

Arizona Department of Revenue

Sunset Factors

Department did not comply with all conflict-of-interest requirements, ensure it collected and reported all State income taxes, and plan for eventual replacement of its main IT system

Sunset Review

June 2019
Report 19-106

A Report to the Arizona Legislature

Lindsey A. Perry
Auditor General





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Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

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Arizona Department of Revenue

Transmitted herewith is the Auditor General's report, *A Sunset Review of the Arizona Department of Revenue*. This report is in response to a September 14, 2016, resolution of the Joint Legislative Audit Committee. The sunset review 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 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 or implement in a different way 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 Sunset Factors

CONCLUSION: The Arizona Department of Revenue (Department) is responsible for administering various taxes, including transaction privilege, use, and severance taxes; corporate income, individual income, and withholding taxes; and luxury tax. It also administers unclaimed property (i.e., abandoned or inactive accounts or assets) and the State property tax laws through the 15 county assessors. We found that the Department did not comply with some conflict-of-interest requirements, had not ensured that it collected and reported all State income taxes, and should begin planning for the eventual replacement of its primary information technology (IT) system. Additionally, the Department supports 3 commissions and 1 committee, and we found that 1 of the commissions did not adhere to all open meeting law requirements. Finally, the Department should document the complaint-resolution processes for its Taxpayer Assistance Office and Criminal Investigation Unit (CI Unit) and track the CI Unit's complaint-resolution timeliness. Our report also provides information about the Native American Veterans Income Tax Settlement Fund (NASF).

Department did not comply with some conflict-of-interest requirements

Arizona law requires employees of public agencies and public officers to avoid conflicts of interest that might influence or affect their official conduct and outlines several requirements for doing so. Although the Department used an appropriate conflict-of-interest disclosure form that it required new staff to complete, it lacked a special disclosure file required by law, did not require contractors or commission/committee members to disclose conflicts, did not require annual disclosures, and lacked conflict-of-interest policies and procedures. These deficiencies increased the risk of Department employees and public officers not disclosing substantial interests.

After we spoke to the Department about these deficiencies, it developed and implemented a new conflict-of-interest disclosure process that went into effect in February 2019 and addressed each of the deficiencies we noted.

Recommendation

The Department should continue to implement and comply with its new conflict-of-interest disclosure process.

Other Department actions needed

As reported in the Sunset Factors, we identified additional areas where the Department should improve. These include the following:

Fix income-tax-processing issues—The Department is solely responsible for collecting and reporting all State income taxes and should have adequate procedures and systems for doing so. However, the Department's IT system lacks the functionality to perform automatic system checks and reconciliations, and the Department has not performed manual compensating review procedures to ensure all income taxes are collected and reported. As a result, there is an increased risk that the State may (1) not collect all income tax revenue that is due and (2) report inaccurate income tax revenue in its financial statements. We have reported this issue in the State's single audit reports since at least fiscal year 2009.

Recommendation

The Department should address its IT system's limitations or immediately implement alternative review procedures to ensure it collects and reports all State income taxes.

Plan for its primary IT system's end-of-life cycle—The Department relies on its Business Reengineering Integrated Tax System (BRITS) to administer State taxes and the transaction privilege tax for counties, cities, and towns. Prior performance audits of the Department found that BRITS was not adequately designed/implemented in the early 2000s,

has required thousands of system improvements since implementation, and is cumbersome to use. The Department also lacks several IT capabilities used in other states to administer taxes and, instead, relies on workarounds, vendors, and manual, time-consuming processes to perform various functions that are less efficient and more susceptible to error.

Prior Department leadership indicated that BRITS was nearing the end of its useful life and requested funding to conduct a feasibility study for replacing it. However, Department leadership changed and decided to focus on improving existing Department processes before requesting funding to implement a new IT system. Still, best practices recommend continual planning for a system's full life cycle, and organizations should continually plan for the future of their IT systems.

Recommendation

The Department should plan for BRITS' ongoing maintenance and eventual replacement and document these plans.

Ensure its public bodies adhere to all open meeting law provisions—We tested the Department's compliance with open meeting law requirements and found that 1 commission did not provide agendas at least 24 hours in advance for 2 of its meetings and did not provide meeting minutes for 1 of these meetings within the required 3 business days.

Recommendation

The Department should ensure that the commissions and committee it supports adhere to all provisions of the State's open meeting law.

Document complaint-resolution processes and track complaint-resolution timeliness—The Department's Taxpayer Assistance Office, which assists customers in various ways, and CI Unit, which investigates complaints alleging tax fraud and other types of tax-related criminal activity, have not documented their complaint-resolution processes in written policies and procedures. In addition, although the CI Unit had a goal to review and determine the outcome of complaints within 3 business days, it did not track its complaint-resolution timeliness.

Recommendations

The Department should:

- Document its Taxpayer Assistance Office's and CI Unit's complaint-resolution processes in written policies and procedures.
- Track the timeliness of its CI Unit's complaint-resolution process.

Department administers NASF

The Department is responsible for administering the NASF, a temporary program it operates with assistance from the Arizona Department of Veterans Services (ADVS). The Legislature established the NASF to reimburse Native American veterans who were on active duty in the U.S. military and erroneously had Arizona State income tax withheld from military pay between 1977 and 2005. The program was established as of May 2016 and will accept claims through December 31, 2019. The Legislature appropriated \$2 million dollars to the NASF, and any monies not claimed as of June 30, 2021, will revert to the State General Fund.

State law requires claimants to provide specific documentation in order to prove eligibility for a refund. Claimants apply with the ADVS, and both the ADVS and Department process these claims. Per law, each agency has specific time frames for processing claims. We reviewed 4 claims from fiscal year 2019 and found that both agencies processed these claims well within the required time frames.

As of May 15, 2019, the Department had received and processed a total of 243 claims. According to the Department, it approved or partially approved 123 of these claims and denied 120 claims because either the taxpayer had already received a refund or the taxpayer's withholding could not be verified by the U.S. Department of Defense, Department records, or a W-2 provided by the claimant. As of that same date, the Department reported that it had spent more than \$337,300 from the NASF for both approved refunds and administrative costs.



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This is the third of 3 reports released as part of our sunset review of the Arizona Department of Revenue (Department). The first report (Report 19-102) addressed the Department's administration and enforcement of the transaction privilege tax (TPT). The second report (Report 19-103) addressed the Department's provision of support and education services to TPT taxpayers and Arizona's cities and towns. This third report (Report 19-106) addresses the statutory sunset factors, includes a finding on the Department's conflict-of-interest policies and procedures, and provides information about the Native American Veterans Income Tax Settlement Fund (NASF).

Mission and purpose

The Department was established by Laws 1973, Ch. 123, which transferred the powers and duties of the Department of Property Valuation and the Estate Tax Commissioner and certain functions of the State Tax Commission to the Department. The Department's mission is "serving taxpayers." Its primary responsibility is administering various taxes, including TPT, use, and severance taxes; corporate income, individual income, and withholding taxes; and luxury tax (see textbox for definitions). It also administers unclaimed property and the State property tax laws through the 15 county assessors.¹

Arizona's primary tax revenue sources and amounts collected¹ Fiscal year 2018

- **TPT, use, and severance taxes (approximately \$10.9 billion)**—TPT is imposed on a seller for the privilege of doing business in the State. Because it is usually passed on to the buyer, this tax is commonly referred to as a sales tax. Use and severance taxes are similar to TPT but apply to out-of-state purchases and mining of certain minerals, respectively.
- **Corporate income, individual income, and withholding taxes (approximately \$6.4 billion)**—Income taxes are imposed on individuals and corporations earning income in Arizona. In addition, employers must withhold income tax from their employees' compensation and remit it to the Department.
- **Luxury tax (approximately \$409.4 million)**—Luxury taxes apply to liquor and tobacco products. The majority of these monies are distributed to special funds.

¹ The Department also administers many other taxes that bring in less revenue annually such as estate, bingo, and waste tire taxes; however, the revenue from these taxes collectively totaled approximately 1 percent of the total revenue the Department collected in fiscal year 2018.

Source: Auditor General staff review of Department-reported information.

Organization and staffing

The Department is organized into 4 divisions. As of February 25, 2019, the Department reported 514 filled full-time equivalent (FTE) positions and 381 vacancies. The divisions' responsibilities and staffing are as follows:

- **Taxpayer Services (119 filled FTE positions; 72 vacancies)**—This division operates the Department's main call center; provides customer service and support; processes tax protests and appeals; administers and enforces State tobacco tax laws; provides legal, technical, and policy information to taxpayers and other

¹ Unclaimed property refers to abandoned or inactive accounts or assets. The Department's Unclaimed Property Unit collects, safeguards, and distributes unclaimed property to the rightful owners.

agencies; provides general oversight of property values; and returns abandoned (or unclaimed) property to the rightful owner. In addition, this division includes the statutorily required Taxpayer Assistance Office, which responds to escalated taxpayer inquiries and resolves complex tax issues, complaints, and problems (see Sunset Factor 6, pages 14 through 15, for more information about this office's complaint-handling responsibilities). In fiscal year 2018, the Department's main call center reported that it received 403,568 phone calls regarding various topics such as billing notices, returns that have not been received, and balance inquiries. The Department also reported that it returned \$64.3 million in unclaimed property in fiscal year 2018.

- **Education and Compliance (199 filled FTE positions; 175 vacancies)**—This division focuses on educating taxpayers and bringing noncompliant taxpayers into compliance through license compliance, audit, and collections activities and through criminal investigations (see Sunset Factor 6, pages 14 through 15, for more information about the Criminal Investigations Unit's complaint-handling responsibilities). In fiscal year 2018, the Department reported it performed more than 37,400 audits, 37,250 of which were individual income tax audits. According to Department management, the majority of individual income tax audits result from computer-generated audit assessments that are automatically sent to taxpayers in billing letters and do not require Department auditors' assistance. Tax audits yielded more than \$61.8 million in assessments, and the Department also reported collecting more than \$282 million in unpaid taxes in fiscal year 2018.
- **Processing (48 filled FTE positions; 61 vacancies)**—This division processes all tax returns, remittances, and supporting documentation the Department receives. This includes opening, sorting, and reviewing all returns and accompanying mail; performing data entry into the Department's computer systems; and archiving documents. According to the Department, the division uses both manual data entry and imaging technologies to help process the documents it receives. The division reported that it processed 6.4 million tax documents and collected \$17.9 billion in tax revenues in fiscal year 2018.
- **Support (148 filled FTE positions; 73 vacancies)**—This division houses the Director's Office and performs various responsibilities that support the Department's mission. It monitors the Department's budget; creates/delivers the Department's internal and external multimedia communications; coordinates/oversees facility management; manages the Department's financial services, procurement, and human resource services; and provides information technology (IT) support. In addition, this division provides support for and helps facilitate continuous improvement of Department processes. In calendar year 2018, the division's Office of Continuous Improvement helped develop 113 process maps.²

Department-supported commissions and committee

The Department provides support for 3 commissions and 1 committee:

- **Economic Estimates Commission (EEC)**—This commission is responsible for (1) determining and annually reporting to the Legislature the estimated total personal income in the State and (2) determining the maximum dollar amount that is expected to be available for legislative appropriation from State tax revenues. Additionally, the commission is responsible for determining and publishing the annual expenditure limitations for each county, city, town, and community college district, and the aggregate expenditure limitation for all school districts.
- **Municipal Tax Code Commission**—This commission is responsible for reviewing and commenting on municipalities' and taxpayers' proposed revisions to the Model City Tax Code, which outlines the items taxed by individual cities and towns throughout the State.
- **Property Tax Oversight Commission**—This commission is responsible for furthering public confidence in property tax limitations, providing a uniform methodology for determining those limitations, and helping ensure a fair and equitable administration of the property tax laws. The commission's duties include reviewing

² Process maps define the specific steps or actions performed by different Department units for a given process and provide consistency to staff by including step-by-step guidance. According to the Department, its goal is to first map its processes and then to streamline and improve them.

each political subdivision's primary property tax levy, reviewing school district's tax levy and rates, and holding hearings on tax-levy-limits compliance.

- **Education, Training, and Certification Advisory Committee**—This committee is responsible for evaluating the curriculum, exams, and guidelines the Department proposes regarding certifying people who assess property values on behalf of counties.

Revenues and expenditures

As shown in Table 1 (see page 4), the Department is funded from various sources, including the State General Fund and the Administrative Fund, which includes \$24.5 million in unclaimed property monies that is allocated to the Department annually per statute. For fiscal year 2019, the Department estimates total revenues of approximately \$81.3 million and total expenditures of approximately \$81.8 million. The largest expenses are for payroll and related benefits, professional and outside services, and other operating expenses.

Table 1
Schedule of revenues, expenditures, and changes in fund balance
Fiscal years 2017 through 2019

(In thousands)
(Unaudited)

	2017 (Actual)	2018 (Actual)	2019 (Budgeted)
Revenues			
Appropriations			
State General Fund	\$30,556	\$32,938	\$31,064
Administrative Fund ¹	24,500	24,500	24,500
Automation Projects Fund ²		3,000	
Charges for goods and services ³	21,784	23,300	23,756
Tobacco taxes	630	576	682
Intergovernmental	669	771	1,016
Other	19	1	256
Total revenues	78,158	85,086	81,273
Expenditures and operating transfers out			
Payroll and related benefits	40,772	40,703	44,203
Professional and outside services	13,147	16,365	16,539
Travel	94	100	218
Other operating ⁴	15,912	18,473	20,042
Furniture, equipment, and software ⁵	6,027	12,524	813
Total expenditures	75,952	88,165	81,816
Transfers to other agencies ⁶	83	677	
Total expenditures and transfers out	76,035	88,843	81,816
Excess of revenues over (under) expenditures	2,123	(3,757)	(543)
Fund balance, beginning of year	7,893	10,016	6,259
Fund balance, end of year⁷	\$10,016	\$ 6,259	\$ 5,716

¹ Amounts are from unclaimed property monies deposited into the Department's Administrative Fund in accordance with Arizona Revised Statutes (A.R.S.) §44-313.

² The fiscal year 2018 appropriation was for IT infrastructure.

³ Amounts include fees collected from Arizona State agencies, the courts, and political subdivisions when they request the Department to divert income tax refunds to satisfy debts that taxpayers owe to them.

⁴ Other operating expenditures comprise various expenditures such as rent, telecommunications, programming, software support and maintenance, and postage costs.

⁵ According to the Department, the higher amounts in fiscal years 2017 and 2018 were for an IT infrastructure project completed in June 2018.

⁶ The Department transferred to the Arizona Department of Administration approximately \$83,000 in fiscal year 2017 to help pay for replacing the State's electronic procurement system and approximately \$677,000 in fiscal year 2018 for lobby remodeling at the Department's Phoenix and Tucson offices.

⁷ Most of the Department's fund balance is unavailable for use unless the amounts are appropriated in future years.

Source: Auditor General staff analysis of information from the Arizona Financial Information System *Accounting Event Transaction File* and the *State of Arizona Annual Financial Report* for fiscal years 2017 and 2018 and Department-provided financial information for fiscal year 2019.



Department did not comply with some conflict-of-interest requirements

Statute addresses conflicts of interest for public-agency employees and public officers

Arizona law requires employees of public agencies and public officers to avoid conflicts of interest that might influence or affect their official conduct. To determine whether a conflict of interest exists, employees/public officers must first evaluate whether they or a relative has a “substantial interest” in (1) any contract, sale, purchase, or service to the public agency or (2) any decision of the public agency.

If an employee/public officer or a relative has a substantial interest in either circumstance, the employee/public officer is required to fully disclose the interest and refrain from voting upon or otherwise participating in the matter in any way as an employee/public officer.³ The interest must be disclosed in the public agency’s official records, either through a signed document or the agency’s official minutes. In addition, A.R.S. §38-509 requires public agencies to maintain a special file of all documents necessary to memorialize all disclosures of substantial interest and to make this file available for public inspection.

Ensuring compliance with these statutes can help deter self-dealing by employees/public officers and promote transparency and public confidence in an agency’s official conduct.

Key terms

- **Substantial interest**—Any direct or indirect monetary or ownership interest that is not hypothetical and is not defined in statute as a “remote interest.”
- **Remote interest**—Any of several specific categories of interest defined in statute that are exempt from the conflict-of-interest requirements. For example, an employee or public officer may participate in a decision that indirectly affects a relative who is an employee or an officer of another public agency or political subdivision, as long as the decision does not confer a direct economic benefit or detriment to the relative (such as a decision that would affect the relative’s employment).
- **Relative**—An employee’s/public officer’s spouse, child, grandchild, parent, grandparent, full or half-siblings and their spouses, and the parent, brother, sister, or child of the employee’s/public officer’s spouse.

Source: Auditor General staff review of A.R.S. §38-502 and the Arizona Agency Handbook. Arizona Office of the Attorney General. (2018). *Arizona agency handbook*. Phoenix, AZ. Retrieved 4/9/2019 from <https://www.azag.gov/outreach/publications/agency-handbook>.

Deficiencies in Department’s process increased risk of nondisclosure

Although the Department used an appropriate conflict-of-interest disclosure form (form) that it required new staff to complete, we identified several deficiencies in its disclosure process. These deficiencies resulted in the Department’s noncompliance with statutory conflict-of-interest requirements and increased the risk of Department employees and public officers not disclosing substantial interests. Specifically, the Department:

³ See A.R.S. §§38-502 and 38-503(A) and (B).

- **Lacked a special disclosure file as required by statute**—The Department housed its completed forms in each individual employee’s personnel file instead of in a special disclosure file. As a result, the Department lacked a method to track how many employees—and which employees—had disclosed an interest.
- **Did not require contractors or commission/committee members to disclose conflicts**—According to A.R.S. §38-501(A), the State’s conflict-of-interest statutes apply to all employees (including contracted employees) and public officers of any of the State’s departments, commissions, agencies, bodies, or boards.⁴ However, the Department did not require contractors or nonemployees who are members of the Department-supported commissions and committee to complete the forms (see the Introduction, pages 2 through 3, for a list of the commissions and the committee the Department supports).
- **Did not require annual disclosures**—The Department required only new employees to complete the form when they were hired; it did not require employees to complete the form annually. Although annual disclosures are not explicitly required by statute, doing so regularly reminds employees/public officers of the importance of complying with conflict-of-interest laws and helps ensure that potential conflicts of interest are disclosed if an employee’s or public officer’s circumstances change.
- **Lacked policies and procedures**—During our initial interviews, Department staff reported that they were in the process of drafting conflict-of-interest policies, which they provided to us. These policies were not completely drafted, did not contain procedures for staff, and did not fully address the deficiencies we noted during our review.

Department implemented new disclosure process to address deficiencies

Department staff reported that prior to our interviews, they were not aware of all the State’s conflict-of-interest requirements. However, after we spoke to the Department about the identified deficiencies, it developed and implemented a new conflict-of-interest disclosure process that went into effect on February 20, 2019.

The new process includes comprehensive policies and procedures that address each of the deficiencies we noted and provides clear instructions that Department employees/public officers refrain from participating in areas where they have disclosed a potential conflict of interest. The Department now requires all employees, contractors, temporary staff, and commission and committee members to complete annual disclosure forms, with the first annual forms having been due March 1, 2019. Supervisors are required to review their employees’ annual disclosure forms and work with them to develop a plan to manage any potential conflict of interest to ensure the conflict will not interfere with the performance of the respective individual’s responsibilities with the State. A copy of the plan is provided to the Department’s Human Resources Office to be placed in the special conflict-of-interest file.

On March 5, 2019, we reviewed the Department’s new spreadsheet for tracking form completion and found that the Department had collected the forms from most of its full-time employees and contractors and from about half of its temporary staff. However, it had not yet collected disclosure forms from any commission and committee members.

Recommendation

1. The Department should continue to implement and comply with its new conflict-of-interest disclosure process, including obtaining forms annually from all full-time employees, temporary staff, contractors, and commission and committee members.

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

⁴ A.R.S. §38-502(8) defines “public officer” as all elected or appointed officers of a public agency established by charter, ordinance, resolution, State constitution, or statute. According to the *Arizona Agency Handbook*, public officers include directors of State agencies and members of State boards, commissions, committees—whether paid or unpaid.



Native American Veterans Income Tax Settlement Fund

We reviewed the Department’s responsibilities for administering the NASF, a temporary program it operates with assistance from the Arizona Department of Veterans Services (ADVS). This report section has no recommendations but provides information about the NASF program.

NASF established to refund erroneously withheld income taxes

The Legislature established the NASF as a temporary program to reimburse Native American veterans who were on active duty in a branch of the U.S. military armed forces and erroneously had Arizona State income tax withheld from military pay between 1977 and 2005.⁵ The program was established as of May 2016 and will accept claims through December 31, 2019. The Legislature appropriated \$2 million dollars to the NASF, and any monies not claimed as of June 30, 2021, will revert to the State General Fund.

Both ADVS and Department process refund claims

State law requires claimants to provide specific documentation in order to prove eligibility for a refund (see textbox). Claimants apply with the ADVS, which is responsible for reviewing items 1 through 3 in the textbox. If approved, the ADVS then sends the claim to the Department to review items 4 and 5 in the textbox. The Department then approves, partially approves, or denies the claim depending on whether the claimant provided sufficient evidence to support eligibility for each year claimed.⁶

Proof of eligibility

Claimants must provide:

1. A copy of the veteran’s release or discharge from active duty.
2. A statement that the veteran is or was duly registered on Arizona tribal rolls during active duty.
3. Evidence of domicile in the boundaries of an Arizona reservation during the taxable years the State income tax was withheld from active duty military pay.
4. Evidence of the amount of State income tax withheld from active-duty military pay by providing copies of relevant W-2s. If the claimant does not have relevant W-2s, the claimant may request that the Department obtain the form or other withholding information from the U.S. Department of Defense (DOD).
5. A signed statement attesting that the veteran has not received a refund for which the claimant is filing a claim for settlement payment.

Source: Laws 2016, Ch. 125, §22(B).

⁵ Laws 2016, Ch. 125, §§19-28, established the program, which was subsequently extended by Laws 2017, Ch. 215.

⁶ A claimant’s application may include claims for up to 29 years (i.e., 1977 through 2005). The Department may approve some years and deny others, resulting in a partial approval, if the claimant was unable to provide sufficient documentation for each year claimed.

Per law, the ADVS must perform its review within 210 days after receiving a complete and correct claim form, and the Department must perform its review within 210 days of receiving the claim form from the ADVS. According to the Department, these time frames allowed time for claims to be mailed between agencies for processing, which was the original process. However, the Department implemented an electronic claims process in 2017 that allows for faster processing. We reviewed 4 claims from fiscal year 2019 and found that the ADVS processed these claims between 10 and 15 days, and the Department processed them between 5 and 20 days.

Department has processed hundreds of claims

As of May 15, 2019, the Department had received and processed a total of 243 claims. According to the Department, it approved or partially approved 123 of these claims and denied 120 claims because either the taxpayer had already received a refund or the taxpayer’s withholding could not be verified by the DOD, Department records, or a W-2 provided by the claimant. As of that same date, the Department reported that it had spent more than \$337,300 from the NASF for both approved refunds and administrative costs (see Table 2).

As shown in the table, the Department did not approve any refunds in fiscal year 2017. Although the Department received 54 claims that year, the Department reported that none of them included W-2s and that it was unable to process these applications without that information. As a result, these claims were put on hold until the Department entered into a memorandum of understanding (MOU) with the DOD that allows the DOD to provide the Department with required information, such as verification of dates and amounts of withholdings from the DOD’s payments to the veteran. The MOU was finalized in March 2018, and the Department reported that the 54 claims were subsequently processed by the end of fiscal year 2018.

Table 2
Approved NASF refunds and administrative costs
Fiscal years 2017, 2018, and 2019 (through May 15, 2019)
(Unaudited)

	Approved refunds ¹	Administrative costs ²	Total NASF expenditures
2017	\$ 0	\$ 47,669	\$ 47,669
2018	163,289	62,558	225,847
2019 ³	52,710	11,154	63,864
Cumulative totals	\$215,999	\$121,381	\$337,380

¹ Amounts include interest computed on a daily basis from the date of a timely filed return, as required by Laws 2016, Ch. 125, §23.

² Laws 2016, Ch. 125, §21, separately appropriates to both the Department and the ADVS 5 percent of monies in the fund at the beginning of each fiscal year for administrative costs incurred during the fiscal year. According to the Department, administrative costs have included expenses for creating 3 application forms and a publication about the program, modifying the Department’s tax system to allow for processing NASF refunds, and processing claims and tracking/paying refunds.

³ The fiscal year 2019 amounts are for July 1, 2018 through May 15, 2019.

Source: Auditor General Staff review of Department’s fiscal year 2017 and 2018 reports to the Arizona State Senate Appropriations and Finance Committees and Department-reported fiscal year 2019 information.



In accordance with A.R.S. §41-2954, the Legislature should consider the following factors in determining whether the Department should be continued or terminated.

In addition to the recommendations in this report, the Department should address the recommendations directed to it in the other 2 performance audit reports we issued as a part of this sunset review (see Auditor General Reports 19-102 and 19-103).

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

The Department's primary purpose is to administer State tax laws, which includes processing tax documents and payments; auditing taxpayers; collecting monies owed to the State, counties, and cities/towns; and assisting taxpayers who seek tax resources or information. Taxes the Department administers include individual and corporate income, transaction privilege tax (TPT), use, luxury, withholding, estate, and bingo. Additionally, the Department administers its unclaimed property program and regulates property tax by overseeing the counties' efforts to collect property taxes.

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

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

The Department has generally met its statutory objective and purpose in the areas we reviewed, but it should improve in some areas. Examples of where the Department has met its purpose and improved its efficiency include:

- **Call center timeliness**—As part of a strategic initiative to improve customer service, the Department hired a contractor in February 2016 to help oversee various aspects of the Department's call centers, including establishing and maintaining timeliness performance measures. The Department implemented several processes to help monitor and improve call center timeliness, such as monitoring daily timeliness performance-measure reports that are shared with Department leadership, supervising calls in real time, and posting visual reminders of its average speed of answer (ASA) goal of 60 seconds or less for all taxpayer calls.^{7,8} Through these efforts, the Department achieved its ASA goal for all calls for the first time in April 2018 and generally met that goal through October 2018. Although the Department did not continue to meet its goal from November 2018 through February 2019, it was still more timely during these months than for the same time frame during the prior 2 fiscal years. According to the Department, November through April are typically its busiest months because it has a high volume of calls for individual income tax, annual TPT license renewals, TPT calls, and various collections campaigns.

⁷ ASA measures how quickly call center staff answer a call once the taxpayer has selected his/her final choice and is transferred from the automated menu.

⁸ According to industry best practices, each call center must account for its distinct business context, goals, and cost/resource constraints as it evaluates operations, develops performance metrics, and sets targets for improvement. Performance metrics should be realistic and achievable and support the call center's business goals. See Strategic Contact, Inc. (n.d.). *Contact center "best practices."* Beaverton, OR. Retrieved 9/25/2018 from <https://www.strategiccontact.com/pdf/Contact-Center-Best-Practices-2014.pdf>.

- **Fraud detection efforts and TPT audit leads**—The Department contracted with a vendor in November 2015 to provide fraud mitigation and prevention services, such as developing an investigative tool that can identify false or misused identities in tax returns and provide real-time reporting and analysis of these issues. The Legislature appropriated \$2.7 million for this purpose for fiscal year 2016. The Department reported that for fiscal year 2018, it reviewed approximately 3.2 million individual tax returns, flagged 15,371 of those returns as being potentially fraudulent, and prevented approximately \$11.3 million of fraudulent dollars from being paid out in tax refunds.

In summer 2017, the Department and this vendor also started a pilot program to identify single-location restaurants that may be underreporting or misreporting TPT. The pilot program ended in June 2018 and resulted in 617 audit leads, 99 billings sent to taxpayers, and over \$3 million in total assessments. As of March 2019, the Department and the vendor were conducting a similar analysis of prime contractors' payment of TPT.⁹ The Department's audit unit reported that it anticipated pursuing audit leads from this effort but had not yet begun doing so as of April 29, 2019.

- **Arizona Management System (AMS) process improvements**—AMS is an initiative from the Governor's Office based on the idea of continuous improvement. Specifically, AMS principles revolve around serving customers efficiently, including providing timely and accurate service. Since late 2015, the Department has completed or is making progress on several process improvements through its AMS projects, including:
 - In conjunction with the Arizona Department of Transportation, creating a single point of administration for State and city vehicle use taxes (VUT), which the Department reported centralized VUT collection and replaced the prior manual process for calculating VUT with a simpler, more efficient online VUT calculator. The Department reported collecting approximately \$1.3 million on behalf of the cities since the implementation of the VUT calculator in November 2017.
 - Creating a means for taxpayers to obtain 1099-G tax forms electronically instead of by mail, which the Department reported will increase the percentage of online transactions; develop a more efficient and secure method of providing documents containing taxpayer information; and minimize printing, postage, and handling costs for mailing 1099-G forms to taxpayers. The Department reported that in calendar year 2017, it sent over 500,000 paper 1099-G forms to taxpayers. After implementing the online 1099-G form in January 2018, the Department sent a paper form to only the 201 taxpayers who specifically requested it in calendar year 2018. In that same calendar year, the Department reported that 22,843 taxpayers downloaded the new electronic 1099-G form.
 - Completing its AZTaxes Linking project in August 2017 to remove obstacles to filing TPT returns electronically, such as reducing suspended account issues.¹⁰ As of April 16, 2019, the Department reported having 598 suspended transactions in fiscal year 2019 compared to 10,023 suspended transactions in fiscal year 2018.
- **IT Modernization**—Before the Department started its IT Modernization project in July 2017, over 50 percent of its equipment was going to lose vendor support, not receive security updates, and have very high repair and overhead costs. The project focused on replacing end-of-life servers and moving the Department's 3 data centers to a more physically secure, well-cared-for, and reliable data center.¹¹ The project was substantially completed in November 2018. A third-party vendor provided project oversight and reported that the key project objectives were accomplished. The vendor did not observe any concerns with the project.

⁹ A prime contractor is a contractor who is 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.

¹⁰ Online accounts may be suspended (i.e., temporarily inoperative) when errors are detected in the information entered into a website or electronic system.

¹¹ A server provides critical functionality and holds a significant portion of the Department's data.

However, the Department reported that the offsite storage component of the IT Modernization project is not yet complete. During the project's execution, the plan was modified to have a different third-party vendor manage and operate offsite data storage through internet access (i.e., cloud storage), which requires more time to implement.¹² The Department anticipates completing this component by June 30, 2019.

We also identified areas where the Department can improve its efficiency:

- **TPT administration and support services**—Although the Department had substantially implemented TPT reform, we identified several areas where the Department should improve its administration of TPT.¹³ As reported in our 2 performance audits conducted as part of this sunset review, we recommended that the Department ensure that businesses have active and accurate TPT licenses, detect potential underreporting and misreporting of TPT owed and correct errors on TPT returns, enforce statutory filing requirements, correctly distribute TPT collected on behalf of cities and towns, and collaborate with cities and towns on TPT audit and collections efforts (see Auditor General Report 19-102). In addition, regarding support and education services provided to TPT taxpayers, we recommended that the Department further improve its call centers' quality assurance processes, improve internal collaboration on taxpayer education and outreach efforts, and implement its plans for better managing cities' and towns' TPT questions (see Auditor General Report 19-103).
- **Income tax processing**—As reported in our fiscal year 2018 *State of Arizona Single Audit Report*, the Department should strengthen its procedures for processing income tax revenues. The Department is solely responsible for collecting and reporting all State income taxes and should have adequate procedures and systems in place to do so. However, the Department's IT system lacks the functionality to perform automatic system checks and reconciliations, and the Department has not performed manual compensating review procedures to ensure all income taxes are collected and reported. As a result, there is an increased risk that the State may (1) not collect all income tax revenue that is due and (2) report inaccurate income tax revenue in its financial statements. We have reported this issue in the State's single audit reports since at least fiscal year 2009.
- **IT system planning**—We found that the Department should begin planning for its primary IT system's end-of-life cycle. The Department relies on this system, the Business Reengineering Integrated Tax System (BRITS), to administer State taxes and TPT for counties, cities, and towns. The system comprises AZTaxes.gov, a web-based system that handles electronic filing and all the Department's bank deposits, and the Tax Administration System (TAS), the system that supports processing TPT, individual income, withholding, and corporate income taxes. Department records indicate that since fiscal year 2016, the Department has spent approximately \$7 million annually on BRITS maintenance.

Prior performance audits of the Department found that BRITS was not adequately designed/implemented in the early 2000s, has required thousands of system improvements since implementation, and is cumbersome to use. The Department also lacks several IT capabilities used in other states to administer taxes, some of which were intended to be used in conjunction with BRITS. Because it lacks these capabilities, the Department relies on workarounds, vendors, and time-consuming manual processes to perform various functions that are less efficient and more susceptible to error. For example, the Department lacks an audit and collections IT platform that stores taxpayer data for audit selection, audit and collections case management, and tax calculation. Instead, the Department reported that it must rely

¹² According to Department documentation, Amazon Web Services (AWS) will provide cloud storage services. The AWS website explains that cloud storage is a computing model that stores data on the internet (i.e., the "cloud") through a provider who manages and operates data storage as a service. These cloud storage vendors make data accessible all around the world. See Amazon Web Services. (n.d.). *Cloud storage*. Seattle, WA. Retrieved 3/27/2019 from <https://aws.amazon.com/what-is-cloud-storage/>.

¹³ 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. TPT reform required the Department to administer TPT on behalf of all Arizona 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 was substantially implemented in January 2017.

on databases and applications that require a great deal of maintenance and support. The Department reported that these applications contain a high risk of failure as they require system updates that are outside of the Department's control and require large amounts of network space. According to the Department, if these systems were to fail, all Department enforcement activity would halt. Additionally, the Department lacks optical/intelligent character recognition (OCR/ICR) technology to scan and electronically capture handwritten or typed information contained in tax documents. Although the Department initially planned to implement OCR/ICR as part of BRITS, the Department did not implement this technology in order to stay within the target price for the BRITS contract. The Department has started a pilot program with a vendor to pick up TPT tax documents from its mailbox, scan them and deposit any associated payments, and transmit the electronic images back to the Department to be reviewed by software that reads the image file.

In a 2015 Auditor General performance audit (Report No. 15-105), prior Department leadership indicated that BRITS was nearing the end of its useful life and would require replacement and requested funding to conduct a feasibility study for replacing it. However, Department leadership changed after the performance audit was published, and the Department's new leadership decided to first focus on improving existing Department processes before requesting funding to implement a new IT system.

Although the Department has focused on improving various processes, best practices still recommend continual planning for a system's full life cycle. Specifically, IT best practices describe the implementation of an IT system as a life cycle that includes initiating, developing, implementing, operating, and retiring information systems.¹⁴ Therefore, organizations should continually plan for the future of their IT systems. However, the Department could not provide evidence that a life-cycle plan was ever developed for BRITS. Although there might not be value in developing a complete life-cycle plan for BRITS at this point, planning for its ongoing maintenance and eventual replacement would be consistent with best practice. Further, State requirements for approving an eventual BRITS replacement will likely require significant Department preparation and planning.

Recommendations

The Department should:

2. Address its IT system's limitations or immediately implement alternative review procedures to ensure it collects and reports all State income taxes.
3. Plan for BRITS' ongoing maintenance and eventual replacement and document these plans.

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

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

The Department administers and enforces Arizona's tax code, which generates revenue essential to the operation of State and local governments. The Department also administers TPT on behalf of Arizona's 15 counties and 91 cities/towns.

The Department has developed several strategies to provide services to all areas of the State. For example, the Department:

¹⁴ Kissel, R., Stine, K., Scholl M., Rossman, H., Fahlsing, J., and Gulick, J. (2008). *NIST Special Publication 800-64, Revision 2: Security considerations in the System Development Life Cycle*. Gaithersburg, MD: National Institute of Standards and Technology.

- Has offices located in the State's 3 largest cities—Phoenix, Tucson, and Mesa—where taxpayers can walk in to obtain services, such as making tax payments and applying for a TPT license.¹⁵
- Has call centers, where taxpayers can use either a local or toll-free phone number to speak with customer service representatives to ask questions and receive information. In addition, the Department has an Education and Outreach Unit that provides information and education regarding many topics to help taxpayers comply with tax laws (see Report 19-103 for more information about these services).
- Has a Taxpayer Assistance Office that helps resolve taxpayer complaints, provides information about Department procedures to taxpayers, answers taxpayers' questions about filing or preparing Arizona tax returns, and helps find documents or payments the taxpayer has filed with the Department. The Taxpayer Assistance Office has staff in the Department's Phoenix and Tucson offices (see Sunset Factor 6, pages 14 through 15, for more information about the Taxpayer Assistance Office).
- Redesigned and launched a new website on May 17, 2018, that allows visitors to access information on upcoming tax workshop seminars, offers electronic tax filing options, provides both forms and instructions for various tax types, and provides various mail and email addresses that allow taxpayers to contact the Department in service areas such as collections, customer care, bingo tax administration, and media inquiries.

However, we found that the Department should continue to implement its new conflict-of-interest disclosure process to ensure that all employees and public officers disclose conflicts of interest as required by law (see Finding 1, pages 5 through 6).

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

The Department provided a list of statutes that require or allow it to adopt specific rules. We confirmed that the Department had adopted all but one of the statutorily required rules from this list. Specifically, A.R.S. §43-1080(I) mandates that the Department shall prescribe record-keeping requirements by rule for taxpayers who claim a credit for expenses incurred in constructing a qualified environmental technology facility. The Department reported it considered this rule to be discretionary—meaning that it could but was not required to adopt the rule—and determined that promulgating the rule was unnecessary. However, this requirement is not discretionary.

Recommendation

4. The Department should adopt the rule required by A.R.S. §43-1080.

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

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

The Department provided opportunities for public input before adopting rules it created or revised in 2017 and 2018 by publishing notices of proposed rulemaking in the Arizona Administrative Register.¹⁶ The Department did not receive any public comments and/or hold optional oral hearings because there were no requests for hearings for these rules.

¹⁵ As of January 2019, the Department and the City of Mesa signed a memorandum of understanding for the Department to move its Mesa office to the City of Mesa Customer Service Office as a pilot project intended to increase convenience to taxpayers, who will be able to access customer service from both the Department and the City of Mesa at a single location. The Department moved in April 2019. Before then, the Department's Mesa office was colocated with the Arizona Department of Transportation's Mesa office.

¹⁶ We reviewed 3 rule-making packets that were opened between January 13, 2017 and October 20, 2017, and the rules went into effect between July 1, 2017 and May 13, 2018.

In addition, we assessed the Department's compliance with various provisions of the State's open meeting law. As discussed in the Introduction (see pages 2 through 3), the Department supports 3 commissions and 1 committee, and we tested the Department's compliance with open meeting law for 4 meetings.¹⁷ The Department generally posted meeting notices and provided agendas and meeting minutes as required by open meeting law with a few exceptions:

- Although requested, the Economic Estimates Commission did not provide the agendas for both meetings at least 24 hours in advance of the meetings, as required by statute.¹⁸ In both instances, the meeting agendas were provided on the day of each meeting.
- Additionally, the Economic Estimates Commission meeting minutes for its February 2019 meeting were not provided within 3 business days of the meeting as required by statute.¹⁹ The meeting minutes were provided 4 business days after the meeting because the staff member responsible for providing the minutes was out of the office.

Recommendation

5. The Department should ensure that the commissions and committee it supports adhere to all provisions of the State's open meeting law, including ensuring that agendas are available 24 hours in advance and meeting minutes are available within 3 business days of each meeting.

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

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

We reviewed the Department's complaint-handling processes for its Taxpayer Assistance Office and its Criminal Investigations Unit (CI Unit):

- **Taxpayer Assistance Office**—A.R.S. §42-2051 requires the Department to establish a Taxpayer Assistance Office (Office) to assist taxpayers in several ways, such as helping them obtain tax information, negotiating with various Department personnel on the most complex taxpayer problems, and receiving and evaluating complaints of improper or inefficient service by Department employees. This Office receives complaints through various means including email, phone, walk-in, and U.S. mail/fax. According to Department records, the Office received over 2,700 complaints in fiscal year 2018 and resolved them within 1 to 2 days on average.²⁰
- **CI Unit**—In addition, the Department's CI Unit investigates complaints alleging tax fraud and other types of tax-related criminal activity. When CI Unit staff receive complaints from individuals who report that tax preparers are allegedly falsifying documents to get their clients larger tax returns, they will review a sample of the tax preparer's completed returns, interview the tax preparer's clients to establish whether the clients were aware of the tax preparer's activity, and interview the tax preparer. When sufficient evidence is gathered, the CI Unit will turn the case over to the Attorney General for prosecution. The CI Unit also receives and tracks complaint allegations or concerns that, upon CI Unit staff's review, do not require a criminal investigation, such as a taxpayer calling to ask why the Internal Revenue Service put a lien on his/her bank account. These complaints are transferred to another unit within the Department—such as

¹⁷ We attended and reviewed the notice, agenda, and meeting minutes for 3 public meetings: the January 2019 Economic Estimates Commission meeting, the February 2019 Municipal Tax Code Commission meeting, and the March 2019 Education, Training and Certification Advisory Committee meeting. In addition, we reviewed the notice, agenda, and meeting minutes for, but did not attend, the February 2019 Economic Estimates Commission meeting.

¹⁸ A.R.S. §38-431.02(G).

¹⁹ A.R.S. §38-431.01(D).

²⁰ The Office uses a spreadsheet to track key complaint information, including the received date, resolution, and complaint-resolution date.

an audit team or customer care—for further resolution. The CI Unit received more than 500 complaints in calendar year 2018.

According to Department staff, the Department's CI Unit's goal is to review and determine the outcome of a complaint allegation within 3 business days.²¹ However, the CI Unit does not track the timeliness of complaint resolution. Although the CI Unit has a spreadsheet to track the date a complaint is received and other key complaint information, the spreadsheet does not include information on how the complaint was resolved or a complaint-resolution date. The CI Unit has not tracked this information because it had not considered its usefulness in the past. However, without tracking this information, the CI Unit does not know whether it is meeting its goal of 3 business days to determine the outcome of the complaint allegation.

Finally, although both the Taxpayer Assistance Office and the CI Unit have an established process for complaint-handling, neither unit has developed written policies and procedures. Documented policies and procedures would provide consistency for Department staff regarding steps staff should take to receive, document, track, and resolve complaints. Additionally, documenting the requirements and expectations for the process could help identify complaint-handling process gaps and improvement opportunities. Finally, documented policies and procedures would help retain institutional knowledge when staff involved in complaint handling leave Department employment and provide guidance for training new staff on Department complaint-handling processes.

Recommendations

The Department should:

6. Track the timeliness of its Criminal Investigations Unit's complaint-resolution process.
7. Document its Taxpayer Assistance Office's and Criminal Investigations Unit's complaint-resolution processes in written policies and procedures.

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

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

A.R.S. §41-192(A)(1) requires the Attorney General to act as the Department's legal advisor and to provide all legal services the Department requires.

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

The Department did not indicate any deficiencies in its enabling statutes that prevent it from fulfilling its statutory mandate.

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

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

²¹ The outcome of the complaint allegation could result in determining that further investigation is warranted and opening a case file to begin an investigation, determining the complaint is under another Department unit's jurisdiction and transferring the complaint to the appropriate unit, or determining that there is insufficient allegation information and closing the complaint.

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

Without transferring its responsibilities to another agency or other taxing jurisdictions, terminating the Department would harm the public health, safety, and welfare because it collects the taxes that help fund the continued operation of essential health- and safety-related government services. In fiscal year 2018, the Department reported collecting nearly \$18 billion in revenue. According to the Department, \$10.3 billion was distributed to State agencies, \$6 billion to counties and cities/towns, and \$1.6 billion to taxpayers as refunds. In addition, terminating the Department would eliminate tax enforcement and compliance programs that help to ensure that taxpayers pay their tax liabilities.

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

The Department appears to exercise an appropriate level of regulation in the areas where it has regulatory authority. Although the Department's primary function is administering and collecting taxes, the Department has regulatory authority in 4 areas: business licensure and registration; property tax administration; tobacco tax administration; and bingo code regulation (see bullets below). We compared the Department's level of regulation to the regulation provided in 4 other states—Colorado, Indiana, Maryland, and Nevada. We found that the Department's level of regulation in these areas is generally similar to the other states that we reviewed. Specifically:

- **Business licensing and registration**—The Department is responsible for processing TPT license applications, annual license renewals, and business account updates for active TPT license holders. The other 4 states' tax agencies also issue licenses, certificates, or permits to businesses before they may engage in or conduct business as a seller.
- **Property tax administration**—The Department is responsible for the general supervision of county assessors in administering property tax laws to ensure that all property is uniformly valued for property tax purposes. A county assessor's duties include locating and identifying all taxable property in the county and establishing a value for all property subject to property tax. The Department provides guidance to county assessors, assists in valuing certain property, and administers a certification program for persons who assess property value on behalf of a county. Of the other 4 states, only Nevada oversees property assessors and values certain property through its tax agency; the other 3 states oversee or conduct property valuations through other agencies.
- **Tobacco tax regulation**—The Department licenses tobacco distributors and conducts tobacco enforcement activities, such as inspecting tobacco retailers to ensure that their taxable tobacco products are stamped (i.e., registered) with the State's tobacco stamp, administering fines, and seizing unregistered tobacco products found during inspections. The other 4 states' tax agencies also license or certify tobacco distributors/wholesalers and conduct similar tobacco enforcement activities.
- **Bingo regulation**—The Department grants or denies licenses to a person, group of persons, or qualified organization, such as a homeowner's association or church, that holds bingo games; suspends and/or revokes licenses for violations; and keeps records of all transactions. None of the other 4 states regulate bingo through their tax agencies. Instead, they regulate bingo through other entities such as the secretary of state or gaming commissions.²²

²²The Department reported that transferring bingo regulation to the Arizona Department of Gaming (Gaming) would help the Department be more efficient. The Department and Gaming jointly worked on a proposal recommending this transfer, but the proposal has been on hold since March 2018.

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

The Department uses private contractors to assist with temporary staffing, fraud detection, document imaging, call center customer service, and collecting and distributing unclaimed property. The Department also uses a private contract for financial institution matches that allows the Department to issue levies when a debtor has an account with a financial institution.²³

We compared the Department's use of contractors for these services to those used by 4 states: Maryland, Colorado, Indiana, and Nevada. As shown in Table 3, we found that the Department used contractors to a similar or greater extent than the other states. We did not identify any additional areas where the Department should consider using private contractors.

Table 3
Contract use by the Department and 4 other states¹

Type of contract	Arizona	Maryland	Colorado	Indiana	Nevada
Temporary staffing	✓	✓	✓	✓	✓
Fraud detection	✓	✓	✓	✓	
Document imaging	✓	✓	✓		
Call center customer service	✓	✓	✓		
Unclaimed property administration ²	✓	✓	n/a	n/a	n/a
Financial institution matches	✓		✓	✓	

¹ For blank cells, states reported providing these services in-house rather than through private contractors.

² Colorado, Indiana, and Nevada reported that either its Attorney General or State Treasurer administer unclaimed property.

Source: Auditor General staff review of Department information and phone interviews with the other states' tax agencies.

²³ After the financial institution receives the Department's levy, it immediately places a hold on any of the taxpayer's funds needed to pay the Department for delinquent taxes and debts owed to the State.



SUMMARY OF RECOMMENDATIONS

Auditor General makes 7 recommendations to the Department

The Department should:

1. Continue to implement and comply with its new conflict-of-interest disclosure process, including obtaining forms annually from all full-time employees, temporary staff, contractors, and commission and committee members (see Finding 1, pages 5 through 6, for more information).
2. Address its IT system's limitations or immediately implement alternative review procedures to ensure it collects and reports all State income taxes (see Sunset Factor 2, page 11, for more information).
3. Plan for BRITS' ongoing maintenance and eventual replacement and document these plans (see Sunset Factor 2, pages 11 through 12, for more information).
4. Adopt the rule required by A.R.S. §43-1080 (see Sunset Factor 4, page 13, for more information).
5. Ensure that the commissions and committee it supports adhere to all provisions of the State's open meeting law, including ensuring that agendas are available 24 hours in advance and meeting minutes are available within 3 business days of each meeting (see Sunset Factor 5, page 14, for more information).
6. Track the timeliness of its Criminal Investigation Unit's complaint-resolution process (see Sunset Factor 6, pages 14 through 15, for more information).
7. Document its Taxpayer Assistance Office's and Criminal Investigation Unit's complaint-resolution processes in written policies and procedures (see Sunset Factor 6, pages 14 through 15, for more information).



Objectives, scope, and methodology

The Office of the Auditor General has conducted a sunset review of the Department pursuant to a September 14, 2016, resolution of the Joint Legislative Audit Committee. This sunset review was conducted as part of the sunset review process prescribed in A.R.S. §41-2951 et seq. This report addresses the statutory sunset factors and includes a review of various Department processes for disclosing conflicts of interest, adopting rules, holding open meetings, handling complaints, and regulating its business licenses and administering certain taxes. It also provides information about the NASF.

We used various methods to study the issues addressed in this sunset review. These methods included interviewing Department staff and stakeholders and reviewing Department statutes and rules; Department-provided documentation, including policies, procedures, and its response to the sunset factors; prior Auditor General reports; and the Department's *Strategic Plan FY 2018-2022* and *Annual Report for Fiscal Year 2018*. In addition, we used the following methods to address the sunset factors:

- To obtain information regarding the Department's effectiveness and efficiency in fulfilling its key objectives and purposes, we reviewed the Department's:
 - **Call center timeliness**—We observed 3 test calls with main call center management to understand and validate the call timing process, performed 5 mystery shopper calls to further validate the Department's timing of its calls, and reviewed Department-provided information pertaining to the monthly average speed of answer for all of the Department's calls for July 2017 through February 2019.
 - **IT Modernization project**—We observed the new data center and reviewed the vendor's project oversight reports.
 - **IT system planning**—We reviewed previous Auditor General reports, observed staff working with BRITS, reviewed Department-provided budget documents, and reviewed IT best practices.²⁴
- To assess the Department's compliance with the State's conflict-of-interest laws, we reviewed statute, the *Arizona Agency Handbook*, and the Department's conflict-of-interest forms and files.
- To assess the Department's compliance with the State's open meeting law requirements, we reviewed the notice, agenda, and meeting minutes for and attended 3 public meetings: the January 2019 Economic Estimates Commission meeting, the February 2019 Municipal Tax Code Commission meeting, and the March 2019 Education, Training and Certification Advisory Committee meeting. In addition, we reviewed the notice, agenda, and meeting minutes for, but did not attend, the February 2019 Economic Estimates Commission meeting.
- To assess the Department's effectiveness in resolving complaints within its jurisdiction, we interviewed staff within the Department's Criminal Investigations Unit and Taxpayer Assistance Office and reviewed complaint-tracking spreadsheets.

²⁴ Kissel, R., Stine, K., Scholl M., Rossman, H., Fahlsing, J., and Gulick, J. (2008). *NIST Special Publication 800-64, Revision 2: Security considerations in the System Development Life Cycle*. Gaithersburg, MD: National Institute of Standards and Technology.

- To compare the Department's regulatory activities and use of private contractors with other states, we selected 4 states—Colorado, Indiana, Maryland, and Nevada—for comparison.²⁵ We also reviewed these states' statutes and websites, contacted staff in the 4 states to learn more about their regulatory responsibilities and/or use of contractors, and reviewed selected Department contracts.²⁶
- To obtain information about the NASF program, we gained an understanding of the claims process and reviewed the memorandum of understanding between the Department and the U.S. Department of Defense for obtaining withholding information, the Department's annual program reports for fiscal years 2017 and 2018, and 4 claims from fiscal year 2019.
- To obtain information for the report's Introduction, we reviewed Department-provided information on the State's primary tax revenue sources and amounts collected for fiscal year 2018 and the Department's organization and staffing as of February 2019. We also reviewed the statutes for the 4 Department-supported commissions and committee. Additionally, we compiled and analyzed information from the AFIS *Accounting Event Transaction File* and the *State of Arizona Annual Financial Report* for fiscal years 2017 and 2018 and Department-provided financial information for fiscal year 2019.
- Our work on internal controls was limited and focused on the Department's processes for disclosing conflicts of interest and handling complaints. Conclusions on this work are included in the Sunset Factor 1 Finding and in responses to Sunset Factors 3 and 6 (see pages 5 through 6 and 14 through 15 for more information). Computerized system information was not significant to our objectives; therefore, we did not conduct test work on information system controls.

We conducted this audit 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 and staff for their cooperation and assistance throughout the review.

²⁵ These states were judgmentally selected based on geographic proximity to Arizona and demonstrated best practices in areas we conducted work during our review.

²⁶ We selected Department contracts based on a review of contract information in the Arizona Financial Information System (AFIS), Department procurement staff input, and auditor judgment regarding those contracts that help the Department to complete its mission-critical functions.

AGENCY RESPONSE

STATE OF ARIZONA
Department of Revenue



Douglas A. Ducey
Governor

Carlton Woodruff
Interim Director

June 20, 2019

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

Dear Ms. Perry:

The Arizona Department of Revenue (Department) appreciates the opportunity to respond to the Auditor General's report, *Arizona Department of Revenue—Sunset Factors*. 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 did not comply with some conflict-of-interest requirements.

Recommendation 1: The Department should continue to implement and comply with its new conflict-of-interest disclosure process, including obtaining forms annually from all full-time employees, temporary staff, contractors, and commission and committee members.

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

Response explanation: The Department has developed and implemented a new conflict-of-interest disclosure process that went into effect on February 20, 2019, and as of June 5, 2019, has obtained disclosure forms from 95 percent of all full-time employees, temporary staff, contractors, and commission and committee members. The Department plans to be 100 percent compliant with its disclosure forms by the end of fiscal year 2019.

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

Recommendation 2: The Department should address its IT system's limitations or immediately implement alternative review procedures to ensure it collects and reports all State income taxes.

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

Recommendation 3: The Department should plan for BRITS' ongoing maintenance and eventual replacement and document these plans.

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

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

Recommendation 4: The Department should adopt the rule required by A.R.S. §43-1080.

Department Response: The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.

Response explanation: Rather than seek a change to its administrative rules, the Department has decided to pursue a statutory change to remove the requirement to adopt a rule prescribing record-keeping requirements for taxpayers claiming a credit for expenses incurred in constructing a qualified environmental technology facility. If the Department is unsuccessful in changing the statute, it will proceed with rulemaking as recommended.

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

Recommendation 5: The Department should ensure that the commissions and committee it supports adhere to all provisions of the State's open meeting law, including ensuring that agendas are available 24 hours in advance and meeting minutes are available within 3 business days of each meeting.

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

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

Recommendation 6: The Department should track the timeliness of its Criminal Investigations Unit's complaint-resolution process.

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

Recommendation 7: The Department should document its Taxpayer Assistance Office's and Criminal Investigations Unit's complaint-resolution processes in written policies and procedures.

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

