PERFORMANCE AUDIT

DEPARTMENT OF REVENUE

COLLECTIONS DIVISION

Report to the Arizona Legislature
By the Auditor General
August 1985
85-8

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

August 2, 1985

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, Collections Division. This report is in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. The performance audit was conducted as a part of the Sunset Review set forth in A.R.S. §§41-2351 through 41-2379.

The report addresses the need to improve the quality of information available to collectors, and to strengthen collection of withholding, sales, and corporate taxes.

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

Respectfully submitted,

Douglas R. Norton

Douglas R. Norton
Auditor General

Staff: William Thomson
Peter N. Francis
Stephen G. Adelstein
Stuart Goldstein
Dennis B. Murphy
Mark J. Syracuse

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Department of Revenue (DOR), Collections Division in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. This report, the second in a series on the Department of Revenue, was completed as part of the Sunset Review set forth in Arizona Revised Statutes §§41-2351 through 41-2379.

The Collections Division is responsible for collecting past due taxes. The Division collects accounts receivable in the following tax types: corporate and individual income, sales, use, and withholding. The Collections Division is also responsible for detecting and pursuing nonfilers for all tax types except individual income tax. The Collections Section in Tucson performs similar activities.

The Collections Division Does Not Receive Accurate Information (See Page 5)

The data provided to collectors by DOR's accounts receivable system is often inaccurate and untimely. As a result of inaccurate account balances, taxpayers who have paid their accounts in full often continue to be billed and can be subject to erroneous enforced collection actions. Enforced actions include levies on wages or bank accounts, and tax liens placed on personal or real property. In addition to causing frustration for taxpayers, collectors' reliance on inaccurate information results in the inefficient use of resources and reduced collector effectiveness. Collectors spend excessive time researching and rebuilding erroneous accounts.

Inaccurate accounts receivable balances are caused by untimely posting of payments to the accounts receivable system. DOR should study the possibility of modifying its tax processing procedures to help speed processing and reduce errors. Further, inaccurate account balances may remain on the computer even after errors are discovered by collectors

because of delays in data maintenance procedures. DOR management should take action to ensure that all accounts receivable system data maintenance is consistently completed on a timely basis.

In addition, collectors are not provided with all the information necessary to prevent unjustified collection action and maximize collection potential. Collectors should be provided with copies of unapplied payment reports. Also, a Business Master File to coordinate DOR's data on business taxpayers should be designed and implemented. DOR has recognized the need for such a system since 1978.

Withholding Tax Compliance
Could Be Enhanced (See Page 15)

Estimates based on United States Internal Revenue Service (IRS) data indicate that DOR failed to collect $5 million in withholding tax receivables in 1983 and the first three quarters of 1984. DOR could increase compliance by exchanging withholding tax information with the IRS and the Arizona Department of Economic Security. In addition, DOR could better utilize the withholding tax reporting documents it currently receives from employers by internally matching quarterly and yearly reports.

DOR could further encourage compliance by enforcing penalties against employers who fail to pay withholding taxes on a timely basis. In order to do this, DOR should seek passage of legislation clearly establishing the level of penalties to be assessed against late withholding taxpayers.

DOR Could Take Additional Steps To Emphasize
The Potentially Most Productive Accounts (See Page 21)

DOR can increase its collections effectiveness by further emphasizing collection of larger accounts. In fiscal year 1984-85, past trends away from the collection of the potentially most productive accounts have reversed. However, further improvement in the collection of large sales tax, corporate income tax and withholding tax accounts is possible.

DOR should continue to increase emphasis on collecting large accounts of all tax types. To facilitate this, DOR should continue with the implementation of an automated collection system to allow for a more flexible case assignment system. In addition, collector training should be improved and collector productivity should be tracked more effectively. Finally, coordination of work load distribution and policies between the Phoenix and Tucson collection offices should be improved.

Procedural Changes Are Needed To Improve Enforcement Against Bankruptcy Sales Tax Accounts (See Page 33)

Inadequate monitoring of Chapter 11 and 13 bankruptcy accounts may result in revenue loss to the State of Arizona. If a business incurs a liability with DOR after it has gone bankrupt, timely action through the Bankruptcy Court is required to assure payment. However, DOR policy requiring businesses under Chapter 11 or 13 bankruptcy to change their sales tax license numbers has impaired the Collections Division's ability to monitor and collect these accounts. DOR should discontinue the practice of issuing new sales tax licenses to bankrupt businesses, and modify the automated sales tax accounts receivable system so post-bankruptcy petition liabilities can be assigned to the bankruptcy collector as they are incurred by businesses.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Department of Revenue (DOR), Collections Division in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. This report, the second in a series on the Department of Revenue, was completed as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

Collections Division

The Collections Division is responsible for collecting past due taxes. The Division collects accounts receivable in the following tax types: corporate and individual income, sales, use, and withholding. The Collections Division is also responsible for detecting and pursuing nonfilers in all tax types except individual income tax.* The Collections Section in Tucson performs similar activities.

In the past, the Collections Section in Phoenix was part of the Division of Taxation. However, as the result of an agencywide reorganization, the Collections Section was made a separate division in March 1984. This reorganization increased the number of DOR's operating divisions from four to seven.

The assistant director for Collections is responsible for administering DOR's collection policies. However, a Collections Section also operates within the Tucson office. Responsibility for the collection activities in the eight counties served by the Tucson office rests with that office's assistant director.

The Collections Division is comprised of two sections: field and phone. The field section contains three units: Bankruptcy, Field Collections and Liquor. The Bankruptcy Unit monitors business and individual entities

* Individual income tax nonfilers are pursued by DOR's Audit Section.

that have filed for protection under various bankruptcy laws. The Field Unit conducts on-site searches and may seize a taxpayer's assets to satisfy an outstanding tax liability, by authority of A.R.S. §42-1831. The Liquor Unit is responsible for collecting back taxes from businesses that hold liquor licenses. The Phone Section is staffed with collectors, accounting clerks, typists and other administrative staff. Collectors are responsible for contacting taxpayers and securing revenues due the State. Accounting clerks provide clerical support by researching the more complex cases.

Beginning with the 1983 fiscal year, DOR adopted an aggressive stance and started to vigorously pursue past due accounts. Now, if a taxpayer refuses to pay, a collector initiates enforced collection procedures. These procedures include levying the taxpayer's wages or bank account, and attaching a tax lien to the taxpayer's real or personal property. Table 1 highlights collections for fiscal years 1982 through 1984.

TABLE 1

COLLECTIONS OF ACCOUNTS RECEIVABLE
AND DELINQUENT TAX LIABILITIES
BY FISCAL YEAR (1)

	1982	1983	1984
Phone & Field (Phoenix)	$11,716,524	$19,763,290	$26,836,568
Phone & Field (Tucson)	4,518,199	10,804,108	22,553,998
Liquor Enforcement	838,782	2,325,308	3,120,778
Other Collections (2)	2,001,649	3,227,080	888,922
Total	$19,075,154	$36,119,786	$53,400,266

(1) Delinquent tax liabilities result from the discovery of nonfilers.
(2) Other collections include denied penalty waivers, liens, nonsufficient funds checks and tax claims on bankruptcies.

Source: Arizona Department of Revenue Annual Reports: 1982-83 and 1983-84

Staffing And Budget - For fiscal year ended June 30, 1984, 99 of DOR's 712.4 authorized full-time employee positions (FTE) were allocated to the Collections Division. Moreover, the Collections Division consumed 6.6 percent of the Department's total resources. Table 2 shows actual expenditures for fiscal years 1983 and 1984, and estimated expenditures for fiscal year 1985 for the Collections Division.

TABLE 2

DOR EXPENDITURES
FOR THE COLLECTIONS DIVISION
FISCAL YEARS 1983-1985

	Actual (1) 1983	Actual 1984	Estimated 1985
FTE Positions	112.0	99.0	112.0
Expenditures:			
Personal Services	$1,953,600	$1,228,900	$1,713,200
Employee Related	406,600	266,700	392,700
Professional And Outside Services	0	2,400	0
Travel			
In State	39,300	33,400	50,900
Out Of State	0	1,300	0
Other Operating	116,000	40,700	65,500
Equipment	43,800	16,000	0
Total	$2,559,300	$1,589,400	$2,222,300

(1) In the fiscal year ended June 30, 1983, the Collections Division was organized under the Division of Taxation. Therefore, these figures represent DOR's estimate for the collections program.

Source: Department of Revenue budget requests

Scope Of The Audit

Our audit of the Department of Revenue, Collections Division was primarily limited to that Division. However, the audit also included limited work on parts of the Administration Division and the Tucson office, as noted throughout the report.

Detailed work was conducted on the following issues:

- Whether DOR effectively collects the most productive accounts,
- The accuracy of account information provided to collectors,
- Whether DOR actively collects past due withholding taxes, and
- Whether the Bankruptcy Unit operates effectively.

In addition, we developed other pertinent information in the areas of written off accounts and the new billing system. Finally, limited time was devoted to addressing the 12 statutory Sunset Factors. A departmental response to these factors will be prepared at the completion of the series of DOR audits.

In some cases work was delayed due to a lack of accurate and reliable data within the Department. This difficulty resulted from data collection and reporting problems and was not due to a lack of cooperation by the Collections Division.

The Auditor General and staff express appreciation to the assistant director and staff of the Collections Division for their cooperation and assistance during the course of our audit.

FINDING I

THE COLLECTIONS DIVISION DOES NOT RECEIVE ACCURATE INFORMATION

The data provided to collectors by the Department of Revenue (DOR) accounts receivable system is inaccurate and untimely. Taxpayers are billed for amounts previously paid and can be subjected to unjustified enforced collection actions. These erroneous actions occur because payments are not posted in a timely manner, and on-line maintenance procedures are cumbersome. In addition, current DOR systems do not provide all the information collectors need to prevent erroneous collection activity and to increase effectiveness.

Collection Procedures

When DOR identifies a tax liability, it is entered into the computerized accounts receivable system. This system is currently comprised of four independent subsystems: corporate income tax, individual income tax, sales tax and withholding tax. After a receivable is entered into the system, billings are automatically sent out by the computer. If these billings do not result in payment, an account is worked by a telephone collector, who attempts to contact the taxpayer directly. These contacts are attempted based on a prioritization of receivables by dollar amount. If a collector is unable to secure payment, enforced collection actions are undertaken.

Before initiating enforced collection action, the Department sends a final demand letter to the taxpayer. The final demand states in part:

> . . . the Department of Revenue is preparing action against you to secure the interest of the State of Arizona. This action includes, but is not limited to, the service of notice of levy on your wages or bank account. In the event these actions do not satisfy the outstanding liability, a State tax lien may also be filed.

If a taxpayer does not comply with the final demand for payment, the next step is for a collector to uncover a levy source. Potential levy sources are wages and bank accounts. Once a levy source is uncovered, notice of levy is served to the taxpayer's employer or bank. The recipient is obligated by Arizona Revised Statutes (A.R.S.) §42-1832 to comply with the levy request by either garnishing the taxpayer's wages or debiting the taxpayer's bank account.

Furthermore, pursuant to A.R.S. §42-1821, a lien may be filed against a taxpayer's real or personal property for the balance of unpaid tax, penalty or interest. A lien will be filed if a levy does not completely satisfy the taxpayer's outstanding liability.

Taxpayers Contacted After Accounts Have Been Paid

As a result of inaccurately recorded account balances, taxpayers continue to be contacted by DOR employees after their liability has been eliminated. Accounts that have been paid in full remain on the billing cycle. Moreover, taxpayers are subject to erroneous enforced collection actions. Consequently, the full potential of DOR's Collections Division remains unrealized.

Taxpayers Are Billed In Error - Accounts that are not promptly credited with payments continue to be billed. Also, taxpayers who have made estimated payments* or extension payments** continue to be billed when a

* In accordance with A.R.S. §43-581, taxpayers must make quarterly estimated tax payments if they are required to make Federal estimated tax payments.

** Per A.R.S. §43-326, taxpayers can be granted an extension to file their State income tax returns. If the extension is received on or before the original due date with payment of at least 90 percent of the anticipated tax liability, a penalty for late filing will not be assessed.

refund may be due. A randomly generated sample of 210 income tax receivables and 84 sales tax receivables uncovered several instances in which checks deposited by DOR were not posted to a taxpayer's account in a timely fashion. Income tax receivables, in particular, had a high number of errors. Forty-one (19 percent) of the 210 accounts sampled were inaccurate.

The following cases illustrate this point.

- <u>Case 1</u>: A taxpayer remitted $464 to DOR on November 27, 1984. The check was processed by DOR's computer on November 30, 1984, and cleared the taxpayer's bank the same day. The payment was not credited to the taxpayer's account until approximately 60 days later. The account remained on the billing cycle until the payment was posted.

  <u>Comment</u>: The random sample of 210 individual income tax receivables uncovered 17 similar instances in which checks deposited by DOR were not posted to taxpayer's account in a timely fashion.

- <u>Case 2</u>: A major electronics retailer remitted $75,422 for September 1984 sales tax. The check was processed by DOR on October 22, 1984. As of February 4, 1985, the payment remained unposted. Consequently, the firm continued to be billed for taxes that were paid more than 3 months before.

  <u>Comment</u>: The random sample of 84 sales tax accounts revealed six instances of similar posting delays.

- <u>Case 3</u>: A taxpayer made $1,321 in estimated payments and had $227 withheld for the 1983 tax year. His tax liability for the year amounted to $1,482. Instead of receiving a refund of $66, the taxpayer continued to be billed for 1983 taxes, penalty and interest.

  <u>Comment</u>: In the sample of 210 individual income tax cases, ten were not credited with estimated tax payments. Moreover, a DOR memorandum dated January 30, 1985, indicated that approximately 2,500 accounts were not credited with 1983 estimated tax payments. DOR processing officials were unable to determine whether the problem resulted because the information was never entered onto the computer, or because the computer tape used to store the information was damaged.

- Case 4: A taxpayer remitted $252 with an extension request for the 1983 tax year. The extension was received by DOR on April 16, 1984, and granted. The payment was not applied to the taxpayer's account until February 6, 1985, more than 9 months later.

  Comment: Of the 210 accounts randomly selected, 14 were not credited with extension payments. In addition, a DOR computer printout indicates that approximately 1,100 accounts were not credited with 1983 extension payments. Although DOR officials identified the problem, they have been unable to explain why this occurred.

Taxpayers Unjustly Pursued - Inaccurate information can also result in Collections personnel taking unjustified enforced collection action against taxpayers. During 1984, the Collections Division adopted an aggressive stance and began to vigorously pursue past due income tax accounts. Relying on information provided by the accounts receivable system, collectors sent out 2,000 final demand notices during August 1984. However, the former assistant director of Collections estimated that at least 25 percent were sent in error.

The effects of erroneous enforced collection procedures can be more serious than an incorrect final demand notice. The right to levy a taxpayer's wages or bank account is a powerful and effective means of collecting back taxes. However, the information on which the levy is prepared must be accurate. With inaccurate information, collectors can erroneously levy taxpayers' wages or bank accounts. The following case provides an example of this.

- Case: In response to an accounts receivable billing, a taxpayer remitted $962 for 1983 taxes. The check was processed by DOR on December 6, 1984, but was not posted to the taxpayer's account in a timely manner. The collector sent a final demand notice and prepared a levy request. The taxpayer did not respond to the final demand and on January 23, 1985 - 48 days after the payment was processed by DOR - the taxpayer's bank account was levied. When notified by the bank, the taxpayer became infuriated and called the Collections Division. Fortunately, in this case the bank check had not been processed and was returned by DOR to the bank.

Attaching a lien to a taxpayer's property is another effective way of securing the interests of the State. Once filed with the county recorder, a lien becomes a matter of public record. However, attaching a lien to a taxpayer's property as a result of erroneous information can cause the taxpayer undue hardship because the lien becomes part of the taxpayer's credit history. Even when removed, the fact that a tax lien was recorded remains on the taxpayer's credit report and subsequent attempts to obtain financing may be denied. Although collection personnel take steps to ensure that liens and levies are filed only when appropriate, inaccurate information makes this more difficult, and increases the chance for error.

Collection Potential Is Unrealized - In addition to causing taxpayers frustration, collectors' reliance on inaccurate information results in the inefficient use of resources and reduced collector effectiveness. The former assistant director for Collections stated that 30 to 40 percent of sales and income tax accounts greater than $10,000 were recorded inaccurately, and that these percentages may apply to other tax types as well. In addition, several Collections officials have expressed concern about the high percentage of errors. As a result, collectors often spend excessive time researching and rebuilding those accounts, although it is difficult to estimate how much time is actually wasted.

Information Provided By The Accounts Receivable System Is Inaccurate

Information received by collectors regarding account balances is inaccurate for several reasons. Payments are not posted to a taxpayer's account in a timely fashion. In addition, the procedure to change and maintain on-line information is cumbersome and time consuming.

Payments Not Posted In A Timely Manner - Accounts receivable balances are inaccurate because excessive time elapses before payments are properly posted to a taxpayer's account. DOR processing officials have stated that with the exception of the peak income tax processing period (April 11 through April 29), payments should be credited to an individual's account within 14 days. However, delays in updating information in the computer system may result in unwarranted billings being sent and erroneous collection actions being taken. Further, taxpayer or DOR processing errors can delay this posting process even beyond DOR's 14-day standard.

An initial review of DOR's processing procedures regarding input and posting of payment data indicates that system modifications may actually allow payments to be credited to taxpayer accounts significantly faster than 14 days. The existing batch system needlessly delays the processing of error free tax payments.* Modifying the batch system to allow separation of good payments from erroneous ones would speed processing. In addition, a large proportion of tax returns of all tax types are sent to the Error Resolution Section where problems are manually resolved. The manual error resolution process can be time consuming and inefficient. This problem will be addressed more fully in a subsequent audit report.

Another factor contributing to delays is a high number of data entry errors. The former assistant director for Collections estimated that potentially 13,500 income tax accounts out of 54,000 accounts added between April and July 1984 could be affected by processing-related errors. DOR processing officials have acknowledged the need to reduce the number of data entry errors and consequently enhance the quality of output. However, the current emphasis is on speed rather than accuracy. This problem was cited in a 1984 report prepared by the Arizona Chamber of Commerce** that concluded: "DOR does not place enough emphasis on the prevention of errors, believing that it is more cost-effective to correct them through the Error Resolution and Taxpayer Services functions."

Optical character recognition (OCR) equipment could decrease the error rate by reducing the number of keystrokes. This would eliminate a major source of human error. OCR equipment would also enable DOR to process tax

* Currently, the system delays an entire batch of up to 94 accounts receivable payments for any tax type by routing it to the Error Resolution Section if only one of the payments in the batch has a problem.

** The Arizona Chamber of Commerce in conjunction with DOR conducted a study to identify where business practices could help the Department.

forms and credit payments to accounts more quickly. One DOR administrator predicted the payback period for OCR equipment to be less than 1 year. A scanning system is being considered for sales tax processing, but implementation is years away.

On-Line Changes Not Processed In A Timely Manner - Accounts receivable balances are also inaccurate because on-line maintenance changes are not made in a timely manner. If an error is found, collectors must complete a maintenance form specifying the needed change. This form is then forwarded from the Collections Division to the Accounts Receivable Group, where it is entered into the computer system.

DOR policy states that the changes are to be processed within 24 hours of receipt. While the supervisor of the Accounts Receivable Group states that this turnaround time is usually met, Collections personnel repeatedly charge that the changes are not being processed in a timely manner. A review of maintenance forms originating from the Collections Division indicates that often weeks pass before changes are reflected on the system.

Information Necessary To Maximize Collection Potential Is Not Provided To Collectors

Collectors are not provided with the timely information necessary to efficiently and effectively collect past due taxes. Collectors do not receive specific data that would prevent unjustified collection action. Also, collectors are not provided with other information that would increase their effectiveness.

Data Needed To Prevent Unjustified Collection Activity Not Provided - Unapplied payment information is currently unavailable to collectors. Taxpayer or DOR processing errors can result in payments not being applied to an individual's account. A taxpayer may believe that the liability has been eliminated, while the receivable remains on DOR's records. The Error Resolution Group receives computer printouts of unapplied payments but these reports are not distributed to collectors. Providing these reports to collectors would prevent the occurrence of enforced collection activity against taxpayers who have settled their accounts.

Nor do collectors receive information that fully acquaints them with the current status of an account. As a result, collectors often do not know if an account is concurrently being reviewed by another division of DOR. Consequently, collectors continue to pursue accounts when collection action is inappropriate. For example, a taxpayer may already be involved in a formal appeals process to protest the liability.

Information That Could Increase Collector Effectiveness Is Not Provided - Other information that would increase the effectiveness and efficiency of collection operations is also not provided. Collectors do not have information concerning a taxpayer's place of employment. This data is necessary to provide collectors with a levy source. Presently, DOR accounting clerks must go to the Department of Economic Security (DES) to access employment files. At best, this occurs weekly. A backlog results, and enforced collection action does not occur in a timely manner. Providing collectors with the ability to tie into DES employment files from the Collections office would enable collectors to quickly uncover potential levy sources. The Collections Division has recognized this need and has negotiated an agreement with DES that will enable DOR personnel to access DES employment files from remote locations. Although a target date of mid-May 1985 has not been met, Collections management is presently trying to implement the new interface as soon as possible.

In addition, a Business Master File (BMF) that consolidates a firm's Federal identification number, sales tax number and withholding license number does not currently exist. DOR management originally identified the need for such a file in a comprehensive licensing study completed by DOR personnel in November 1978. As a result, a BMF Development Committee was formed and wrote the following in a need perception report dated June 21, 1982.

> The Department does not have a central data base of taxpayers. Each licensing unit maintains its own complete file. Data in each file is duplicate data maintained in other units. In addition to failing to cross reference this data for compliance, the redundancy results in duplicate application processing, data entry, computer space and file update activities.

The report goes on to say that "under this present system the Department is unable to match and combine receivables from the same taxpayer. A collector who collected one tax may find later another tax was due from the [same] business account."

The expected benefits of the BMF file include a significant increase in taxpayer compliance and on-line information retrieval, improved data dissemination to users, and an increase in the efficiency of the Collections Division. The BMF would also eliminate redundancy of data storage and duplicate file maintenance. Further, combined mailings would be possible and DOR would realize significant postage and handling savings. While a needs assessment for the BMF was finally drafted in June 1984, no target date for completion of the project was set.

Finally, a new billing system that will use several status flags to inform collectors of various account contingencies has been designed. This system was scheduled to be operational by the end of January 1985. However, termination of the assistant director for Collections has delayed the implementation of the new billing system. Although DOR's most recent target date of May 30, 1985, was not met either, DOR administrators state the system will be operational in the near future.

CONCLUSION

Taxpayers are billed in error and face unjustified enforced collection action because DOR's accounts receivable system contains inaccurate information and is not updated in a timely manner. Further, DOR computer systems do not provide Collections personnel with vital account information. As a result, the full collections potential remains unrealized.

RECOMMENDATIONS

1. DOR should determine whether the existing batch system could be modified to reduce the degree to which processing of good accounts receivable payments is delayed by problem payments in the same batch.

2. DOR should investigate the possibility of obtaining Optical Character Recognition equipment for initial data entry.

3. DOR management should take steps to ensure that the Accounts Receivable Group consistently meets its goal of making on-line maintenance changes to the accounts receivable system with 24 hours.

4. Collections personnel should be provided with copies of unapplied payment reports.

5. DOR management should finalize plans for the Business Master File and set a target date for the project's completion.

FINDING II

WITHHOLDING TAX COMPLIANCE COULD BE ENHANCED

The Department of Revenue (DOR) could increase withholding tax compliance by: 1) participating in information exchanges with United States Internal Revenue Service (IRS) and the Arizona Department of Economic Security (DES), and (2) cross matching internal documents. In addition, withholding tax compliance could also be improved if DOR had the authority to impose more appropriate penalties for noncompliance.

Withholding taxes, as established by Arizona Revised Statutes (A.R.S.) §43-401, are those amounts withheld by employers from employees' wages to offset the employees' state income tax liability. The amount of state withholding is a percentage of the total Federal income tax withheld from employees' wages. Employers are required to reconcile the wages withheld from employees and file returns with DOR quarterly. When returns are not filed with DOR as required, an employer is considered delinquent. When returns are filed but an employer fails to make the necessary payments, an account receivable is established by DOR for that employer. According to A.R.S. §43-415, once the employer has collected the taxes, they become a "special fund in trust for the state." Fraudulent use of the trust funds by the employer is a class 4 felony. In addition, any employer required by A.R.S. §43-401 to collect withholding taxes who fails to do so is personally liable for the amount of taxes not collected or accounted for and remitted to DOR.

Failure to adequately enforce withholding tax laws can result in a substantial loss of revenue. DOR did not actively collect withholding tax accounts receivable and delinquencies in 1983 and the first three quarters of 1984. These accounts were not worked primarily because DOR was not able to develop and implement its new automated withholding tax system in a timely manner. According to DOR officials, Electronic Data Processing staff resources needed to implement the system were diverted to higher priority projects. As a result, based on IRS data we estimate that over

$5 million* in withholding tax receivables went uncollected during this 21-month period.

Because of the importance of withholding tax enforcement and the potential revenue loss, the IRS recently established an eight member pilot project to audit and collect Federal employment taxes. Initial results indicate that this increased emphasis on compliance is identifying significant employer noncompliance.

<u>DOR Should Participate In Information Exchanges</u>

DOR could increase compliance by coordinating the exchange of withholding tax information with the IRS and DES. Although IRS and DES have exchanged information on employers for several years, DOR has not participated in the past, due to a lack of computerization. DOR's future participation will require the adoption of the Federal Employer Identification Number (FEIN) as an information exchange standard.

The IRS and DES-Unemployment Insurance Administration share employment tax information through computer magnetic tape exchanges in attempts to increase compliance. Two tape exchanges are currently conducted. The first occurs annually and consists of a tape sent from the IRS to DES listing all employers in the State of Arizona who paid Federal unemployment or withholding tax during the previous year. DES-Unemployment Insurance Administration uses the tape to identify any employers paying Federal tax who are not paying State unemployment insurance. The second exchange occurs quarterly when the IRS provides DES-Unemployment Insurance Administration with a tape of new applications for FEINs in Arizona. DES reviews this listing of applicants and contacts any employer appearing on the tape who has not applied for State unemployment insurance.

* This figure is derived by computing 15 percent of the Federal withholding tax accounts receivable collected in Arizona, less any State withholding tax receivables collected by DOR during the same period.

DOR's inadequate participation in the withholding tax information exchange with IRS and DES in the past was due to the lack of a fully automated withholding tax system. Previous attempts to coordinate DOR collection efforts with DES required excessive manual comparisons of employer information because of DOR's inability to match records by computer. In addition, efforts to exchange withholding tax information with the IRS have been negatively affected by the limited computerization of DOR's withholding tax system.

DOR management indicated that the recently implemented withholding tax processing system will allow them to participate in an information exchange with the IRS and DES. However, if DOR is to participate and benefit from IRS and DES information, the FEIN, assigned to all employers by the IRS, must be adopted as an information exchange standard. The FEIN is currently used by the IRS and DES in their information exchanges, and is the only universal identifier that can ensure successful information matching. Although the new processing system has space designated for the FEIN, DOR does not currently require the FEIN from all employers registered to remit State withholding tax. DOR's failure to obtain and utilize the FEIN will continue to limit its participation in the exchange of withholding tax information and affect DOR's ability to ensure withholding tax compliance.

Reporting Documents Should Be Cross Matched

DOR could increase compliance by coordinating the use of withholding tax reporting documents received from employers. Two documents are involved: quarterly withholding tax returns (A1QR) and yearly reconciliation returns (A1R). A computerized matching of these documents would greatly increase withholding tax compliance, particularly in light of DOR's limited withholding tax auditing. However, DOR cannot conduct these matches because the A1Rs are not fully utilized once received.

To increase employer compliance with withholding tax laws, DOR should match the quarterly A1QRs to the A1R received from each employer. This would enable DOR to ensure consistent reporting of withholding taxes by employers.

The computerized matching of these reporting documents would also assist in determining to which employers DOR should devote their withholding tax auditing resources. Presently, DOR primarily audits employers for withholding tax as part of corporate income tax or sales tax audits. The matching of the reporting documents could identify which employers had discrepancies in the withholding tax they reported and remitted, thereby flagging them as potentially successful audits.

However, although the two reporting documents are required by DOR, they are never used to their fullest potential. The employers year-end reconciliation report (A1R), required by A.R.S. §43-412, is used only by DOR to check whether an employer claimed a debit or credit for the amount of withholding tax paid during the year. Otherwise, DOR files the A1R, ignoring the other information provided, and fails to enter it into the withholding tax processing system. In addition, the fact that an employer did not file an A1R is never recognized by DOR; no delinquency run is created and nonfilers are never contacted.

Withholding Tax Penalties Need Revision

DOR could increase compliance by enforcing penalties against employers who fail to pay withholding taxes on a timely basis. Although DOR has limited statutory authority to impose penalties, this authority has not been used. Additional legislation is necessary to adequately establish more flexible penalties for withholding tax violations to deter noncompliance.

Presently, DOR assesses penalties only against those employers who fail to file quarterly returns and pay the correct amount of tax due on time. If a quarterly return is late, DOR is authorized to assess a 5 percent penalty on the amount due under A.R.S. §43-821, "Penalty for failure to file return." However, if the quarterly return is filed on time without full payment, only interest is incurred on the outstanding balance.

DOR currently has statutory authority to impose a 25 percent penalty against employers who fail to make timely payments, yet file quarterly returns on time. However, according to DOR officials, a decision was made not to assess the penalty provided by A.R.S. §43-826 because it was deemed excessive, particularly against employers who missed a payment deadline by only a few days.

In an attempt to consolidate all late payment penalties, during the 1985 legislative session A.R.S. §42-136 was amended, effective June 30, 1986, to provide for assessment of a 10 percent penalty against late payers for all tax types, including withholding. However, this legislation is designed for payments made at the time of filing, and would not specifically address deposit payments made by employers during the quarter. Additional legislation is needed to clearly authorize enforcement of penalties against late depositors.

CONCLUSION

DOR could increase withholding tax compliance through matching and exchanging withholding tax data with the IRS and DES-Unemployment Insurance Administration. Revising statutes and enforcing penalty provisions would also enhance compliance.

RECOMMENDATIONS

1. DOR should take action to obtain the FEIN from all employers registered to remit withholding tax to the State of Arizona.

2. DOR should match internal withholding tax documents and match information with the IRS and DES to increase compliance with withholding tax laws.

3. DOR should seek passage of legislation clearly establishing the level of penalties to be assessed against employers who deposit withholding taxes late. Once such legislation is obtained DOR should enforce penalties for untimely payments.

FINDING III

DOR COULD TAKE ADDITIONAL STEPS TO EMPHASIZE THE POTENTIALLY MOST PRODUCTIVE ACCOUNTS

The Department of Revenue (DOR) can increase its effectiveness by taking additional steps to emphasize collection of larger accounts. Although significant improvement has been made recently, greater emphasis on the potentially most productive accounts can further increase revenue collected. Collector assignment methods, collector training, and productivity monitoring can be improved. In addition, limited coordination between Phoenix and Tucson has reduced DOR's collections effectiveness.

DOR's collections have improved dramatically in the last 4 years. Table 1 on page 2 indicates that total collections, including both the Phoenix and Tucson offices, have increased from just over $19 million in fiscal year 1981-82 to over $53 million in fiscal year 1983-84. In addition, the latest data shows that over $76 million was collected in fiscal year 1984-85. This represents a 300 percent increase in collections over the last 4 years.

Some Large Accounts Are Not Effectively Collected

Some accounts receivable with high balances are not being effectively collected. Collection Division policy emphasizes the importance of timely collection of large balance accounts.* However, this policy is not followed for all tax types.

* One of the main elements affecting the collectibility of a receivable is its age. The older a receivable is allowed to get before collection efforts are begun, the less likely is the chance of collection. For this reason, it is crucial to work potentially productive accounts as quickly as possible. A United States Internal Revenue Service official stated that his goal is to have no more than 2 percent of receivables exceeding 2 years in age.

DOR policy assigns a higher priority to collecting accounts with large balances. This policy should permit limited collection resources to be used most effectively. For example, a Collections Division policy memorandum states:

> Sales and withholding taxes are the backbone of the State's tax system, and therefore, the first priority of the Collection Division will be to timely collect and deposit these taxes. . . . All telephone calls on [sales and withholding tax] cases in excess of $5,000 should be completed within five work days of receipt, assuming inventories are manageable.*

Collectors have not always concentrated on accounts with high balances, however. Approximately $46 million of sales tax accounts receivable were assigned to collectors as of December 1984. Over $7.9 million (17 percent) of this amount represents sales tax accounts with balances greater than $10,000 that were more than 3 years old (see Table 3). This indicates that sales tax accounts with large balances have gone uncollected for very substantial periods of time. A former assistant director of the Collections Division estimated that 45 percent of all sales tax accounts may now be uncollectible due to age and other factors.

* Withholding tax collection is addressed in Finding II, page 15.

TABLE 3

SALES TAX ACCOUNTS RECEIVABLE BY AGE(1) AND AMOUNT
AS OF DECEMBER 1984

Amount	3-5 Years	5-8 Years	Over 8 Years	Total
$500-2,500	$ 649,000	$ 606,000	$ 288,000	$ 1,543,000
$2,501-10,000	1,279,000	1,522,000	633,000	3,434,000
More Than $ 10,000	4,421,000	2,490,000	1,008,000	7,919,000
Total	$6,349,000	$4,618,000	$1,929,000	$12,896,000

(1) Age is based on the date each receivable was established. Date established is the date DOR identifies the existence and amount of a receivable (e.g. through an audit). It was impossible to generate similar tables for individual income, corporate income, or withholding taxes because DOR does not have reliable data on the date liabilities for these tax types were established.

Source: Computer generated by Auditor General staff using December 1984 data tapes provided by DOR

An Auditor General Review of 86 current sales tax accounts with balances greater than $10,000 revealed that the Collections Division is now doing a better job of investigating these accounts on a timely basis. However, concentration on sales tax accounts with large balances can be further improved. Sales tax collections for the last 4 months of 1984 were 18 percent of outstanding sales tax receivables, as shown in Table 4. This is very close to the percentage shown for income tax collections during the same period (17.2 percent), although the average sales tax account is more than five times the size of the average income tax account. Thus, further emphasis of sales tax accounts may be warranted based on their potential productivity.

Further, collectors may not be working other large accounts as effectively as possible. As shown in Table 4, during the last 4 months of 1984 17.2 percent of all individual income tax accounts and 18 percent of all sales tax accounts receivable were collected, while only 3.6 percent of corporate income tax receivables and 2.1 percent of withholding receivables were collected. Corporate and withholding receivables had average account balances of $3,499 and $1,165, respectively, while income tax accounts averaged only $457.

Corporate and withholding tax collections have been relatively low because the computer systems for these tax types are relatively new and have had many problems. However, in spite of these problems the Collections Division should expend more effort to collect large accounts in these tax types as quickly as possible to prevent their aging and becoming less collectible. DOR does report significantly increased corporate collections of $1,175,000 for the first 3 months of 1985, but this is still not at the level of sales and income tax collections.

TABLE 4

ACCOUNTS RECEIVABLE BALANCES AS OF JANUARY 1985
AND AMOUNTS COLLECTED DURING LAST 4 MONTHS OF 1984

	Corporate	Sales	Income	Withholding
Number of Accounts	2,867	19,669	115,267	7,536
Balance 1-85 (1)	$10,033,000	$49,192,000	$52,660,000	$8,779,000
Average Amount Per Account	$ 3,499	$ 2,501	$ 457	$ 1,165
Total Collected 9-84 to 12-84	$ 364,000	$ 8,840,000	$ 9,034,000	$ 184,000
Percentage of 1-85 Balance Collected	3.6%	18.0%	17.2%	2.1%

(1) January 1985 data was used as a basis for comparison because a large number of income tax accounts with balances of less than $10 were purged from the accounts receivable system in January. Use of data prior to January would have reflected a misleadingly high number of income tax accounts.

Source: Number of accounts and balances obtained from DOR computer reports dated January and February 1985. Amounts collected obtained from reports prepared manually by the Collections Division (Phoenix) and the Tucson Collections Section for September 1984 through December 1984.

Factors Inhibiting Collection Of Large Accounts

At least three factors limit DOR's ability to emphasize large accounts. They are: (1) the manner in which cases are assigned to collectors, (2) lack of training for collectors, and (3) inadequate monitoring of collector productivity.

Poor Assignment System - The current collector assignment system does not allow DOR to concentrate adequately on high balance accounts. Little consideration is given to several factors that would increase emphasis on the most productive accounts. Also, problems with the computer system cause additional problems with collector assignments.

In assigning accounts to collectors, little consideration is given to the type of account or size of balance. Accounts receivable cases are assigned to collectors according to taxpayer zip codes.* In the Collections Division, all the accounts within a certain zip code are assigned to one collector regardless of tax type. In the Tucson Collections Section, however, some zip code assignments are divided between two collectors.**

No effort is made to keep the number and total dollar amount of cases equitable among collectors. The present zip code assignment system includes no mechanism to ensure that collectors will not be assigned too many, or too few accounts. As shown in Table 5, collector I had only 307 accounts while collector B had 6,681 accounts. In addition, one collector may be assigned many accounts with high balances while another may have mostly small accounts. Because portfolios are so dissimilar, an account that is too small to merit attention in one collector's portfolio might be considered a high priority in another portfolio. This results in different collectors working with a wide range of different priorities at any given time.

* All zip codes in Arizona are distributed among the office collectors. The accounts assigned to collectors in this manner are referred to as the collectors' portfolios.

** Since some zip codes are divided, several Tucson collectors can concentrate on particular tax types within their designated zip codes. All account assignments, however, are still based on taxpayer zip codes.

TABLE 5

ACCOUNTS RECEIVABLE PORTFOLIOS FOR 15 RANDOMLY SELECTED PHONE COLLECTORS(1)

	Number of Accounts					
	Sales	Corporate	With-holding	Income	Total Number of Accounts	Total Dollar Value
Phoenix						
Collector A	633	77	8	3,035	3,753	$1,722,000
Collector B	1,087	87	13	5,494	6,681	2,714,000
Collector C	523	60	5	3,771	4,359	1,740,000
Collector D	505	66	6	2,881	3,458	1,434,000
Collector E	176	33	4	688	901	381,000
Collector F	401	60	0	2,503	2,964	1,427,000
Collector G	212	41	3	1,545	1,801	936,000
Collector H	833	117	9	4,088	5,047	2,292,000
Collector I	14	4	2	287	307	465,000
Collector J	641	120	7	4,150	4,918	2,256,000
Collector K	226	33	1	1,475	1,735	842,000
Collector L	191	27	4	699	921	543,000
Collector M	181	24	2	750	957	434,000
Tucson						
Collector N	84	15	1	94	194	146,000
Collector O	157	72	5	2,545	2,779	1,085,000

(1) Fifteen Collector portfolios were randomly selected from the total of 47 collector portfolios (30 in Phoenix, 17 in Tucson).

Source: Compiled by Auditor General staff from DOR computer printouts dated January and February 1985

Other factors not considered in making collector assignments are age of receivables, tax type and the relative experience of collectors. Age is an important factor affecting an account's collectibility, since the older an account, the less likely it can be successfully collected. Tax type should be considered to ensure that all types receive appropriate attention by collectors. Finally, experience and ability are important because some collectors have the expertise to handle particular types of accounts or more complex cases. Not taking these factors into consideration has resulted in potentially productive accounts not being effectively worked while less productive accounts receive too much attention.

The problem is further complicated by the automated assignment system, which does not allow for easy reassignment of accounts among portfolios. Presently, a Collections accounting clerk can change account assignments through an on-line terminal. However, these reassignments can only be made for one account at a time, making it cumbersome and time consuming to redistribute a portion of a large portfolio among several small portfolios.* In addition, if the system is being updated while a clerk is making assignment changes, the changes will not be permanent and the clerk will have to input them again later. Because of the difficulty involved, portfolios may not be reassigned when a collector leaves DOR or is transferred.** Instead, much of the portfolio may remain unworked until the position is eventually filled.

An Automated Collection System (ACS) that could allow DOR to concentrate effectively on high balance, productive accounts, is being planned. An invitation for bid proposals was dated November 6, 1984. A vendor was recently selected and a tentative contract has been forwarded to State Purchasing for review.

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* For example, one portfolio currently has more than 25,000 cases representing over $23 million. Many of the cases should be reassigned to other collectors. This will require a significant manual effort.

** In January 1985 there were four vacant office collector positions in Phoenix and Tucson, representing a total portfolio value of over $3.9 million.

The ACS will put all case assignments on an on-line system and allow cases to be prioritized by age, size and tax type. In addition, the system will automatically prepare lien and levy forms, and management reports on aging and account size. The system is designed to give collectors a paperless work environment. It will add the flexibility necessary to allow DOR to address portfolio equitability and collectibility issues, and to increase collector productivity.

DOR has done a cost/benefit analysis which indicates that staff savings alone resulting from the ACS will recover all but $116,000 of the $2.2 million the ACS will cost over the next 5 years.* Further, DOR's benefit analysis did not consider the potential for a substantial increase in collections resulting from better prioritization of accounts. The assistant director of the Management Services Division estimates that ACS can be operating 8 to 10 months after the contract is finalized.

<u>Minimal Collector Training</u> - Collection of the most productive accounts is also severely hampered by lack of training. Two Collections Division employees in supervisory positions have indicated that sales tax acccounts have not been worked effectively because collectors are not confident about how to handle them. Consequently, relatively low balance income tax accounts are worked, while high balance sales tax accounts are not. Lack of training could also cause collectors to neglect complex accounts of any tax type. A Collections Division administrator stated that collectors lack the sophistication to handle the more complex cases.

Currently, collectors receive minimal formal training. The only training new collectors receive is by working with a more experienced collector. There is also a lack of continuing training for collectors already on the job. Although collector training modules are available from DOR's

* The total cost of the system, discounted at 12 percent over the next 5 years, is estimated to be $2.2 million. This includes hardware purchase plus annual lease, maintenance and software license costs.

Management Services Division, it is left to the discretion of team supervisors in the Collections Division to schedule attendance. Supervisors do not currently send their collectors to the training modules. A Collections administrator stated that these modules are not adequate for collectors' needs. As a result, collectors are not as knowledgeable as they should be regarding procedures, policies and law. The administrator stated that lack of familiarity with the law has caused collectors to make bad determinations based on poor advice from other DOR employees. Therefore, taxpayers sometimes get the impression that collectors don't know their jobs.

Other states place more importance on collector training. For example, the California Board of Equalization has two core courses totaling 160 hours that all collectors take. It also has a 72-hour supervisory training course. Other states also emphasize training for new collectors in such subjects as telephone techniques, legal and statutory training, and collection procedures and methods.

Productivity Not Monitored - Collections management in both Phoenix and Tucson have not effectively monitored the productivity of their collectors to ensure collection of high balance accounts. The only management information available has been related to dollars collected. Little has been done to evaluate individual collector performance. A performance audit of DOR's sales tax program completed by the Auditor General's Office in 1981 recommended that supervisors more closely monitor collector performance. Additional information such as the amount and age of accounts worked by each collector per day by tax type should be gathered. This would allow management to monitor collector performance and compliance with DOR policies.

The new ACS system will be able to provide detailed information on individual collector performance, including time taken to resolve cases, and the number, type and size of cases worked. In addition, the Phoenix collections office has recently implemented a time reporting system that tracks the amount of time spent in direct collection activities, support activities, administration and training. This system, however, does not track specifics on the accounts worked, such as tax type or age. Combined data from both the ACS system and the new time reporting system, if used to closely monitor collector activity, should allow Collections management to significantly increase productivity by making certain that the Division's resources are directed toward the most productive areas. In addition, Collections management will be able to evaluate collector performance more effectively.

Tucson And Phoenix Collection Functions Are Not Coordinated

The organizational independence of the Tucson collections office also limits DOR's ability to emphasize high balance, productive accounts. Differences in work loads between Phoenix and Tucson create inequities in portfolio sizes and dollar values. In addition, Phoenix and Tucson have not had uniform policies and procedures, further reducing efficiency and leading to unequal treatment of taxpayers based on their location within the State.

Discrepancies in staffing and work loads between Tucson and Phoenix prevent efficient coordination and utilization of collection resources, and adequate emphasis on high balance accounts. Currently, Tucson collectors work all zip codes in the eight southern counties, while Phoenix handles the remaining seven counties. This has resulted in Tucson having fewer accounts per collector. The average collector work load in Phoenix is 2,843 accounts valued at over $1.3 million, as shown in Table 6. Tucson averages only 988 accounts at $450,000. Because the Tucson Collections Section reports to the assistant director of the Tucson office rather than to the assistant director of the Collections Division in Phoenix, the Collections Division doesn't have the authority to correct this imbalance.

TABLE 6

AVERAGE ACCOUNTS RECEIVABLE PER COLLECTOR(1) FOR PHOENIX AND TUCSON AS OF JANUARY/FEBRUARY 1985

	Sales Tax	Corporate Tax	Income Tax	Total	$ Per Collector
Phoenix	420	59	2,364	2843	$ 1,347,000
Tucson	109	17	862	988	$ 450,000

(1) Tucson had 28 collectors in February 1985, but had only 17 collector portfolios, resulting in some portfolios being assigned two collectors. Phoenix had 29 collector portfolios, with one collector per portfolio.

Source: Compiled by Auditor General staff from DOR computer reports dated January and February 1985

In addition, policies relating to assignments, how cases are worked, and the types of documentation maintained have been different in Phoenix and Tucson. For example, in the past Phoenix prepared written partial payment agreements, while Tucson permitted such agreements to be oral. In addition, the terms that went into the agreements have been different, leading to possible inequitable treatment of taxpayers based on location. DOR officials have stated that part-pay agreement discrepancies were recently corrected.

CONCLUSION

Although DOR has recently made progress, some potentially productive past due accounts are not effectively pursued by collectors. Large sales, corporate income tax and withholding accounts have not always received adequate attention. This has been caused by poor assignment procedures, inadequate management information regarding productivity, and lack of training. Limited coordination between the Phoenix and Tucson collection operations has further limited DOR's ability to effectively collect the most productive accounts and results in possible inequitable treatment of taxpayers.

RECOMMENDATIONS

DOR management should:

1. Increase emphasis on the collection of large sales tax, corporate income tax and withholding accounts.

2. Continue plans to implement the Automated Collection System as soon as possible. The ability to make assignments based on a variety of parameters including account size, age and tax type is essential.

3. Require that training be conducted for Collections personnel. Training should cover collection procedures, telephone techniques and applicable statutory provisions.

4. Track collector productivity to direct resources toward the most productive areas and to evaluate collector performance. The ACS should be used in conjunction with the new time reporting system to capture the necessary data.

5. Coordinate work loads and ensure uniformity of policies between the Phoenix and Tucson collection offices.

FINDING IV

PROCEDURAL CHANGES ARE NEEDED TO IMPROVE ENFORCEMENT AGAINST BANKRUPTCY SALES TAX ACCOUNTS

Procedural changes are needed to enforce collection actions against bankruptcy sales tax accounts. Inadequate monitoring of Chapter 11 and 13 bankruptcy accounts can result in revenue loss to the State of Arizona. The Department of Revenue's (DOR) elimination of a policy to issue new license numbers to businesses under Chapter 11 and 13 bankruptcy would greatly assist in resolving the problem.

Chapter 11 and 13 bankruptcies are established by the Federal Bankruptcy Code. They are designed to provide protection to financially troubled businesses while they pursue a reorganization in hopes of paying off their debts. Chapter 11 and 13 bankruptcy law gives businesses the protection of the Federal Bankruptcy Court by requiring all creditors to take enforcement actions through the Court. In return, a business is required to file a plan with the Court detailing methods and time frames to repay outstanding debts. In addition, a business is required to operate without incurring additional debt, and maintain current payment of all taxes. If taxes are not paid DOR can move to have the Court dismiss the bankruptcy and remove its protection, or DOR can ask the Court to convert the bankruptcy to a Chapter 7 bankruptcy and force liquidation.

Inadequate Identification Of Bankruptcy Accounts

The Collections Division does not adequately identify and monitor Chapter 11 and 13 bankruptcy accounts. This failure can result in revenue loss.

Current Procedures Do Not Allow Timely Identification Of Bankruptcy Accounts - DOR's procedures to monitor bankruptcy accounts result in untimely identification of post-petition liabilities. All sales tax accounts receivable involving Chapter 11 or 13 bankruptcies are assigned to one collector who monitors bankruptcy sales tax accounts and serves as DOR's liaison to the U.S. Bankruptcy Court. The bankruptcy collector is also responsible for contacting a business undergoing a Chapter 11 or 13 bankruptcy and notifying the business that its old sales tax license has been canceled and that application must be made for a new license. However, if and when the new license is issued, the bankruptcy collector is not notified of the new sales tax number, and therefore has no way of knowing if the business is paying current taxes.

If a business owes taxes under the new sales tax license, the account is treated like any other receivable and is assigned to a phone collector through the standard assignment method. In most instances, the phone collector discovers the bankruptcy status of the account only upon contacting the business. However, since the business has agreed to maintain payment of current taxes as part of the Chapter 11 and 13 bankruptcy agreement, it may not be in the business's best interest to provide this information to the phone collector (see case example, page 35). Once an account has been identified by the phone collector as a Chapter 11 or 13 bankruptcy account, notification must be made to the bankruptcy collector and the account must be manually transferred through the automated sales tax accounts receivable system to the bankruptcy collector's inventory.

<u>Lost Revenue</u> - Failure to promptly identify and act on bankruptcy accounts can result in revenue loss. A review of the Collections Division's inventory of approximately 284 Chapter 11 and 13 bankruptcy accounts identified 44* businesses that owed a total of $105,500** in taxes under their new sales tax licenses. Such cases require timely action through the Bankruptcy Court to assure payment. As shown in the case example, if action is delayed and these businesses fail or protection is lifted, remaining assets may be insufficient to pay the taxes.

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* Additional accounts may exist since a majority of the 44 were identified by computer matching the names of all sales tax accounts to bankruptcy accounts. This method is limited since businesses do not always apply for their second license under the same business name.

** This figure includes penalty and interest.

- Case: In March of 1983 a business was granted Chapter 11 bankruptcy protection by the U.S. Bankruptcy Court, District of Arizona. As of that date, the business owed $11,239.69 (including penalty and interest) to the Department of Revenue for past due sales taxes. As required by DOR policy, the business's original sales tax license was canceled and a new license was issued on May 1, 1983.

  The business immediately fell behind on the payment of its taxes under its new license number. Fifteen months later, in August 1984, a collector began work on the account.* After three unsuccessful attempts to contact the business's owner by telephone, the phone collector transferred the account to a Phoenix field collector in September 1984. The field collector took escalated enforcement actions against the business, including a bank levy that netted approximately $1,400, and service of a subpoena for the delinquent sales tax returns. According to the two collectors, the owner of the business never informed them that the business was under the shelter of a Chapter 11 bankruptcy.

  On January 4, 1985, the U.S. Bankruptcy Court dismissed the Chapter 11 bankruptcy as a result of a motion filed by the Internal Revenue Service (IRS). At this time, since the business was no longer under the protection of the Bankruptcy Court, DOR began efforts to collect both pre- and post-petition liabilities owed by the business, which now totaled more than $50,000. In February of 1985, a truck owned by the business was seized by DOR field collectors and later sold for $2,150. Because other creditors, including the IRS, had already seized all other assets, the field collector recommended that the account be written off.

  Comment: Due to the Collections Division's failure to identify and take timely collection actions against a bankrupt business that failed to pay current taxes, at least $50,000 in sales tax revenue was lost. If DOR had identified the business as under Chapter 11 bankruptcy sooner and taken action through the U.S. Bankruptcy Court to restrain the business, the size of the loss may have been reduced.

DOR Does Not Need To Issue New License Numbers

A DOR policy requiring businesses under Chapter 11 or 13 bankruptcy to change their sales tax license numbers has impaired the Collections Division's ability to monitor and collect these accounts. Although this problem has been identified by DOR personnel, little has been done to remedy the situation.

* This account was first assigned to the Tucson office, but was not worked. After 12 months it was reassigned to the Phoenix office.

DOR's Policy Of Changing Sales Tax Numbers To Distinguish Pre- and Post-Bankruptcy Petition Liabilities Is Unnecessary - Current DOR policy requires a sales tax licensee under the shelter of a Chapter 11 or 13 bankruptcy to file for a new sales tax license. DOR does this to enable the computer system to stop billing under the old license and to provide the ability to distinguish between pre- and post-bankruptcy petition taxes. However, a new license does not need to be issued. First, because of the protection from harassment given to businesses under the Bankruptcy Code, DOR must still take action to prevent billings being sent to the business regardless of whether it has a new or old account number. Second, DOR can develop a simple internal control method within the automated accounts receivable reporting system to distinguish between pre- and post-bankruptcy petition liabilities. This can be done by establishing a procedure that identifies the pre-petition balance, thereby separating it from any post-petition liabilities yet maintaining the same licensing number. This is the method used by the IRS in similar cases. If a business retains the same number, all tax liabilities incurred by the bankrupt business will be assigned to the bankruptcy collector for immediate attention.

Agency Response To Problem Is Slow - The problems caused by issuing two license numbers to a bankrupt business were identified by DOR as early as June 1984. Currently, DOR's Data Processing Section has a "request for services" to make changes in the accounts receivable system that could resolve the problem. However, these changes will not completely address the situation because the proposed solution does not identify a method to distinguish between pre- and post-petition liabilities.

CONCLUSION

Procedural changes are needed to more adequately monitor and take timely collection actions against Chapter 11 and 13 bankruptcy sales tax accounts. DOR's policy of issuing new licenses to businesses under Chapter 11 and 13 bankruptcy sometimes delays identification and monitoring of these accounts and may result in a loss of revenue.

RECOMMENDATION

DOR should discontinue the practice of issuing new sales tax licenses to businesses under Chapter 11 and 13 bankruptcy. License numbers should remain the same and the automated sales tax accounts receivable system should be modified so both pre- and post-bankruptcy petition liabilities can be assigned to the bankruptcy collector as they are incurred by a business.

OTHER PERTINENT INFORMATION

During the audit, we developed pertinent information in two areas: 1) lack of Attorney General approval of write-offs, and 2) plans for a new automated billing system.

Written Off Accounts Not Approved By The Attorney General

The Department of Revenue (DOR) places accounts receivable on inactive status when it is determined that collection is unlikely.* Once the necessary paperwork is prepared, these accounts are permanently removed from the computerized accounts receivable system and from collector portfolios.

Although lists of these written off accounts are prepared, the accounts are never subsequently monitored. As a result, DOR may be violating statutes requiring that permanently abated accounts be approved by the Attorney General's Office. If written off accounts are not monitored and assets were not previously liened, a write-off could be considered the same as a permanent abatement. Arizona Revised Statutes §§42-1048 and 43-642 require Attorney General approval of all permanent abatements of taxes receivable.

New Billing System Being Developed

A new billing system is being designed to automate the phone collections process. This new billing system will work in conjunction with the proposed Automated Collection System. DOR needs this billing system in order to streamline the collections function and enhance DOR's collection potential.

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* These accounts include defunct corporations with account balances less than $5,000, income tax or withholding cases with balances of less than $1,000 when the taxpayer can't be located, or accounts in which taxpayers are unable to pay due to indigence or death. This procedure is also referred to as writing off accounts receivable.

Presently, every receivable is assigned to a phone collector as soon as a liability is established. This results in the inefficient use of collectors, because billings alone can result in payment. In addition, final demand letters are manually generated, resulting in the further inefficient use of Collections personnel.

Under the proposed billing system, an account will be billed twice and then a computer generated final demand notice will be sent to the taxpayer.* The billing cycle is set for 60 days but can be shortened for high dollar receivables (those exceeding $1,000). During the billing sequence, if mail is returned or a taxpayer indicates an inability or refusal to pay, the account will be taken off the billing cycle and assigned to a phone collector. The phone collector will then pursue the account according to DOR's established policies and procedures.

* Larger accounts (exceeding $1,000) will be billed only once before a final demand notice is sent.

AREAS FOR FURTHER AUDIT WORK

During the course of our audit, we identified several potential issues that we could not pursue because they were beyond the scope of our audit or we lacked sufficient time. These areas include the following.

- **Is DOR's computer programming staff qualified to design and develop major systems?**

  The Department of Revenue's (DOR) Electronic Data Processing (EDP) staff currently designs most of the major computer systems that DOR needs, including the accounts receivable systems for all four tax types (income, sales, corporate and withholding). During the course of our audit work we obtained information which indicates that internally developed systems may be poorly designed. Further audit work is needed to determine whether DOR programming staff are qualified to develop the Department's major systems and whether the EDP Section's programming work load exceeds available resources. One alternative that should be studied is to contract more often for the development of major systems (such as DOR is currently doing with the Automated Collection System - see Finding III).

- **Is the Taxpayer Information Services group effectively coordinating programmers and systems users?**

  Taxpayer Information Services (TIS) is intended to be a liaison between computer system users and the programmers who design the systems. This should ensure that systems adequately meet user needs. DOR system users have pointed out, however, that their needs are often not being met. Further audit work is necessary to ascertain whether TIS is performing its liaison job effectively.

- <u>Are collection statistics distorted by double counting?</u>

  Some amounts reported as being collected through the collections function may also be reported as audit revenue by the audit function. Although efforts are made to allow for the resultant double counting, further audit work is needed to determine whether statistics used by DOR management and figures reported outside of DOR are overstated with regard to either audit or collections revenue.

- <u>What can be done to provide a career ladder for Collections personnel?</u>

  Currently, phone collectors have no promotional or career opportunities within the phone unit. This can make it difficult for DOR to retain experienced phone collectors. In addition, Collections personnel salaries are significantly below salaries for similar positions in the IRS. Although DOR management has recognized the need to establish a career ladder for collectors, further audit work is necessary to determine specifically what should be done.

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

Bruce Babbitt
Governor

July 31, 1985

Mr. Douglas R. Norton
Auditor General
111 West Monroe, Suite 600
Phoenix, Arizona 85003

Dear Mr. Norton:

The Department of Revenue has completed its review of the draft report on the performance audit of the Collections Division. I believe the following points put into perspective our performance over this audit period and are relative to this evaluation.

We have gone from collecting a little over $19 million (FY '81-'82) to collecting over $76 million (FY '84-'85), which is indeed a 300 percent increase in collections over the last four years. This amounts to about $921,000 brought in by each collector (FY '84-'85), supervisors excluded. We accomplished this by implementing a stringent enforcement program and it is working. The value of this program lies not just in the tens of millions of dollars it generates, but also in the fact that better equity is achieved in our state's tax structure. If this money were not generated, some state programs would have to be eliminated and/or taxes increased for those who do pay.

We think we even can improve upon this productivity of our collectors. We are pleased that your auditors concur with our own analysis that an automated collection system appears to be the next logical step for our program. If we are able to proceed with this enhancement, our productivity should increase and our service to the taxpayer will improve.

Some of your recommendations deal with better service and we concur that this is a necessary direction to take in the collections area. Our proposed automated collection system will greatly facilitate this. We have also implemented changes in our processing of payments by utilizing electronic cashiering equipment so that we can track payments received and process those without errors as quickly as possible.

Mailing address (Capitol):
1700 W. Washington
Phoenix, AZ 85007

Other locations:
Phoenix Uptown
5555 N. 7th Avenue

Tucson
402 W. Congress

We recognize there is still substantial progress that can and should be made in our collection programs and we shall continue to move forward in that direction. We generally concur with the findings and recommendations. Specific comments for each finding are attached for your information and inclusion in the final report.

Your staff has been cooperative and helpful in the conduct of the performance audit. Their findings and recommendations will assist us to improve the administration of the collections' functions.

Please contact me if you have any questions concerning our written reply.

Sincerely,

ARIZONA DEPARTMENT OF REVENUE

JEHibbs

J. Elliott Hibbs
Director

blm

attachment

DEPARTMENT OF REVENUE COMMENTS
PRELIMINARY REPORT OF THE AUDITOR GENERAL
PERFORMANCE AUDIT - COLLECTIONS DIVISION

In general, we concur with the findings of the performance audit and have already adopted, are implementing or are planning implementation of most of the recommendations.

Our comments are offered in the sequence of the findings in the report.

Finding I: The Collections Division does not receive accurate information.
Recommendation 1: DOR should determine whether the existing batch system could be modified to reduce the degree to which processing of good accounts receivable payments is delayed by problem payments in the same batch.

DOR RESPONSE

We have addressed this situation in income tax accounts receivable payments and it is not a problem. In our sales tax system, this is a problem but we have corrected it in the rewrite of this system. By August 1985, problem payments will no longer impact the processing of good accounts receivable payments in the same batch for sales tax.

Recommendation 2: DOR should investigate the possibility of obtaining optical character recognition equipment for initial data entry.

DOR RESPONSE

We concur and will investigate the feasibility of such equipment and propose it for funding if applicable.

Recommendation 3: DOR management should take steps to ensure that the accounts receivable group consistently meets its goal of making on-line maintenance changes to the accounts receivable system within 24 hours.

DOR RESPONSE

We agree and this section's objectives reflect this. Our upcoming Business Master File will address nonmoney on-line maintenance which will assist in meeting this objective.

Recommendation 4: Collections personnel should be provided with copies of unapplied payment reports.

DOR RESPONSE

This would be unproductive as these reports are not sorted in a usable format for collection purposes. Our NCR cash register system provides reports on payments received and is better suited for collection's research.

Recommendation 5: DOR management should finalize plans for the Business Master File and set a target date for the project's completion.

DOR RESPONSE

The Business Master File was funded for FY '85-'86, and will take two years to complete and become operational.

Finding II: Withholding tax compliance could be enhanced.
Recommendation 1: DOR should take action to obtain the FEIN from all employers registered to remit withholding tax to the State of Arizona.

DOR RESPONSE

We agree and are working toward this goal. We request this information on new licenses and will fully implement this field for new and old licenses as part of implementing the Business Master File.

Recommendation 2: DOR should match internal withholding tax documents and match information with the I.R.S. and D.E.S. to increase compliance with withholding tax laws.

DOR RESPONSE

We agree and will have the capability to accomplish this once our Business Master File is completed. We are presently implementing a computer linkage with D.E.S. to match our files for individual compliance.

Recommendation 3: DOR should seek passage of legislation clearly establishing the level of penalties to be assessed against employers who deposit withholding taxes late. Once such legislation is obtained, DOR should enforce penalties for untimely payments.

DOR RESPONSE

We have already sought this legislation as part of our General Tax Administration Bill passed this last legislative session. It takes effect July 1, 1986.

Finding III. DOR could take additional steps to emphasize the potentially most productive accounts.
Recommendation 1: Increase emphasis in the collection of large sales tax, corporate income tax and withholding accounts.

DOR RESPONSE

We have, we do, and we shall continue to emphasize the collection of large accounts. To obtain the 300 percent increase in collections over the last four years (as determined by the Auditor General) obviously has required emphasis on large accounts. Anyone can improve and we shall strive to continue our improvements.

Recommendation 2: Continue plans to implement the automated collection system as soon as possible. The ability to make assignments based on a variety of parameters, including account size, age and tax type is essential.

DOR RESPONSE

We obviously agree with this recommendation since it affirms our unilateral action to automate and improve collector productivity. If our study of the proposed system is positive and it is affordable, then we shall implement.

Recommendation 3: Require that training be conducted for Collection's personnel. Training should cover collection procedures, telephone techniques, and applicable statutory provisions.

DOR RESPONSE

This fiscal year, we are addressing the best way to improve collector knowledge and productivity. In the past we have utilized on-the-job training with some classroom type work. Our goal will be to provide the tools needed for a collector to best service the taxpayer.

Recommendation 4: Track collector productivity to direct resources toward the most productive areas and to evaluate collector performance. The ACS should be used in conjunction with the new time reporting system to capture the necessary data.

DOR RESPONSE

Our present manual system for evaluating collector productivity is less than ideal but the collection results are excellent. If we implement an automated collection system, it will be based on the belief that the system cost is justified due to a potential increase in productivity.

Recommendation 5: Coordinate workloads and ensure uniformity of policies between the Phoenix and Tucson Collection Offices.

DOR RESPONSE

At the time we increased our collection efforts, we were able to hire trained personnel, in Tucson, while the Phoenix market contained fewer available candidates. It should be noted that the results of the Tucson Office have been outstanding. We totally agree that there should be uniformity of policies between Phoenix and Tucson and will continue to correct any disparity as it is identified.

Finding IV: Procedural changes are needed to improve enforcement against bankruptcy sales tax accounts.
Recommendation: DOR should discontinue the practice of issuing new sales tax licenses to businesses under Chapter 11 and 13 bankruptcy. License numbers should remain the same and the automated sales tax accounts receivable system should be modified so both pre- and post-bankruptcy petition liabilities can be assigned to the bankruptcy collector as they are incurred by a business.

DOR RESPONSE

The manual approach is not ideal but recognizes that regulation R15-5-22-5(B) requires a new license as based on the advice of the Attorney General's Office relating to ARS 42-1308. We have tightened up our procedures to better track new licenses against old licenses. Our automated collection system should simplify this tracking even more.