

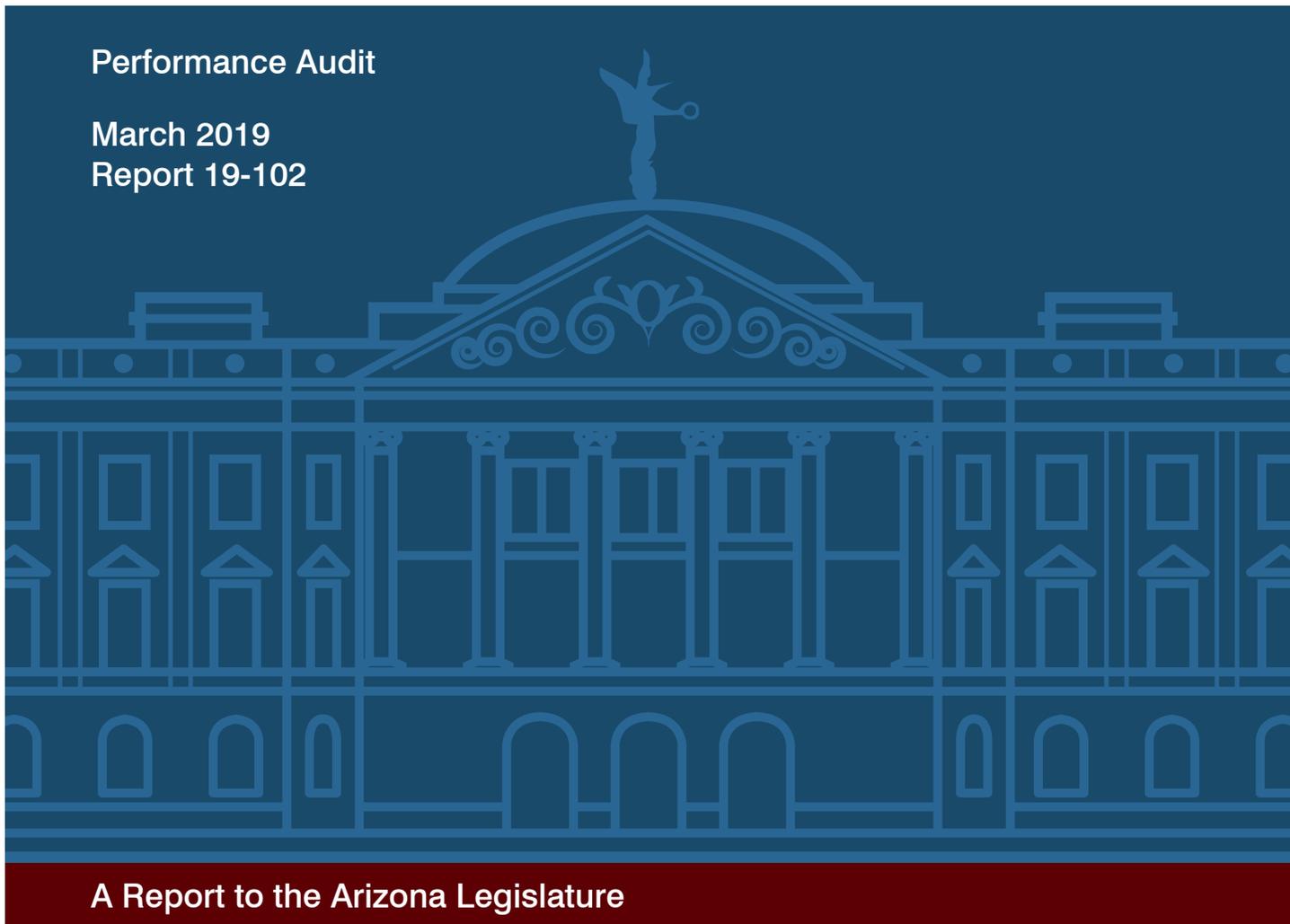
# Arizona Department of Revenue

## Transaction Privilege Tax Administration and Enforcement

Department should improve its TPT licensure, filing, distribution, and enforcement processes

Performance Audit

March 2019  
Report 19-102



A Report to the Arizona Legislature

Lindsey A. Perry  
Auditor General





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March 13, 2019

Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

Mr. Carlton Woodruff, Interim Director  
Arizona Department of Revenue

Transmitted herewith is a report of the Auditor General, *A Performance Audit of the Arizona Department of Revenue—Transaction Privilege Tax Administration and Enforcement*. This report is in response to a September 14, 2016, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting within this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona Department of Revenue agrees with all of the findings and plans to implement all of the recommendations.

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

Sincerely,

Lindsey Perry, CPA, CFE  
Auditor General



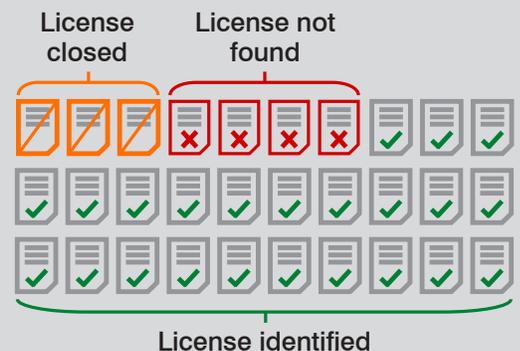
## Arizona Department of Revenue Transaction Privilege Tax Administration and Enforcement

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

### Department should take actions related to TPT licensure

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

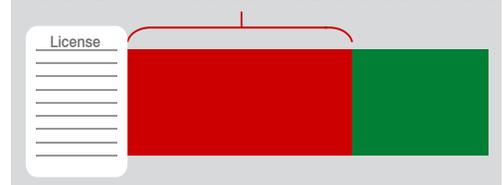
Department could not identify active TPT licenses for **7 of 30** operating businesses



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

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

15 of 24 TPT licenses had address errors



## Recommendations

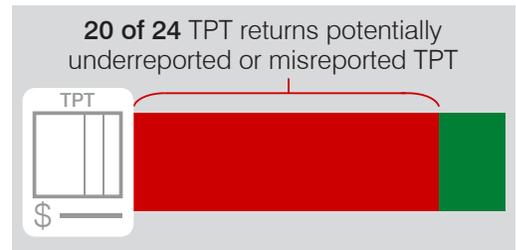
The Department should:

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

## Department should take actions related to TPT filing

### Better identify and address TPT underreporting or misreporting—

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



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

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

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

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

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

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

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

## Recommendations

The Department should:

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

## Department should address issues affecting city/town TPT distributions

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

## Recommendations

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

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

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

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



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

## Recommendations

The Department should:

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





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Most TPT returns we reviewed contained at least 1 instance of possible unidentified TPT underreporting or misreporting

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## Recommendations

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Department has not yet programmed its tax system to enforce mandatory e-filing requirement

## Recommendation



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TPT reform required property management companies to bulk e-file returns on behalf of property owners

Department has not enforced e-filing requirement for property management companies

Department processing of paper-filed returns from property management companies increases risk of processing errors and misapplied payments

Department sought to accommodate property management companies' transition to new statutory requirements

## Recommendations

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Department is not assessing the minimum statutory penalty for late TPT filing

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## Recommendations

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Department responsible for administering city/town TPT and providing distribution reports

Department's complex, manual record-keeping process increases the risk of TPT distribution errors

TPT distributions and reports rely on the accuracy of tax system data

Department has made little progress addressing functional limitations in its tax system that affect city/town TPT distributions

## Recommendations

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Issue 1: Enhancing audit planning efforts through collaboration with cities and towns

Department employed fewer TPT auditors who performed fewer audits

Performing fewer TPT audits may limit their intended deterrent effect



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Department plans to increase the number of TPT audits it performs in fiscal year 2019

Further collaboration with cities may increase deterrent effect of TPT audits

## Recommendations

Issue 2: Collecting and analyzing data from its TPT collections pilot project with cities and towns

Department is piloting a collaborative TPT collections process

Department has not yet fully implemented a collaborative collections program or assessed the pilot project for potential improvement

## Recommendations

Issue 3: Informing cities and towns of taxpayers' requests for offers in compromise (OICs) Department accepts OICs from taxpayers

Department had previously not collaborated with cities and towns in accepting OICs on their behalf

## Recommendation

Issue 4: Analyzing its process for placing liens and developing staff guidance based on that analysis

Department may place liens on taxpayer property to collect on TPT liabilities

Department had not been collaborating with cities and towns on placing liens to collect on TPT liabilities

## Recommendations

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49

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The Office of the Auditor General has simultaneously released 2 performance audit reports of the Arizona Department of Revenue’s (Department) administration of the transaction privilege tax (TPT) on behalf of the State and its cities and towns.<sup>1</sup> This first report (Report 19-102) focuses on the Department’s processes for administering and enforcing TPT and provides additional background information on TPT and legislative reforms that have affected its administration. The second report (Report 19-103) focuses on the Department’s provision of support and education services to TPT taxpayers and Arizona’s cities and towns. A third report will address the statutory sunset factors.

## Department administers TPT, the single largest source of collected tax revenue

The Department is responsible for collecting and administering TPT on behalf of the State, counties, and cities and towns (taxing jurisdictions). TPT is a tax imposed on a seller for the privilege of doing business in the State, regardless of whether the seller passes on the economic burden of the tax to the buyer.<sup>2</sup> Because it is usually passed on to the buyer, this tax is commonly referred to as a sales tax. Statute defines various business activities that are subject to TPT, such as retail sales and hotel/motel lodging.

Each taxing jurisdiction is authorized to establish the associated tax rate for the various business activities subject to TPT. Monthly, the Department publishes an updated list of tax rates for the cities and towns. As shown in Table 1, sellers typically charge buyers a combined tax that includes the tax rates for each applicable taxing jurisdiction.

**Table 1**  
**Example combined TPT rates for retail sales in different taxing jurisdictions**  
**October 2018**

Taxing jurisdiction	Seller 1	Seller 2
State/county <sup>1</sup>	Maricopa 6.3%	Cochise 6.1%
City	Phoenix 2.3%	Bisbee 3.5%
<b>Combined rate</b>	<b>8.6%</b>	<b>9.6%</b>

<sup>1</sup> The Department combines State-owed TPT and county-owed excise tax as a single tax rate.

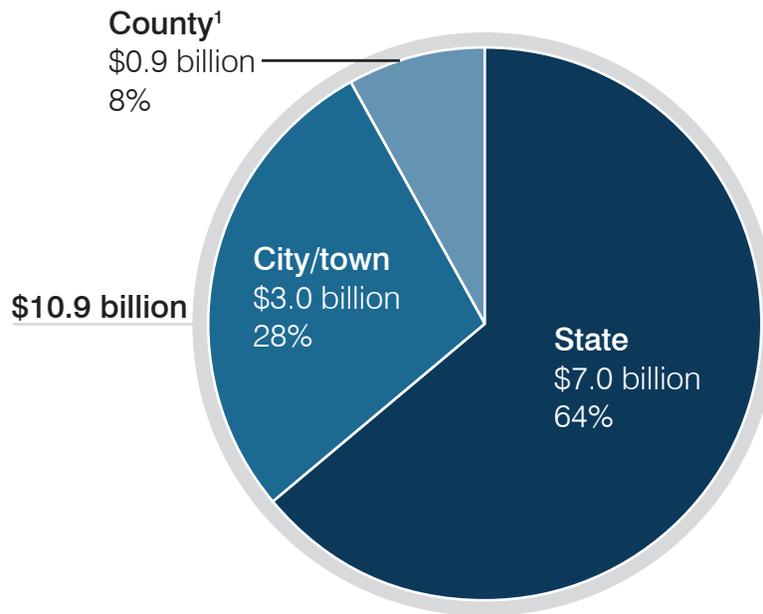
Source: Auditor General staff analysis of Department information.

As shown in Figure 1 (see page 2), TPT accounted for approximately \$10.9 billion, which was 61 percent of gross revenue the Department collected in fiscal year 2018. The TPT revenues that the Department collected on behalf of cities and towns was approximately \$3 billion, or 28 percent, of the total TPT collected in fiscal year 2018.

<sup>1</sup> Arizona Revised Statutes (A.R.S.) §42-6102(A)(1) allows county excise taxes to be reported and paid with State TPT. Because this audit focused primarily on the Department’s administration of TPT as affected by TPT reform (see pages 2 through 3 for an explanation of TPT reform)—which did not impact the Department’s administration of county excise taxes—the Department’s administration of county excise taxes was not included in the audit’s scope.

<sup>2</sup> Arizona Administrative Code R15-5-2002.

**Figure 1**  
**TPT collected by taxing jurisdiction**  
**Fiscal year 2018**  
(Unaudited)



<sup>1</sup> Per A.R.S. §42-6102, county excise tax is reported and paid with State TPT.

Source: Auditor General staff analysis of Department documents.

TPT can be the largest source of revenue for cities and towns. For example, the City of Chandler’s fiscal year 2019 budget forecasted \$122.8 million from TPT revenues, approximately 53 percent of Chandler’s total forecasted revenue.

## Legislative reform in 2013 made significant changes to TPT administration in Arizona

Laws 2013, Ch. 255—commonly referred to as TPT reform—made several statutory changes with the intent of simplifying the State’s TPT administration. Prior to TPT reform, many of Arizona’s largest cities and towns administered and collected their own TPT. This meant that taxpayers with businesses in multiple jurisdictions often had to file multiple, separate TPT returns with the applicable taxing jurisdictions, including the State and applicable cities and towns. TPT reform required the Department to administer TPT on behalf of all cities and towns. As a result, taxpayers now file a single TPT return with the Department that reports taxable business activity in each applicable taxing jurisdiction. TPT reform also required the Department to develop a coordinated electronic method for taxpayers to file and pay TPT. Additionally, the Department was required to establish intergovernmental agreements (IGAs) with Arizona’s 91 cities and towns to administer all aspects of city/town TPT, which it has done (see textbox, page 3, with example IGA provisions). TPT reform was substantially implemented in January 2017.<sup>3</sup>

TPT reform also required cities and towns to annually pay the Department for administering TPT on their behalf. According to session laws passed each year from 2015 through 2018, the total amount paid by all cities and towns was not to exceed \$20,755,835 annually.<sup>4</sup> Although the Department received the monies from this ongoing

<sup>3</sup> TPT reform laws were passed in 2013 and gave the Department until January 2015 to prepare to collect and administer TPT on behalf of all 91 Arizona cities and towns; however, the Department did not substantially implement TPT reform laws until January 2017.

<sup>4</sup> See Laws 2015, Ch. 10, §21; Laws 2015, Ch. 323, §21; Laws 2016, Ch. 125, §18; Laws 2017, Ch. 312, §16; and Laws 2018, Ch. 283, §12.

fee, those monies were offset by a reduction of the same amount in the Department's State General Fund appropriation.

Further, statute requires the Department to bill each city and town a portion of this amount based on population data from the U.S. Census Bureau. For example, in fiscal year 2018, the Department billed the Town of Cave Creek (with a population of approximately 5,300) approximately \$11,100 and the City of Glendale (with a population of approximately 240,000) approximately \$498,000. Additionally, Laws 2015, Ch. 10, required certain cities to pay a one-time fee to the Department. According to the Joint Legislative Budget Committee's fiscal year 2016 *Appropriations Report*, this one-time fee was to hire temporary information technology (IT) staff to complete changes to the Department's primary IT system that were needed to implement TPT reform.

The IGAs between the Department and cities and towns require the Department to provide several TPT-administration services, such as:

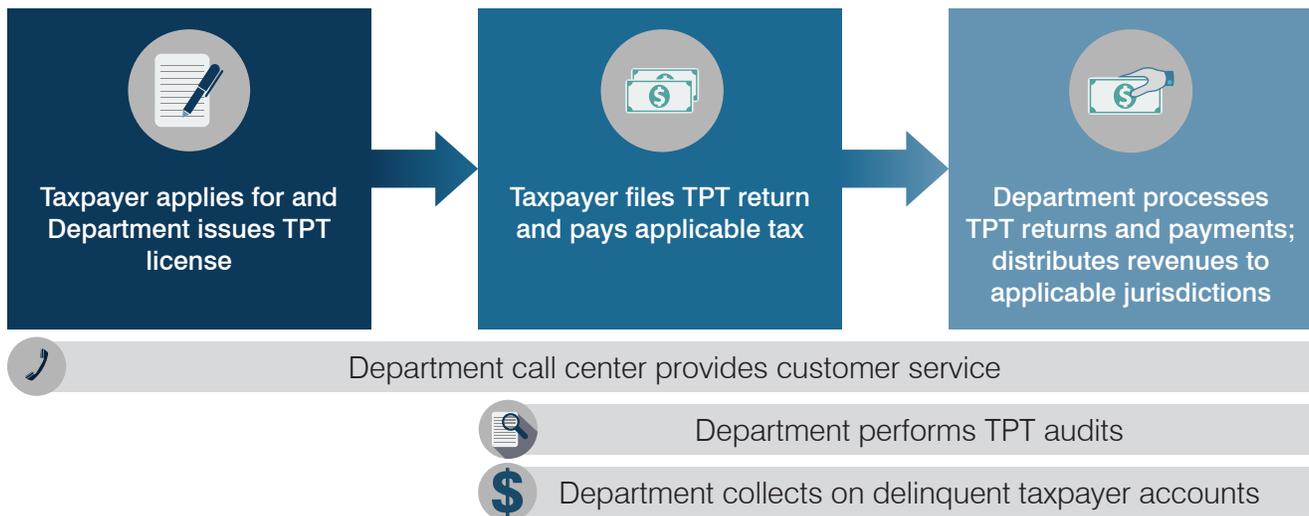
- Providing the cities and towns weekly and monthly distribution reports.
- Providing a minimum of 3 trainings per year for city/town audit staff.
- Reviewing and approving taxpayer refund requests on behalf of the State and cities and towns.

Source: Auditor General staff review of the IGAs.

## Department and taxpayers have several TPT-administration responsibilities

As shown in Figure 2 and described on pages 4 through 5, the Department and businesses subject to TPT have specific TPT-administration responsibilities related to licensing, filing, distributing, auditing, collecting on delinquent TPT payments, and providing customer service.<sup>5</sup> The Department relies on its primary IT system—the Business Reengineering/Integrated Tax System (BRITS)—to perform its TPT-administration responsibilities. BRITS comprises multiple applications, including both the Tax Administration System (tax system) and AZTaxes.gov. The tax system supports the processing of TPT, individual income, withholding, and corporate income taxes. AZTaxes.gov is the online portal that handles electronic tax return filings and payments for several tax types.

**Figure 2**  
TPT-administration processes



Source: Auditor General staff analysis of Department documents.

<sup>5</sup> Because Department staff perform some of these functions for several tax types—including TPT, individual income, withholding, and corporate income—this report does not include Department staffing levels specific to TPT administration.

The Department's administration of TPT includes the following specific processes, which are described further in this report's findings:

- **Licensing**—Statute requires business owners engaging in a taxable activity to have an active State TPT license and to be licensed with each city and town in which the business operates. When a business applies for a TPT license with the Department, the business must pay the applicable State, city, and town licensing fees and provide the following information: (1) the address of each business location, (2) the taxing jurisdictions in which each location conducts business, and (3) the type of business activity conducted at each location, such as retail sales or commercial leases. The Department asks businesses to keep this information up to date by submitting a business account update form with the Department, as needed. Businesses are also required to annually renew their TPT licenses and, although there is no fee to renew a State TPT license, may be required to pay renewal fees depending on whether the cities and towns in which they are licensed assess a renewal fee. The Department is responsible for processing license applications, annual license renewals, and business account updates for active TPT license holders. As of July 2018, the Department reported that there were approximately 284,000 active TPT licenses. See Findings 1 through 3 (pages 7 through 17) for our findings and recommendations related to the Department's TPT-license-administration processes.
- **Filing**—Statute requires TPT taxpayers to file a return with the Department for each filing period, and the Department requires taxpayers to file a return even if there is no taxable activity to report. A taxpayer's filing frequency—monthly, quarterly, or annually—is determined by the taxpayer's estimated annual TPT liability. Statute and rule require certain taxpayers to file and pay their TPT electronically. For example, taxpayers whose tax liability exceeds a specified statutory threshold are required to file and pay electronically through AZTaxes.gov.<sup>6</sup> Other taxpayers can either submit a paper return and corresponding payment or file and pay electronically through AZTaxes.gov. Department staff are responsible for processing paper-filed and electronically filed (e-filed) TPT returns and corresponding payments. Department documents indicate that the Department processed more than 2 million paper- and e-filed TPT returns in fiscal year 2018. See Findings 4 through 7 (pages 19 through 38) for our findings and recommendations related to the Department's TPT-filing-administration processes.
- **Distributing city/town TPT**—Once TPT returns and payments are processed and recorded in the tax system, Department staff analyze the amount of city/town TPT revenues remitted by taxpayers, compare these amounts to historic trends, resolve any identified discrepancies, and, on a weekly basis, determine the total amount of city/town TPT revenue that should be distributed to each city and town. The Department records the weekly distribution totals in the State's accounting system, and the Arizona Office of the State Treasurer ultimately disburses the revenues to cities/towns. The Department also prepares 8 detailed distribution reports that it provides to the cities and towns on a weekly basis and 1 additional report that it provides on a monthly basis. See Finding 8 (pages 39 through 42) for our findings and recommendations related to the Department's city/town TPT distribution processes.
- **Auditing**—The Department collaborates with cities and towns to perform audits of selected taxpayers to help ensure that they are filing and paying the correct amount of TPT. Through these efforts, the Department reported it assessed approximately \$20.7 million in fiscal year 2018 that taxpayers owed for TPT. Department audit staff also review taxpayer TPT refund requests. See Finding 9 (pages 43 through 45) for our finding and recommendations related to the Department's TPT-audit processes.
- **Collecting on delinquent accounts**—The Department collects taxes owed on delinquent accounts. The Department reported it collected approximately \$218 million in fiscal year 2018 from taxpayers who owed TPT. See Finding 9 (pages 45 through 48) for our findings and recommendations related to the Department's TPT-collections processes.
- **Providing customer service**—Throughout the TPT-administration process, Department call center staff provide customer service to taxpayers, such as answering questions on licensing responsibilities, filling out

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<sup>6</sup> Laws 2017, Ch. 60, §15, established the following schedule lowering the annual TPT liability threshold for mandatory electronic filing: \$20,000 in 2018, \$10,000 in 2019, \$5,000 in 2020, and \$500 in 2021 and thereafter.

forms, or collections activities. The Department also provides customer service through its City Services Team, which acts as a liaison between the cities and towns and the Department. Report 19-103 provides additional information about these customer service functions.





# Department should ensure businesses have active TPT licenses

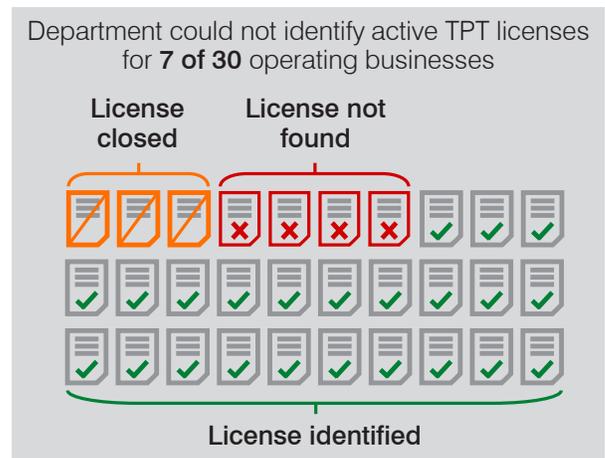
## Businesses subject to TPT are required to have licenses

A.R.S. §42-5005(A) and (B) require that all businesses subject to TPT have a TPT license, and the Department is responsible for administering and enforcing this requirement. Additionally, intergovernmental agreements (IGAs) between the Department and each of Arizona’s cities and towns require the Department and cities and towns to coordinate efforts to help ensure all businesses subject to TPT have a TPT license.

The Department relies on TPT licenses to efficiently process, distribute, and enforce TPT payment. For example, the Department uses the TPT license number to ensure tax returns and payments are applied to the correct taxpayer. If a taxpayer attempted to file and pay TPT without a TPT license, it would lead to inefficiencies in Department processing of the tax returns and the possibility of the payment not posting properly. This is because Department staff must manually attempt to determine if that payment is related to any licensed taxpayer and then determine which jurisdictions should receive the tax distribution. Department staff reported that if they cannot find a TPT license and determine where the tax payment should be distributed, they distribute the payment to the State General Fund. If later they receive information to help them determine where the payment should have been distributed, they reverse the original distribution and distribute the payment correctly.

## Some Arizona businesses are likely operating without TPT licenses and not paying TPT

We judgmentally selected a sample of 30 operating businesses in different industries throughout Arizona and found that the Department could not identify an active TPT license for 7 of the businesses.<sup>7</sup> These 7 businesses included a beauty salon, a bookstore, an annual festival, a coin-operated car wash, an amusement rental company, a resort, and an event venue. Three of these businesses appeared to be operating with a closed TPT license.<sup>8</sup> Department staff were unable to locate any licensure information for the other 4 businesses. Without identifying an active license for these 7 businesses, the Department cannot confirm if the businesses are filing and paying TPT without conducting research to identify, locate, and audit the businesses. Further, if the businesses are filing and paying TPT without a license, the Department cannot confirm that the revenues are being distributed to the appropriate taxing jurisdictions.



<sup>7</sup> In April 2018, we judgmentally selected 30 operating Arizona businesses by using internet resources and a map of Arizona.

<sup>8</sup> One of the 3 businesses with a closed license is a nonprofit organization that may or may not be subject to TPT. The Department could not conclude whether this business is subject to TPT without further information from the business.

## Department gradually discontinued its license-compliance program by April 2018

Although the Department is required to enforce TPT license requirements and doing so helps to ensure that businesses are paying the appropriate tax, Department records show that, from fiscal year 2015 to fiscal year 2018, the Department reduced the number of full-time equivalent staff (FTE) devoted to identifying unlicensed businesses and ensuring these businesses obtain TPT licenses. Consequently, the number of TPT licenses brought into compliance through Department efforts declined considerably. Specifically, Department records show that in fiscal year 2015, an average of 4.75 license-compliance FTE identified more than 1,300 businesses that did not have a TPT license and helped ensure these businesses obtained a license. For fiscal year 2018, the Department averaged fewer than 1 FTE in this function, and estimates show they brought fewer than 100 businesses into compliance. By April 2018, no Department staff were specifically assigned to this function, and the Department had stopped performing any license-compliance work. According to Department management, this decline resulted from employee attrition, agency budget reductions during the recession, and competing priorities as a result of TPT reform.

Department staff reported that in previous years they performed numerous license-compliance activities to determine if businesses should be licensed, including:

- Canvassing businesses and special events like the Tucson Gem Show and Arizona State Fair.
- Reviewing business lists and information shared by cities and towns.
- Researching businesses using publicly available information from organizations like the Arizona State Registrar of Contractors and the Arizona Department of Liquor Licenses and Control.

Further, the Department created a license-compliance handbook for Department staff and city/town staff who performed their own license-compliance work.<sup>9</sup>

## Department implemented new license-compliance program in October 2018

In developing its new license-compliance program during the audit, the Department performed the following:

- Staffed the new program with 4 auditors/inspectors and 1 manager. These staff are primarily responsible for researching and contacting potentially unlicensed businesses.
- Developed goals for its license-compliance program. These goals include identifying 1,000 unlicensed businesses, helping to ensure these businesses become licensed, and increasing TPT revenues by \$5 million from these newly licensed businesses by the end of fiscal year 2019.
- Started tracking license-compliance cases, including license fees paid, tax returns filed and taxes paid by businesses, and other relevant information once the business has obtained a license.
- Created an updated license-compliance manual, associated internal policies and procedures, and letters that it uses to encourage businesses to comply with TPT license requirements. The Department reported that they provided these resources to cities and towns in October 2018. The license-compliance manual and policies and procedures are intended to provide guidance for both Department staff and cities and towns that perform work to enforce TPT license requirements.

The Department reported that it also plans to use data analytics to identify businesses that may be operating without a license. For example, staff reported that they would like to review lists that cities and towns provide of businesses that are operating in those cities/towns and compare those against businesses with TPT licenses

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<sup>9</sup> Arizona businesses are required to have a State TPT license and a license for every city and town in which they do business. To enforce the city/town license requirement, some cities and towns perform their own license-compliance work to bring businesses into compliance.

in its tax system to identify potentially unlicensed businesses. As of October 2018, Department staff reported that the Department had received 1 business list from a city that it planned to use for this purpose. However, the Department had not yet fully implemented any data analytics to identify potentially unlicensed businesses. The Federation of Tax Administrators, a national organization that improves the quality of state tax administration by providing services to state tax authorities, reported that using data analytics to identify businesses that are not paying taxes is a promising practice.

Department records show that between October 2018 and January 2019, the Department licensed 131 previously unlicensed businesses, which resulted in approximately \$78,300 in TPT revenue from the newly licensed businesses.

## **Recommendations**

The Department should:

1. Continue implementing its new license-compliance program, including its plans to use information provided by cities and towns and data analytics to identify and license unlicensed businesses to meet its goals.
2. Review the effectiveness of its new license-compliance program and make improvements as needed.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.





# Department should improve nonfiler program to ensure operating businesses maintain active TPT licenses

## Department cancels TPT licenses for nonfilers

The Department is responsible for administering and enforcing the State's tax code, including TPT requirements. Statute requires businesses subject to TPT to obtain a TPT license from the Department—which is valid for 1 calendar year and may be renewed—and to file a TPT return with the Department in the month following the filing period.<sup>10</sup> The Department requires taxpayers to file a TPT return for each filing period, regardless of whether any tax is owed for the period.

Statute authorizes the Department to revoke a TPT license if the taxpayer fails to comply with TPT filing requirements. Under this statutory authority, the Department periodically identifies and cancels TPT licenses for businesses that have not filed a return for 13 consecutive months, known as nonfilers.<sup>11</sup> This process, referred to as the “nonfiler program,” is intended to reduce inefficiencies in the Department's license renewal and collections processes by eliminating licenses for closed businesses from the Department's records. However, not all businesses that have not filed for 13 consecutive months are closed businesses, as some may be active businesses that are noncompliant with TPT filing requirements.

## Department has inappropriately canceled licenses of active businesses through nonfiler program, potentially resulting in lost revenues

We reviewed a judgmentally selected sample of 444 TPT licenses that the Department identified in September 2017 as being eligible for cancellation through the nonfiler program and determined that the Department inappropriately canceled TPT licenses for at least 13 of these businesses that appeared to be operating at the time of cancellation.<sup>12</sup> In response to notification of license cancellation from the Department, 7 of the businesses took action to reactivate their licenses between October 2017 and January 2018, such as through filing a return or calling the Department. However, as of August 2018, the remaining 6 businesses were operating without a TPT license. As a result, the Department has no assurance that these 6 businesses are filing TPT returns and remitting any taxes owed to the State and cities and towns. As explained in Finding 1, the Department relies on active TPT licenses to efficiently process, distribute, and enforce TPT payment.

<sup>10</sup> A taxpayer's filing frequency—monthly, quarterly, or annually—is determined by the taxpayer's estimated annual TPT liability.

<sup>11</sup> Laws 2017, Ch. 60, granted the Department authority to revoke a TPT license when a taxpayer fails to file a return for 13 consecutive months.

<sup>12</sup> We reviewed 444 of the 2,699 TPT licenses the Department identified as eligible for cancellation during the September 2017 nonfiler program.

## Department lacks effective process to verify business status before canceling licenses

The Department does not verify whether identified nonfilers are still operating an active business prior to canceling their TPT licenses through the nonfiler program. Instead, once the Department identifies nonfilers, it sends a notification letter informing them that their TPT licenses are subject to cancellation within 30 days. However, we identified some deficiencies with this notice, see Figure 3.

**Figure 3**  
Example of a TPT license-cancellation notice and associated issues

**Transaction Privilege Tax License Cancellation Notice**

**1** You are receiving this letter because you have not filed for a period of twelve months. As a result, your Transaction Privilege Tax (TPT) license is subject to cancellation.

\* If you do nothing, your license will be canceled within 30 days from the date of this letter.

**2** \* If you do not object to the cancellation or/are no longer operating the business, you do not need to do anything.

\* If you object to the cancellation, please contact a Revenue Officer at the number listed below.

**3** This action does not relieve license holders of previous or future tax liabilities. If you have sales or taxes that have not been reported, or you owe use tax on items purchased tax exempt, you must amend your TPT1 tax returns to report that income and pay the tax within this 30-day period. TPT1 forms and instructions are available on our website at [www.azdor.gov](http://www.azdor.gov).

If you have questions about this matter, please contact a Revenue Officer at (602) 364-2045 in Phoenix or (520) 628-6442 in Tucson, Monday through Friday from 8:00am to 5:00pm.

- 1** Informs the taxpayer that his/her license is subject to cancellation but does not inform the taxpayer of the statutory requirement that businesses subject to TPT are required to maintain an active TPT license.
- 2** States that if the taxpayer does not object to the cancellation, such as if the business has closed, the taxpayer does not need to take any action. However, this could result in noncompliant taxpayers further evading filing requirements because the process does not account for operating businesses that are intentionally not complying with TPT filing requirements.
- 3** States that the taxpayer should file a return if the business has sales or taxes to report but does not inform the taxpayer that the Department requires businesses to file a return for every filing period even if the business has no sales to report. Additionally, it does not inform the taxpayer that he/she is subject to late-filing and late-payment penalties for each delinquent return.

Source: Auditor General staff analysis of a TPT notice provided by Department staff.

## Department collaborated with some cities and towns in 2018 to identify nonfilers whose licenses should remain active

In 2018, the Department identified 12,816 nonfilers whose licenses it planned to cancel. Ten cities and towns—including some of Arizona's largest municipalities, such as Phoenix, Tucson, and Mesa—volunteered to review a Department-provided list of identified nonfilers with businesses located in their taxing jurisdictions.<sup>13</sup> The Department allowed these cities and towns approximately 5 weeks to verify the businesses' statuses and respond to the Department. According to the Department, the 10 participating cities and towns identified 3,260 nonfilers

<sup>13</sup> Department staff reported requesting input from cities and towns in September 2017 regarding licenses that they determined should not be canceled because of active business statuses, but they could not provide evidence of responses received from any cities or towns.

in their taxing jurisdictions whose licenses should potentially remain active.<sup>14</sup> The Department reported that it began a collections campaign in August 2018 on these licenses to bring the businesses that are still operating into compliance for past owed TPT.

Despite the results of this collaboration with the participating cities and towns, the Department still lacks a process to routinely verify the status of the businesses located in all 91 cities and towns and, therefore, remains at high risk of canceling licenses for operating businesses that are noncompliant.

## Recommendations

The Department should:

3. Improve the nonfiler license-cancellation notice to include language explaining statutory TPT licensing and filing requirements, informing the taxpayer of late-filing and late-payment penalties, requiring the taxpayer to inform the Department whether the business is operating or not, and informing the taxpayer to take action to resolve instances of noncompliance with TPT filing requirements.
4. Develop and implement a process to verify businesses' statuses prior to canceling licenses through its nonfiler program, such as through continued and/or expanded collaboration with cities and towns or through its new license-compliance program.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

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<sup>14</sup>The Department did not track how many of the 12,816 nonfilers these 10 cities and towns collectively reviewed, so we could not determine the percentage that the 3,260 nonfilers represented relative to the number of nonfilers they reviewed; however, the 3,260 nonfilers are approximately 25 percent of the total 12,816 nonfilers the Department identified.



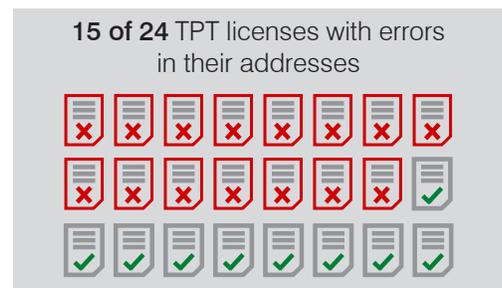


# Department should help ensure accurate address information for TPT licenses

## Most TPT licenses we reviewed contained inaccurate address information

As part of the TPT licensing process, the Department requires taxpayers to provide address information. Department staff use address information to mail correspondence to the taxpayer—such as license renewal or collections notices—and search for licensed taxpayers’ accounts in the Department’s tax system to correctly apply payments or to confirm that a TPT license exists.

We reviewed 24 active TPT licenses as of August 2018 and identified several errors in the addresses for 15 of the TPT licenses reviewed, including 1 instance of noncompliance with Department policy.<sup>15</sup> These errors included mailing addresses that were not current; misspellings; and incorrect street addresses, zip codes, or cities. Based on the review of 24 licenses, we also identified several instances of addresses recorded in the Department’s tax system in an unstandardized format, such as misusing abbreviations or omitting parts of the address (see textbox for more information on address standardization).



## Inaccurate and unstandardized addresses hinder Department’s ability to administer and enforce TPT

Inaccurate and unstandardized addresses in its tax system affect the Department’s ability to perform functions such as audit and collections work, annual license renewals, and license-compliance efforts. For example, when there is an error in the mailing address on a TPT license, the taxpayer will not receive any correspondence the Department sends, such as delinquency or license renewal notices.<sup>16</sup> Also, due to limited search capabilities in the Department’s tax system, when an address is incorrect or in an

### Address standardization

According to the U.S. Postal Service, a standardized address is fully spelled out, abbreviated using the Postal Service standard abbreviations, and written in the proper format for address style.

<b>Standardized address:</b>	1507 E MAIN ST STE 204 MESA AZ 85203
<b>Unstandardized variation 1:</b>	1507 EAST MAIN ST SUITE #204 MESA AZ 85203
<b>Unstandardized variation 2:</b>	1507 E. MAIN ST. SUITE 204 MESA ARIZONA 85203

Source: Auditor General staff review of U.S. Postal Service. (2015). *Publication 28: Postal addressing standards*. Washington, DC.

<sup>15</sup> In April 2018, we judgmentally selected a sample of 30 operating businesses in different industries throughout Arizona. The Department could not identify active TPT licenses for 7 of the 30 businesses (see Finding 1, page 7). One of the 23 businesses had 2 active TPT licenses for its separate business functions, bringing the sample size to 24 TPT licenses reviewed.

<sup>16</sup> The Department reported receiving approximately 185,000 post office returns for all tax types and all correspondence in fiscal year 2018.

unstandardized format, Department staff are unable to effectively search for existing licenses in the tax system. As a result, Department staff may not be able to (1) apply payments that are submitted without a TPT license number to the correct account, (2) prevent the creation of a duplicate TPT license for a single business, or (3) confirm that an active business is licensed with the Department.

Additionally, without correct addresses in the tax system, staff cannot properly conduct potential license-compliance work to determine if a business is properly licensed with the Department, such as matching address information in the tax system with outside data sources (e.g., utility and business permit address data). Further, inaccurate addresses in the tax system may affect the accuracy of information in the TPT reports that the Department provides to the cities and towns. The cities and towns rely on the detailed information in these reports to conduct their internal reconciliation and budget analysis processes, which they perform to help ensure their TPT distribution is accurate (see Finding 8, pages 39 through 42, for more information).

## Department lacks IT controls and targeted education efforts to help ensure accurate addresses

We identified 2 factors contributing to inaccurate addresses:

- **Lack of address-standardization controls**—Taxpayers and Department staff may enter addresses with inconsistent formats, misspellings, or other errors because both the tax system and AZTaxes.gov lack information technology (IT) controls to ensure address standardization. As of August 2018, the Department had begun to develop a project plan to implement address-standardization controls in AZTaxes.gov, which taxpayers use to submit address information using online forms. These controls would include a process to validate an address against the official U.S. Postal Service’s database and address-verification software that corrects the address to the standardized format. However, the Department does not have a plan to implement address-standardization controls in its tax system, which is where Department staff enter taxpayer-address information from paper-filed forms.
- **Lack of targeted taxpayer education efforts to improve accuracy of address information**—When taxpayers do not regularly update address information on their TPT license, such as if a zip code changes or the business has relocated, the addresses can become inaccurate. For example, zip codes change in developing areas as they become more populated, but the taxpayer may never update the business address on file with the Department. The Department has not identified or analyzed patterns in taxpayer behavior that contribute to taxpayers providing inaccurate TPT license addresses. This kind of information would potentially inform a targeted taxpayer education campaign to instruct taxpayers on how to correctly enter and update address information. Such a campaign could include reminders to regularly update their information in various correspondences to taxpayers, such as the monthly TPT e-newsletter, strategically placed reminders on the Department’s website or social media outlets, and pop-up instructions in the online application forms. Without such education, taxpayer behavior may continue and result in taxpayers not updating business addresses in a timely manner.

## Department’s manual review process does not catch all inaccurate addresses

The Department implemented a weekly process to review information on newly issued licenses for errors. This process involves a Department staff person manually filtering and reviewing TPT license information in an Excel spreadsheet to identify licenses with formatting errors, such as extra spacing, and content errors, such as misspellings. However, this process is inefficient, manual, and prone to human error, resulting in unidentified errors on TPT licenses. We reviewed a list of newly issued TPT licenses from May 2018 and found several address

errors that Department staff did not identify through the Department's manual review process.<sup>17</sup> For example, we identified the following 2 errors that were not identified through the manual review process: when processing TPT license applications in the tax system, staff entered (1) "Poke" instead of "Polk" Street, and (2) a street address as "Fountain Hills," which is a town and not a valid street address.

If the Department fully implemented address-standardization controls in AZTaxes.gov and its tax system, the Department could ensure that all addresses entered through either system are valid and in the standardized format. This would lessen its reliance on its manual and error-prone review process to identify and correct errors on new licenses, including address errors.

## Recommendations

The Department should:

5. Implement its plan to add address-standardization controls to AZTaxes.gov and add these controls to its tax system.
6. Identify and analyze trends in taxpayer behavior that contribute to inaccurate address information and develop and implement a targeted taxpayer education campaign to address the behavior.
7. Until it implements its plan to add address-standardization controls to AZTaxes.gov and its tax system, review the effectiveness of its manual process to review newly issued licenses and work with Department IT staff to look for ways to automate this process.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

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<sup>17</sup> In addition to incorrect addresses, the Department's process looks for errors in the business ownership type (e.g., sole proprietor or limited liability company) and errors in other required fields. Although these errors may not affect TPT distribution, we identified other errors that Department staff did not identify through the review process. For example, we identified several new licenses for which Department staff had entered the ownership type as sole proprietorship when processing the TPT license application in the tax system, but the business entity name indicated it was a limited liability company.





## Department should take steps to better identify and address TPT underreporting or misreporting

### Taxpayers required to provide business information and file periodically

As described in the Introduction, before filing a return, a taxpayer is required to apply for a TPT license and provide the following information to the Department:

- The address of each business location.
- The taxing jurisdictions in which each location conducts business.
- The statutorily defined classifications of taxable business activity conducted at each location (see textbox for example business activity classifications).

As described in Finding 2, the Department requires taxpayers to file a TPT return with the Department for each filing period, regardless of whether any tax is owed. The return should report the tax liability for each business location, each taxing jurisdiction to which TPT is owed, and each classification of taxable business activity that the business engaged in during the filing period.<sup>18</sup> Once filed, returns are processed using the Department's tax system.

### Department's IT controls are not designed to identify all TPT filing errors

The Department uses some IT controls to identify a limited number of errors when processing TPT returns in its tax system. Specifically, the tax system reviews the information reported on the tax return and identifies returns that violate certain logic tests, known as suspense rules (see Figure 4, page 20). Examples of common suspense rules include:

- If a taxpayer's calculations differ from the tax system's calculations.
- If the return is missing required information.
- If the information reported includes an invalid value—such as a negative number—that the tax system cannot recognize.

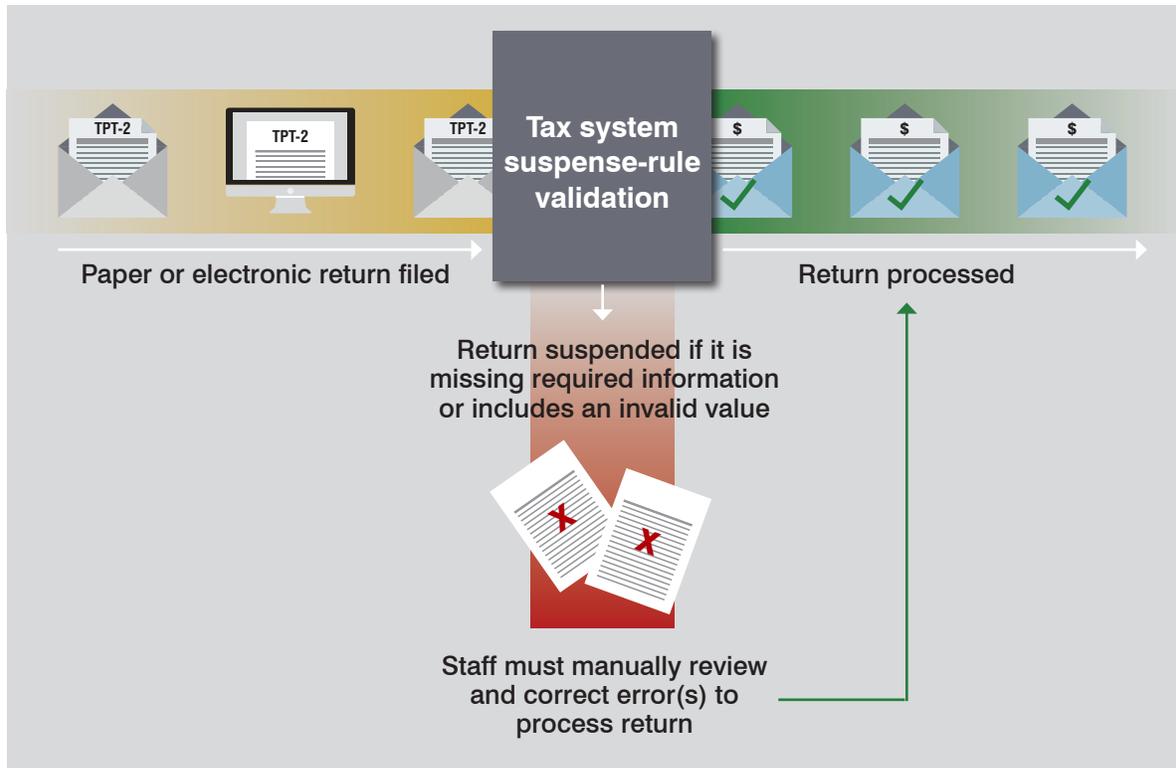
<sup>18</sup> A.R.S. §42-5014(G) requires a taxpayer subject to TPT to prepare a tax return showing the amount of tax for which the taxpayer is liable for the preceding period and file the return with the Department. A taxpayer's filing frequency—monthly, quarterly, or annually—is determined by the taxpayer's estimated annual TPT liability.

#### Example TPT business activity classifications

- **Amusement**—Business of operating entertainment events or venues such as movie theaters, concerts, fairs, or bowling alleys.
- **Retail**—Business of selling goods at retail, such as clothing or furniture, not including services.
- **Utilities**—Business of producing and furnishing consumers with natural/artificial gas, water, and electricity.
- **Commercial lease**—Business of renting the use or occupancy of real property for commercial purposes.

Source: Auditor General staff review of A.R.S. §§42-5061 through 42-5076.

**Figure 4**  
**Department’s tax system suspense-rule validation process**



Source: Auditor General staff observation and analysis of Department processes and documents.

When the tax system identifies a return that violates a suspense rule, it halts the processing of the return, or suspends it. When a return is suspended, Department staff must manually review the return and make the necessary changes to the return information recorded in the tax system to allow it to correctly process the return (see Finding 5, pages 25 through 27, for more information on this process).

However, as discussed in the next section, the Department's IT controls in the suspense-rule process are not designed to identify all errors, which may result in the Department not identifying instances of taxpayer misreporting or underreporting.

## Most TPT returns we reviewed contained at least 1 instance of possible unidentified TPT underreporting or misreporting

We reviewed the last TPT return filed for calendar year 2017 for 24 TPT licensees and compared the taxable business activity reported on each TPT return with the information listed on each taxpayer's TPT license.<sup>19</sup> Through this comparison, we identified instances in 20 of the 24 returns in which the taxpayer potentially underreported or misreported TPT owed—errors that the IT controls in the suspense-rule process are not designed to identify. These instances included the taxpayer not accurately reporting activity for each active business site, for each taxing jurisdiction in which the business conducted taxable activity, or for each taxable activity in which the business was engaged.

<sup>19</sup> In April 2018, we judgmentally selected a sample of 30 operating businesses in different industries throughout Arizona. The Department could not identify active TPT licenses for 7 of the 30 businesses (see Finding 1). One of the 23 businesses had 2 active TPT licenses for its separate business functions, bringing the sample size to 24 TPT licenses reviewed. We reviewed the TPT return submitted for the December 2017 filing period for 22 of the 24 licensees. As of May 2018, 2 licensees in the sample had not filed TPT returns for December 2017; therefore, we reviewed the last return they filed with the Department in July and November 2017, respectively.

Some of the instances of possible underreporting or misreporting may have resulted from the information on the license not reflecting the business' current locations and activities, but some instances may have resulted from the taxpayer not accurately reporting all taxable activity to the Department. For example:

- A taxpayer for a contracting business did not report activity for the City of Scottsdale even though this city was listed as an active jurisdiction on the taxpayer's TPT license. This may have resulted in lost revenue for Scottsdale if business activity occurred within its jurisdiction. The business may not have conducted taxable activity in Scottsdale for the filing period we reviewed, but Department staff reported that the taxpayer should have included Scottsdale on its return and reported no tax liability if that were the case.
- A taxpayer has 5 locations of a retail store in the City of Mesa. Although the taxpayer reported activity for 4 of the 5 locations on the TPT return we reviewed, it reported activity for the fifth location to the Town of Gilbert. This instance of misreporting may have resulted in the Department incorrectly distributing \$88,681.90 to Gilbert. Additionally, as Gilbert and Mesa have different tax rates for the taxable activity this taxpayer reported, this instance of misreporting may have resulted in the Department collecting an estimated \$6,177 in excess tax during the filing period we reviewed.
- A taxpayer for a concert venue reported taxable amusement activity for the City of Tucson but did not report this taxable activity for the State. Because the concert venue reported amusement activity at the city level for the filing period we reviewed, it is likely that the taxable activity was underreported at the State level. As a result, the Department did not collect an estimated \$264 owed to the State.<sup>20</sup>
- A taxpayer with multiple brick and mortar stores across Arizona did not report activity for 2 of its 6 stores in the City of Avondale and 1 of its 3 stores in the Town of Queen Creek. The taxpayer may have underreported sales in these instances, which would have resulted in the Department not collecting an estimated \$12,129 owed to Avondale, \$4,205 owed to Queen Creek, and \$31,259 owed to the State.<sup>21</sup>

Additionally, this taxpayer reported activity for the City of Peoria for a store located in the City of Glendale. It is likely that the taxpayer may have misreported where the taxable activity occurred by reporting Peoria instead of Glendale on the return. As a result, the Department may have incorrectly distributed \$3,790.68 to Peoria and did not collect and distribute an additional \$2,167.30 owed to Glendale because of the different municipal tax rates. See Finding 8, pages 39 through 42, for additional information about the Department's city/town TPT distribution process and an additional example of misreporting affecting TPT distribution.

## Data analytics help detect potential underreporting or misreporting

Federal and state tax administration agencies have expanded their use of data to identify abnormal filing patterns and risk of tax fraud. For example, the U.S. Government Accountability Office (U.S. GAO) reported that the Internal Revenue Service (IRS) has implemented a Return Review Program that uses data analytics and IT controls—including predictive models, business rules, clustering, and use of third-party taxpayer data—to identify risk of fraudulent individual income tax returns (see textbox on page 22). Specifically, the IRS uses a combination of these data analytics and IT controls to analyze the content of each return in addition to historical data associated with the taxpayer to determine the likelihood that the return is fraudulent. The IRS uses the Return Review Program to review returns for instances of possible fraud during return processing so that if the program detects possible fraud, the IRS can reject the return. The U.S. GAO recommended that the IRS could further leverage the data analytics used in the Return Review Program to improve other tax enforcement activities such as detecting taxpayer underreporting of income and tax owed, which is similar to the possible underreporting and misreporting of TPT identified through our review of TPT returns.<sup>22</sup>

<sup>20</sup> Taxpayers report taxable activity sales for the State and the counties together on the TPT return. This estimate includes both TPT owed to the State and excise tax owed to Pima County.

<sup>21</sup> We based these estimates on TPT return information the taxpayer reported for the other Avondale and Queen Creek stores. The estimate for the State also includes excise tax owed to Maricopa and Pinal Counties.

<sup>22</sup> U.S. Government Accountability Office. (2018). *Tax fraud and noncompliance: IRS could further leverage the Return Review Program to strengthen tax enforcement*. Washington, DC.

Although this example of the IRS' use of data analytics relates to individual income tax, data analysis techniques can be applied to other tax types, including TPT. The Department has applied data analytics to identify audit leads but not to identify underreporting or misreporting during TPT processing. In May 2017, the Department began working with a third-party vendor to pilot an audit and enforcement campaign in which it applied data analytics to review processed TPT returns for single-location restaurants to identify inconsistent and abnormal filing patterns that may be predictive of underreported income tax and TPT. Through this effort, the Department audited several noncompliant restaurants, resulting in approximately \$228,000 in proposed assessments of taxes owed as of August 2018. However, the Department has not yet applied data analytics to the greater population of TPT returns or strengthened its existing IT controls—such as the suspense-rule process—to consistently identify underreported or misreported TPT prior to return processing.

## Data analytics and IT controls used in the IRS Return Review Program

- **Predictive models**—Analyze data to identify filing patterns predictive of fraud that can be used to detect inconsistent or abnormal taxpayer behavior in returns during processing.
- **Business rules**—Use “Yes” or “No” questions to flag returns that contain evidence of abnormal filing behavior during processing.
- **Clustering**—Analyzes data for patterns or relationships to identify clusters of returns that share traits predictive of fraud.
- **Third-party data**—Information about the taxpayer not included on the return, such as prior filing history or income information.

Source: Auditor General staff review of U.S. Government Accountability Office. (2018). *Tax fraud and noncompliance: IRS could further leverage the Return Review Program to strengthen tax enforcement*. Washington, DC.

## Department cannot implement data analytics until it verifies quality and accuracy of license information in tax system

The Department cannot use taxpayers' TPT license information in its tax system as an IT control or in other data analytics to determine if what the taxpayer reports on a TPT return is complete and accurate because TPT license information in the tax system is incomplete and inaccurate. According to accepted data-analytics standards for tax administration, data should be verified for quality and accuracy before it can be used in data analytics. This includes evaluating data for errors, consistency, or possible missing information.<sup>23</sup>

For 17 of the 24 TPT licenses reviewed in the tax system, we identified at least 1 piece of inaccurate licensing information regarding the business sites, the taxing jurisdictions in which the business operates, or the type of taxable activity the business conducts. For example, license information in the tax system listed locations for business sites that were not in operation.

We identified several factors contributing to the inaccuracy of TPT license information in the tax system, including:

- **Holdover license information from previous TPT processes**—Department staff reported that, prior to TPT reform, whenever the Department issued a new TPT license, the tax system automatically reflected every business classification for the designated taxing jurisdictions on the new license, regardless of the type of activity it conducted. This programming decision resulted in license information in the tax system that does not accurately reflect the business' taxable activities conducted, which we observed during our review of license profiles.
- **Data entry errors**—Although the Department provides guidance, templates, and instructions to taxpayers and Department staff for completing TPT license applications and returns, there are greater risks for error when using paper-filed forms. For example, the Department reported that staff may enter information from paper-filed documents incorrectly into the tax system, or a taxpayer may submit a document with incorrect information that staff then enter into the tax system. This could include errors in the business locations, taxing jurisdictions, or business classifications listed in the license information in the tax system.

<sup>23</sup> Treasury Inspector General for Tax Administration. (2017). *The Return Review Program increases fraud detection; However, full retirement of the Electronic Fraud Detection System will be delayed*, Ref. No. 2017-20-080. Washington, DC: U.S. Department of the Treasury.

TPT license information and taxpayer returns that are processed electronically are less likely to contain data-entry errors due to the additional IT controls in the Department's online portal, AZTaxes.gov. For example, when a taxpayer enters the business address on the online license application, AZTaxes.gov suggests the applicable taxable business classifications for the jurisdiction based on the address because cities and towns in Arizona do not universally tax the same business activities (e.g., not all jurisdictions tax advertising). Therefore, AZTaxes.gov would use the business' location address to suggest only the taxable business classifications for each business location on a TPT license application. The Department's website encourages taxpayers to file online for faster processing and fewer errors. However, the Department reported that taxpayer use of electronic TPT license application and filing methods during calendar year 2017 was less than 50 percent.<sup>24</sup> As reported in Finding 7, although statute requires electronic filing for certain taxpayers under certain conditions, the Department has not implemented these requirements (see pages 33 through 38 for additional information and our recommendations).

- **Lack of targeted taxpayer education efforts to help ensure accurate TPT license information—** Incorrect TPT license information may also result from taxpayers not regularly updating their license information or filing an inaccurate TPT return. As previously explained in Finding 3 (see page 16), the Department has not identified or analyzed patterns in taxpayer behavior that contribute to taxpayers providing inaccurate TPT license addresses. Our review of TPT returns and license information in the Department's tax system found that some taxpayers are not regularly updating their license information when a business location closes or changes addresses.

## Recommendations

The Department should:

8. Evaluate whether additional IT controls in its suspense-rule process could be implemented to reduce the risk of misreported or underreported TPT, implement any identified additional IT controls, and assess the effectiveness of its efforts.
9. Analyze its return-processing procedure, develop and implement a plan to reduce the risk of misreported or underreported TPT through data analysis, and assess the effectiveness of its efforts.
10. Develop and implement a plan to identify and address errors in its tax system licensing information and assess the effectiveness of its data-cleanup efforts.
11. Develop and implement a plan to increase TPT taxpayer use of AZTaxes.gov for TPT license applications and enforce statutory requirements for electronic TPT return filing in conjunction with Recommendation 19 in Finding 7.
12. Develop and implement targeted taxpayer education campaigns to help ensure accurate TPT license information in conjunction with Recommendation 6 in Finding 3.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

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<sup>24</sup> The Department reported that in calendar year 2017, 48.2 percent of TPT license applications and 40.6 percent of TPT returns were processed electronically through AZTaxes.gov.





## Department should consistently perform reviews to ensure staff accurately process TPT error-resolution changes

### Department staff have discretion to change TPT return information recorded in its tax system

As described in Finding 4 (see pages 19 through 20), when the Department's tax system identifies a TPT return that contains certain taxpayer errors, the tax system suspends the return. To process suspended returns, Department error-resolution staff research the taxpayer's account to obtain any needed information and use the best information available to change the return information recorded in the tax system to correct the error and process the return. According to Department records, the Department processed an approximate average of 29,000 suspended TPT returns per month during June and July 2018. This process also generates a tax correction notice that the Department sends to the taxpayer to notify the taxpayer of any filing errors (see Finding 6, pages 29 through 31, for additional information about tax correction notices).

Department error-resolution staff have discretion to change return information in the tax system to correct the identified error(s) and process the return. These changes include deleting taxable activity that was reported on a return; altering values, such as the total gross receipts of taxable activity reported by the taxpayer; or changing the taxing jurisdiction for which the taxpayer reported taxable activity, such as replacing "City of Flagstaff" with "City of Phoenix," all within the tax system.

### Department prioritizes processing TPT returns quickly, which may result in reporting and distribution errors

The Department reported that it prioritizes processing returns quickly so that TPT revenue can be distributed to applicable taxing jurisdictions without delay. However, this results in error-resolution staff not always verifying with taxpayers the accuracy of the changes they make to return information in the tax system. Specifically, the Department reported that when error-resolution staff are unable to obtain the needed information from the tax system to correct a suspended return, staff must attempt to contact the taxpayer to obtain the information. If staff cannot reach the taxpayer within 2 days, staff correct the suspended return with the best information available.<sup>25</sup> However, the Department lacked written policies defining how staff should consult with taxpayers to ensure return information is accurate prior to processing suspended returns or how staff should document the consultation with the taxpayer in the tax system. This increases the risk of inaccurate TPT reporting and distribution. For example:

- For one suspended return we reviewed, the taxpayer reported negative values in both the gross receipts and the deduction fields on 3 transaction lines on the return. Because the tax system cannot recognize negative values, the return was suspended. Department staff changed the negative values in the gross receipts field to different positive values not in the original return, although staff did not document the source

<sup>25</sup> In October 2018, the Department updated its process to allow staff 24 hours to contact the taxpayer before processing the return with the best information available.

or rationale for the new values. Department staff did not correct the negative values in the deduction field but, instead, deleted the 3 transaction lines in the tax system altogether, thus removing from the tax system any record of taxes owed to the City of Peoria, the City of Globe, and the Town of Dewey-Humboldt, which may have resulted in lost revenues for these jurisdictions. In both instances of staff editing the taxpayer's return information, Department staff did not document in the tax system why the changes were made or if staff attempted to consult with the taxpayer before making the changes.

- For another suspended return we reviewed, the taxpayer did not provide the business classification information for the activity reported, which is required for the tax system to determine the applicable tax rate to calculate the tax owed. Absent this information, Department staff may have incorrectly classified the business activity on the return in the tax system, which resulted in the Department incorrectly assessing a higher tax rate for the taxable activity and, thus, a higher tax liability. There was no documentation in the tax system indicating that Department staff attempted to consult with the taxpayer before entering the business classification for the return.

By not contacting the taxpayer prior to making these changes, the Department assumes the taxpayer's intention and does not verify the accuracy of this assumption. This can result in inaccurate reporting, which may result in the Department not collecting and distributing revenue owed to taxing jurisdictions or the Department incorrectly assessing a taxpayer's TPT liability. Additionally, it is unclear whether the Department has statutory authority to make these changes to information recorded in the tax system from taxpayers' TPT returns, and the Department did not provide us with documentation of its authority to do so.

## Department lacks effective quality control process

During the audit in March 2018, the Department implemented an informal quality control process to conduct post-processing reviews of a sample of changes error-resolution staff made to suspended TPT returns. However, we identified 3 issues with this process:

- Department staff reported that this process involves error-resolution staff reviewing an average of 10 to 12 percent of the returns processed by other error-resolution staff, which includes but is not limited to TPT returns. However, we reviewed quality control reports for 3 error-resolution staff and determined that, from April 10, 2018 through August 27, 2018, Department staff were generally not conducting these reviews for TPT returns. Specifically, only 1 TPT return processed by 1 of these staff was reviewed, and no TPT returns processed by the other 2 staff were reviewed.
- There is no written guidance on how often these reviews should occur, what content of the TPT return should be reviewed, or whether the taxpayer should be contacted to verify if the changed information is accurate.
- There is no supervisory review for this process to ensure that the reviews are conducted correctly and consistently.

## Recommendations

The Department should:

13. Consult with its legal counsel and determine its statutory authority to make changes to information recorded in its tax system from taxpayers' TPT returns.
14. Develop and implement written policies and procedures that require error-resolution staff to (1) consult with taxpayers prior to making changes to TPT return information in its tax system when the information necessary to process the return is not available in the tax system, (2) document communication or attempted communication with taxpayers in these situations, and (3) document the reasons when changes are made in the tax system.
15. Develop and implement written policies and procedures for its error-resolution quality control process that specify how often reviews should occur, how many returns per staff person should be reviewed, what should

be reviewed, if the information should be verified with the taxpayer, the time frames for addressing any errors identified through reviews, and who is responsible for performing and overseeing the error-resolution quality control process.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.





## Department should ensure tax correction notices are accurate and adequately instruct TPT taxpayers

### Department automatically generates notices to inform taxpayers of overpayments, underpayments, and filing errors

As explained in Finding 5 (see page 25), Department staff change taxpayers' TPT return information in the Department's tax system to correct errors that prevent the return from being processed. When Department staff correct return information that contains an error or when a taxpayer remits a payment that is more or less than the tax owed according to the tax system's calculations, the tax system automatically generates a TPT tax correction notice (notice) to inform the taxpayer of the identified overpayment, underpayment, or error made on the TPT return. The notices are then printed and mailed to taxpayers by a third-party vendor. The Department generates thousands of notices to be sent to TPT taxpayers monthly. For example, for the week of May 6, 2018 through May 12, 2018, the Department generated approximately 1,500 notices for TPT taxpayers.

Although the Department does not have a written policy defining what information these notices should contain, the notices generally include a narrative description of the filing or payment errors and provide instruction to the taxpayer on how to correct the issue. In 2016, as part of TPT reform, the Department expanded the types of errors that would trigger a notice and updated the design of the notice to include a table displaying the return transaction line(s) with the identified error(s).

### Notices do not always accurately reflect TPT return errors and may not provide adequate taxpayer instruction

According to the Internal Revenue Service's Taxpayer Bill of Rights, taxpayers have a right to be informed, to receive clear explanations of decisions made and outcomes regarding their accounts, and to receive clear and easily understandable communication.<sup>26</sup>

We reviewed a sample of 9 notices and identified issues in all 9 notices (see Figure 5, page 30, for an example notice with these issues highlighted).<sup>27</sup> Specifically, these notices included at least 1 of the following issues:

- Displayed inaccurate calculations.
- Lacked a written explanation for all the errors listed in the calculation tables on the notice.
- Contained wording that did not accurately reflect the reason for the notice.
- Lacked instruction to file an amended return to correct the issue.

<sup>26</sup> Internal Revenue Service. (2017). *Taxpayer Bill of Rights*. Washington, DC: U.S. Department of the Treasury.

<sup>27</sup> We obtained approximately 1,500 notices that were generated between May 6, 2018 and May 12, 2018, from Department staff and judgmentally selected a sample of 9 notices for review.

**Figure 5**  
**Example notice and associated issues**

Return Top Portion With Payment

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**TAX CORRECTION NOTICE**

Keep Bottom Portion For Your Records

License	Notice #	Notice Date
[REDACTED]	[REDACTED]	05/09/2018

1 A review of your Transaction Privilege return received on 05/25/2017 indicates that you owe \$155.88. This amount includes penalty and interest. For the period ending 04/30/2017, the due date is 05/22/2017. If you do not pay the amount shown as due by 05/30/2018, additional penalty and interest will accrue. If you have any questions, please contact Taxpayer Information and Assistance at (602) 255-3381. (Additional phone numbers in back.)

2 You reported activity for Business Code 000. This Business Code is not part of your TPT license profile. To correct your profile use the Business Account Update form.

All forms and instructions are available in the FORMS section of [www.azdor.gov](http://www.azdor.gov).

	Late Filing	Late Payment	Extension Underpayment	Estimated Underpayment	Other Penalties	Interest	Total
<b>Penalties Breakdown</b>	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$6.42	\$6.42

	Loc. Code	Reg. Code	Bus. Code	Gross Receipts	Deductions	Net Taxable	Total Tax	Accounting Credit	Tax Due	\$ Change
Taxpayer Calc.	0	000	000	\$149,464.35	\$0.00	\$149,464.35	\$3,437.68	\$0.00	\$3,437.68	
DOR Calc.						\$149,464.35	\$102.94	\$0.00	\$102.94	\$0.00
Reason	Invalid Region Code									

- 1 The notice was not timely. It was dated for May 2018 for a return the Department received in May 2017.
- 2 The notice lacks an explanation of how the reported \$155.88 owed was determined. According to the Department's tax system, this amount equals the taxpayer's underpayment of \$149.46 plus accrued interest. However, without the correct Department calculation on the notice (see issue 5), that taxpayer may not understand that the \$149.46 is the difference between the taxpayer's calculation and the Department's calculation.
- 3 The notice does not instruct the taxpayer to file an amended return to correct the filing errors.
- 4 The notice does not explain the invalid region code error that is listed in the calculation table.
- 5 Although the notice correctly reflects the taxpayer's erroneous calculation of \$3,437.68, it does not correctly reflect the Department's calculation. The notice reflects a Department calculation of \$102.94, but according to the Department's tax system, the Department's calculation was \$3,587.14.

Source: Auditor General staff analysis of a TPT notice provided by Department staff.

## Inaccurate and inadequate notices may contribute to continued filing errors and inefficiencies

According to Department staff, notices are intended to instruct taxpayers on how to correct the filing error and to provide education to the taxpayer that can help reduce future incorrect filing behavior. However, given the issues we noted, the notices do not adequately meet this intent and may confuse taxpayers. For example, our review of Department records found that a taxpayer called the Department at least 3 times to better understand the information provided in the notice he received.<sup>28</sup>

When taxpayers receive notices that are confusing, inaccurate, and not instructive, taxpayers may not file an amended return to correct the error and may continue to file future returns improperly. For example, although 5 of the 9 notices we reviewed instructed the taxpayer to file an amended return, 4 taxpayers did not. Additionally, none of the taxpayers who were not instructed to file an amended return did so even though an amended return would be needed to correct the error. Finally, if the taxpayers' reporting errors are persistent, because notices are untimely or provide insufficient instruction, they may result in increased processing costs

<sup>28</sup> This notice was not included in the sample of 9 notices that we reviewed.

for the Department and, in some cases, increased costs for the taxpayer if additional penalties or interest are applicable. Confusing notices may also increase the volume of taxpayer calls to the Department.

## Department solutions have not addressed IT and notice content issues, and it lacks an effective quality review process

During a 2016 review of the content of its notices, the Department identified IT programming issues that resulted in the notices displaying inaccurate calculations. Although Department IT staff reported resolving the identified issues, these issues persisted in the notices we reviewed. Department staff also worked to edit the narrative content of the notices, such as adding a sentence identifying the filing period of the return in the notice's text. However, the narrative text of notices that we reviewed still lacked complete instruction and did not always reflect the reason for the notice.

Although the Department has a process to review notice quality, this process may be ineffective in identifying the issues that we identified through our review. The Department generates multiple batches of correspondence each week that include hundreds of notices for all tax types, including transaction privilege, corporate income, withholding, and individual income taxes. Department policy instructs staff to review a random sample of approximately 5 notices from each batch that is generated—which include notices from all tax types—for formatting issues, missing information, or discrepancies in billing amounts between the notices and Department tax system records before the notices are mailed.<sup>29</sup> According to the Department, if staff identify an issue, staff make the necessary corrections in the tax system for that notice and have a new notice printed and mailed by the third-party vendor.

Department staff reported performing this quality control review daily and estimated identifying approximately 1 error per month for all notices reviewed. However, we identified at least 1 error in each of the 9 judgmentally selected notices reviewed, indicating that the Department's review process may be ineffective in identifying the persistent errors on the notices. Additionally, the Department does not track how many notices staff review or the errors identified through the review process, so Department staff are not able to identify trends in errors that can be used to address IT programming issues.

### Recommendations

The Department should:

16. Resolve IT programming issues for TPT tax correction notices to ensure they are accurate and timely.
17. Improve text content to ensure that TPT tax correction notices provide appropriate taxpayer instruction for all types of TPT errors, overpayments, and underpayments.
18. Evaluate its TPT tax correction notice quality review policy to identify and implement improvements to ensure the policy is effective in identifying and resolving inaccurate or confusing information on TPT tax correction notices, such as specifying how often reviews should occur, how staff should review the content and calculations on the notices, how staff should track notices that are reviewed and the errors identified, how the identified errors are resolved, and who is responsible for overseeing the review process.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

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<sup>29</sup> The total number of notices that staff review each day varies because the number of batches of tax correction notices that are generated varies each day and the number of notices per batch varies based on the number of taxpayer errors. Department staff estimated that the number of batches typically varies between 5 and 20 batches generated per day, which would result in staff reviewing between 25 and 100 tax correction notices per day.





## Department should enforce existing statutory TPT filing requirements

We identified 3 statutory TPT filing requirements that the Department did not implement by their statutory effective dates and that had not been implemented as of November 2018. As shown in Table 2, the Department was not (1) enforcing mandatory electronic TPT filing, (2) requiring electronic filing by property management companies on behalf of residential rental property owners, and (3) assessing late-filing penalties correctly.

**Table 2**  
Statutory filing requirements the Department had not implemented by statutory effective dates and status as of November 2018

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

Source: Auditor General staff analysis of session laws, statutes, and Department records.

## Issue 1: Not enforcing mandatory electronic TPT filing

### Statute requires increased use of electronic filing, which is less error-prone than paper filing

Laws 2017, Ch. 60, §15, requires the Department to increase the TPT electronic filing, or e-filing, rate by requiring more taxpayers to e-file TPT returns each year based on their tax liability. For example, as of January 1, 2018, a taxpayer with an annual TPT liability of \$20,000 or more is required to e-file, and, by 2021, taxpayers with

an annual tax liability of \$500 or more must e-file.<sup>30</sup> Increased e-filing would reduce the number of filing errors on TPT returns and the amount of time it takes Department staff to process returns because of the limited number of manual steps and additional controls associated with processing e-filed returns. We reviewed a Department report of approximately 68,000 TPT returns processed between June 1, 2018 and August 9, 2018, that the Department identified as including at least 1 filing error and found that 79 percent of these returns were paper-filed, while 21 percent were e-filed.

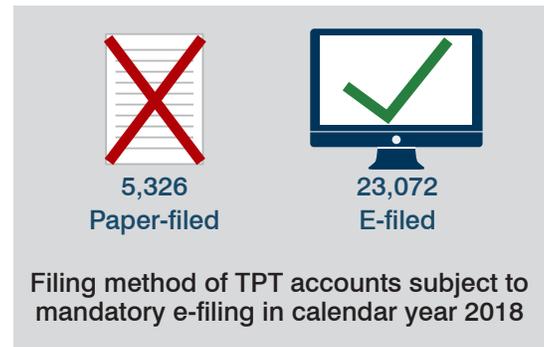
**E-filing**—The process of using a computer program to transmit tax information electronically to another party. E-filing offers taxpayers an easier, less-time consuming, and more secure method of filing taxes. For tax processors such as the Department, e-filing offers lower processing costs, faster processing, and more accurate and complete taxpayer information entering the system.

Source: Auditor General staff summary of information from the Department and the Federation of Tax Administrators.

## Department has not yet programmed its tax system to enforce mandatory e-filing requirement

According to Department management, the Department has not prioritized timely implementation of the mandatory e-filing thresholds because it has prioritized implementing statutory changes that help the taxpayer, such as implementing an expanded tax credit for taxpayers, before implementing statutory changes that penalize the taxpayer.<sup>31</sup> Although this new statutory e-filing requirement was effective January 1, 2018, the Department reported that it did not begin implementation work until April 2018 and had not yet completed the necessary programming changes to its tax system in order to implement this requirement as of November 2018.

As a result, the Department has allowed taxpayers who are statutorily required to e-file to continue to file more error-prone paper returns. Department records indicate that about 18.8 percent of taxpayers with annual tax liabilities of over \$20,000 paper-filed at least 1 of their TPT returns in calendar year 2018.<sup>32</sup>



### Recommendation

19. The Department should implement and annually update the necessary tax system programming changes to enforce the statutory TPT e-filing requirements included in Laws 2017, Ch. 60, §15.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendation.

<sup>30</sup> Laws 2017, Ch. 60, §15, established the following schedule to lower the annual tax liability thresholds for mandatory e-filing: \$20,000 in 2018, \$10,000 in 2019, \$5,000 in 2020, and \$500 in 2021 and thereafter.

<sup>31</sup> Per A.R.S. §42-1125(X)(2), beginning January 1, 2019, the Department will be required to impose a penalty of 5 percent of tax owed or \$25, whichever is greater, on a taxpayer if the taxpayer is required to file electronically but fails to do so.

<sup>32</sup> Some taxpayers are required to file multiple TPT returns in a calendar year because a taxpayer’s filing frequency—monthly, quarterly, or annually—is determined by the taxpayer’s estimated annual TPT liability.

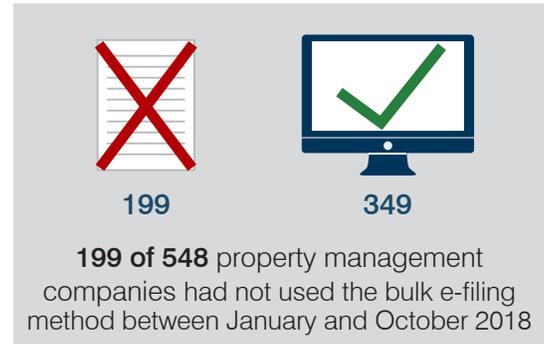
## Issue 2: Not requiring e-filing by property management companies on behalf of residential rental property owners, which may increase the risk of processing errors

### TPT reform required property management companies to bulk e-file returns on behalf of property owners

Prior to January 1, 2018, the Department issued TPT licenses to property management companies so they could report residential rental TPT on behalf of their individual property owners. However, Laws 2016, Ch. 208, §11, which became effective January 1, 2018, required all property owners with taxable residential rental property to individually obtain and file under a unique TPT license. Laws 2016, Ch. 208, §11, also allows property management companies to file TPT returns on behalf of property owners using the property owners' TPT license numbers. Statute requires these property management companies to file their individual property owners' TPT returns on an electronic consolidated return form the Department developed, and the Department established a bulk e-filing method with a combined single form for property management companies to use.

### Department has not enforced e-filing requirement for property management companies

Since January 2018, the Department has allowed property-management companies to continue to paper-file returns for multiple property owners' TPT licenses with a single payment. Department records indicate that between January and October 2018, more than 36 percent of property management companies filing TPT with the Department had not used the bulk e-filing method.



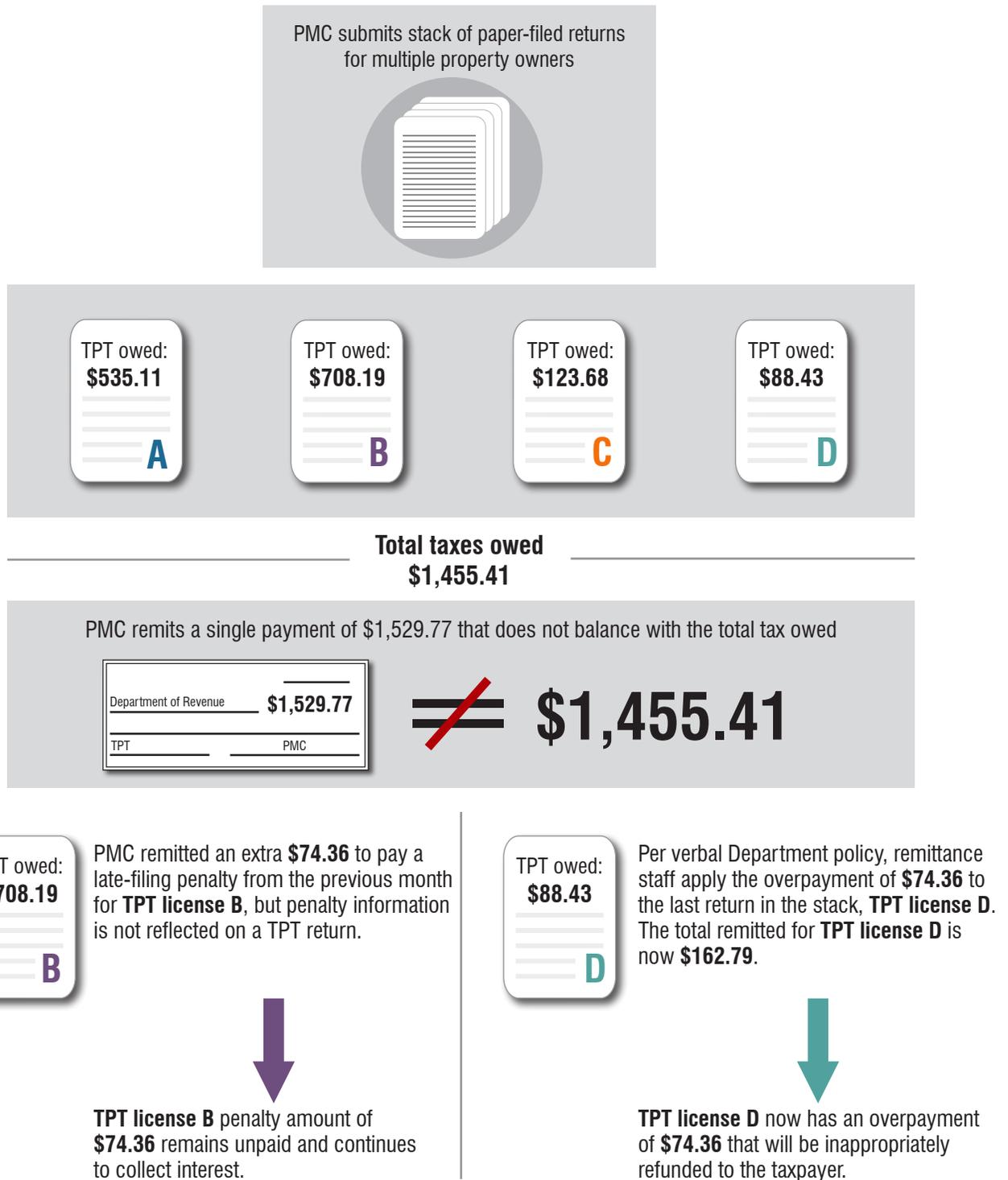
### Department processing of paper-filed returns from property management companies increases risk of processing errors and misapplied payments

We observed Department staff process paper-filed returns from 3 property management companies in April 2018. In each instance, the payments remitted by these property management companies did not equal the reported total tax owed for all the returns. A taxpayer may remit a payment that is either more or less than the total tax owed on a return if the taxpayer has an outstanding penalty on the account that needs to be paid or if the taxpayer has a credit on the account from a previous month that can be applied to the current return. Information concerning a balance due or credit associated with an account is only stored in the Department's tax system and would not be included on the paper-filed return. We observed that rather than Department staff researching the discrepancy to resolve it correctly while processing the returns, they simply adjusted the amount remitted for the last return in the pile to balance it with the property management company's payment (see Figure 6, page 36, for a visual representation of this problem). The bulk e-filing method reduces the risk of processing errors and misapplied payments because it displays the calculated tax owed for each TPT license, so, if necessary, property management companies can elect to make an underpayment or overpayment for a specific TPT license.

As illustrated by Figure 6 (see page 36), the Department's manual adjustment process creates a misapplied underpayment or overpayment in its tax system for 1 property owner's license that may be associated with a refund or a balance due on another property owner's license. In addition, making these types of changes is a violation of

**Figure 6**

Fictional example to illustrate Department processing of paper-filed TPT returns from a property management company (PMC)



Source: Fictional example created from Auditor General staff observation of the Department's process.

statute. Specifically, A.R.S. §42-5004(B) requires the Department to keep full and accurate records of all monies it receives. By misapplying the payment in its tax system, the Department's records are no longer accurate. Further, these misapplied payments may result in the Department not appropriately distributing revenues as they are received/owed. For example, a payment for a penalty owed for 1 TPT license, which should be distributed to the applicable taxing jurisdictions, may be refunded as an overpayment to another TPT license, which would result in the Department not appropriately distributing the penalty revenues owed to the taxing jurisdictions.

## Department sought to accommodate property management companies' transition to new statutory requirements

Although the Department has provided multiple educational workshops and hosted meetings for property management companies, Department staff reported that many property management companies have struggled to comply with the new filing requirements for residential rental, specifically using the Department's bulk e-filing method. Because the Department prioritizes processing TPT returns quickly and has sought to accommodate property management companies' transition to the new statutory requirements, it has chosen to process rather than reject paper-filed TPT returns from property management companies despite the statutory requirement for these companies to bulk e-file and the risk of processing errors associated with paper-filed returns.

### Recommendations

The Department should:

20. Enforce statutory e-filing requirements included in Laws 2016, Ch. 208, §11, to help ensure accurate filing by property management companies on behalf of residential rental property owners.
21. While it works to implement its enforcement strategy, evaluate and implement changes to its policy for processing paper-filed TPT returns from property management companies to ensure taxpayer payments are applied correctly and the taxpayer is educated on statutory filing requirements.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

## Issue 3: Not assessing late-filing penalties correctly

### Department is required to assess late-filing penalties on delinquent TPT returns

A.R.S. §42-5014(A) states that TPT returns are due on or before the 20th day of the month following the end of the filing period, and returns are considered delinquent if the Department does not receive them by the second-to-last business day of the month for paper-filed returns and by the last business day of the month for e-filed returns. The taxpayer is subject to a penalty if the return is delinquent. Prior to August 2017, statute required the Department to impose a late-filing penalty of 4.5 percent of the tax owed. Laws 2017, Ch. 60, §3, which became effective in August 2017, requires the Department to impose a late-filing penalty of 4.5 percent of the tax owed or \$25, whichever is greater, for each month or partial month a return is delinquent. When a taxpayer files a TPT return late, the Department automatically calculates and assesses a late-filing penalty through its tax system.

### Department is not assessing the minimum statutory penalty for late TPT filing

We reviewed delinquent paper- and e-filed returns submitted for the September 2017 filing period and found that although the Department assessed a late-filing penalty, it did not always assess the statutorily required greater

of the 2 penalties, 4.5 percent of tax owed or \$25.<sup>33</sup> As a result, as of May 2018, the Department underassessed taxpayers approximately \$73,000 in TPT penalties for the September 2017 filing period.

For example, 1 taxpayer submitted a return 4 months late, and the Department assessed a late-filing penalty of \$4.44, or \$1.11 per month that the return was delinquent. Under the statutory minimum penalty of \$25 per month that a return is delinquent, the Department should have assessed a \$100 late-filing penalty.

## Department has not yet implemented programming changes in its tax system to correctly assess the TPT late-filing penalty

According to Department management, the Department has prioritized implementing TPT-related statutory changes that help the taxpayer, such as implementing an expanded tax credit for taxpayers, before implementing statutory changes that penalize the taxpayer. Department management reported that the Department plans to complete the implementation of the necessary tax system programming changes to correctly assess the TPT late-filing penalty by December 2018.

### Recommendations

The Department should:

22. Complete the necessary tax system programming changes to enforce late-filing penalties required by Laws 2017, Ch. 60, §3.
23. Consult with its legal counsel to determine if the Department should retroactively assess the correct TPT late-filing penalty for late filings where the penalty was not correctly assessed since August 2017.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

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<sup>33</sup> We reviewed 2,788 delinquent returns for the quarterly and monthly filing periods ending in September 2017. This included paper-filed returns the Department received after the second-to-last business day of October 2017 and e-filed returns the Department received after the last business day of October 2017.



## Department should address issues that affect the accuracy of city/town TPT distributions

### Department responsible for administering city/town TPT and providing distribution reports

The Department is responsible for administering the TPT it collects on behalf of Arizona’s cities and towns (i.e., city/town TPT). As stated in the Introduction, TPT can be the largest source of revenue for cities and towns, and, according to Department records, it collected approximately \$3 billion in city/town TPT in fiscal year 2018. The Department has established a process to distribute city/town TPT. This process involves Department staff using data from the Department’s tax system to determine, on a weekly basis, the amount of city/town TPT revenue that should be distributed to each city and town. Department staff then report these amounts to the Arizona Office of the State Treasurer, which makes the actual distributions. This process also involves various Department processes that occur on a daily, monthly, and annual basis, including analyzing city/town TPT collection trends and reconciling city/town TPT transactions, to help ensure TPT revenues are accurately distributed.

The Department is also responsible for preparing 9 TPT distribution reports (see textbox) with detailed taxpayer information for the cities and towns, who rely on these reports for their internal reconciliation and budget analysis processes. Because these reports are the cities’ and towns’ primary source of information detailing city/town

#### Department’s 9 city/town TPT distribution reports<sup>1</sup>

**City payment journal summary report and city payment journal detail report**—Provide summary and detailed transactional information about TPT revenue taxpayers paid that is distributed to a city/town.

**Deduction report**—Provides detailed information about the deductions that taxpayers took on taxable activity within a city/town.

**New license report and license update report**—Provide demographic information about taxpayers that have completed a TPT license application or made changes to their taxpayer license profiles.

**Fund distribution summary report and fund distribution detail report**—Provide summary and detailed transactional information about TPT revenue that is collected and distributed to specific fund accounts of a city/town.

**Return activity report**—Provides detailed transactional information about tax liabilities from TPT returns.

**No money report**—Provides information about taxpayers that have either not filed a TPT return, filed a return reporting no tax liability, or filed a return reporting a tax liability but have not submitted payment.

<sup>1</sup> All reports, with the exception of the no money report, are provided weekly. The no money report is provided monthly.

Source: Auditor General staff analysis of Department documents.

TPT transactions and payments, inaccurate or incomplete reports may hinder their ability to identify and mitigate errors and provide taxpayer assistance.<sup>34</sup>

However, as discussed in the remainder of this finding, we identified 3 issues that impact the accuracy of city/town TPT distributions and reports. Specifically:

- The complexity of the Department's manual record-keeping process for TPT distributions increases the risk of distribution errors.
- TPT distributions and reports rely on the accuracy of Department tax system data, which may not always be accurate.
- The tax system has functional limitations that impact its ability to correctly calculate and distribute city/town TPT in certain circumstances.

## Department's complex, manual record-keeping process increases the risk of TPT distribution errors

According to A.R.S. §42-5004(B), the Department is responsible for keeping full and accurate records of all monies it receives and showing how monies are disbursed. To carry out their TPT distribution responsibilities, Department staff follow a complex process that involves copying and pasting tax-system-generated data multiple times into several different Excel spreadsheets, where additional calculations and manual adjustments to city/town TPT distributions are made (see textbox). In addition, staff review 2 tax-system-generated reports: 1 that provides total distribution amounts that is used to check for accuracy of these distribution amounts and 1 that is used to analyze variances in city and town TPT collections. This last report must be converted to Excel to facilitate analyzing the data.

However, this process increases the risk of human errors due to the number of manual inputs staff must correctly copy and paste and the manual way in which adjustments are tracked and made. For example, when reviewing fiscal year 2018 monthly city/town TPT distribution summary reports to understand the process, we identified at least 2 instances where Department staff did not properly adjust a distribution to a city or town, which resulted in the city and town receiving more TPT revenues than they should have. Specifically:

### Department staff manually track and make adjustments to weekly city/town TPT distributions

Department staff use tax system data to determine the amount of city/town TPT that should be distributed to each city and town. This determination accounts for tax payments collected and situations that reduce the amount of tax owed on prior payments, such as tax refunds, audits, and amended returns. As a result, distribution amounts might be negative for a city or town in a given week.

Because the Department cannot distribute a negative amount, nothing is distributed to the city or town that week, and the Department needs to reduce future distributions to offset the negative balance. Department staff must manually track adjustments that should be made to future distributions because the tax system is able to provide a total dollar amount on a weekly basis only based on filed returns and payments made. As a result, Department staff need to manually account for revenues that have already been distributed to cities and towns.

For example, the Department might collect \$2,500 on behalf of a city for a given week. However, that city may have a negative \$1,000 balance from prior weeks resulting from taxpayer refunds. Consequently, Department staff would manually adjust the amount to be distributed to that city to \$1,500 to account for the refunds.

Source: Auditor General staff observation and analysis of Department processes and documents.

<sup>34</sup>The City of Phoenix has developed an analytics tool that it uses to analyze the data provided in the Department's 9 distribution reports. Other cities and towns reported contracting with the City of Phoenix to use this tool and that it has helped them to better understand TPT transaction data, perform reconciliations, and prepare budgets.

- Approximately \$53,000 was overdistributed to the Town of Pima in February 2018, which more than doubled the typical monthly amount distributed to the town in the previous 7 months. We notified the Department of this error in May 2018, and the Department corrected the error by reducing Pima’s weekly distributions during May and June 2018 to recover the overdistribution.
- Exactly \$25 was overdistributed to the City of San Luis in September 2017. Department staff reported that they identified and corrected this error in October 2017. However, in June 2018, Department staff mistakenly reversed the correction. We notified the Department of this error in August 2018, and the Department reported that it corrected the error that month.

The Department’s IT staff indicated to us that the tax system can export data directly to Excel, which may eliminate Department staff’s need to manually copy and paste information and help reduce the risk of errors associated with this step in the process.

## TPT distributions and reports rely on the accuracy of tax system data

The Department’s city/town TPT distribution process relies on the accuracy of TPT data recorded in its tax system, and we determined that city/town TPT distributions were consistent with tax system data for the week we tested.<sup>35</sup> However, as explained in Finding 4 (see pages 19 through 23), we identified several instances in which a taxpayer potentially underreported or misreported TPT owed that the Department’s IT controls are not designed to identify. In addition, as explained in Finding 5 (see pages 25 through 27), Department error-resolution staff can also enter incorrect TPT data in the tax system.

Such errors, if not prevented or detected, are subsequently recorded in the tax system and can lead to incorrect city/town TPT distributions and inaccuracies in distribution reports. For example, we became aware of a publicized example where 3 businesses located in the City of Globe incorrectly filed TPT returns from October 2014 through February 2018 indicating that they were located in the Town of Miami, which is how the returns were recorded in the tax system. As a result, approximately \$269,000 owed to Globe was incorrectly distributed to Miami. Staff in Miami identified the error, and Miami and Globe came to a repayment agreement in March 2018.

## Department has made little progress addressing functional limitations in its tax system that affect city/town TPT distributions

In 2016, the Department compiled a list of 39 scenarios where its tax system may not properly calculate and assess TPT owed to the various taxing jurisdictions and established an IT project to fix these scenarios by June 2018. However, as of August 2018, the Department had not yet completed this project, citing other IT projects as having a higher priority, and it could not provide a timeline or estimated completion date for this IT project. Further, Department staff reported that they do not track how frequently all of the scenarios occur or the dollar impact they have on city/town TPT distributions.

These scenarios apply to various TPT transactions, including tax credits, amended returns, license fees, audit adjustments, and taxpayer refunds. For example, a taxpayer files a TPT return claiming a State or county tax credit that reduces their corresponding tax liability. However, the tax system may incorrectly apply that tax credit to all transactions on the return, including city/town TPT transactions, and not just to the State or county transactions where the credit is valid. As a result, in this scenario, the tax system would incorrectly calculate that less TPT is owed to cities/towns than indicated on the taxpayer’s return.

<sup>35</sup> We reviewed the distributions for all 91 cities and towns for the week of January 5, 2018 through January 11, 2018, and compared each distribution to the amount of TPT collected in that week as recorded in the Department’s tax system. For this week tested, all city/town TPT payments the Department collected were distributed in accordance with tax return data as recorded in the tax system. Our test work was specific to the amount of TPT distributed to cities and towns and did not include an assessment of revenues distributed to counties or special taxing districts.

## Recommendations

The Department should:

24. Identify and implement opportunities to streamline or automate the Department's process for manually adjusting and tracking city/town TPT distributions to help reduce the risk of process errors, where possible.
25. Complete its IT project to address the 39 scenarios affecting city/town TPT distributions.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.



## Department should further collaborate with cities and towns to enhance its TPT enforcement efforts

We identified 4 TPT enforcement areas where the Department can improve its collaboration with cities and towns. These areas are: (1) enhancing its audit planning efforts through collaboration with cities and towns, (2) collecting and analyzing data from its collections pilot project with cities and towns, (3) informing cities and towns of taxpayers’ requests to compromise on a TPT debt (called offers in compromise), and (4) analyzing its process to place liens—or legal holds—on taxpayer assets until a TPT debt is paid and developing staff guidance based on that analysis.

### Issue 1: Enhancing audit planning efforts through collaboration with cities and towns

#### Department employed fewer TPT auditors who performed fewer audits

Since fiscal year 2015, the Department has conducted fewer TPT audits and employed fewer TPT auditors (see Table 3).<sup>36</sup> Specifically, Department records show that, from fiscal years 2015 to 2018, the number of TPT audits decreased by approximately 83 percent.<sup>37</sup> According to Department records, for fiscal year 2018, the Department audited approximately 0.01 percent of Arizona’s approximately 284,000 TPT license holders.

**Table 3**  
**Department TPT auditors, audits, and assessments**  
**Fiscal years 2015 through 2018**  
(Unaudited)

Fiscal year	Average number of auditors	Number of audits performed	Total amount assessed <sup>1</sup>
2015	32.1	214	\$17,489,290
2016	28.2	174	8,907,207
2017	12.8	85	13,896,380
2018	12.0	37	20,656,644

<sup>1</sup> The total amount assessed—also known as a tax assessment—is the amount of tax owed as determined by the audit.

Source: Auditor General staff analysis of Department information.

<sup>36</sup> TPT audits involve reviewing a business’ records, often at that business’ location, to determine whether the business has paid the appropriate amount of TPT.

<sup>37</sup> Performing fewer audits in a given year does not necessarily mean there will be a lower total assessment for that year. For example, as shown in Table 3, despite conducting the fewest TPT audits in fiscal year 2018, Department records show a higher assessment that year than in previous years. Department staff reported that this was due to improved Department TPT audit selection practices and having audited businesses that owed larger TPT assessments that year.

In addition to having fewer TPT auditors available to perform audits than in prior years, during fiscal year 2018, TPT auditors also spent 77 percent of their time on nonaudit tasks. Department staff reported that some of these nonaudit tasks often required an auditor’s skillset. Nonaudit tasks included:

- Reviewing TPT refund requests.
- Performing special projects, such as testing audit software and training.
- Performing discretionary/administrative activities, such as taking annual leave and sick time or attending meetings.

## Performing fewer TPT audits may limit their intended deterrent effect

The Department’s Education and Compliance Management Plan lists “provide taxpayers with an incentive to comply with tax laws” as one of the specific goals of performing audit work. According to the Department, conducting audits allows the Department to maintain a presence in the business community, which can help deter businesses’ noncompliance with TPT requirements.

## Department plans to increase the number of TPT audits it performs in fiscal year 2019

For fiscal year 2019, the Department plans to perform 217 TPT audits. This increase would mean that the Department plans to audit approximately 0.08 percent of TPT license holders. Department staff reported that they hope to meet this goal by shifting auditor priorities away from nonaudit tasks. Further, the Department has identified the number of simple, medium, or complex TPT audits that it will perform for the fiscal year.<sup>38</sup> The Department reported that, as of September 2018, the Department had completed 14 TPT audits and had 89 TPT audits in progress. The Department reported that assessments for the 14 completed audits totaled nearly \$2.4 million.

## Further collaboration with cities may increase deterrent effect of TPT audits

Prior to the implementation of TPT reform in 2017, the Department collaborated with cities and towns to perform and coordinate TPT audits. As part of implementing TPT reform, the Department entered into intergovernmental agreements (IGAs) with cities and towns. These IGAs contain specific requirements for TPT audits. For example, the IGAs state that although the Department should conduct TPT audits of taxpayers who do business in multiple locations, cities and towns may request to perform these audits under Department supervision, and that the Department should generally approve these requests. For taxpayers who conduct business in only 1 jurisdiction, cities and towns may perform these TPT audits but should notify the Department of their intention to do so.

Regardless of whether the Department or a city or town performs a TPT audit, the auditing entity must conduct the audit on behalf of all Arizona taxing jurisdictions in which the taxpayer does business. For example, if the City of Phoenix performed a TPT audit of a business with locations around the State, it would be responsible for performing the audit on behalf of all taxing jurisdictions in which the business operates. As a result, the State and other applicable taxing jurisdictions may benefit from the deterrent effect of audits individual cities and towns perform.

The Department reviews and approves city and town requests to conduct a TPT audit. When reviewing these requests, Department staff check to ensure that the requesting city has the correct identifying information for the taxpayer, that the business has not recently been or is not being audited, and that other criteria are met. However, the Department has not collaborated with the cities and towns in considering how to best leverage

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<sup>38</sup> The Department categorizes a simple audit as one that takes up to 40 hours to complete, a medium audit as one that takes up to 80 hours to complete, and a complex audit as one that takes up to 180 hours to complete.

all available audit resources to increase the number of TPT audits performed or to better target audit activities. Additionally, although the Department holds regular TPT audit collaboration meetings with the cities and towns, these meetings have generally focused on specific audit issues and not discussions for leveraging available audit resources.

## Recommendations

The Department should:

26. Continue to implement its plans to increase the number of TPT audits it performs and reduce the amount of time TPT audit staff spend on nonaudit tasks.
27. Discuss opportunities to leverage available audit resources with cities and towns and implement identified opportunities for the benefit of the State and cities and towns.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

## Issue 2: Collecting and analyzing data from its TPT collections pilot project with cities and towns

### Department is piloting a collaborative TPT collections process

Prior to TPT reform, cities and towns that administered their own TPT also performed their own collections activities on tax revenues owed to them. As part of TPT reform, the Department assumed responsibility for administering the collection of all TPT liabilities that occurred after TPT reform, regardless of the jurisdiction to which they are owed. However, city and town collectors can continue to collect on those TPT liabilities that were assessed prior to TPT reform implementation.

In spring 2018, the Department started a pilot project to allow city and town collectors to work onsite at the Department's Phoenix office to collect on certain post-TPT reform cases, including smaller-dollar cases and cases that included both single-city money and single-city and State money. This pilot project addressed issues that affected the cities and towns. For example:

- The Department prioritizes collections cases based on their dollar amount and collectability. Cities and towns may not benefit from this model because it might not prioritize the types of collections cases that may be important to a specific city. For example, if a taxpayer owes a combined \$1,000 liability to a city and the State, this case might not be prioritized for review when considered against a \$5,000 case in which the taxpayer owes money only to the State. In observations of the pilot project, we observed city collectors working on some smaller-dollar cases that are of value to those cities.
- According to the Department, its tax system, which houses information on taxpayers' TPT collections cases, does not grant off-site system access to city and town collectors. This means they cannot work on cases with tax monies owed to them from their local offices. By allowing city and town collectors to work onsite at the Department, these staff can access information in the tax system to assist taxpayers in paying their TPT liability.

### Department has not yet fully implemented a collaborative collections program or assessed the pilot project for potential improvement

As of September 2018, the Department reported that 7 cities participated in the collections pilot project, including Chandler, Mesa, and Phoenix. We observed city collectors successfully contacting taxpayers regarding TPT monies owed. However, as of September 2018, the Department had not yet collected or analyzed any data or results related to the pilot project. For example, the Department had not collected data on the number of

collections calls that city collectors have made or the outcomes of these calls. Without this data, the Department is not able to determine whether the pilot project has been effective and/or if and how the pilot project can be improved and expanded.

## Recommendations

The Department should:

28. Determine what data would be helpful in assessing the collections pilot program's effectiveness.
29. Collect and analyze relevant data from the collections pilot program to assess the program's effectiveness and make continued program improvements.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.

## Issue 3: Informing cities and towns of taxpayers' requests for offers in compromise (OICs)

### Department accepts OICs from taxpayers

A.R.S. §42-1004 allows the Department to abate, or reduce, all or part of an outstanding tax liability if the costs of collecting the liability exceed the amount the taxpayer owes. One of the ways the Department abates a tax balance is through OICs, which are offers that taxpayers make to the Department to compromise on a tax debt. For example, if a taxpayer owes the Department \$1,000 in taxes and \$200 in penalty and interest, the taxpayer might offer the Department a \$1,000 total payment as a compromise offer to settle the debt. For an OIC to be approved, it must be in the State's best interest, and not all taxpayers qualify for an OIC (see textbox).

Taxpayers who do not qualify for an OIC include those who are unemployed (and can seek other relief); who have active, profitable businesses with assets; who have the ability to pay or sufficient assets that could be liquidated to offset the tax liability; who simply do not want to pay penalty and interest; and/or who are in bankruptcy.

### Department had previously not collaborated with cities and towns in accepting OICs on their behalf

Although the Department's IGAs with the cities and towns require the Department to seek their input on all OICs that include any city/town money, the Department did not obtain this input. Department procedures include specific instructions for how to notify cities and towns of OICs that include city/town money. However, staff did not follow these procedures. For a sample of 8 OIC files involving city/town money that we randomly selected, Department staff confirmed that the Department had not notified any of the cities and towns of these OICs.<sup>39</sup>

During the audit—after informing us that Department staff had not been obtaining city/town input on OICs—the Department informed the cities and towns that it had not been appropriately seeking their input on accepting OICs and requested clarification from the cities and towns about the circumstances under which they would like to be informed about OICs. The cities and towns agreed that they would like to be informed of any OIC that includes taxes owed to them. The Department reported that, since September of 2018, they have notified cities and towns of all OICs that include city/town TPT.

<sup>39</sup> We originally selected 10 OICs that the Department received between January 1, 2018 and May 30, 2018, from a list of 41 OICs that included money owed to cities, towns, and counties. Of the 10 OICs selected, 8 included money owed to cities and towns, and 2 contained money owed to counties. We did not consider cases where counties were owed money since Department staff reported there is no requirement for the Department to share OIC information with the counties.

## Recommendation

30. The Department should ensure it obtains city/town input for any OIC it considers that includes TPT owed to a city/town and train staff on this process.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendation.

# Issue 4: Analyzing its process for placing liens and developing staff guidance based on that analysis

## Department may place liens on taxpayer property to collect on TPT liabilities

Department staff reported that they place liens on taxpayer property conservatively, on a case-by-case basis, because there could be negative effects or costs associated with a lien's use that could impact the Department's ability to collect the tax liability owed (see textbox for definition of lien). For example:

- Placing a lien could negatively impact a taxpayer's access to credit. Without access to credit, it might be more difficult for a business to operate and, thus, less able to pay a liability.
- Placing a lien has an associated cost for the Department. For example, if the Department wanted to place a lien on a business in Greenlee County, the Department would pay a total of \$20 to place the lien. Releasing the lien would cost an additional \$13. If the Department places a lien and doing so negatively affects the taxpayer's ability to pay the tax liability, the Department may possibly pay these fees without recouping any monies.

A **lien** is a legal claim that the Department may place on a taxpayer's property if the taxpayer owes a tax debt. By placing a lien on a taxpayer's property, the Department prevents the taxpayer from selling the property until the lien is released.

The Department maintains a policy regarding which staff may place a lien, but this policy contains no specific guidance on how staff should determine when to place a lien. Department records show that in fiscal year 2017, Department staff placed 651 TPT liens. Additionally, Department staff reported that they have not done any analysis to determine what percentage of liens are successful or under what circumstances the use of a lien would be most effective. Without this information, Department staff are left to their own judgment for the use of a lien, and staff may not use liens consistently or effectively.

## Department had not been collaborating with cities and towns on placing liens to collect on TPT liabilities

In an April 2018 meeting between the Department and cities and towns, city and town staff expressed their interest in collaborating with the Department to increase the number of liens placed on taxpayers who owe TPT to both the State and cities and towns. In the meeting, cities and towns reported that they had found liens to be an effective method for collecting tax liabilities. The Department reported that as of September 2018, it was working with the cities and towns to determine if the cities and towns can help pay for some liens. By collaborating with cities and towns to use liens, the Department could also incorporate their experiences into its lien-decision-making guidance.

## Recommendations

The Department should:

31. Analyze collections-case characteristics to determine under what circumstances a lien would be most advantageous and develop and implement policies and procedures to help staff know when and how to use them.
32. Collaborate with the cities and towns to establish a process for determining when issuing liens is advantageous and most effective for both parties. In addition, it should also collaborate with the cities and towns to establish a process that allows the cities and towns to help pay for liens they request.

**Department response:** As outlined in its [response](#), the Department agrees with the finding and will implement the recommendations.



### Prime contractor TPT requirements

This report section has no recommendations but provides information regarding TPT requirements for prime contractors and the Department's commission of a study to determine the rate of noncompliance with those requirements.

### TPT reform and subsequent statutory changes affected prime contractors' TPT requirements

Similar to other business owners, prime contractors engaged in taxable construction projects or activities are required to obtain a TPT license, file returns, and remit owed TPT to the Department (see textbox for the definition of a prime contractor). Department records show that as of October 2018, there were approximately 47,370 active prime contracting TPT licensees in Arizona. Additionally, an October 2018 Joint Legislative Budget Committee monthly fiscal highlights report stated that prime contracting had the highest year-to-date growth of any other TPT business type.

**Prime contractor**—Contractor responsible for performing and/or coordinating the modification or development of any building, highway, road, or other structure or project. A prime contractor may hire subcontractors to work on the main project, but the prime contractor is usually responsible for completing the project and remitting owed TPT to the Department.

Source: Auditor General staff review of A.R.S. §42-5075(R)(10) & (D).

Prior to TPT reform, prime contractors were required to remit TPT on their gross proceeds from a construction project and any purchased materials used to complete the project. Beginning with TPT reform and in subsequent legislative sessions in 2014, 2015, and 2018, the Legislature made several statutory changes regarding the applicability of TPT to activities involving the modification and alteration of real property. As of January 1, 2015, prime contractors who perform both modification contracts and maintenance, repair, replacement, and alteration activities—collectively referred to as MRRA activities—must have a TPT license and remit TPT on the gross proceeds of their construction projects after they have deducted applicable MRRA activities. Modification contracts that are subject to TPT include “ground up” construction, grading and leveling ground, wreckage, and demolition activities.

In contrast, as of January 1, 2015, prime contractors who enter into contracts directly with property owners for the following types of MRRA-only projects are not required to obtain or renew a TPT license and are only required to pay TPT on the materials purchased for projects:

- **Maintenance**—The upkeep of property or equipment, such as an annual HVAC system tune-up.
- **Repair**—The return of inoperable or nonfunctional real property to a usable state, such as fixing a leak from a bathtub or shower.
- **Replacement**—The removal of an existing component or system installed in existing property and the installation of a new component or system that replaces what was removed, such as a sprinkler system.
- **Alterations**—Any activities or actions that cause a direct physical change to existing property, such as adding a kitchen island as part of a kitchen remodel. Whether an activity is considered nontaxable alteration or taxable modification depends on the property type and scope of the contract. For existing residential properties, activities are considered nontaxable alteration as long as the total amount for the contract does

not exceed 25 percent of the property's full cash value. For commercial and other nonresidential properties, the amount for the contract cannot exceed \$750,000. Activities that exceed these thresholds are considered taxable modification projects.

## Department provides guidance to prime contractors on its website

The Department's website includes guidance to help prime contractors understand statutory requirements regarding what activities are subject to and exempt from TPT. For example, the Department's website lists contracting guidelines, definitions of taxable construction activities, a link to the license application, surety bonding requirements, facts on recent statutory changes affecting prime contractors, and example scenarios to help prime contractors understand taxable and nontaxable contracting activities.

However, stakeholders expressed concerns that some prime contractors might not correctly file TPT because of prime contracting laws' complexity.

## Study estimated unpaid prime contracting TPT and identified potential audit leads

Laws 2018, Ch. 305, §1, appropriated \$75,000 to the Department for fiscal year 2019 to contract for a study of the rate of noncompliance with prime contracting TPT requirements. On October 31, 2018, the Department executed a task order with 1 of its contractors to conduct this study, which was completed in 2 phases. For the first phase—which cost \$15,000—the contractor estimated that the amount of true tax liability that was not paid voluntarily and timely for calendar years 2010 through 2016 totaled approximately \$963 million. The contractor developed this estimate by applying a noncompliance rate (i.e., the rate of nonfiling, underreporting, and underpayment of taxes) of 18.3 percent from an IRS study, which represented the overall rate of noncompliance across multiple tax types.<sup>40</sup> For the second phase—which cost \$60,000—the Department reported that the contractor identified 70 leads for potential TPT audits of prime contractors by Department auditors.

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<sup>40</sup>The IRS study included individual income, corporation income, employment, estate, and excise taxes. The rate of noncompliance for these tax types ranged from 10 percent for employment tax to 26 percent for individual income and estate taxes. See Internal Revenue Service. (2016). *Federal tax compliance research: Tax gap estimates for tax years 2008-2010*. Washington, DC: U.S. Department of the Treasury.



# SUMMARY OF RECOMMENDATIONS

## Auditor General makes 32 recommendations to the Department

The Department should:

1. Continue implementing its new license-compliance program, including its plans to use information provided by cities and towns and data analytics to identify and license unlicensed businesses to meet its goals (see Finding 1, pages 7 through 9, for more information).
2. Review the effectiveness of its new license-compliance program and make improvements as needed (see Finding 1, pages 7 through 9, for more information).
3. Improve the nonfiler license-cancellation notice to include language explaining statutory TPT licensing and filing requirements, informing the taxpayer of late-filing and late-payment penalties, requiring the taxpayer to inform the Department whether the business is operating or not, and informing the taxpayer to take action to resolve instances of noncompliance with TPT filing requirements (see Finding 2, pages 11 through 13, for more information).
4. Develop and implement a process to verify businesses' statuses prior to canceling licenses through its nonfiler program, such as through continued and/or expanded collaboration with cities and towns or through its new license-compliance program (see Finding 2, pages 11 through 13, for more information).
5. Implement its plan to add address-standardization controls to AZTaxes.gov and add these controls to its tax system (see Finding 3, pages 15 through 17, for more information).
6. Identify and analyze trends in taxpayer behavior that contribute to inaccurate address information and develop and implement a targeted taxpayer education campaign to address the behavior (see Finding 3, pages 15 through 17, for more information).
7. Until it implements its plan to add address-standardization controls to AZTaxes.gov and its tax system, review the effectiveness of its manual process to review newly issued licenses and work with Department IT staff to look for ways to automate this process (see Finding 3, pages 15 through 17, for more information).
8. Evaluate whether additional IT controls in its suspense-rule process could be implemented to reduce the risk of misreported and underreported TPT, implement any identified additional IT controls, and assess the effectiveness of its efforts (see Finding 4, pages 19 through 23, for more information).
9. Analyze its return-processing procedure, develop and implement a plan to reduce the risk of misreported and underreported TPT through data analysis, and assess the effectiveness of its efforts (see Finding 4, pages 19 through 23, for more information).
10. Develop and implement a plan to identify and address errors in its tax system licensing information, and assess the effectiveness of its data-cleanup efforts (see Finding 4, pages 19 through 23, for more information).
11. Develop and implement a plan to increase TPT taxpayer use of AZTaxes.gov for TPT license applications and enforce statutory requirements for electronic TPT return filing in conjunction with Recommendation 19 (see Finding 4, pages 19 through 23, for more information).

12. Develop and implement targeted taxpayer education campaigns to help ensure accurate TPT license information in conjunction with Recommendation 6 (see Finding 4, pages 19 through 23, for more information).
13. Consult with its legal counsel and determine its statutory authority to make changes to information recorded in its tax system from taxpayers' TPT returns (see Finding 5, pages 25 through 27, for more information).
14. Develop and implement written policies and procedures that require error-resolution staff to (1) consult with taxpayers prior to making changes to TPT return information in its tax system when the information necessary to process the return is not available in the tax system, (2) document communication or attempted communication with taxpayers in these situations, and (3) document the reasons when changes are made in the tax system (see Finding 5, pages 25 through 27, for more information).
15. Develop and implement written policies and procedures for its error-resolution quality control process that specify how often reviews should occur, how many returns per staff person should be reviewed, what should be reviewed, if the information should be verified with the taxpayer, the time frames for addressing any errors identified through reviews, and who is responsible for performing and overseeing the error-resolution quality control process (see Finding 5, pages 25 through 27, for more information).
16. Resolve IT programming issues for TPT tax correction notices to ensure they are accurate and timely (see Finding 6, pages 29 through 31, for more information).
17. Improve text content to ensure that TPT tax correction notices provide appropriate taxpayer instruction for all types of TPT errors, overpayments, and underpayments (see Finding 6, pages 29 through 31, for more information).
18. Evaluate its TPT tax correction notice quality review policy to identify and implement improvements to ensure the policy is effective in identifying and resolving inaccurate or confusing information on TPT tax correction notices, such as specifying how often reviews should occur, how staff should review the content and calculations on the notices, how staff should track notices that are reviewed and the errors identified, how the identified errors are resolved, and who is responsible for overseeing the review process (see Finding 6, pages 29 through 31, for more information).
19. Implement and annually update the necessary tax system programming changes to enforce the statutory TPT e-filing requirements included in Laws 2017, Ch. 60, §15 (see Finding 7, pages 33 through 34, for more information).
20. Enforce statutory e-filing requirements included in Laws 2016, Ch. 208, §11, to help ensure accurate filing by property management companies on behalf of residential rental property owners (see Finding 7, pages 35 through 37, for more information).
21. While it works to implement its enforcement strategy, evaluate and implement changes to its policy for processing paper-filed TPT returns from property management companies to ensure taxpayer payments are applied correctly and the taxpayer is educated on statutory filing requirements (see Finding 7, pages 35 through 37, for more information).
22. Complete the necessary tax system programming changes to enforce late-filing penalties required by Laws 2017, Ch. 60, §3 (see Finding 7, pages 37 through 38, for more information).
23. Consult with its legal counsel to determine if the Department should retroactively assess the correct TPT late-filing penalty for late filings where the penalty was not correctly assessed since August 2017 (see Finding 7, pages 37 through 38, for more information).
24. Identify and implement opportunities to streamline or automate the Department's process for manually adjusting and tracking city/town TPT distributions to help reduce the risk of process errors, where possible (see Finding 8, pages 39 through 42, for more information).
25. Complete its IT project to address the 39 scenarios affecting city/town TPT distributions (see Finding 8,

pages 39 through 42, for more information).

26. Continue to implement its plans to increase the number of TPT audits it performs and reduce the amount of time TPT audit staff spend on nonaudit tasks (see Finding 9, pages 43 through 45, for more information).
27. Discuss opportunities to leverage available audit resources with cities and towns and implement identified opportunities for the benefit of the State and cities and towns (see Finding 9, pages 43 through 45, for more information).
28. Determine what data would be helpful in assessing the collections pilot program's effectiveness (see Finding 9, pages 45 through 46, for more information).
29. Collect and analyze relevant data from the collections pilot program to assess the program's effectiveness and make continued program improvements (see Finding 9, pages 45 through 46, for more information).
30. The Department should ensure it obtains city/town input for any OIC it considers that includes TPT owed to a city/town and train staff on this process (see Finding 9, pages 46 through 47, for more information).
31. Analyze collections-case characteristics to determine under what circumstances a lien would be most advantageous and develop and implement policies and procedures to help staff know when and how to use them (see Finding 9, pages 47 through 48, for more information).
32. Collaborate with the cities and towns to establish a process for determining when issuing liens is advantageous and most effective for both parties. In addition, it should also collaborate with the cities and towns to establish a process that allows the cities and towns to help pay for liens they request (see Finding 9, pages 47 through 48, for more information).





## Objectives, scope, and methodology

The Office of the Auditor General conducted this performance audit of the Department pursuant to a September 14, 2016, resolution of the Joint Legislative Audit Committee. The audit was conducted as part of the sunset review process prescribed in A.R.S. §41-2951 et seq. This audit addresses the Department's processes for administering and enforcing TPT.

We used various methods to study the issues addressed in this performance audit. These methods included reviewing Department statutes, applicable session laws, and intergovernmental agreements (IGAs) with cities/towns; reviewing Department-provided documents, including policies and procedures, training documents, project documents, and information on the Department's website; interviewing Department staff and stakeholders; reviewing recommended practices, as cited throughout the report; and observing various Department processes and process-mapping sessions, during which time Department staff defined the specific steps or actions performed by different Department units for a given process. In addition, we used the following specific methods to meet the audit objectives:

- To evaluate the Department's enforcement and administration of TPT licensing requirements, we:
  - Reviewed TPT licenses, or lack thereof, for a sample of 30 businesses judgmentally selected in April 2018 from different industries located in various jurisdictions across Arizona and assessed the accuracy and consistency of the data on each license.
  - Reviewed a weekly report dated May 11, 2018, that included information on 1,291 newly issued TPT licenses to assess the effectiveness of the Department's process to identify and resolve errors on new licenses.
  - Reviewed a judgmentally selected sample of 444 of the 2,699 licenses that the Department closed through its nonfiler program in September 2017 to assess whether the Department inappropriately closed licenses for active businesses that are subject to TPT. We confirmed whether the businesses were active by conducting Google searches and calling the businesses.
  - Observed Department staff processing license applications and researching potentially unlicensed taxpayers.
  - Reviewed the license-compliance process policies and procedures the Department established in October 2018.
- To evaluate the Department's enforcement and administration of TPT filing requirements, we:
  - Reviewed 2,788 delinquent monthly and quarterly TPT returns submitted for the September 2017 filing period and analyzed the Department's assessment of late filing penalties.
  - Reviewed the last TPT return filed in calendar year 2017 for applicable licensed businesses and corresponding return data recorded in the Department's tax system for the 30 judgmentally selected businesses discussed previously. We assessed the accuracy of information reported on each return and whether the information aligned with the information on the corresponding TPT license.

- Reviewed a judgmentally selected sample of 9 of the approximately 1,500 TPT tax correction notices from May 6, 2018 to May 12, 2018, to assess the accuracy of information and the appropriateness of the instruction provided on the notices.
- Observed Department staff processing paper-filed TPT returns and reviewed the Department's error-resolution procedures.
- To evaluate the Department's provision of resources to assist taxpayers in complying with TPT licensing and filing requirements, we:
  - Reviewed the Department's website and educational resources, including instructions, publications, video tutorials, and electronic newsletters, and assessed the accuracy of information provided.
  - Observed 3 Department outreach events, including 2 public workshop events in October 2017 and January 2018 and a private 1-on-1 meeting between Department staff and a taxpayer in April 2018.
- To evaluate the Department's administration of city/town TPT distributions, we:
  - Reviewed the IGAs between the Department and cities and towns and 1 set of 9 city/town TPT distribution reports against the reporting requirements described in the IGAs.
  - Reviewed a random sample of 77 of the 3,132 city/town TPT transactions from the last filed TPT return in calendar year 2017 for 21 of the 30 judgmentally selected businesses discussed previously. We compared the transaction details on the returns to the return activity report the Department provides cities and towns to assess report accuracy.
  - Reviewed the TPT distributions for all 91 cities and towns for the week of January 5, 2018 through January 11, 2018, and compared each distribution to the amount of TPT collected in that week as recorded in the Department's tax system.
- To evaluate the Department's administration of enforcement processes, such as audits and collections, we:
  - Observed city collectors make collections telephone calls as part of a pilot program between the Department and some Arizona cities.
  - Reviewed 15 randomly selected city and town field-audit requests to perform audits that the Department processed in 2017 to assess the timeliness and accuracy of Department processing.
  - Combined and analyzed monthly audit reports for fiscal years 2017 and 2018 to determine types of audit tasks Department audit staff performed.
  - Interviewed the Federation of Tax Administrators and the Multi-State Tax Commission to learn about enforcement practices.
- To obtain additional information regarding the Department's efforts to commission an independent study to determine the rate of noncompliance with prime contracting TPT requirements, we reviewed legislative fact sheets, watched archived legislative committee hearings, reviewed the task order and original contract with the independent consultant, and reviewed the results of the first phase of the study.
- To obtain additional information for the Introduction, we obtained information from the Department about the total TPT revenues collected in fiscal year 2018. We also reviewed the Department's fiscal years 2015 through 2018 city and town billing reports to determine if the Department billed cities and towns for TPT administration consistent with statute. We also reviewed the Model City Tax Code and Department-generated monthly TPT tax rate tables.<sup>41</sup>

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<sup>41</sup> The Model City Tax Code is designed to assist the business community in determining which items are taxed by each individual city and town and which items are exempt from taxation.

- Our work on internal controls, including information system controls, included reviewing the Department's policies and procedures and, where applicable, testing its compliance with these policies and procedures; testing the Department's implementation and compliance with statutory and IGA requirements; observing Department staff perform their duties; reviewing Department-prepared reports and analyses; and reviewing the completeness and accuracy of information recorded in the Department's tax system. We reported our conclusions on applicable internal and information system controls and the Department's needed efforts to improve them in Findings 1 through 9.

We conducted this performance audit of the Department 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.

We express our appreciation to the Department's Interim Director, staff, and former Director, who retired in December 2018, for their cooperation and assistance throughout the audit.



# AGENCY RESPONSE

# STATE OF ARIZONA

Arizona Department of Revenue



Douglas A. Ducey  
**Governor**

Carlton Woodruff  
**Interim Director**

March 8, 2019

Lindsey Perry, Auditor General  
Arizona Office of the Auditor General  
2910 North 44<sup>th</sup> Street, Suite 410  
Phoenix, Arizona 85018

Dear Ms. Perry:

The Arizona Department of Revenue (Department) appreciates the opportunity to respond to the report of the Auditor General, *A Performance Audit: TPT Administration and Enforcement*. Additionally, the Department would like to thank your staff for the professional and collaborative approach of the Office of the Auditor General during the audit process. As discussed in the enclosed response, the Department will implement all recommendations contained in the report.

Thank you,

Carlton Woodruff  
Interim Director

**Finding 1:** Department should ensure businesses have active TPT licenses

**Recommendation 1:** The Department should continue implementing its new license-compliance program, including its plans to use information provided by cities and towns and data analytics to identify and license unlicensed businesses to meet its goals.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 2:** The Department should review the effectiveness of its new license-compliance program and make improvements as needed.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 2:** Department should improve nonfiler program to ensure operating businesses maintain active TPT licenses

**Recommendation 3:** The Department should improve the nonfiler license-cancellation notice to include language explaining statutory TPT licensing and filing requirements, informing the taxpayer of late-filing and late-payment penalties, requiring the taxpayer to inform the Department whether the business is operating or not, and informing the taxpayer to take action to resolve instances of noncompliance with TPT filing requirements.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 4:** The Department should develop and implement a process to verify businesses' statuses prior to canceling licenses through its nonfiler program, such as through continued and/or expanded collaboration with cities and towns or through its new license-compliance program.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 3:** Department should help ensure accurate address information for TPT licenses

**Recommendation 5:** The Department should implement its plan to add address-standardization controls to AZTaxes.gov and add these controls to its tax system.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 6:** The Department should identify and analyze trends in taxpayer behavior that contribute to inaccurate address information and develop and implement a targeted taxpayer education campaign to address the behavior.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 7:** The Department should, until it implements its plan to add address-standardization controls to AZTaxes.gov and its tax system, review the effectiveness of its manual process to review newly issued licenses and work with Department IT staff to look for ways to automate this process.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 4:** Department should take steps to better identify and address TPT underreporting or misreporting

**Recommendation 8:** The Department should evaluate whether additional IT controls in its suspense-rule process could be implemented to reduce the risk of misreported and underreported TPT, implement any identified additional IT controls, and assess the effectiveness of its efforts.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 9:** The Department should analyze its return-processing procedure, develop and implement a plan to reduce the risk of misreported and underreported TPT through data analysis, and assess the effectiveness of its efforts.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 10:** The Department should develop and implement a plan to identify and address errors in its tax system licensing information, and assess the effectiveness of its data-cleanup efforts.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 11:** The Department should develop and implement a plan to increase TPT taxpayer use of AZTaxes.gov for TPT license applications and enforce statutory requirements for electronic TPT return filing in conjunction with Recommendation 19.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 12:** The Department should develop and implement targeted taxpayer education campaigns to help ensure accurate TPT license information in conjunction with Recommendation 6.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 5:** Department should consistently perform reviews to ensure staff accurately process TPT error-resolution changes

**Recommendation 13:** The Department should consult with its legal counsel and determine its statutory authority to make changes to information recorded in its tax system from taxpayers' TPT returns.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 14:** The Department should develop and implement written policies and procedures that require error-resolution staff to (1) consult with taxpayers prior to making changes to TPT return information in its tax system when the information necessary to process the return is not available in the tax system, (2) document communication or attempted communication with taxpayers in these situations, and (3) document the reasons when changes are made in the tax system.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 15:** The Department should develop and implement written policies and procedures for its error-resolution quality control process that specify how often reviews should occur, how many returns per staff person should be reviewed, what should be reviewed, if the information should be verified with the taxpayer, the time frames for addressing any errors identified through reviews, and who is responsible for performing and overseeing the error-resolution quality control process.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 6:** Department should ensure tax correction notices are accurate and adequately instruct TPT taxpayers

**Recommendation 16:** The Department should resolve IT programming issues for TPT tax correction notices to ensure they are accurate and timely.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 17:** The Department should improve text content to ensure that TPT tax correction notices provide appropriate taxpayer instruction for all types of TPT errors, overpayments, and underpayments.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 18:** The Department should evaluate its TPT tax correction notice quality review policy to identify and implement improvements to ensure the policy is effective in identifying and resolving inaccurate or confusing information on TPT tax correction notices, such as specifying how often reviews should occur, how staff should review the content and calculations on the notices, how staff should track notices that are reviewed and the errors

identified, how the identified errors are resolved, and who is responsible for overseeing the review process.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 7:** Department should enforce existing statutory TPT filing requirements

**Recommendation 19:** The Department should implement and annually update the necessary tax system programming changes to enforce the statutory TPT e-filing requirements included in Laws 2017, Ch. 60, §15.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 20:** The Department should enforce statutory e-filing requirements included in Laws 2016, Ch. 208, §11, to help ensure accurate filing by property-management companies on behalf of residential rental property owners.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 21:** The Department should, while it works to implement its enforcement strategy, evaluate and implement changes to its policy for processing paper-filed TPT returns from property-management companies to ensure taxpayer payments are applied correctly and the taxpayer is educated on statutory filing requirements.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 22:** The Department should complete the necessary tax system programming changes to enforce late-filing penalties required by Laws 2017, Ch. 60, §3.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 23:** The Department should consult with its legal counsel to determine if the Department should retroactively assess the correct TPT late-filing penalty for late filings where the penalty was not correctly assessed since August 2017.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 8:** Department should address issues that affect the accuracy of city/town TPT distributions

**Recommendation 24:** The Department should identify and implement opportunities to streamline or automate the Department's process for manually adjusting and tracking city/town TPT distributions to help reduce the risk of process errors, where possible.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 25:** The Department should complete its IT project to address the 39 scenarios affecting city/town TPT distributions.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Finding 9:** Department should further collaborate with cities and towns to enhance its TPT enforcement efforts

**Recommendation 26:** The Department should continue to implement its plans to increase the number of TPT audits it performs and reduce the amount of time TPT audit staff spend on nonaudit tasks.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 27:** The Department should discuss opportunities to leverage available audit resources with cities and towns and implement identified opportunities for the benefit of the State and cities and towns.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 28:** The Department should determine what data would be helpful in assessing the collections pilot program's effectiveness.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 29:** The Department should collect and analyze relevant data from the collections pilot program to assess the program's effectiveness and make continued program improvements.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 30:** The Department should ensure it obtains city/town input for any OIC it considers that includes TPT owed to a city/town and train staff on this process.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 31:** The Department should analyze collections-case characteristics to determine under what circumstances a lien would be most advantageous and develop and implement policies and procedures to help staff know when and how to use them.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

**Recommendation 32:** The Department should collaborate with the cities and towns to establish a process for determining when issuing liens is advantageous and most effective for both parties. In addition, it should also collaborate with the cities and towns to establish a process that allows the cities and towns to help pay for liens they request.

Department Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

