the responsiveness to delinquent part-pays.

8. During the last year the requirements for an automated system have been studied and refined. The experience gathered in the operation of the interim system has provided invaluable data which has been used in the design of the automated system which is due to be implemented in the fall of 1981.

   Among the features being designed in the automated A/R system are the following improvements:

   a) The system will provide math and data checks on the computer which are not now available. Any math check that is currently performed is being manually accomplished in the edit cycle. Since time constraints prohibit extensive edit time, the math check is not as comprehensive as the automated system will be.

   b) Single entry of documents for both revenue distribution and A/R. Currently these are separate systems requiring redundant entry.

c) Regular billing of all receivables which is integrated with delinquency runs. In addition, billings will be more complete and will be on data processible forms.

d) Automatic allocation of payments. Currently, clerks must allocate partial payments of receivable monies.

e) Automatic lien generation and lien release production. This will allow for a significant increase in the number of liens filed and the speed of filing as clerks will only have to perform quality control checks.

f) Automatic generation of liquor and contractor complaints.

g) The ability to generate a number of reports not currently feasible such as

- Total number of accounts and dollars in the system each month.
- Stratification of accounts by multiple levels for each in assignment to collection staff.
- Aging of receivable.
- Prompt reaction to delinquent part-pay accounts.
- Interaction of receivables, delinquency and licensing programs.
- Terminal access to A/R to increase flexibility of staff in receivables, collections and taxpayer assistance to access the data.

h) Substantially improved processing time. All receivables will be posted in the normal cycle, a period of days rather than weeks, thus improving the accuracy and credibility of the data.

9. Prior to this period, correspondence associated with A/R was a particular problem. Letters were channeled throughout the Department with little or no coordination of replies. Since then correspondence handling has been consolidated in one unit where it can be uniformly handled.

10. In part, as a result of the above changes, penalty and interest voucher receipts have risen an average of $73,000 + per month in FY 79/80 over the last half of FY 78/79. (That is the earliest these numbers were produced on computer statistical reports.)

APPENDIX XVI

DOR SALES TAX MASTER FILE
RETENTION SCHEDULE

RECORDS RETENTION AND DISPOSITION SCHEDULE

TO:

RECORDS MANAGEMENT CENTER
1130 NORTH 22ND AVENUE
PHOENIX, ARIZONA 85009

FROM:

Agency or Department Arizona Department of Revenue

Section or Division Sales Tax Division

Address 1700 W. Washington, Phoenix, Arizona 85007

Submitted by Patrick N. Kelly Telephone 255-4569

NO.	RECORD SERIES	RETENTION PERIOD (YRS.)			REMARKS
		Total	Office	Records Center	
1	Sales Tax License Applications*	5	5	0	Retain while business is in operations. Retain for 5 years after cancellation of license.
2	Use Tax License Applications	5	5	0	Retain for 5 years after cancellation of license.
3	Bingo Tax License	5	5	0	Retain for 5 years after cancellation of license.
4	Monthly Reports from Licensees*	5	5	0	
5	Quarterly Report from Licensees *	5	5	0	
6	ROT Records (Tax on Long term Leases)	5	5	0	Destroy 5 years from period of inactivity.
7	Audits and Collection Records *	5	5	0	Retain 5 years after new audit or collection.
8	Tax Liens/Bankruptcy *	4	4	0	Retain 4 years after liens have been cleared or declared bankruptcy.
9	Warrant Register	5	5	0	
10	Computer Printout	5	5	0	Destroy when no longer needed for reference.
11	Monthly and Annual Statistical Report	5	5	0	
12	Special Statistical Report	5	5	0	

APPROVED BY:

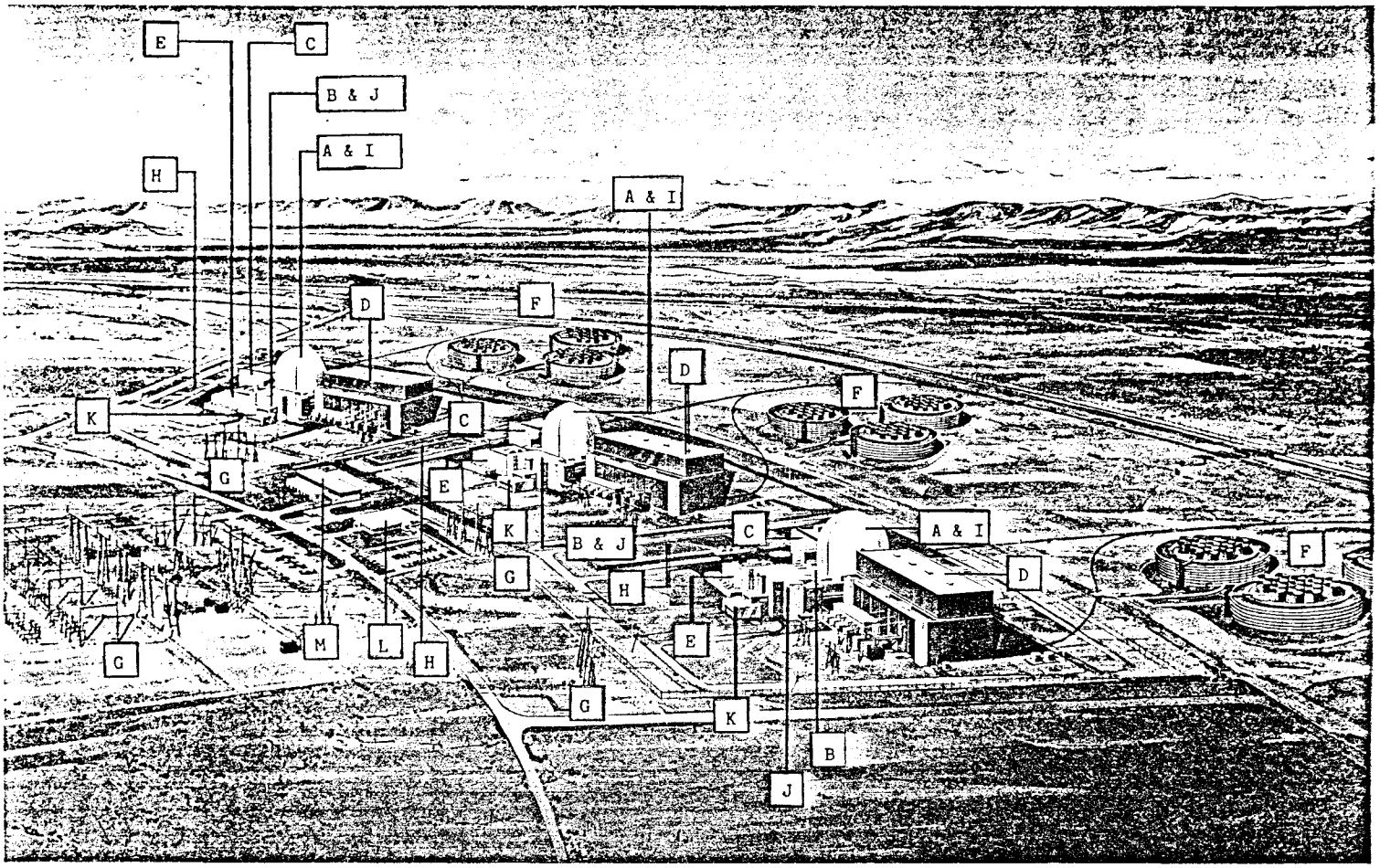
* **Records that should be located in a sales tax master file.**

DATE

DIRECTOR, DEPT. OF LIBRARY, ARCH. & PUB. RECORDS

APPENDIX XVII

TAX STATUS OF STRUCTURES AT THE PALO VERDE NUCLEAR GENERATING STATION



Key	Structure	Tax Status
A	Containment	Exempt
B	Auxiliary	Exempt
C	Fuel	Exempt
D	Turbine	Exempt
E	Radioactive waste	Exempt
F	Cooling towers and intake	Exempt
G	Switchyard facility and associated bulk-transmission towers	Exempt
H	Reservoir, spray ponds, evaporation ponds	Exempt
I	Containment building's permanently affixed work platforms	Partially taxable (46.86%)
J	Control structure	Partially taxable (25.00%)
K	Diesel generating building	Taxable
L	Administration building	Taxable
M	Unable to identify	Unable to determine

Water reclamation facility, which is exempt, is not shown. Main steam support structure, which is exempt, is located between the turbine and containment structures and is not visible.

APPENDIX XVIII

CORRESPONDENCE BETWEEN APS OR ITS
REPRESENTATIVES AND AUDITOR GENERAL STAFF
REGARDING REQUESTS FOR COST INFORMATION

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

November 5, 1980

Mr. Robert C. Bates
Snell and Wilmer
3100 Valley Bank Center
Phoenix, AZ 85073

Dear Mr. Bates:

I understand that our telephone conversation on November 5, 1980 covered the following:

1. Cash expenditures for construction of the Palo Verde Nuclear Generating Facility as of June 30, 1980 totaled $1,640,899,855.

2. As of October 19, 1980, total cash expenditures at completion of the Palo Verde facility were projected to be $3.616 billion.

3. Costs of each structure, both as of June 30, 1980 and total projected, are not known by APS and are therefore not available to the Office of the Auditor General.

Please confirm the correctness of the above statements. A written reply is requested by November 12, 1980.

Sincerely,

Dawn Sinclair
Performance Auditor

DRS/gck

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LAW OFFICES
SNELL & WILMER

3100 VALLEY BANK CENTER
PHOENIX, ARIZONA 85073
(602) 257-7211
TELEX 165088

November 6, 1980

Dawn Sinclair
Performance Auditor
Office of the Auditor General
Legislative Services Wing
Suite 200
State Capitol
Phoenix, AZ 85007

Dear Dawn:

This will confirm our telephone conversation yesterday, during which I responded to your questions concerning expenditures for the Palo Verde Nuclear Generating Station ("PVNGS") as follows:

1. As of June 20, 1980, the request for cash funds for the total construction costs of PVNGS was One Billion Six Hundred Forty Million Eight Hundred Ninety Nine Thousand Eight Hundred Eighty Five Dollars ($1,640,899,885.00). That sum excludes costs for research and development, effluent, nuclear fission materials, pre-operating and maintenance staffing, training and startup.

2. As of October 9, 1980, the estimated cost to complete PVNGS was Three Billion Six Hundred Sixteen Million Dollars ($3,616,000,000.00). That sum excludes costs for transmission lines, switchyards, ad valorem taxes, nuclear fission materials, startup power, operating and maintenance expenses, allowances for funds used during construction and capitalized training costs.

Also, in accordance with your request, this will confirm that I have arranged a tour of the PVNGS facilities next

Thursday at 9:00 a.m. for yourself, Dwight Ochocki, Jerry Silva and Brian Dalton.

Very truly yours,

Robert C. Bates

RCB/pn

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

November 21, 1980

Mr. Robert C. Bates
Snell and Wilmer
3100 Valley Bank Center
Phoenix, Arizona 85073

Dear Mr. Bates:

In my letter of November 5, 1980, I requested confirmation of three points covered in our November 5, 1980 telephone conversation. Your response confirmed the actual and projected costs of the entire Palo Verde Project (points 1 and 2) but did not deal with the costs by structure (point 3).

Please confirm the correctness of the following, per our November 5, 1980 conversation:

> Costs of each structure, both as of June 30, 1980 and total projected, are not known by APS and are therefore not available to the Office of the Auditor General.

The Office of the Auditor General will assume that this statement is correct if a written response is not received by November 28, 1980.

Sincerely,

Dawn Sinclair
Performance Audit Division

DS/gck

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LAW OFFICES
SNELL & WILMER

3100 VALLEY BANK CENTER
PHOENIX, ARIZONA 85073
(602) 257-7211
TELEX 165088

November 26, 1980

Dawn Sinclair
Performance Audit Division
Office of the Auditor General
Legislative Services Wing
Suite 200
State Capitol
Phoenix, AZ 85007

Dear Dawn:

I did not receive your November 21, 1980 letter until yesterday. Since your letter took four days to reach me, and because tomorrow is the Thanksgiving holiday, it may well be that you will not receive this letter by your November 28, 1980 deadline.

I will respond to the confirmation requested by your November 21, 1980 letter in due course.

Very truly yours,

Robert C. Bates

RCB/pn

ARIZONA PUBLIC SERVICE COMPANY

STA. 1886

P.O. BOX 21666 - PHOENIX, ARIZONA 85036

December 8, 1980

Ms. Dawn Sinclair
Performance Audit Division
Office of the Auditor General
Legislative Services Wing
Suite 200
State Capitol
Phoenix, AZ 85007

Dear Ms. Sinclair:

Bob Bates, Martin Shultz and myself wish to express our thanks for the opportunity to meet December 3, 1980 with you, Jerry Silva and Brian Dalton.

Although, as acknowledged by Mr. Silva, the Auditor General's office probably does not have the authority to require APS to answer any inquiries, APS is always willing to cooperate with the Auditor General's Office (as well as any other governmental agencies) as long as the inquiries serve a reasonable purpose and are capable of being answered without creating an undue burden on APS.

In order to coordinate APS's responses, it is suggested that all inquiries from the Auditor General's office be made in writing to me. Also, because of the complex nature of some of your inquiries and the number of APS personnel who may be involved, it is suggested that you will not impose any response deadline dates, nor state that you will assume a fact to be true if we do not respond within a given time.

As you and Mr. Silva requested, we will attempt to obtain an estimate of the Arizona privilege (sales) and use taxes payable for the entire three-unit Palo Verde Nuclear Generating Station construction project, both with and without the electric utility exemption set forth by the Arizona statutes.

Very truly yours,

Robert M. Lippelt

Robert M. Lippelt, Manager
Tax Services

RML:sm

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

December 5, 1980

Mr. Robert Lippelt
Manager, Tax Services
Arizona Public Service
P.O. Box 21666
Phoenix, AZ 85036

Dear Mr. Lippelt:

As agreed during a telelphone conversation with Marty Shultz on December 3, 1980, all requests for information concerning the Palo Verde Nuclear Generating facility and any other current or proposed APS projects will be directed to you.

On October 9, 1980, Arnie Shaw of APS told me that since 1967 APS has installed the following facilities in Arizona:

11 gas (combustion) turbines
3 combined cycle units
2 units at the Cholla facility, near Holbrook
Navajo facility, near Page.

I would appreciate your assistance in obtaining the following information concerning these facilities:

1. The locations (names of facilities & towns by which they are located) of 11 gas turbines and 3 combined cycle units.

2. The number of units installed at the Navajo facility.

3. The costs of each turbine and cycle unit, the total cost of both units at the Cholla facility and the total cost of all units in which APS particpated at the Navajo facility, as of December 31, 1979.

I understand that the Navajo facility is a participation project involving five other utilities and that the total cost may not be available. Please indicate whether the cost represents cost to all participants or to APS only.

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It is also my understanding that the cost figures which APS can supply include improvements as well as original construction costs. In order to accurately present these costs, please indicate any component costs, such as transmission lines, ad valorem taxes and allowances for funds, which have been excluded.

Your assistance is appreciated. If you have any questions concerning this request, please contact me at 255-4385.

Sincerely,

Dawn Sinclair
Performance Audit Division

DS/gck

ARIZONA PUBLIC SERVICE COMPANY

STA. 1886

P.O. BOX 21666 · PHOENIX, ARIZONA 85036

December 24, 1980

Ms. Dawn Sinclair
Performance Audit Division
Office of the Auditor General
Legislative Services Wing
Suite 200
State Capitol
Phoenix, AZ 85007

Dear Ms. Sinclair:

As discussed with you by telephone, Monday, December 22, 1980, the information that you have requested regarding APS power plants construction costs will not be available by December 26, 1980.

Very truly yours,

Robert M. Lippelt

Robert M. Lippelt
Manager
Tax Services

RML:sm

APPENDIX XIX

LETTER FROM SALT RIVER PROJECT OFFICIAL
REGARDING COST OF GENERATING FACILITIES

SALT RIVER PROJECT
P.O.BOX 1980
PHOENIX, ARIZONA 85001

December 9, 1980

TELEPHONE (602) 273-5900

Ms. Dawn Sinclair
Office of the Auditor General
Legislative Services Wing
Suite 200, State Capitol
Phoenix, Arizona 85007

Dear Dawn:

As you requested, attached is a schedule showing Salt River Project's investment in generating facilities in Arizona during the 13-year period ending December 31, 1979.

In evaluating the cost data related to the exemption of generating and transmission facilities from Arizona transaction privilege (sales) and use taxes, we offer the following words of caution for your consideration.

The value of services in Arizona are generally exempt from sales and use taxes. This would include a substantial portion of the labor involved in constructing generating plants and such costs are a very large part of the capitalized costs we are submitting.

In addition, Federal guidelines for electric utility accounting permit capitalization of such construction costs as allowance for funds used during construction (formerly called interest during construction), property and payroll taxes, insurance, administrative and general expenses and several others which would not be subject to sales and use taxes.

Furthermore, Arizona sales and use taxes were paid on certain items specifically excepted from the exemption for generating facilities and those items are also included in the costs on the attached schedule.

As it would be a monumental, if not impossible, task to analyze these costs over such a long period, we are unable to identify the portion of our investment in generating facilities to which the exemption applies. Nevertheless, any conclusions drawn from the information submitted should be broadly qualified as suggested above.

Sincerely,

J. Donald Jones, Jr., Supervisor
Taxes & Valuation Division

JDJ:mlh

SALT RIVER PROJECT

Investment in Electric Generating Units
during Period of 1/1/67 through 12/31/79
(Thousands of Dollars)

Generating Unit(s)	SRP Ownership	Original Installed cost @ 12/31/79
Navajo 1, 2 & 3	21.7%	$166,005
Coronado 1	70.0	343,986
Agua Fria 4, 5 & 6	100.0	22,281
Kyrene 3, 4, 5 & 6	100.0	22,064
San Tan 1, 2, 3 & 4	100.0	59,011
Horse Mesa 4	100.0	12,876
Mormon Flat 2	100.0	11,066
Roosevelt 1	100.0	11,234

APPENDIX XX

ARIZONA LEGISLATIVE COUNCIL MEMORANDUM

OCTOBER 31, 1980

ARIZONA LEGISLATIVE COUNCIL

MEMO

October 31, 1980

TO: Douglas R. Norton
Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-80-51)

This is in response to a request submitted on your behalf by Gerald A. Silva in a memo dated October 14, 1980. No input was received from the Attorney General concerning this request.

FACT SITUATION:

Arizona Revised Statutes (A.R.S.) provide numerous exemptions from sales and use taxes and establish lower rates for some industries and types of sales.

QUESTIONS PRESENTED:

A. What exemptions are provided from sales and use tax? To which industries do these exemptions apply?

B. Which industries and types of sales or transactions within each industry are provided with lower rates?

ANSWERS:

A. The following are deductions and exemptions which are currently allowed and which operate to reduce a taxpayer's sales (transaction privilege tax, education excise tax and special excise tax for education), rental occupancy and use tax liability:

Deductions In Computing
Sales Tax Liability

1. State sales and use taxes and municipal sales taxes. (A.R.S. section 42-1302)

2. For retailers, a manufacturer's cash rebate on the sales price of an article if the purchaser assigns his right in the rebate to the dealer. (A.C.R.R. R15-5-1841)

3. For retailers, bad debts if the income was originally reported as taxable for the month in which the sale took place. (A.C.R.R. R15-5-1813)

4. For retailers, cash discounts, refunds in cash or credit and redemption of coupons issued by the retailer. (A.R.S. section 42-1301, paragraphs 8, 9 and 10; A.C.R.R. R15-5-1840)

5. For retailers, 50% of the tax otherwise collectable on retail sales of tangible personal property directly to the United States government, its departments and agencies. (A.R.S. section 42-1321, subsection C; A.C.R.R. R15-5-1824)

6. For retailers, charges for services in connection with retail sales, if shown separately on invoices and records. (A.R.S. section 42-1312, subsection A, paragraph 3; A.C.R.R. R15-5-1815)

7. For retailers, the value allowed for a trade-in article accepted by the merchant for part payment of the article sold. (A.R.S. section 42-1301, paragraph 9; A.C.R.R. R15-5-1818)

8. For contractors and dealers of manufactured buildings, a 35% standard deduction in lieu of all other deductions for labor and subcontractors and in addition to the allowable deduction for land. (A.R.S. section 42-1310, paragraph 2, subdivisions (i) and (l); A.C.R.R. R15-5-623)

9. For contractors and dealers of manufactured buildings, the sale price of land, not to exceed the fair market value. (A.R.S. section 42-1310, paragraph 2, subdivisions (i) and (l); A.C.R.R. R15-5-627)

10. For contractors and dealers of manufactured buildings, certain payments made for labor. (A.R.S. section 42-1310, paragraph 2, subdivisions (i) and (l); A.C.R.R. R15-5-624; R15-5-625)

11. For contractors, certain amounts paid to subcontractors. (A.C.R.R. R15-5-626)

12. For timbering, mining and common carriers otherwise taxable under A.R.S. title 40, the charge for freight when included in the sales price of tangible personal property. (A.R.S. section 42-1321, subsection D; A.C.R.R. R15-5-908; R15-5-1906; R15-5-2005, subsection C)

13. For newspapers, compensation paid to carriers and vendors. (A.R.S. section 42-1310, paragraph 2, subdivision (g))

14. Service charges by landlords for individual utility use. (A.R.S. section 42-1314, subsection A, paragraph 3)

15. Contributions by a commercial landlord directly to a merchants' association for tenants' promotional benefit. (A.C.R.R. R15-5-1611)

Exempions From Sales Tax

1. Retail sale of stocks and bonds. (A.R.S. section 42-1312, subsection A, paragraph 1; A.C.R.R. R15-5-1802, subsection D)

2. Professional or personal service occupations which involve only incidental sales of tangible personal property (including barbers, cosmetologists, dry cleaners, advertising agencies, etc.). (A.R.S. section 42-1312, subsection A, paragraph 2; A.C.R.R. R15-5-305; R15-5-307; R15-5-1816)

3. Services rendered in connection with retail sales (see number 6 under "Deductions"). (A.R.S. section 42-1312, subsection A, paragraph 3; A.C.R.R. R15-5-1815)

4. Sale of warranty or service contracts with a term factor cost of $400 or less. (A.R.S. section 42-1312, subsection A, paragraph 4; A.C.R.R. R15-5-1838, subsection B)

5. Retail sale of prescription drugs. (A.R.S. section 42-1312, subsection A, paragraph 5; A.C.R.R. R15-5-1819, subsection A)

6. Retail sale of prosthetic appliances, insulin and insulin syringes, eyeglasses and contact lenses, hearing aids, hospital beds, wheelchairs, crutches, etc. and component and repair parts. (A.R.S. section 42-1312, subsection A, paragraphs 6 through 10; A.C.R.R. R15-5-1819, subsections B and C)

7. Retail sales to nonresidents for use outside Arizona when the vendor ships or delivers the item out of state. (A.R.S. section 42-1312, subsection A, paragraph 11; A.C.R.R. R15-5-1814)

8. Retail sales of food not for consumption on the premises. (A.R.S. section 42-1312, subsection A, paragraph 12; title 42, chapter 8, article 1.3; A.C.R.R. R15-5-1867)

9. Sales by artists of paintings, sculptures and other art works. (A.C.R.R. R15-5-1837, subsection A)

10. Services in connection with data processing hardware, design, analysis and software. (A.C.R.R. R15-5-1853, subsections B, C and F)

11. Casting and setting type and photoplates for others and income received from reproduction proofs furnished to printers in connection with such services. (A.C.R.R. R15-5-1107)

12. Proceeds from film processing, dubbing and other production services without a transaction in tangible personal property and developing and printing photographs for retailers for resale. (A.C.R.R. R15-5-304, subsection B; R15-5-1836, subsection B)

13. Sales of tangible personal property to retailers, manufacturers, contractors or others engaged in reselling such property in the normal course of business. (A.R.S. section 42-1301, paragraph 20; A.R.S. section 42-1312, subsection D; A.C.R.R. R15-5-1811)

14. Sales of articles to be incorporated into a manufactured product. (A.R.S. section 42-1312.01; A.C.R.R. R15-5-1839)

15. Sales of articles to a licensed contractor with a transaction privilege tax license for incorporation or fabrication under a contract. (A.R.S. section 42-1321, subsection A, paragraph 3)

16. Subcontractors operating under a prime contractor or a dealer of manufactured buildings. (A.R.S. section 42-1310, paragraph 2, subdivisions (i) and (l); A.R.S. section 42-1371, subsection A, paragraphs 6 and 12; A.C.R.R. R15-5-602)

17. Producers of agricultural, livestock, dairy and poultry products, other than for processed, retail sale. (A.R.S. section 3-563)

18. Agricultural tillage of improved farmlands. (A.C.R.R. R15-5-606, subsecton C)

19. Slaughtering animals for food, packing, processing or compounding meat or meat products; butcher services; processing dead animals into fertilizer or tallow for sale at wholesale or retail outside this state. (Laws 1974, 1st sp. ses., ch. 2, sec. 11; A.R.S. section 42-1319; A.C.R.R. R15-5-802; R15-5-804; Op. Att'y. Gen. January 9, 1951)

20. Sales by the United States, the State of Arizona, counties, community college districts, school districts and special districts other than those designated as municipal corporations. (A.R.S. section 42-1301, paragraph 15)

21. Gross proceeds or gross income from casual sales. (A.R.S. section 42-1301, paragraph 2; A.C.R.R. R15-5-1812)

22. Schools for airplane pilots. (A.C.R.R. R15-5-1407)

23. Events sponsored by the Arizona coliseum and exposition center board and county fair commissioners. (A.R.S. section 42-1314, subsection C; A.C.R.R. R15-5-409)

24. Leasing or renting a dwelling unit for 30 or more consecutive days to an individual tenant. (A.R.S. section 42-1314, subsection F; A.C.R.R. R15-5-1614)

25. Sales in interstate or foreign commerce when taxation is prohibited by federal law. (A.R.S. section 42-1321, subsection A, paragraph 4; A.C.R.R. R15-5-1814)

26. Income received from transportation of passengers or property into, out of or through the state. (A.R.S. section 42-1310, paragraph 2, subdivision (d); section 42-1371, subsection A, paragraphs 1 and 4; A.C.R.R. R15-5-1403)

27. Sales where title to tangible personal property passes outside Arizona (Goodyear Aircraft Corp. v. State Tax Comm'n., 1 Ariz. App. 302, 402 P.2d 423 (1965))

28. Income from renting equipment which is shipped or delivered for use out of the state. (A.C.R.R. R15-5-1503, subsection B)

29. Sales to Indians which occur on the reservation; sales by federally licensed Indian traders; sales to tribes regardless of where they occur. (Warren Trading Post Co. v. Arizona Tax Comm'n., 380 U.S. 685 (1965); Central Machinery Co. v. Arizona State Tax Comm'n., ___ U.S. ___, 100 S. Ct 2592 (1980); A.C.R.R. R15-5-1844)

30. Income from contracting by Indians on a reservation. (A.C.R.R. R15-5-619)

31. Sales of machinery or equipment used in manufacturing processing, fabricating, job printing, refining or metallurgical operations. (A.R.S. section 42-1312.01, subsection A, paragraph 1)

32. Sales of machinery or equipment used in mining. (A.R.S. section 42-1312.01, subsection A, paragraph 2)

33. Sales of central office switching equipment, switchboards, private branch exchange equipment, microwave radio and carrier equipment and coaxial cable. (A.R.S. section 42-1312.01, subsection A, paragraph 3)

34. Sales of certain machinery, equipment and transmission lines used in the production or transmission of electricity. (A.R.S. section 42-1312.01, subsection A, paragraph 4)

35. Sales of certain pipes and valves used for transporting oil, natural or artificial gas, water or coal slurry. (A.R.S. section 42-1312.01, subsection A, paragraph 5)

36. Sales of airplanes, navigational and communication instruments, accessories and related items to certificated airlines and foreign governments. (A.R.S. section 42-1312.01, subsection A, paragraph 6; A.C.R.R. R15-5-1843)

37. Sales of rolling stock, rails, ties, and signal control equipment used in rail transportation. (A.R.S. section 42-1312.01, subsection A, paragraph 7)

38. Sales of machinery or equipment used in drilling for or extracting oil or gas from the earth. (A.R.S. section 42-1312.01, subsecton A, paragraph 8)

39. Until 1990, sales of solar energy devices at retail and by contractors. (A.R.S. section 42-1310, paragraph 2, subdivision (i); A.R.S. section 42-1312.01, subsection A, paragraph 9)

40. Sales of buses or other mass transit vehicles to certificated bus lines or mass transit systems. (A.R.S. section 42-1312.01, subsection A, paragraph 10)

41. Income from the rental of certain equipment used in manufacturing or processing, mining, telephone and telegraph, electricity production, pipelines, airlines, railroads, oil and gas production, solar energy devices and bus companies. (A.C.R.R. R15-5-1508)

42. Sales of job printing, utilities, publications and other tangible personal property to or leased by hospitals operated by the United States government, State of Arizona, counties or cities and qualified charitable nonprofit organizations or any licensed nursing or residentail care institution or kidney dialysis center. (A.R.S. section 42-1321, subsection A, paragraph 5; A.C.R.R. R15-5-1108; R15-5-1306; R15-5-1509; R-15-5-1821; R15-5-2109)

43. Sales of motor vehicle fuel and use fuel (diesel fuel) upon which a fuel tax is levied. (A.R.S. section 42-1321, subsection A, paragraph 1)

44. Common or contract motor carriers if they are taxed or regulated by the corporation commission. If Proposition 101 is ratified November 4, 1980, this exemption will apply if the carrier pays a public highway use tax. (A.R.S. section 42-1321, subsection A, paragraph 2)

45. Sales of tangible personal property to nonprofit charitable organizations recognized as such for income tax purposes by the internal revenue service or the department of revenue. (A.R.S. section 42-1321, subsection A, paragraph 6; A.C.R.R. R15-5-1832)

46. Sales of tangible personal property to the United States government by a manufacturer, modifier, assembler or repairer. (A.R.S. section 42-1321, subsection B, paragraph 1)

47. Sales to a manufacturer, modifier, assembler or repairer of ingredients or component parts of products sold directly to the United States government. (A.R.S. section 14-1321, subsection B, paragraph 2)

48. Retail sales of tangible personal property to the United States government, its departments and agencies are taxed at one-half the normal rate; sales to a federal credit union. (A.R.S. section 42-1321, subsection C; A.C.R.R. R15-5-1824)

49. Sales of electricity, natural or artificial gas and water to a distributor who has a sales tax license. (A.R.S. section 42-1310, paragraph 2, subdivision (b); A.R.S. section 42-1371, subsection A, paragraph 2)

50. Interstate sales of electricity, gas or water. (A.C.R.R. R15-5-2104)

51. Sales of electricity to consumers by the United States water and power resources service. (A.C.R.R. R15-5-2108)

52. Income from interstate telephone and telegraph messages. (A.R.S. section 42-1310, paragraph 2, subdivision (c); A.R.S. section 42-1371, subsection A, paragraph 3)

53. Income from interstate pipeline operations. (A.R.S. section 42-1310, paragraph 2, subdivision (e))

54. Income from interstate private car line operations. (A.R.S. section 42-1310, paragraph 2, subdivision (f))

55. Income from sales of national advertising. (A.R.S. section 42-1310, paragraph 2, subdivisions (g) and (j); A.R.S. section 42-1371, subsection A, paragraphs 5 and 11))

56. Sales of job printing, engraving, embossing and copying to out-of-state customers and to persons in this state who have a sales tax license for resale. (A.R.S. section 42-1310, paragraph 2, subdivision (h); A.R.S. section 42-1371, subsection A, paragraph 8; A.C.R.R. R-15-5-1109; R15-5-1110)

57. Manufacturing or publishing books. (A.R.S. section 42-1310, paragraph 2, subdivision (g); A.R.S. section 42-1371, subsection A, paragraph 5)

58. Sales to an owner-builder of tangible personal property upon which a sales tax has already been imposed. (A.R.S. section 42-1310, paragraph 2, subdivision (k); A.R.S. section 42-1371, subsection A, paragraph 7)

59. Property constructed or improved by an owner-builder, if held for at least two years prior to sale. (A.R.S. section 42-1310, paragraph 2, subdivision (k); A.R.S. section 42-1371, subsection A, paragraph 7)

60. Amusements, exhibitions or instructions sponsored by religious or educational institutions. (A.R.S. section 42-1314, subsection A, paragraph 1)

61. Income received under a lease or rental agreement entered into before December 1967, other than hotels, guest houses, resorts, etc.; extensions or renewals of such agreements, if a rental occupancy tax is levied on the lease or rental agreement. (A.R.S. section 42-1314, subsection B)

62. Income received from rentals of films, tapes and slides by theatres, movies or television or radio stations which are otherwise subject to sales tax. (A.R.S. section 42-1314, subsection D; A.C.R.R. R15-5-1511)

63. Income from coin operated washing, drying, dry cleaning and car washing businesses. (A.R.S. section 42-1314, subsection E; A.C.R.R. R15-5-1510)

64. Charges for recreational facilities offered by private clubs which are included in membership dues. (A.C.R.R. R15-5-406)

65. Admission charged by organizations supported by subscriptions from the public or its members, whose members receive no compensation or share of the profits from its activities and which operate or conduct a symphony, opera, drama, etc. (A.C.R.R. R15-5-408)

66. A cabinet maker who constructs and delivers cabinets to a contractor without installation. (A.C.R.R. R15-5-616, subsection B)

67. Income from rental of storage facilities if the proprietor retains full control of the location of the stored goods within the building. (A.C.R.R. R15-5-1608)

68. Income from an agreement whereby a department store provides a licensee with space within the store. (A.C.R.R. R15-5-1609)

69. Income from agreements whereby a landowner received compensation from a sharecrop venture solely on the basis of profits derived from the operaton. (A.C.R.R. R15-5-1612)

70. Tenants' security and other refundable deposits. (A.C.R.R. R15-5-1617)

71. Amounts charged by a seller as a gratuity and separately stated on the check or bill. (A.C.R.R. R15-5-1708)

72. The sale of an entire business as an operating enterprise. (A.C.R.R. R15-5-1817)

73. Receipts of utility customer security deposits. (A.C.R.R. R15-5-2110)

In addition, certain activities are excluded from the application of the sales tax simply because they are not specifically included under the statutes. Some of the most prominent of these activities are sales of real estate, garage sales, swap meets and private sales of automobiles.

Exemptions From The Rental Occupancy Tax

1. Rental of premises occupied by a tenant who is exempt from taxation under the Constitution or laws of the United States or this state. (A.R.S. section 42-1712, paragraph 1; A.R.S. section 42-1361, subsection A, paragraph 3)

2. Rental under a lease entered into before December 1967:

   a. Which the Constitution or laws of the United States or Arizona would prohibit from taxing if the landlord were the tenant. (A.R.S. section 42-1712, paragraph 2; A.R.S. section 42-1361, subsection A, paragraph 3)

   b. If the length of the term of the lease or the size of the premises is subsequently changed. (A.R.S. section 42-1701, paragraph 5, subdivision (a); A.R.S. section 42-1361, subsection A, paragraph 3)

   c. For the businesses of hotels, resorts, apartments, office buildings, etc. (A.R.S. section 42-1701, paragraph 5, subdivision (b); A.R.S. section 42-1361, subsection A, paragraph 3)

3. Rental of property if it is used as the principal residence of the lessee. (A.R.S. section 42-1712, paragraph 3; A.R.S. section 42-1361, subsection A, paragraph 3)

Exemptions From Use Tax

Tangible personal property is exempt from the use tax when:

1. The property is subject to sales tax. (A.R.S. section 42-1409, subsection A, paragraph 1; A.C.R.R. R15-5-2312)

2. Subject to an excise tax of another state equal to or greater than the Arizona use tax. (A.R.S. section 42-1409, subsection A, paragraph 2; A.C.R.R. R15-5-2305)

3. Prohibited from taxation by federal law. (A.R.S. section 42-1409, subsection A, paragraph 3; A.C.R.R. R15-5-2313)

4. Incorporated as an ingredient or component of a manufactured, fabricated or processed article, substance or commodity for sale. (A.,R.S. section 14-1409, subsection A, paragraph 4; A.C.R.R. R15-5-2314)

5. Motor vehicle fuel and use fuel (diesel fuel) which is subject to fuel taxes. (A.R.S. section 42-1409, subsection A, paragraph 5; A.C.R.R. R-15-5-2315)

6. Incorporated into a building or structure by a licensed contractor who holds a sales tax license. (A.R.S. section 42-1409, subsection A, paragraph 6; A.C.R.R. R-15-5-2316)

7. Brought into Arizona by a nonresident for his own storage, use or consumption while temporarily in this state and not used in business in this state. (A.R.S. section 42-1409, subsection A, paragraph 7; A.C.R.R. R15-5-2317)

8. Used or consumed in the business of farming, ranching and feeding livestock or poultry, except for equipment, fertilizers, herbicides and insecticides. (A.R.S. section 42-1409, subsection A, paragraph 8; A.C.R.R. R15-5-2318)

9. Brought into Arizona from outside the United States for personal use, up to $200 in value per month. (A.R.S. section 42-1409, subsection A, paragraph 9; A.C.R.R. R15-5-2319)

10. Purchased by hospitals organized and operated for charitable purposes or by hospitals owned and operated by the state or a political subdivision. (A.R.S. section 42-1409, subsection A, paragraph 10; A.C.R.R. R15-5-2320)

11. Consisting of prosthetic appliances, eyeglasses and contact lenses, insulin and insulin syringes, hearing aids, hospital beds, braces, wheelchairs, etc. (A.R.S. section 42-1409, subsection A, paragraphs 11 through 15; A.C.R.R. R15-5-2330)

12. Food purchased outside Arizona. (A.R.S. section 42-1409, subsection A, paragraph 16; A.C.R.R. R15-5-2331)

13. Directly used as machinery or equipment in manufacturing, processing, fabricating, job printing, refining or metallurgical operations. (A.R.S. section 42-1409, subsection B, paragraph 1; A.C.R.R. R15-5-2321)

14. Directly used as machinery or equipment in commercial mining. (A.R.S. section 42-1409, subsection B, paragraph 2; R15-5-2321)

15. Used as telephone or telegraph company central office switching equipment, switchboards, private branch exchange equipment, microwave radio and carrier equipment and coaxial cable. (A.R.S. section 42-1409, subsection B, paragraph 3; A.C.R.R. R15-5-2321)

16. Directly used as machinery or equipment in the production or transmission of electricity, excluding machinery or equipment used for distribution of electricity, transformers and equipment used at transmission sites. (A.R.S. section 42-1409, subsection B, paragraph 4; A.C.R.R. R15-5-2321)

17. Consisting of pipes or values four inches or greater in diameter, used for transporting or distributing gas, oil, water or coal slurry. (A.R.S. section 42-1409, subsection B, paragraph 5; A.C.R.R. R15-5-2321)

18. Consisting of airplane, navigational and communications instruments and other accessories and related equipment acquired and used in transporting for hire, and owned by certificated airlines. (A.R.S. section 42-1409, subsection B, paragraph 6; A.C.R.R. R15-5-2321)

19. Consisting of rolling stock, rails, ties and signal control equipment used directly in transporting for hire. (A.R.S. section 42-1409, subsection B, paragraph 7; A.C.R.R. R15-5-2321)

20. Used directly as machinery or equipment in drilling for oil or gas or used directly in the process of extracting oil or gas from the earth for commercial purposes. (A.R.S. section 42-1409, subsection B, paragraph 8; A.C.R.R. R15-5-2321)

21. Consisting of solar energy devices. (A.R.S. section 42-1409, subsection B, paragraph 9; A.C.R.R. R15-5-2321)

22. Consisting of buses used directly in transporting for hire and owned by certificated bus companies. (A.R.S. section 42-1409, subsection B, paragraph 10; A.C.R.R. R15-5-2321)

23. Purchased from an out-of-state vendor for subsequent resale, lease or rent in Arizona. (A.R.S. section 42-1401, paragraphs 6, 8 and 10; A.C.R.R. R15-5-2322; R15-5-2323)

24. Purchased by the United States government. (A.R.S. section 42-1401, paragraph 4; A.C.R.R. R15-5-2324)

25. Purchased from private individuals out of state. (A.R.S. section 42-1401, paragraph 6; A.C.R.R. R15-5-2326)

26. Purchased by military personnel assigned to a military base who are not legal residents of Arizona. (A.C.R.R. R15-5-2329)

27. Provided under the terms of a warranty or service contract, taxed at one-half the rate otherwise applicable to tangiblew personal property. (A.R.S. section 42-1408.01)

B. According to the statutory treatment of various businesses and for administrative convenience, the department of revenue has established the following classifications, shown with the applicable sales tax rates:

Classification	Combined Sales Tax Rate (a+b+c)	Transaction Privilege Tax Rate (a)	Education Excise Tax Rate (b)	Special Excise Tax For Education Rate (c)
Advertising	4%	1%	1%	2%
Amusements	4%	2%	2%	--
Communications	4%	1%	1%	2%
Contracting	4%	1%	1%	2%
Feed Wholesale	3/8%	1/4%	1/8%	--

Classification	Combined Sales Tax Rate (a+b+c)	Transaction Privilege Tax Rate (a)	Education Excise Tax Rate (b)	Special Excise Tax For Education Rate (c)
Mining	2 1/2%	1%	1/2%	1%
Pipelines	4%	1%	1%	2%
Printing	4%	1%	1%	2%
Private Car Lines	4%	1%	1%	2%
Publishing	4%	1%	1%	2%
Railroads and Aircraft	4%	1%	1%	2%
Rental and Personal Property	4%	2%	2%	--
Rental of Real Property	3%	2%	1%	--
Restaurants and Bars	4%	2%	2%	--
Retail	4%	2%	2%	--
Timbering	1 1/2%	1%	1/2%	--
Transporting and Towing	4%	1%	1%	2%
Utilities	4%	1%	1%	2%

Business in the mining classification, which by definition includes oil and gas production, may claim a credit against the special excise tax for education otherwise due according to Laws 1980, 2d sp. ses., ch. 89, sec. 90:

> A. Each taxpayer subject to section 42-1371, subsection B, Arizona Revised Statutes, is entitled to a credit against the taxes otherwise due and payble by the taxpayer under such provisions in each of the fiscal years 1980-81, 1981-82 and 1982-83 in an amount computed as follows:
>
> 1. Determine the percentage of the taxpayer's full cash value for tax year 1979 of property classified under section 42-136, subsection A, paragraph 1, Arizona Revised Statutes which is equal to the amount paid by the taxpayer as property taxes in tax year 1979.
>
> 2. Determine the percentage of the taxpayer's full cash value for the current tax year of property classified under section 42-136, subsection A, paragraph 1, Arizona Revised Statutes which is equal to the amount paid by the taxpayer as property taxes in the current tax year.
>
> 3. Subtract the result obtained in paragraph 1 from the result obtained in paragraph 2.
>
> 4. Multiply the percentage amount obtained in paragraph 3 by three-fourths and multiply the resulting product by the full cash value of the taxpayer in the current tax year of property classified under section 42-136, subsection A, paragraph 1, Arizona Revised Statutes.
>
> B. The dollar amount obtained in subsection A, paragraph 4 of this section is the maximum eligible credit of the taxpayer in each of the fiscal years for which the credit applies. The amount may be applied against tax payments due under title 42, chapter 8, article 1.2, Arizona Revised Statutes, not to exceed the total tax liability under such article. Any unused amount of the credit for any year may not be used against any tax liability resulting in any subsequent year.

In addition, the use tax and rental occupancy tax are levied at a combined rate on the storage, use or consumption of tangible personal property and the rental of real property, respectively, as follows:

Classification	Combined Tax Rate (a+b+c)	Use Tax Rate (a)	Rental Occupancy Tax Rate (b)	Education Excise Tax Rate (c)
Use Tax	4%	2%	--	2%
Rental Occupancy Tax	3%	--	2%	1%

Note that the rental occupancy tax applies only to certain leases entered into before December 1967. All other leases are subject to the sales tax, unless exempted.

From these tables and using the list of exemptions under the response to question A, it is possible to determine the probable sales, use and rental occupany tax liability in the case of individual taxpayers.

cc: Gerald A. Silva
Performance Audit Manager