



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Sunset Review

Arizona Department of Revenue—Sunset Factors

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Report No. 15-117



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Auditor General

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

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September 30, 2015

Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

Mr. David Raber, Director
Arizona Department of Revenue

Transmitted herewith is a report of the Auditor General, *A Sunset Review of the Arizona Department of Revenue*. This report is in response to an October 3, 2013, resolution of the Joint Legislative Audit Committee and was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq.

Although this report does not include any recommendations, the Arizona Department of Revenue provided a brief response to the report.

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

Sincerely,

Debbie Davenport
Auditor General

Attachment

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INTRODUCTION

Scope and Objectives

The Office of the Auditor General has conducted a sunset review of the Arizona Department of Revenue (Department) using the criteria in Arizona's sunset law. This review was conducted pursuant to an October 3, 2013, resolution of the Joint Legislative Audit Committee and prepared as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

This report includes responses to the sunset factors specified in A.R.S. §41-2954 and is the final in a series of three reports on the Department. The first report addressed the Department's use of information technology (IT) and its IT governance and management processes (see Report No. 15-105). The second report examined the Department's security of state taxpayer information (see Report No. 15-116).

Department administers state tax laws

Mission and purpose

The Department was established by Laws 1973, Ch. 123, which transferred the powers and duties of the Department of Property Valuation and the Estate Tax Commissioner and certain functions of the State Tax Commission to the Department. The Department's mission is to "serve the people of Arizona by administering tax laws with integrity, fairness, and efficiency." One of the Department's primary responsibilities is to collect tax revenues, which it collects for several tax types, including transaction privilege, use, and severance taxes; corporate income, individual income, and withholding taxes; and luxury tax (see textbox).

Arizona's primary tax revenue sources and amounts collected¹ Fiscal year 2014

- **Transaction privilege, use, and severance taxes (approximately \$7.1 billion)**—A transaction privilege tax (TPT) is imposed on the seller for doing business in the State. Because it is usually passed on to the customer, this tax is commonly referred to as a sales tax. Use and severance taxes are similar to TPT but apply to out-of-state purchases and mining of certain minerals, respectively.
- **Corporate income, individual income, and withholding taxes (approximately \$5.4 billion)**—Income taxes are imposed on individuals and corporations earning income in Arizona. In addition, employers must withhold income tax from their employees' compensation and remit it to the Department.
- **Luxury tax (approximately \$400 million)**—Luxury taxes apply to liquor and tobacco products. The majority of these monies are distributed to special funds.

¹ The Department also administers many other taxes that bring in less revenue annually such as estate, bingo, and waste tire taxes; however, the revenue from these taxes collectively totaled approximately 1 percent of the total revenue the Department collected in fiscal year 2014.

Source: Auditor General staff analysis of department documentation.

Organization and staffing

The Department is organized into eight divisions in addition to its Office of the Director. As of June 30, 2015, the Department reported it had 757.75 filled full-time equivalent (FTE) positions. The divisions' responsibilities and staffing are as follows:

- **Director’s Office (23 filled FTE positions)**—The director is responsible for the Department’s direction, operation, and control. The director’s office staff include department executives and assistants such as the chief deputy director, the deputy director, the problem resolution officer, the legislative liaison, two internal auditors, and the eight divisional assistant directors.¹ In addition, the Director’s Office includes the Office of Economic Research and Analysis (Office), which provides statistical analysis and research services to the Department, the Governor’s Office, the Legislature, and others. The Office provides staff support for the Economic Estimates Commission, the Debt Oversight Commission, and the Property Tax Oversight Commission (see textbox, page 4, for more information about these commissions).
- **Administrative Services (39.5 filled FTE positions)**—This division is responsible for oversight of the Department’s financial and employee services by helping to prepare the Department’s annual budget, executing internal training, and handling purchasing, payroll, and facilities. This division also holds hearings and issues written decisions on protests of department assessments and refund denials relating to income, withholding, and estate taxes. Finally, this division administers unclaimed property in an effort to return the property to its rightful owner, such as dormant bank accounts; insurance policy proceeds; security deposits; unclaimed stocks, bonds, and mutual fund accounts; safe deposit box contents; and all types of uncashed checks.
- **Audit (187 filled FTE positions)**—The Audit Division performs audits of selected taxpayers for most tax types to ensure that they are paying the correct amount of state tax. The Department reported that the division assessed nearly \$207 million in fiscal year 2014 that taxpayers owed to the State. The division also administers bingo and tobacco taxes and issues licenses to bingo operations and tobacco distributors (see Sunset Factor 11, pages 16 through 17, for more information about bingo and tobacco taxes). Finally, the division is responsible for special programs and projects, including maintaining the Model City Tax Code and supporting the Municipal Tax Code Commission (see textbox, page 4, for details).
- **Collections (162 filled FTE positions)**—The Collections Division is responsible for collecting taxes owed on delinquent accounts. The Department reported that this division collected approximately \$232 million in fiscal year 2014 from taxpayers who owed taxes to the State. This division is also responsible for the interception and redirection of income tax refunds for taxpayers who owe debts to other state agencies, the courts, and political subdivisions of the State, and for ensuring those debts are paid before a refund is released to the taxpayer.
- **Information Technology (IT) (108 filled FTE positions)**—The IT Division is responsible for providing an integrated IT environment and automated business processes. The Department’s primary IT system for its tax administration and enforcement functions is the Business Reengineering/Integrated Tax System (BRITS). BRITS comprises multiple applications, including both the Taxpayer Accounting System (TAS) and AZTaxes. TAS refers to the system that supports the processing of individual income, withholding, corporate income, and transaction privilege taxes. AZTaxes is the Web-based system that handles electronic filing of tax returns and all of the Department’s bank deposits. In addition to

¹ As of July 2015, the chief deputy director and the deputy director positions were vacant.

maintaining the primary IT system, the division provides support services, project management, vendor management, and operations and security functions department-wide.

- **Process Administration (86 filled FTE positions)**—The Process Administration Division is responsible for processing all tax returns for taxes the Department administers, including those submitted electronically or on paper, and for processing payments and refunds for Arizona taxpayers. In fiscal year 2014, the division processed approximately 5.7 million tax returns, of which 54 percent were electronically filed.
- **Property Tax (29 filled FTE positions)**—The Property Tax Division is responsible for the general oversight of county assessors in administering Arizona’s property tax laws and ensuring the application of uniform appraisal methods and techniques county assessors use to determine the value of locally assessed property (see textbox for county assessor duties). The division provides an assessor certification program for county appraisal staff and supports the Education, Training, and Certification Committee (see textbox, page 4, for more information about this committee). The division is also responsible for setting values for complex properties that require specific expertise and for properties that stretch across county lines, such as utilities, railroads, and mines.
- **Taxpayer and External Services (89 filled FTE positions)**—This division is responsible for the Department’s customer service and handles incoming phone calls, e-mails, and walk-ins to assist taxpayers. This division provides taxpayer and tax practitioner educational programs and provides licensing and registration services for those who wish to conduct business within the State. The division’s Criminal and Civil Investigations Unit enforces tobacco tax laws and investigates tax evasion and improper or fraudulent tax activity by both taxpayers and tax preparers.
- **Tax Policy and Research (34.25 filled FTE positions)**—This division is responsible for providing administrative tax policy for the Department, support for the Audit Division, and guidance and interpretative advice to other department divisions. The division also acts as a liaison to the Attorney General’s Tax Section and provides additional support to the department director, as needed.

A county assessor’s duties:

- Locate and identify all taxable property in the county and its ownership.
- Establish a value for all property subject to property taxation.
- List the values of all property on the assessment roll.

Source: Auditor General staff analysis of A.R.S. §42-13051 and <http://www.azleg.gov>.

Commissions and committee the Department supports

Debt Oversight Commission—To provide more accurate and meaningful information to the public regarding bond issues, this commission is responsible for reviewing information provided to the State Treasurer to determine how much each taxing jurisdiction in the State owes from the issuance of public bonds and securities compared to established debt limits.

Economic Estimates Commission—This commission is responsible for determining and annually reporting to the Legislature the estimated total personal income in the State and determining and publishing the maximum dollar amount that is expected to be available for legislative appropriation from state tax revenues. The Commission is also responsible for determining and publishing the annual expenditure limitations for each county, city, town, community college district, and school district.

Education, Training, and Certification Advisory Committee—This committee is responsible for evaluating the curriculum, exams, and guidelines the Department proposes regarding certifying people who perform the duties or exercise the authority of a property appraiser on behalf of a county to assess property values.

Municipal Tax Code Commission—This commission is responsible for reviewing and commenting on revisions municipalities and taxpayers propose regarding the Model City Tax Code, which outlines how all cities and towns in Arizona should administer the TPT tax.

Property Tax Oversight Commission—This commission is responsible for furthering public confidence in property tax limitations, providing a uniform methodology for determining those limitations, and helping ensure a fair and equitable administration of the property tax laws. The commission's duties include reviewing each political subdivision's primary property tax levy, reviewing tax levy and rate of school districts, and holding hearings on tax levy limits compliance.

Source: Auditor General staff analysis of Arizona statutes, the Arizona Constitution, and the Department's Web site.

Department revenues and expenditures

As shown in Table 1 (see page 5), the Department receives funding for its operations from various sources. Specifically, the Department was appropriated approximately \$46.4 million from the State General Fund in fiscal year 2015. In addition, the Department was appropriated approximately \$7.2 million in Automation Projects Fund (APF) monies for various IT projects and \$24.5 million from its Administrative Fund, which primarily includes unclaimed property monies that are allocated to the Department according to statute.¹ The Department also received approximately \$1.8 million from other sources, including nearly \$1.1 million from charges for services and \$544,000 from tobacco taxes. As shown in Table 1, the Department's fiscal year 2015 expenditures totaled nearly \$79 million, with more than \$52.5 million, or 67 percent, going toward personal services and related benefits, and approximately \$10.4 million, or 13 percent, going toward professional and outside services. Travel, building and land rental costs, other operating, and equipment expenditures totaled nearly \$16 million.

¹ The APF was created by Laws 2012, Ch. 298, and is used by state agencies to implement, upgrade, or maintain automation and IT projects. The APF is administered by the Arizona Department of Administration, and proposed projects require the Joint Legislative Budget Committee's (JLBC) review. The Arizona Department of Administration must submit quarterly project reports to the JLBC that include the projects' deliverables, completion timeline, expenditures to date, and current status.

**Table 1: Schedule of revenues, expenditures, and changes in fund balance
Fiscal years 2013 through 2015
(In thousands)
(Unaudited)**

	2013	2014	2015
Revenues			
Appropriations:			
State General Fund	\$ 45,032	\$ 46,334	\$ 46,449
Administrative Fund ¹	25,015	23,806	24,500
Automation Projects Fund	3,431	1,324	7,233
Charges for services ²	1,066	1,060	1,086
Tobacco taxes	676	575	544
Intergovernmental revenue	150	149	150
Other	<u>16</u>	<u>10</u>	<u>26</u>
Total revenues	<u>75,386</u>	<u>73,258</u>	<u>79,988</u>
Expenditures			
Personal services and related benefits	47,397	49,970	52,519
Professional and outside services	7,061	9,529	10,404
Travel	579	542	419
Building and land rental costs	3,074	3,147	3,073
Other operating	10,624	9,293	9,287
Equipment	<u>5,017</u>	<u>1,261</u>	<u>3,213</u>
Total expenditures	<u>73,752</u>	<u>73,742</u>	<u>78,915</u>
Excess of revenues over expenditures	1,634	(484)	1,073
Fund balance, beginning of year	<u>3,747</u>	<u>5,380</u>	<u>4,896</u>
Fund balance, end of year ³	<u>\$ 5,380</u>	<u>\$ 4,896</u>	<u>\$ 5,969</u>

¹ Amounts are primarily from unclaimed property monies allocated to the Department in accordance with A.R.S. §44-313.

² Amount includes fees collected from Arizona state agencies, the courts, and political subdivisions when they request the Department to divert income tax refunds to satisfy debts that taxpayers owe to them.

³ Most of the Department's fund balance is unavailable for the Department's use unless the amounts are appropriated in future years.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File* and the AFIS Management Information System *Status of General Ledger-Trial Balance* screen for fiscal years 2013 through 2015.

SUNSET FACTORS

Sunset factor analysis

In accordance with Arizona Revised Statutes (A.R.S.) §41-2954, the Legislature should consider the following factors in determining whether to continue or terminate the Arizona Department of Revenue (Department).

Auditors' analysis of the sunset factors found the Department's performance satisfactory with regard to many of these factors. However, it needs to address the recommendations directed to it in the other two audit reports issued as part of this sunset review (see Report Nos. 15-105 and 15-116).

1. The objective and purpose in establishing the Department and the extent to which the objective and purpose are met by private enterprises in other states.

The Department was established by Laws 1973, Ch. 123, which transferred the powers and duties of the Department of Property Valuation and the Estate Tax Commissioner and certain functions of the State Tax Commission to the Department. The Department's mission is to "serve the people of Arizona by administering tax laws with integrity, fairness, and efficiency." The Department's key functions include processing tax documents and payments, auditing taxpayers, and collecting money owed to the State. The Department also regulates property tax by overseeing the counties' efforts to collect property taxes and assists taxpayers who require information or tax resources (see the Introduction, pages 1 through 5, for more information about the Department's functions).

Auditors did not identify any states that met the Department's objectives and purpose through private enterprises.

2. The extent to which the Department has met its statutory objective and purpose and the efficiency with which it has operated.

The Department has generally met several of its statutory objectives and purposes but should improve in some areas. Some examples of where the Department has met its purpose and improved its efficiency include:

- **Tax collected and returns processed**—In fiscal year 2014, the Department reported it collected more than \$13 billion in gross revenues from all tax types and processed approximately 5.7 million tax returns. In addition, it reported collecting more than \$525 million in revenue in fiscal year 2014 through its collections, accounts receivable, and audit functions. According to the Department, in fiscal year 2014, its collectors brought in an average of approximately \$1.7 million dollars per collector, and auditors collected at different levels depending upon the type of audit work performed, with transaction privilege tax (TPT) auditors collecting an average of approximately \$2 million per auditor.
- **Efforts to prevent individual income tax refund fraud**—In response to criminals fraudulently claiming taxpayers' individual income tax refunds, the Department reported that it began monitoring for this type of fraud in 2009 and that it has enhanced its monitoring efforts annually. Before tax refunds are released, each return proceeds

through a series of electronic system checks to look for matches against specific criteria that may indicate a fraudulent return. After returns have been screened in the system, the direct deposit returns go through an additional series of checks for bank fraud. With these efforts, the Department reported that it has identified more fraud recently than in prior years, stopping more than \$70 million in fraudulent returns each year in 2014 and 2015. Department staff reported that they generally investigate any return identified as potentially fraudulent within 4 weeks. However, if a taxpayer calls and reports he/she is a victim of identity theft and is concerned about his/her return, staff reported that a return can usually be investigated within 3 days. As a comparison, the Department reported that the average time to issue an individual income tax refund that was not detected for fraud was approximately 9 days in fiscal year 2014.

The Department reported that staff participate in monthly conference calls with other states to continually develop new methods for detecting tax refund fraud and that staff attend annual Federation of Tax Administrators training to improve their fraud-prevention practices.¹ Finally, the Department is preparing to contract for private fraud-prevention investigation services (see Sunset Factor 12, page 18, for details). A department official said that this contract will likely include services to screen or assist in screening individual income tax returns for fraud and may include handling some communications with taxpayers who may be involved in or are victims of fraudulent filings.

- **Streamlined processes**—The Department has completed several process improvements through Lean projects with the Arizona Government Transformation Office (GTO), a division of the Arizona Department of Administration.² The GTO advocates following the Lean paradigm, a system of principles and tools often used in the private sector that focuses on minimizing waste by empowering employees to improve processes while maximizing customer value. Since 2013, the Department has worked with the GTO on nine Lean projects, including the following:
 - The Department's Process Administration Division conducted a Lean project to streamline the processing of paper-filed individual income tax returns prepared with barcode technology. The division was able to reduce the overall average number of days to process these returns from 4.48 days in calendar year 2013 to 3.29 days in calendar year 2014, resulting in a 26 percent reduction in processing time. Improvements included relocating all processing functions to a single-level facility to improve visual management of the work and put resources where needed to prevent bottlenecks (see page 9 for additional information about the processing facility move).
 - According to the Department, in 2015, its Taxpayer and External Services Division engaged in a Lean project and hired additional staff to improve the turnaround time to process and issue business licenses from an average of 19 to 2.3

¹ The Federation of Tax Administrators is a national organization whose purpose is to improve the quality of state tax administration by providing services to state tax authorities and administrators, including research and information exchange, training, and intergovernmental and interstate coordination.

² The GTO works directly with state agencies and their employees to help develop better processes for operation.

days. The Lean team brought together internal and external stakeholders, including business owners who must apply for the license. Some of the reported benefits of the project include improved customer satisfaction, shorter time to receive a license, and elimination of duplicate work.

- In May 2015, the Department began working on a Lean project focused on providing a simplified license application and filing process for property management companies and property owners of residential rental properties to pay transaction privilege tax. The Department hopes this project will result in a business- and taxpayer-friendly process where the State processes fewer returns and provides one central location for the licensing and registration of all residential rentals in the State.
- **Relocation of tax-processing division**—As mentioned previously, one of the Department’s Lean projects resulted in relocating the Process Administration Division to a single-level facility, which was completed in May 2014. Prior to the move, the division was located on multiple floors of the Department’s main location in Phoenix. As a result, hundreds of department employees had access to the division, and staff time was required to move paper tax documents around the building, creating additional risk of those documents becoming lost or inappropriately accessed. Additionally, housing the division in the Department’s main office increased the risk of unauthorized access since the main office is well known and frequently visited by the public. To mitigate these risks and provide increased efficiency in document processing, the division moved to a separate, single-floor, unmarked warehouse that is accessible to only division employees. This provided additional security for both paper and electronic taxpayer information. Further, the new location is significantly closer to the post office, and the division reported saving a minimum of 2.5 hours per week in staff time transporting documents to and from the post office.
- **Electronic filing system for the luxury tax on tobacco**—The Department launched a new e-file software program for the tobacco tax on July 1, 2015. This program is designed to handle all tobacco tax functions for tobacco distributors, including applying for a license, submitting returns, and purchasing tobacco stamps to affix to tobacco products prior to sale. Expected benefits of the new system include reduced processing time, improved accuracy of system data, automatic correspondence features, electronic filing and payment options for taxpayers, and the Department’s enhanced control of taxpayer access.
- **Simplified TPT administration project in process**—The Department is in the process of implementing efficiencies in how it administers TPT as required by Laws 2013, Ch. 255—also known as TPT reform. The reform’s intent is to simplify Arizona’s TPT administration by allowing businesses to pay all TPT taxes and obtain and renew their TPT licenses in a single place using an on-line portal administered by the Department. This simplified administration of the TPT was supposed to be in effect beginning January 2015. However, the Department reported that complying with the statutory changes has required major modifications to its primary information technology (IT) system—the Business Reengineering/Integrated Tax System (BRITS)—and making the changes has been time and resource intensive. Specifically, the Department indicated that modifying BRITS to report on taxes paid by businesses for each business location primarily contributed to the project’s delays and complexity. As a result, the Department reported that the Governor granted a 1-year

extension in October 2014, providing the Department with additional time to implement the on-line portal by January 2016.

The Department is taking several steps to implement TPT reform. For example, it hired a program manager that reports to the department director in January 2015 to oversee the TPT reform project and monitor both the project's risks and progress. Additionally, the Department has updated its agreements with local governments to coordinate licensing, collections, and auditing efforts; revised its licensing process; held over 90 information sessions across the State; and posted information on its Web site along with videos of several training seminars. Further, the Department formed three committees to help complete the TPT reform work. One committee oversees the project and consists of department leadership and key stakeholders, such as members from the League of Arizona Cities and Towns. The other two committees consist of local government and/or department staff who are responsible for working on the project's details.

The Department believes that its on-line portal for processing TPT tax revenues will be ready to process the January 2016 license renewals and TPT filings. However, stakeholders expressed concern about the complications and delays in carrying out the TPT reform project and the Department's aggressive timeline to make BRITS programming changes and test the new processes. Therefore, in September 2015, the Department agreed to allow cities who issued TPT licenses to businesses for 2015 to renew these licenses again for 2016 as a precautionary measure in the event that the on-line portal is not ready in time. However, the Department reported that it plans to offer all remaining businesses in the State the option of renewing licenses by using the on-line portal, mail, or walk-in services. Additionally, in September 2015, members of the committee that oversees the TPT project requested that the Department delay the full implementation of the on-line portal until the portal has been sufficiently tested, placed into production for a period of time, and affected TPT taxpayers have been given sufficient notice of when they must begin using the portal. In October 2015, the committee plans to identify the testing needs for the portal and how much taxpayer notice and education should be provided before the portal is fully implemented.

The Department reported that until TPT reform is complete, businesses with locations across the State will continue filing TPT returns to multiple taxing jurisdictions. In addition, businesses who file their TPT returns directly with the Department will need to continue using the Department's e-filing system or file by paper (see the Office of the Auditor General Report No. 15-105 for more details on the TPT e-filing process).

In addition to the Department's efforts to improve its processes, the performance audits completed as part of the Department's sunset review also identified areas for improvement. Specifically:

- **Establishing IT leadership processes and preparing for planned IT system replacement**—The Office of the Auditor General's April 2015 performance audit (Report No. 15-105) found that the Department's use of IT is hindered by ineffective IT leadership, specifically IT governance and management processes, for making and

carrying out IT decisions.^{1,2} This struggle to effectively implement IT systems and tools can be seen in the Department's inadequate implementation of BRITS, as the Office of the Auditor General reported in 2005 (Report No. 05-15), and that it remains plagued by problems. In addition, the Department lacks IT capabilities other states use to improve effectiveness and efficiency, as the Department has not fully leveraged electronic filing capabilities, underutilizes data analytics to select leads for taxpayer audits, and has not implemented various technologies that could be used to more effectively collect delinquent taxes. Although the Department has initiated efforts to improve its IT governance processes, it should continue these efforts and establish effective IT management processes.

This report also recommended that the Department take additional actions to effectively prepare for its planned replacement of BRITS. According to department officials, BRITS is nearing the end of its useful life and will need to be replaced starting in fiscal year 2017. The Department has adopted project management and system development policies and procedures, which could help the Department avoid repeating the system implementation problems it experienced with BRITS. However, the Department will need to ensure that these procedures are aligned with the needed improvements in IT governance and management, and ensure that staff follow the procedures in conducting this expensive and important system replacement.

- **Improving security of taxpayer information**—The Office of the Auditor General's September 2015 performance audit (Report No. 15-116) found that the Department needs to take steps to improve its IT security controls to ensure that state taxpayer information is better protected from unauthorized access. Attacks on IT systems exploit IT weaknesses and can result in considerable costs to both organizations and individuals whose information is accessed. Although the Department has established various IT security controls and practices, the IT systems that auditors tested on the Department's internal network contained common security weaknesses that allow unauthorized access to sensitive information, such as contents of tax returns, social security numbers, and other personal information. To better protect the information contained within internal network systems, the Department should improve its IT security practices by sufficiently reviewing vulnerabilities; documenting and following its process for applying patches, or updates and fixes, to its IT systems; more securely configuring its IT systems; ensuring proper management of access rights; and implementing structured log-monitoring practices.

In addition, the Department should continue developing a comprehensive information security program. The Department has strengthened the authority of its information security officer (ISO) position, which is responsible for directing and coordinating department information security efforts, but should ensure that the ISO regularly monitors department-wide compliance with security policies and procedures. Additionally, the Department has begun developing an information security program consistent with state requirements by drafting additional information security policies. As of July 2015, the Department had drafted but not finalized all of its policies and had not yet developed most of the related

¹ IT governance includes processes for evaluating, directing, and monitoring IT in an organization and ensuring the effective and efficient use of IT to enable an organization to achieve its goals. IT management includes the processes for carrying out the direction set by the governance body through planning, implementing, and monitoring IT activities and projects.

² ISACA. (2012). *COBIT5: Enabling processes*. Rolling Meadows, IL.

procedures. For example, the Department lacked adequate procedures in four key security program areas auditors reviewed: data classification, risk assessment, information security awareness education and training, and incident response. The Department should develop and implement an action plan and milestones to finish developing its information security program, including finalizing all of the policies and developing and implementing related procedures.

Finally, although the Department has taken steps to ensure the physical security of taxpayer information, some of its efforts can be strengthened. Proper physical security is necessary to protect both paper and electronic taxpayer information from unauthorized access. Whether paper or electronic, taxpayer information should not be accessed by department employees with no work-related reason to view the information or by anyone else who may attempt to gain access to the information. The Department physically safeguards this information using various measures, including security guards and cameras, maintaining barriers between publicly accessible and secure areas, controlling building access through electronic badge readers, and moving the Process Administration Division to a more secure facility. However, the Department should document its destruction of former employees' badges and ensure they are deactivated in a timely manner. Additionally, the Department requires employees to assist in limiting access to taxpayer information by following certain policies. Auditors found that some employees inconsistently follow these policies, and the Department should enhance its efforts in this area.

3. The extent to which the Department serves the entire State rather than specific interests.

The Department administers and enforces Arizona's tax code state-wide, which generates revenue essential to the operation of state government. The Department has developed several strategies to provide services to all areas of the State. For example, the Department has offices located in the State's three largest cities—Phoenix, Tucson, and Mesa—where taxpayers can obtain services, such as making tax payments and applying for a business license. The Department reported that it provided over 90 informational sessions across the State during fiscal year 2015 to educate taxpayers and tax practitioners about tax topics such as the TPT reform discussed on pages 9 through 10. The Department also provides information to the public and offers electronic filing options on its Web site. Specifically, the Web site includes the Department's locations and telephone numbers, forms and instructions for the various tax types, electronic services, business information, and other various publications. Additionally, the Web site provides links to frequently asked questions, the U.S. Internal Revenue Service, Arizona Revised Statutes, the Arizona Administrative Code, and the Model City Tax Code, which outlines how all cities and towns in Arizona should administer the TPT tax. Finally, the Department's Taxpayer and External Services Division provides taxpayer assistance by telephone, written correspondence, and walk-in service.

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

The Auditor General's general counsel has analyzed the Department's rule-making statutes and believes that the Department has established all of the rules statute requires and that established rules are consistent with statute.

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

The Department has provided opportunities for public input before adopting its rules by publishing notices of proposed rulemaking in the Arizona Administrative Register. Specifically, the Department submitted proposed rules in the Arizona Administrative Register when it created or revised rules in the 10 years since the Office of the Auditor General's 2005 sunset review. When comments were received, the Department responded to comments and sometimes made adjustments to the proposed rules based on those comments.

Additionally, the Department uses its Web site to post proposed rules, rulings, and procedures, and to explain how the public can provide input regarding these proposals. Additionally, its Web site contains information regarding existing department rulings, procedures, and decisions. The Department also complies with A.R.S. §41-1091.01, which requires agencies to post on their Web site (1) the full text, or the Web site address and location of the full text, of each rule in use; (2) each substantive policy statement in use, including the full text, if practicable; and (3) a notice that the substantive policy statement is advisory only.

Further, the Department provides taxpayers with tax updates using mailing inserts and offers educational seminars. The Department also reported that it meets with stakeholders in order to assess needs and identify opportunities to improve tax forms and processes.

Auditors also assessed the Department's compliance with various provisions of the State's open meeting law. The Department supports four commissions and one committee that are subject to open meeting law requirements (see Introduction, page 4, for additional information on these commissions/committee). Auditors observed three meetings as follows: the Education, Training, and Certification Advisory Committee in September 2014, the Property Tax Oversight Commission in March 2015, and the Economic Estimates Commission meeting in March 2015. The Department provided meeting minutes within 3 days of these meetings and posted meeting notices and agendas as required by the open meeting law with one exception: as of September 2014, the Department's Web site did not include information regarding the location of physical postings for meetings. The Department corrected this omission in March 2015.

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

A.R.S. §42-2051 requires the Department to establish a Taxpayer Assistance Office (Office) to assist taxpayers in several ways, such as helping them obtain tax information, negotiating with various department personnel on complex taxpayer problems, and receiving and investigating

complaints of improper or inefficient service by department employees. Office records indicated it received more than 1,500 complaints by phone in fiscal year 2015 and resolved those complaints in an average of 2 days. The Office also reported receiving thousands of complaints by e-mail in fiscal year 2015 and resolving these complaints in a generally faster time frame.

Although not required by statute, the following department divisions also investigate and resolve complaints:

- The Director's Office receives complaints directly from taxpayers and through the Governor's Office. For example, taxpayers may complain that they do not understand or agree with notices or letters from the Department regarding taxes owed. Complaints are forwarded to the appropriate division, which may follow up with the taxpayer for clarification, and then the division provides the Department's official response to the taxpayer. The Department reported that its staff generally respond within a week of receiving the complaint. The Department received and responded to 138 complaints through this correspondence process in fiscal year 2015.
- The Taxpayer and External Services Division's Criminal and Civil Investigations Unit investigates complaints of tax fraud and other types of tax-related criminal activity. For example, staff receive complaints from taxpayers reporting that their attempt to file their individual income tax return electronically had been rejected. The system check that rejects the return can indicate a taxpayer's identity has been stolen, as this automated statement is generated any time a second return is filed with the same social security number. In such cases, the Department researches whether a fraudulent return was filed in that taxpayer's name, and if so, staff will clear the account of the fraudulent claim so that the taxpayer's legitimate return can be filed and processed. In addition, department staff receive reports of unregulated tobacco sales at neighborhood stores. For these complaints, department inspectors will visit the store in question, inspect tobacco products to ensure tobacco tax stamps are affixed as required by law, and review invoices to ensure tobacco products are purchased from licensed distributors. The Criminal and Civil Investigations Unit received over 1,000 complaints in fiscal year 2015.
- The Audit Division's Special Taxes Unit reported receiving complaints from citizens who play bingo at department-licensed, noncasino-operated bingo facilities, such as bingo facilities operated by fraternal organizations or homeowner associations. Complainants have alleged that bingo licensees have violated rules for running the game. Although the Department has the authority to investigate and suspend or revoke a bingo license after a complaint is made, the unit reported that complaints have not resulted in discipline. The unit handles complaints by interviewing both licensees and players to determine if a violation has actually taken place and whether the player and the bingo operation can reach a compromise. For example, the bingo operator may give the player a consolation prize. In fiscal year 2015, the Department reported that it received one to two complaints per month and that it resolved each of these complaints in a week or less.

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

A.R.S. §41-192 authorizes the Attorney General to act as the Department's legal advisor and provide legal services as the Department requires. Additionally, A.R.S. §42-1004 authorizes the Attorney General to prosecute (or delegate the authority to any county attorney) on the State's behalf all actions necessary to allow the Department to fulfill the provisions of the Department's enabling statutes. For example, the Attorney General prosecutes all cases where tobacco distributors licensed by the Department or other individuals commit felonies such as selling untaxed tobacco. This statute also gives the Attorney General authority to defend all actions brought against the Department.

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

According to the Department, there are no deficiencies in its enabling statutes that prevent it from fulfilling its statutory mandate. However, the Department reported that the Legislature made several significant changes in statute that affected the Department in the last 5 years. For example:

- Laws 2010, 7th S.S., Ch. 12, amended A.R.S. §42-1207 and other statutes to allow the Department to enter into agreements with financial institutions for the purpose of accessing taxpayer bank accounts to assist the Department in collecting delinquent taxes, penalties, and interest.
- Laws 2013, Ch. 255, amended A.R.S. §42-1004 and other statutes to require the Department to administer an online portal to serve as a single point for licensing and paying the TPT for all state, county, and municipal taxing jurisdictions (see Sunset Factor 2, pages 9 through 10, for more information).
- Laws 2014, Ch. 121, amended A.R.S. §42-6053 regarding the official copy of the Model City Tax Code, which outlines how all cities and towns in Arizona should administer the TPT. This statute requires cities and towns imposing a new or different tax rate to notify the Municipal Tax Code Commission and the Department. The statutory change renders a new or different tax rate void if a city or town fails to notify the Commission and Department about the change, or if the change is not reflected in the official copy of the Model City Tax Code.

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

Auditors did not identify any needed changes to the Department's statutes.

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

Without transferring its responsibilities to another agency, terminating the Department would harm the public health, safety, and welfare, because it collects the taxes that help fund the

continued operation of essential government health- and safety-related services. In fiscal year 2014, the Department reported collecting more than \$13 billion in revenue, depositing more than \$7.5 billion into the State General Fund, and distributing the remaining \$5.5 billion to cities, counties, special funds, and taxpayer refunds. In addition, terminating the Department would eliminate enforcement and compliance programs that help to ensure that all taxpayers pay their tax burden.

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

The Department appears to exercise an appropriate level of regulation in the areas where it has regulatory authority. Although the Department's primary function is administering and collecting taxes, the Department has regulatory authority in the areas of licensing and registering businesses, property tax administration, and tobacco and bingo code enforcement and regulation. The Department's level of regulation in these areas is somewhat similar to other western states that auditors contacted.¹ Specifically:

- The Taxpayer and External Services Division's License and Registration Unit is tasked with issuing business licenses to assist with collecting TPT, use, and unemployment/withholding taxes. The unit verifies information on completed license applications through identification checks and screening applicants to ensure applicants owe no back-taxes prior to issuing their licenses. The Department requires all licensees to reapply annually and pay any renewal fees cities set. The Department can cancel licenses for inactivity or revoke a license if the business has delinquent tax payments. Other western states auditors reviewed similarly license businesses before they begin collecting taxes.
- The Property Tax Division is responsible for the general supervision of county assessors in administering Arizona's property tax laws to ensure that all property is uniformly valued for property tax purposes. For example, pursuant to statute, the Division certifies people who perform the duties or exercise the authority of a property assessor or appraiser on behalf of a county to assess property values. A county assessor's duties include locating and identifying all taxable property in the county and establishing a value for all property subject to property taxation. According to the Department, many states operate similarly to the Department by providing oversight and training, but not all states oversee county assessors, and in some states, the county assessor offices are more autonomous. For example, a Colorado official explained Colorado county assessors act with significant autonomy; however, they receive some guidance from the Colorado Department of Local Affairs, which offers training and facilitates the development of assessors' manuals.
- The Audit Division issues tobacco distributor licenses to persons who distribute cigarettes, cigars, or other tobacco products on which the Arizona Luxury Tax must be paid. Once distributors have their licenses, they are able to pay the tobacco tax by purchasing tobacco stamps from the Department that must be affixed to their tobacco

¹ Auditors contacted officials and reviewed statutes and Web sites for government agencies in California, Colorado, Utah, and Washington.

products prior to selling them to retailers. The division also processes the monthly returns that tobacco distributors must file. According to the Federation of Tax Administrators, all 50 states require tobacco distributors to be licensed. In addition, other states, such as California, Utah, and Washington, require licenses for tobacco retailers.

Another department division also assists with the regulation of the tobacco tax. Specifically, the Taxpayer and External Services Division's Criminal and Civil Investigations Unit is authorized to inspect tobacco distributors and retailers to help ensure the tobacco tax has been paid. The Department reported it inspects over 3,000 tobacco distributor and retail locations each year. Tobacco inspectors can make warnings, issue citations, or conduct seizures. In fiscal year 2015, the unit issued nine citations and conducted 37 seizures.

- The Audit Division's Special Taxes Unit is responsible for regulating bingo in the State, including complaint handling, for all noncasino operations (see page 14 for more information). Specifically, the Audit Division issues bingo licenses and reviews bingo financial reports. In February 2015, the Division reported there were 670 bingo licensees in the State. The unit does not regulate bingo through physical inspections; however, an audit staff member conducts desk reviews of bingo licensees' financial reports to ensure licensees are complying with the State's bingo statute for filing required tax reports. Other western states auditors reviewed do not have revenue agencies responsible for regulating bingo. Specifically, bingo is regulated by other state entities in Colorado and Washington, while it is regulated by counties in California. Utah does not regulate bingo because it is an illegal activity in that state.

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

The Department uses private contractors to assist with collections, data imaging, temporary staffing, unclaimed property administration, and expert property valuation. Auditors contacted state revenue collection agencies in seven states, including five western states, and found the Department's contracting practices are generally similar to these other states.¹ Specifically:

- **Collections for some income tax cases**—Similar to Colorado, Minnesota, Indiana, Oregon, and Utah, the Department contracts with vendors to assist in collecting on some delinquent accounts for individual income tax. The Department indicated it was in the process of renewing or acquiring new contracts for these collection services and expects to select vendors by September 2015. The new contracts may include additional services such as locating past-due and delinquent filing taxpayers who have moved with no forwarding address, handling courtesy calls to taxpayers, or assisting with taxpayer inquiries. The Department reported that these additional services would allow it to have access to private sector technology and services that it does not have, with the intent of more efficiently and effectively collecting on past-due cases.
- **Data imaging**—The Process Administration Division contracts with a vendor to create electronic images of all paper tax forms received, which, according to the Department,

¹ Auditors contacted state revenue agencies in California, Colorado, Indiana, Minnesota, Oregon, Utah, and Washington based on population size, proximity to Arizona, and/or recognition for its practices.

helps department staff more quickly enter data from the paper forms. However, other states use a common technology called optical character recognition to scan paper documents and electronically capture handwritten or typed information contained in the documents, thus minimizing manual data entry (see Auditor General Report No. 15-105 for more information). In addition, a department official reported that some states have contracts with private companies to process all paper documents. Previously, the Division also contracted with a microfilm vendor to convert paper tax forms into microfilm images for archival purposes but reported that it stopped using this vendor's services in early 2015 because it began to exclusively use electronic imaging services.

- **Temporary staffing**—Similar to Colorado, Indiana, Oregon, and Utah, the Department has several divisions that contract for temporary staff. For example, similar to Arizona, some of these states hire temporary staff to assist with tax processing, collecting on delinquent accounts, taxpayer assistance telephone support, and IT activities.
- **Unclaimed property administration**—The Administrative Services Division reported that it contracts with vendors to provide unclaimed property services, such as holding, appraising, and auditing unclaimed property, to ensure compliance with the State's Unclaimed Property Act. The revenue agency in Washington also outsources some unclaimed property functions. However, other states, such as California, Indiana, and Oregon, reported administering unclaimed property through agencies other than their state revenue agencies, such as the state controller's office.
- **Expert property valuation**—Similar to Oregon, the Property Tax Division contracts with vendors, at least occasionally, for expert valuations and property appraisals.

In fiscal year 2015, the IT Division contracted with a vendor to create and maintain a new electronic filing system for the tobacco luxury tax (see Sunset Factor 2, page 9, for more information). Depending on this new system's success, the IT Division may determine if it can use this or similar vendors in the future to administer other tax types as the Department undergoes the process of replacing its primary IT system as reported by the Office of the Auditor General in April 2015 (see Report No. 15-105).

The Department also reported that it is planning to enter into a contract for private investigation services to assist with its fraud-prevention efforts (see Sunset Factor 2, pages 7 through 8, for more information regarding fraud prevention). The Legislature appropriated \$3.15 million for this contract for fiscal year 2016. A department official said that the contract will likely include services to screen or assist in screening individual income tax returns for fraud and may include handling some communications with taxpayers who may be involved in or victims of fraudulent filings. Indiana—one of the leaders in identifying refund fraud—already contracts with a vendor for similar fraud detection services.¹

The audit did not identify any additional areas where the Department should consider using private contractors.

¹ Center for Digital Government. (2014). *Research survey brief, interview findings: State government approach to state tax refund fraud*. e.Republic: Folsom, CA.

APPENDIX A

Methodology

This appendix provides information on the methods auditors used to meet the audit objectives.

This sunset review was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Auditor General and staff express appreciation to the Arizona Department of Revenue's (Department) Director and staff for their cooperation and assistance throughout the audit.

The Department's performance was analyzed in accordance with the statutory sunset factors. Auditors used various methods to address the sunset factors. These methods included gathering information on the Department's statutory duties and responsibilities, filled staff positions, revenues and expenditures, and contracts. Auditors also reviewed applicable statutes and rules, information from the Department's Web site, information from the Department's fiscal year 2014 annual report, and other department documentation. In addition, auditors interviewed department management and staff, and staff from the Federation of Tax Administrators and the Arizona League of Cities and Towns.

Further, performance audit work related to the Department's use of information technology (see Report No. 15-105) and the security of taxpayer information (see Report No. 15-116) provided information for this report.

Auditors also used the following additional methods:

- To determine the Department's efficiencies created by implementing Lean projects, auditors interviewed the administrator for the Arizona Government Transformation Office, a division of the Arizona Department of Administration.
- To develop an understanding of the transaction privilege tax (TPT) reform project, auditors attended several TPT meetings in April, June, July, and September 2015 for the three TPT committees that are either overseeing or assisting with the reform project.
- To assess the Department's compliance with the State's open meeting law requirements, auditors observed three public meetings held between September 2014 and March 2015 of two commissions and one committee for which the Department provides staff and support. Specifically, auditors reviewed and examined meeting documents, including notices, agendas, and minutes related to the three meetings auditors attended and observed.
- To assess the Department's use of private contractors, auditors compiled and analyzed unaudited expenditure data from the Arizona Financial Information System (AFIS) to determine the estimated amount of state monies the Department spent on goods and services in fiscal year 2014.
- To compare the Department's regulatory activities with other states, auditors contacted officials and reviewed statutes and Web sites for government agencies in four western states—California, Colorado, Utah, and Washington. To compare the Department's use of private contracts with other states, auditors contacted revenue-collecting agencies in seven

states—California, Colorado, Indiana, Minnesota, Oregon, Utah, and Washington—based on population size, proximity to Arizona, and/or recognition for its practices.

- To obtain information for the report Introduction, auditors compiled and analyzed unaudited information from the *AFIS Accounting Event Transaction File* and the *AFIS Management Information System Status of General Ledger-Trial Balance* screen for fiscal years 2013 through 2015.
- Auditors' work on internal controls was limited and focused on the Department's processes to carry out its responsibilities, such as implementing TPT reform (see Sunset Factor 2, pages 9 through 10). Conclusions on this work are included in the response to the Sunset Factors. Computerized system information was not significant to the auditors' objective; therefore, auditors did not conduct test work on information system controls.

AGENCY RESPONSE

AGENCY RESPONSE



Douglas A. Ducey
Governor

David Raber
Director

September 25, 2015

Debra K. Davenport, CPA
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, AZ 85018

RE: Arizona Department of Revenue Sunset Review; Revised Draft Report dated September 18, 2015

Dear Ms. Davenport:

Thank you for the opportunity to review the revised report of the Sunset Review of the Arizona Department of Revenue (ADOR).

We appreciate that your report points out some of the important work that ADOR is accomplishing including:

- Efforts to prevent individual income tax fraud
- Process Improvements facilitated by Lean Methods
- Efficiencies and internal control improvements gained by relocating our Processing Division and Warehouse to a single-story facility
- Implementation of a new e-filing system for luxury tax on tobacco products
- Advancements made in implementing Transaction Privilege Tax Simplification for Arizona's taxpayers

Given that the report includes no formal recommendations requiring a response, let me take this opportunity to thank your highly skilled and talented staff. These individuals provided helpful insights and analysis that will help to make ADOR a better agency.

We look forward to sharing our progress as we continue to address the recommendation offered in your two performance audit reports (use of information technology and security of taxpayer information) issued as part of this Sunset Review.

Sincerely,

David Raber, Director

Performance Audit Division reports issued within the last 18 months

14-102	Gila County Transportation Excise Tax
14-103	Arizona State Board of Dental Examiners
14-104	Arizona Office of Administrative Hearings
14-105	Arizona Board of Executive Clemency
14-106	State of Arizona Naturopathic Physicians Medical Board
14-107	Arizona Department of Child Safety—Children Support Services—Emergency and Residential Placements
14-108	Arizona Department of Administration—Arizona State Purchasing Cooperative Program
15-101	Arizona Department of Child Safety—Child Abuse or Neglect Reports, Substantiation Rate, and Office of Child Welfare Investigations
15-102	Arizona Department of Administration—State-wide Procurement
15-103	Arizona Medical Board—Licensing and Registration Processes
15-104	Arizona Department of Transportation—Motor Vehicle Division
15-105	Arizona Department of Revenue—Use of Information Technology
15-CR1	Independent Review—Arizona’s Child Safety System and the Arizona Department of Child Safety
15-CR1SUPP	Supplemental Report to the Independent Review—Arizona’s Child Safety System and the Arizona Department of Child Safety
15-106	Arizona State Retirement System
15-CR2	Independent Operational Review of the Arizona State Retirement System’s Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers
15-107	Arizona Sports and Tourism Authority
15-108	Arizona Department of Administration—Personnel Reform Implementation
15-109	Arizona Department of Administration—Sunset Factors
15-110	Arizona Foster Care Review Board
15-111	Public Safety Personnel Retirement System
15-CR3	Independent Operational Review of the Public Safety Personnel Retirement System Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers
15-112	Arizona Commerce Authority
15-113	Arizona Department of Transportation—Transportation Revenues
15-114	Arizona Department of Transportation—Sunset Factors
15-115	Arizona Radiation Regulatory Agency, Arizona Radiation Regulatory Hearing Board, and Medical Radiologic Technology Board of Examiners
15-116	Arizona Department of Revenue—Security of Taxpayer Information

Future Performance Audit Division reports

Arizona Department of Child Safety—Child Safety, Removal, and Risk Assessment Practices
Arizona Department of Environmental Quality—Vehicle Emissions Inspection Program

