PERFORMANCE AUDIT

DEPARTMENT OF REVENUE

TAX PROCESSING FUNCTION

Report to the Arizona Legislature
By the Auditor General
September 1985
85-9

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

September 25, 1985

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

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Revenue, Tax Processing Function. This report is in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. The performance audit was conducted as a part of the Sunset Review set forth in A.R.S. §§41-2351 through 41-2379.

The report discusses how DOR could improve processing efficiency and reduce errors. We recommend that the Department rely less extensively on temporary employees, strengthen quality control in its processing units, and improve design of tax forms and instructions. The report also addresses the need to improve monitoring of vendor contracts and controls over receipts.

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

Respectfully submitted,

Douglas R. Norton

Douglas R. Norton
Auditor General

Staff: William Thomson
Peter N. Francis
Stephen G. Adelstein
Jerome E. Miller
Gregg J. Halemba
Mark J. Syracuse
Lucinda A. Trimble

Enclosure

SUMMARY

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

The processing function includes the receipt of tax returns and payments, sorting and batching of returns, preparation of payments for deposit, entry of data from returns into the computer system, and resolution of errors uncovered during processing.

The Department of Revenue's Excessive Use Of Temporary Employees Impairs Tax Processing Productivity (see page 5)

The Department has relied too heavily on temporary employees to process tax returns. At least 37, and possibly as many as 60 temporary positions are used on a continuous year-round basis in four important processing areas. There were only 55 permanent nonsupervisory positions in these areas. Some temporary employees have supervisory and training responsibilities, or are in positions requiring highly specialized knowledge.

DOR's extensive use of temporary personnel has resulted in high turnover and reduced productivity in processing sections. In addition, the large number of temporary personnel has limited DOR's ability to provide adequate staff training.

Because of the generally higher productivity of permanent, full-time staff, DOR could replace long-term temporary employees with fewer, higher paid permanent employees, and realize a savings. For example, 37 temporary positions could be filled with 30 permanent employees at a savings of approximately $36,000. DOR should not use temporary staff in supervisory, training or key processing positions. In addition, a two-tier training program should be established to train permanent

employees while providing temporary employees with enough knowledge to accomplish their assigned tasks.

DOR Could Reduce Processing Errors
And Correct Errors More Efficiently (see page 15)

A large number of returns are routed to the Error Resolution Group, which slows processing. DOR statistics indicate that 43 percent of the 1.2 million individual income tax returns filed and processed for the 1984 tax year were routed to the Error Resolution Group. Rough DOR estimates indicate that approximately 84 percent of corporate income tax returns, 25 to 65 percent of sales tax returns, and all withholding returns filed since the third quarter of 1984 were referred to Error Resolution. However, many of these business tax referrals were due to computer system deficiencies rather than actual errors. High numbers of returns going to Error Resolution Units contribute to inventory backlogs and hinder timely processing.

DOR has not developed adequate procedures to prevent returns from being sent to Error Resolution Units. Minimal quality control in such areas as the NCR Unit contributes to high Error Resolution referrals. In addition, DOR processing supervisors have not established adequate monitoring of employee error rates. The primary emphasis of existing DOR productivity monitoring systems is speed, not accuracy. Further, DOR does not have a formal program to monitor data entry vendor performance, making it difficult to compare vendors to each other or to some objective performance standard.

DOR could also reduce errors and increase efficiency by improving the design of its tax forms and instructions. In general, Arizona individual income tax forms average more taxpayer errors than Federal income tax returns. DOR should take steps to identify recurring taxpayer errors and their causes, in order to develop ways to prevent them. In addition, tax instructions should be clearly arranged in a step by step format and in the order in which the taxpayer should complete the return. Headings and print styles in the instructions should be better designed for the taxpayers' ease of use. Further, tax forms should be made more conducive to data entry operations in order to promote processing efficiency.

DOR Needs To Improve Its Contract Monitoring Procedures (see page 29)

The Department does not adequately administer and monitor its outside vendor contracts. Poor verification of the keystrokes for which it is charged by data entry vendors resulted in approximately $423,000 of overcharges by one vendor for the 17-month period between January 1984 and May 1985. In addition, DOR permits data entry vendors to unilaterally evaluate the quality of the tax documents they input, which could result in possible overcharges by vendors that vary their rates based on document quality. Further, DOR does not monitor keypunch error rates of data entry vendors to determine whether they are under contractually established maximum error rates. Contracts stipulate that if error rates exceed two per 10,000 keystrokes, DOR is not subject to additional charges for 100 percent key verification. These charges range from 50 percent to 100 percent of the charge for nonverified keypunching, depending on the vendor.

DOR also incurred overcharges for temporary personnel because it did not adequately monitor vendor billing rates. Vendor billing rates were incorrectly generated, resulting in at least $28,000 in overcharges for a 1-year period. DOR should take immediate steps to prevent such overbillings from happening in the future, and to retrieve from the vendor amounts already overpaid.

The Department of Revenue Could Improve Control Over Receipts (see page 37)

DOR could improve control over its revenues to reduce the risk of theft or loss. The Department has seven areas that receive monies. The internal controls in at least three of these areas do not appear adequate to ensure timely deposits, or to safeguard against possible theft or loss. Weaknesses in physical security, inadequate record keeping, and lack of separation of duties were uncovered. DOR should create an independent internal audit group that reports to the Director of DOR. Part of the responsibilities of this group should be to review internal controls for adequacy and to ensure that controls are being adhered to. The group should have expertise in accounting and internal controls.

In addition, DOR should strengthen controls over changes to taxpayer accounts made by the Income Error Resolution Unit on the computer system. An instance of employee fraud in 1984 indicates weakness in controls. DOR has since implemented new controls, however, further separation of duties should be implemented and the dollar amount above which changes are checked should be lowered.

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INTRODUCTION AND BACKGROUND

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

The tax processing function is part of the Division of Administration. The Division of Administration includes three major sections: Mail and Document Processing, Accounting and Finance, and Data Processing (which includes data entry functions).

Processing Procedures And Work Load - Tax returns are received in the DOR Mail Room. Mail Room personnel open envelopes and briefly scan each document to determine if it looks processible. The returns are then sorted by tax type and forwarded to the Document Processing Section where they are batched with like documents and prepared for NCR coding* or for data entry. The document and money (usually a check or money order) are encoded with matching serial numbers for identification, and prepared for deposit. The documents are then sent to data entry for input into the computer system. Returns without money go directly from document processing to data entry.

If a tax form contains an error caused by a taxpayer or DOR personnel the computer rejects the form and the document is sent to the Error Resolution Unit for correction. All individual income tax forms are eventually microfilmed.

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* NCR (National Cash Register) machines are used to encode and serialize all business tax documents, individual income tax documents with money attached, and all checks accompanying these documents. Individual income tax documents received without money bypass NCR coding.

Table 1 shows DOR's tax processing activity for fiscal years 1982-83 and 1983-84, and estimated activity for fiscal years 1984-85 and 1985-86.

TABLE 1

MAIL AND DOCUMENT PROCESSING WORK LOAD AND ACTIVITIES
FOR FISCAL YEARS 1982-83 THROUGH 1985-86
(Unaudited)

	Actual 1982-83	Actual 1983-84	Estimated 1984-85	Estimated 1985-86
Mail				
Daily Mail Received	2,411,683	2,543,700	3,000,000	3,050,000
Certified Received	23,546	34,083	35,000	40,000
Returns and Documents Processed(1)				
Individual Income		1,466,722	1,598,727	1,742,612
Corporate Income		71,815	73,060	76,188
Withholding		679,813	700,207	721,213
Sales and Use		985,251	991,489	998,575
Other(2)		57,266	60,418	63,746
Revenue Collected				
Individual Income	$195,584,283	$ 231,658,295	(4)	(4)
Corporate Income	169,039,740	207,341,166		
Withholding	400,596,831	418,869,050		
Sales and Use	848,197,357	1,143,854,349		
Luxury	66,181,687	66,974,279		
Estate	13,856,122	14,553,127		
Other(3)	81,452,310	84,200,798		
Total	$1,774,908,330	$2,167,451,064		

(1) Prior to July 1, 1983, Remittance Processing handled only checks; after July 1, 1983, Remittance Processing handled all checks and documents.
(2) This category includes State and city licenses, bingo licenses, and partnerships.
(3) Other revenues include flight property tax, private car tax, nuclear plan assessment and State property taxes.
(4) Data not available

Source: Data on revenue collected obtained from Department of Revenue Annual Report for 1983-84. All other data obtained from Department of Revenue Budget Request 1985-86.

Staffing And Budget - The processing function is currently budgeted under DOR's Division of Administration. Prior to fiscal year 1984-85, the processing function was a separate budgetary unit. The Division of Administration is authorized 235 full-time equivalent (FTE) positions for fiscal year 1985-86, or 28 percent of DOR's 826 FTEs; 87 of these are authorized for mail and document processing (not including data entry operators). Table 2 shows appropriations and expenditures for the Division of Administration during fiscal years 1983-84 through 1985-86.

TABLE 2

ADMINISTRATION DIVISION
ACTUAL EXPENDITURES FOR FISCAL YEAR 1983-84,
ESTIMATED EXPENDITURES FOR FISCAL YEARS 1984-85
AND APPROPRIATIONS FOR FISCAL YEAR 1985-86
(Unaudited)

	Actual 1983-84	Estimated 1984-85	Approved 1985-86
FTE Positions	206.4	205.0	235.0
Personal Services	$3,110,300	$3,413,200	$4,023,800
Employee Related Expenses	703,100	782,300	914,200
Professional and Outside Services	2,332,500	1,881,000	1,972,000
Travel - State	6,500	6,500	8,200
Travel - Out of State	9,900	0	0
Other Operating Expenses	2,727,300	2,489,100	2,616,600
Equipment	135,800	0	40,300
Total	$9,025,400	$8,572,100	$9,575,100

Source: State of Arizona Appropriations Report 1985-86

Scope Of Audit

Our audit of the Administration Division concentrated on tax processing functions. The audit also included limited work on other parts of the Administration Division and other divisions, as noted throughout the report. In addition, we visited the Internal Revenue Service Center in Ogden, Utah and reviewed its processing procedures. The information gathered was used throughout the audit.

Detailed work was conducted on the following issues:

- Whether DOR's use of temporary employees is excessive,
- Whether the manner in which DOR handles and corrects errors is adequate,
- Whether DOR monitors its outside service contracts effectively, and
- Whether DOR's control over tax revenues is adequate.

In addition, we developed other pertinent information on tax processing procedures. Also, a limited work measurement study was conducted of employees in some tax processing areas to determine if detailed audit work was necessary regarding employee productivity. The study included the Mail Room, Computer Assisted Data Entry, Error Resolution and NCR Coding. The results indicated that DOR processing employees were generally productive in performing their tasks, and further work measurement was therefore not undertaken. Finally, limited time was devoted to addressing the 12 statutory Sunset Factors. A Departmentwide response to these factors will be prepared following the completion of our other Department of Revenue audits.

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

The Auditor General and staff express appreciation to the Director of DOR and staff of the Administration Division for their cooperation and assistance during the course of our audit.

FINDING I

THE DEPARTMENT OF REVENUE'S EXCESSIVE USE OF TEMPORARY EMPLOYEES IMPAIRS TAX PROCESSING PRODUCTIVITY

The Department of Revenue (DOR) is not utilizing its processing staff resources efficiently or effectively. The Department has relied too heavily on temporary employees to process income and business tax returns. This reliance on temporary employees has resulted in high turnover and reduced productivity, and has limited the Department's ability to provide adequate training for its employees. The cost of converting temporary positions into permanent full-time equivalent (FTE) positions would be more than offset by increases in staff stability and processing efficiency.

DOR Has Relied Too Heavily On Temporary Employees

The Department of Revenue has relied too heavily on temporary employees to meet its tax processing work load. Although it converted a total of 30 positions from temporary to permanent status in fiscal year 1985-86, DOR still employs numerous temporary employees on a continuous, year-round basis. This indicates that DOR's permanent processing staff cannot handle minimum, nonseasonal work loads. The excessive use of temporary employees is not consistent with practices of other tax administration bureaus, nor with Arizona State regulations relating to temporary employees.

Temporary Employees Overutilized - DOR utilizes temporary staff on a continuous, year-round basis. Since 1982 DOR has contracted with outside vendors to supply temporary support personnel during periods when tax processing work loads exceed the capacity that can be managed by permanent staff. Interviews with processing supervisors and a review of temporary personnel billing invoices indicate that at least 37 and possibly as many as 60 temporary positions are utilized on a continuous, year-round basis in the Incoming Mail, Document Processing, NCR and Error Resolution processing sections.*

These temporary employees, a number of whom have worked for DOR for 1 year or longer, perform normal, nonpeak processing functions and make up a major portion of DOR's core, nonseasonal processing staff.

As of May 1985 there were approximately 55 permanent, nonsupervisorial employees assigned to these processing areas.** To meet its minimum, nonseasonal work loads, DOR has found it necessary to augment (with temporary personnel) its core permanent, nonsupervisory processing staff by 67 to 109 percent.

Interviews with DOR management indicate that this extensive utilization of temporary personnel resulted from rapid growth in processing work loads. In addition, temporary staff has been used to keep permanent staff growth to a minimum during the State's recent fiscal crisis. During this period, DOR administrators believed that there was a greater likelihood of the legislature increasing their support services budget than increasing the number of processing positions.

In addition to employing temporary personnel year-round, DOR utilizes temporary employees in positions of substantial responsibility. DOR organization charts and interviews with processing supervisors confirm that year-round temporary staff often have supervisory and employee training responsibilities. For example, as of May 1985, three Income Error

* It was difficult to accurately determine how many temporary personnel are hired on such a continuous basis due to DOR's lack of data. No centralized record of temporary employee utilization patterns in processing sections is compiled by DOR. Because of high turnover among temporary staff, processing supervisors and managers could only generally estimate how many temporary employees are utilized on a continuous, year-round basis in their respective sections. These estimates were compared with an analysis of weekly billing invoices to come up with the range of 37 to 60 temporary employees.

** These positions include approximately ten State Personnel temporary positions that were made permanent FTEs in the fiscal year 1985-86 budget.

Resolution temporary employees were in lead clerk positions each having supervisory responsibility over three other clerks.*

Furthermore, many long-term temporaries are in positions requiring highly specialized tax processing knowledge that can only be obtained through extensive training (2 to 3 months) and first-hand tax processing experience. For example, in the Business Error Resolution area, there are 12 temporary employees in such vital positions, and only eight permanent FTEs in this processing area.

Interviews with Business and Income Error Resolution supervisors indicate that the processing of tax returns in these sections would be seriously hampered if long-term temporary employees with specialized tax knowledge were to leave DOR. Employees in these positions need to be skilled in the operation of a computer terminal and possess extensive knowledge of the tax processing system they are working in (e.g., income, corporate, sales or withholding). This includes familiarity with various system correction codes and an ability to interpret system-generated exception reports that indicate why documents have been routed to Business and Income Error Resolution.

A graphic illustration of this problem occurred in June 1985. Because of unanticipated temporary personnel needs, poor staffing projections and inadequate monitoring of the temporary personnel budget, DOR experienced budget deficiencies that resulted in processing sections laying off most of their temporary personnel for 2 weeks until the start of the new fiscal year in July. This layoff included temporary personnel filling key positions. As a result, a significant backlog of unprocessed tax returns accumulated, especially in the more specialized and complicated processing areas.

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* There are eight lead clerk positions in Income Error Resolution. Five of these are considered permanent FTEs, the remaining three are long-term temporary slots.

Processing administrators acknowledged that there was a significant delay in the processing of tax documents. However, this layoff had a further long-term impact in that three key temporary employees in Income Error Resolution left shortly after being recalled on July 1 because they found new jobs as a result of a job search they initiated during their 2-week layoff.

Other Agencies Limit Use of Temporary Employees - Other tax bureaus limit the use of temporary personnel. The Internal Revenue Service (IRS) and California Franchise Tax Boards utilize temporary and seasonal employees to assist in the processing of tax returns during tax seasons.* In California, seasonal tax help can only be employed continuously for a period of 9 months. The IRS is permitted to hire temporary employees for a period up to 1 year. The IRS has indicated that it is better to staff year-round positions with permanent employees.

DOR's extensive utilization of temporary employees is not consistent with State regulations pertaining to the employment of temporary help. While the Department may not be in actual violation of State regulations because temporary employees are provided by a private vendor under contract to DOR and not hired through State Personnel, these regulations could be considered a standard for the appropriate use of temporary personnel. Rule R2-5-101.62 of the Arizona Compilation of Revised Rules and Regulations states that temporary appointment is "the appointment . . . established to meet a temporary program need with a specified duration." Rule R2-5-204.E places a time limit on a temporary appointment. "The appointment of a person to a position for not more than one year shall constitute a temporary appointment . . . Such appointment may be extended for not more than six months by the Director."**

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* The California Franchise Tax Board has long been considered a model state tax administration bureau by other tax administrators and the IRS.

** Tenure data provided by the temporary support personnel vendor indicates that 11 temporary employees have worked continuously for DOR for a period of 1 year or longer.

Excessive Utilization Of Temporary Personnel Has Reduced Tax Processing Efficiency

The Department of Revenue's excessive utilization of temporary employees has resulted in high turnover in processing sections. In addition, extensive use of temporaries reduces productivity and limits DOR's ability to develop adequate training programs.

Staff Instabilities - DOR's excessive use of temporary personnel has contributed to instability among its processing staff. Data on temporary employee turnover rates in DOR processing sections indicates high turnover among temporary employees. DOR conducted a cursory analysis of temporary turnover rates in the Mail Room in October 1984, using corresponding 6-week periods (April 1 through May 15) in 1983 and 1984. The turnover rate for these two periods was 24.3 percent. Extrapolating this figure over 1 year would result in a yearly turnover rate of 211 percent.

A study conducted by Auditor General staff of a comparable period in 1985 for the Income Error Resolution Section produced similar results. The turnover rate for this section was 28.6 percent. Extrapolation of this figure suggests a yearly turnover rate of 248 percent.

According to authoritative literature*, individuals seek temporary assignments for two general reasons: 1) to supplement their income until they can find a permanent position, or 2) for personal reasons that preclude them from searching for a more permanent position. In both

* See Virginia L. Olesen and Frances Katsuranis, Urban Nomads: Women in Temporary Clerical Services, in Ann H. Stromberg and Shirley Harkess (eds.), Women Working: Theories and Facts in Perspective, Mayfield Publishing Company, Palo Alto, 1978.

cases the possibility of long-term tenure in a temporary position is relatively small.*

Reduced Productivity - Evidence indicates that temporary employees are not as productive as their permanent counterparts. A comparison of 7 months of productivity records for permanent and temporary revenue control technicians in Business and Income NCR Sections (October 1984 through April 1985) reveals that permanent employees are 21.6 percent more productive than temporary personnel doing similar work.**

Such comparisons cannot be made in other processing sections because permanent staff in these areas are in lead clerk, training or quality control positions and are not regularly involved in front-line processing tasks. However, a comparison of more experienced and less experienced temporaries involved in front-line processing in Income Error Resolution's Math and Data Unit reveals similar results. Of all Income Error Resolution units, the Math and Data Unit hires the most temporaries in long-term positions. The day shift Math and Data Unit hires five temporary employees year-round. In fiscal year 1984-85, the night shift hired approximately ten temporary employees year-round. However, during the peak income tax season in April and May the number of night shift temporaries increases to approximately 35. An analysis of 2 1/2 months of employee productivity logs (March through mid-May 1985) in this Unit by

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* Local economic fluctuations must also be taken into consideration in evaluating the expected tenure and quality of temporary staff. As unemployment rates rise, the possiblity of obtaining qualified personnel who can reasonably be expected to stay with DOR Processing for extended periods of time will increase. Under poor economic conditions, these unemployed individuals have fewer employment options. However, as the economy improves and unemployment rates decrease, the qualifications and expected tenure of the temporary employee pool will also decrease. If DOR did not rely as heavily on temporary employees, its core staffing would be less affected by fluctuations in the local economy.

** Statistical analysis shows that differences in the average productivity rates among permanent and temporary employees are statistically significant.

Auditor General staff indicates that temporary employees who have been with the Math and Data Unit 2 months or longer are 46.2 percent more productive than temporary employees who have been with this unit for less than 2 months.*

Furthermore, according to the night shift supervisor of Income Error Resolution, Math and Data Unit employees are expected to process 32 to 45 documents per hour. However, night shift temporaries, in the aggregate, only processed an average of 28 documents per hour during this same period.** This indicates that units with primarily short-term, temporary front-line employees may not be meeting minimum processing standards.

These analyses indicate that productivity increases with experience. However, as long as the Department of Revenue continues to rely on temporaries to fill its core staff requirements, the attainment of such experience will be seriously impaired by high staff turnover.

<u>Inadequate Training</u> - Employee training is inadequate within DOR processing sections. Processing training programs seem to be designed to functionally prepare the temporary employee for a specific job task as rapidly as possible. Given high turnover, this approach may be the only way DOR can provide training and expect to recover its investment. There is little to no difference in the type and comprehensiveness of training provided new permanent and temporary employees.

Much of the training is done on the job, by an experienced employee who is often also a temporary. New employees are provided little in the way of formal training material, and much of what is provided must be considered tentative since most work procedures in the Income and Business Processing Sections are currently being formalized, developed and revised.

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* Statistical analysis shows that the difference in the average number of documents worked per hour by short-term temporary versus long-term temporary employees is statistically significant.

** If allowances for training time of newer staff are not included, the productivity figure increases to 29.74 documents per hour, which is still less than the minimally accepted productivity rate of 32.

Increasing Permanent Staff Would Actually Result In Savings To DOR

The costs associated with converting some temporary positions to permanent FTEs would be more than offset by increases in processing efficiency. In the long run the Department of Revenue could experience cost savings.

Generally, permanent staff are more productive than temporary employees. For example, NCR productivity comparisons of permanent and temporary NCR operators indicate that permanent employees are 21.6 percent more productive than their temporary counterparts.

Similarly, in Income Error Resolution, and Math and Data Units, long-term temporary employees are 46.2 percent more productive than less experienced temporary personnel.

Converting temporary staff to permanent positions would result in savings due to the higher productivity of permanent staff. Based on the conservative estimate that permanent staff are 21.6 percent more productive than temporary staff on the average, 37 year-round temporary positions could be replaced with 30 permanent FTE positions* at a savings of approximately $36,279 (see Table 3). If 60 temporary positions are actually used on a continuous basis in processing sections, the savings of replacing these positions with 49 permanent FTEs would increase to $53,342. Further, productivity comparisons of long- and short-term temporary employees in Income Error Resolution, and the Math and Data Unit indicates that the figure may be significantly greater than 21.6 percent.**

* This is in addition to the permanent processing FTEs already converted from temporary positions in fiscal year 1985-86.

** Actual savings of using permanent staff in core processing positions instead of temporary personnel are probably greater. These figures do not take into consideration increased training, quality control and supervision costs associated with the use of temporary employees.

TABLE 3

COST SAVINGS OF CONVERTING
TEMPORARY TO PERMANENT POSITIONS

Position	Number	Temporary Cost(1)	Total	Number(2)	Permanent Cost(3)	Total
Mail Clerk	4	$10,460	$41,840	3	$11,435	$34,305
File Clerk	7	10,460	73,220	6	11,435	68,610
NCR Operator	1	12,820	12,820	1	14,176	14,176
Document Processing Clerk	1	12,590	12,590	1	15,015	15,015
Error Resolution Clerk	24	13,050	313,200	19	15,015	285,285
Total	37		$453,670	30		$417,391
					Cost Savings:	$ 36,279

(1) Based on vendor contract billing rate X 2,088 hours
(2) Assuming that permanent employees are 21.6 percent more productive than their temporary counterparts, each temporary employee is equivalent to .82 percent of a permanent employee with similar responsibility.
(3) Based on yearly salary + ERE (23.44 percent X yearly salary)

Source: Compiled by Auditor General staff from DOR processing support personnel services contract billing rates, Department of Administration official State salary schedule, and employee utilization records

CONCLUSION

The Department of Revenue has relied too heavily on temporary personnel to staff its tax processing sections. Shifting some temporary positions to permanent FTEs would result in greater staff stability, increased processing efficiency and savings to the Department.

RECOMMENDATIONS

1. The Legislature should increase DOR's permanent processing FTE allocations by at least 30 positions. The costs of these increased FTE allocations should be transferred from the temporary personnel budget.

2. DOR should not hire temporary personnel for supervisory, training and key positions in the processing stream. These positions should be filled with permanent employees.

3. DOR should institute a two-tier training program to provide permanent employees with more formalized and intensive training while providing temporary personnel with enough knowledge to adequately complete the tasks assigned to them.

FINDING II

DOR COULD REDUCE PROCESSING ERRORS AND CORRECT ERRORS MORE EFFICIENTLY

The Department of Revenue (DOR) encounters a number of errors that prevent the timely processing of tax returns. An inordinate number of returns are routed to the Error Resolution Group, which slows processing and creates additional work. This is because DOR has not implemented adequate procedures to reduce errors and prevent returns from being referred to Error Resolution. In addition, DOR could reduce the incidence of taxpayer errors and increase processing efficiency through better forms design.

If a tax form contains an error after being entered into the system, the computer will reject it and route the document to Error Resolution. These errors are identified by the computer through various matches, and math and data checks. Examples of errors or problems that go to Error Resolution are:

- Data entered by data entry operators* does not match data entered by the NCR group,**

- Erroneous or inconsistent mathematical calculation on the return,

- The taxpayer used the wrong tax table,

- Two taxpayers used the same social security number for the same tax year, and

- Information on a return does not match computerized information from prior years' returns for the same taxpayer.

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* To expedite the processing of tax returns, most individual income tax forms are keyed by outside data entry vendors. Other types of tax forms are keyed by DOR data entry operators.

** This group utilizes NCR (National Cash Register) machines to automatically serialize each document and check.

Error Resolution clerks take the necessary actions to correct the problems and allow the return to be properly processed. In addition, returns that meet certain criteria can be referred to Error Resolution for verification even though errors had not been previously detected.

Excessive Number Of Tax Forms Are Referred To Error Resolution

For a variety of reasons, a disproportionately large number of tax returns are handled by DOR's Error Resolution Unit. Approximately 40 percent of all individual income tax documents must be corrected by Error Resolution. Moreover, many business tax returns are also referred to Error Resolution, but this is attributable to data processing systems problems as well as errors. High referral rates result in processing inefficiencies and increased operating costs.

Individual Income Tax Processing - According to DOR statistics for the 1984 tax year, 43 percent of approximately 1.2 million individual income tax returns processed as of August 2, 1985, were routed to the Error Resolution Group.* Income tax returns sent to the Error Resolution Group have been rejected by DOR's main computer because of taxpayer errors or DOR processing errors. Taxpayer or tax preparer errors can generally be classified into three broad categories: 1) arithmetic mistakes, 2) use of the wrong tax table, and 3) an incorrect social security number is entered. DOR caused errors result from: 1) keypunch mistakes during the NCR function, 2) keypunch mistakes during the Data Entry function, and 3) systems or programming inadequacies.

We performed an analysis of the returns corrected by Income Error Resolution clerks during a 2-week period in May 1985. As shown in Table 4, our analysis showed that 71 percent of the errors were caused by taxpayers or tax preparers, and approximately 29 percent were caused by DOR or DOR systems inadequacies.

* Most returns were received during the week of the April 15 filing deadline.

TABLE 4

CAUSES OF INDIVIDUAL INCOME TAX ERRORS

	Taxpayer Errors	DOR Errors	Undeterminable Errors	Total
Taxpayer	9,244			9,244
Tax preparer	4,506			4,506
Mail Room		179		179
Document Processing		259		259
NCR		1,040		1,040
Data Entry*		3,259		3,259
Systems/Programming		781		781
Undeterminable			52	52
Total	13,750	5,518	52	19,320
	71.1%	28.6%	.3%	100%

Source: Auditor General study of problems corrected by income tax Error Resolution clerks during a 2-week period in May 1985

* Data Entry errors include those of outside keypunch vendors under contract to DOR.

Business Tax Processing - It was very difficult to review the incidences of business tax return errors because of a lack of DOR data. DOR processes tax returns for the remittance of corporate income tax, sales/use tax and withholding tax.*

According to DOR information as of June 17, 1985, approximately 84 percent of 1984 corporate returns keyed into DOR's computer have been referred to Error Resolution. Many of these referrals, however, are related to systems problems or inadequacies rather than to actual errors. An analysis by Auditor General staff during a 2-week period in May 1985 revealed that a vast majority (89.9 percent) of corporate returns referred to Error Resolution could not be processed by DOR's computer and therefore, had to be manually resolved.

We did not determine the percentage of sales tax returns and withholding tax documents referred to the Business Error Resolution Unit because: 1) no centralized records are compiled by the Business Error Resolution Unit for either sales or withholding taxes, and 2) some sales documents referred to the unit were delinquent and may not be erroneous. (Delinquent returns are assessed penalty and interest charges and must be manually processed by Error Resolution personnel before the receivable is established.) Although DOR processing supervisory staff estimated that approximately 25 to 65 percent of all sales returns filed will be referred to the Error Resolution Unit, no detailed records were kept that verify this estimate. Moveover, because of the complexity of the sales tax system, a complete analysis of the causes of sales tax errors was not performed. Finally, DOR's Processing Manager said that because of continuing systems-related problems, all withholding tax returns filed since the third quarter of 1984 would have to be investigated by Error Resolution personnel.

* Most corporate returns are received by April 15, although returns are received throughout the year due to fiscal year filers. Sales/use tax returns are filed monthly and most withholding tax returns are filed quarterly.

High Referral Rates Impede Tax Processing - High Error Resolution referral rates contribute to inventory backlogs in the Error Resolution Units and increase tax form processing time, because once a form is referred to Error Resolution it must be manually processed. According to DOR's processing manager, the average turnaround time for an individual income tax form that contains only one type of error is 2 weeks.* The majority of this is holding time.

However, if an Error Resolution clerk cannot make the correction through an on-line computer terminal, a maintenance form must be completed and sent to DOR's Data Entry Section. This can add another 1 to 7 days to the process.

In addition to causing delays, manual processing increases operating expenses. DOR estimates Error Resolution personnel expenditures (including expenditures for temporary personnel) to be approximately $884,000. This represents roughly 46 percent of DOR's total processing expenditures for personnel.

Procedures To Detect And Monitor Errors Are Inadequate

DOR has not developed adequate procedures to detect errors and prevent returns from being routed to the Error Resolution Section. DOR does not place enough emphasis on quality control and formal communication among the various processing units. Moreover, employee productivity is not adequately monitored. Finally, DOR does not effectively evaluate the performance of its data entry vendors.

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* Income tax returns can contain up to four different types of errors. In the extreme case, if one return contains all four types, it could go through Error Resolution four times, which could take an average of 8 weeks. This is because each type of error is handled separately by a different section.

Quality Control Is Minimal - At least two of DOR's processing sections make only limited use of quality controls. For example, quality control in the NCR Unit is limited to two areas: 1) ensuring that check totals and batch totals match, and 2) using a check digit on all business forms and labeled income tax returns to verify ID numbers or social security numbers.* Our analysis of the returns in the Income Tax Error Resolution Section revealed that approximately 19 percent of all DOR caused processing errors were attributable to the NCR Unit. Specifically, the majority of NCR errors were incorrectly keyed social security numbers. We estimate that a minimum of 21,500 forms are referred to Error Resolution with social security numbers miskeyed by NCR operators.

Key verification of social security numbers in the NCR Unit would reduce the need to correct miskeyed social security numbers in the Error Resolution Unit, a process that currently involves the services of three DOR employees. First, a filing clerk needs to retrieve the original tax document so it can be reviewed by an Error Resolution clerk. Second, the Error Resolution clerk must reconcile the correct social security number in the original form with the computer printout reflecting the incorrect social security number keyed by the NCR operator. Third, since social security number corrections cannot be made on-line, the Error Resolution clerk must complete a maintenance form which will be forwarded to the Data Entry Unit to be keyed into the computer.

Quality control checks occur in the Mail Room only during the peak income tax season, despite high error rates. An 8-week study conducted by DOR personnel revealed a 10 percent error rate among mail clerks. Most of these errors are identified by Document Processing staff and are informally discussed with the Mail Room supervisor. However, improving formal communication among processing units would enable DOR to more closely monitor errors and staff performance.

* Unfortunately, DOR reports that most income tax filers don't use preprinted labels, therefore, check digit verification of social security numbers can't be performed. In addition, NCR staff have indicated that the check digit on some preprinted labels is erroneous.

A DOR administrator confirmed that no quality control reports are generated and no formal communication exists among the various processing sections. As a result, specific error information and performance feedback is not available to each processing unit. Without this information, employees in the various processing units may not be made aware of their errors in a timely manner and can continue to make the same mistakes.

Employee Performance Is Not Adequately Monitored - DOR processing supervisors have not established adequate formal employee productivity monitoring systems. While productivity forms are utilized in all processing sections, their primary purpose is to monitor the speed of employee productivity, not accuracy.* For example, errors made by Mail Room, Income Document Processing and Business Error Resolution employees are not systematically monitored. Standards for acceptable error levels are not established. Moreover, employee productivity logs in the NCR Unit reflect only keypunch errors that cause batch totals to be out of balance. As discussed earlier, closer monitoring of NCR operators' performance would reduce the number of forms referred to Error Resolution.

Furthermore, two processing sections used poorly designed productivity reports. The Data Entry "operator exception report" is not designed to quantify the number of keypunch errors made by a specific employee. The Math and Data Correction Unit of Income Error Resolution utilized a form that inadvertently captured only a small percentage of the errors made by front-line Math and Data clerks. The form was used for 2 months until the deficiency was corrected.

Vendor Performance Not Evaluated - DOR does not have a formal data entry vendor evaluation program. Without an evaluation program, vendor

* A November 1984 Arizona Chamber of Commerce study of DOR identified similar deficiencies in the prevention of tax processing errors. See Arizona Chamber of Commerce, "Business Applications to Government Program: Department of Revenue - Phase I, Subcommittee Report Findings and Recommendations," 1984, page 4.

performance cannot be accurately measured. Although a data control supervisor schedules the work flow to the vendors, that person is not responsible for monitoring and evaluating the quality of the vendors' performance. As a result, DOR management is unable to compare vendors to each other or to some objective performance standard.

Improvements In Tax Forms And Instructions Could Reduce Errors And Increase DOR's Processing Efficiency

DOR could further reduce errors and increase efficiency by improving the design of its tax forms and instructions. Although DOR encounters an excessive number of taxpayer errors, it does not give enough consideration to reducing recurring taxpayer errors. In addition, arrangement and format of tax form instructions could be improved. Furthermore, efficiency of DOR data entry operations could be increased with better forms design.

In general Arizona individual income tax forms have more taxpayer errors than Federal individual income tax returns. The Internal Revenue Service Center in Ogden, Utah processes Federal individual income tax returns filed by Arizona residents. The latest IRS statistics for the 1984 tax year reveal that approximately 12 percent of Federal individual income tax returns contained taxpayer errors. In contrast, approximately 16 percent of Arizona individual income tax returns contain taxpayer errors.*

Recurring Taxpayer Errors - Recurring taxpayer errors could be significantly reduced if DOR took steps to identify their causes and developed techniques to prevent them. The following examples of recurring taxpayer errors indicate several different problems with existing tax forms and instructions.

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* This percentage is derived from an analysis of DOR data on the number and types of actual taxpayer errors corrected by the Error Resolution Section.

Example 1

DOR officials have indicated that many individual income tax filers have used the wrong tax table. The tax form and accompanying instructions provide little guidance for the taxpayer as to what table to use. More clarification in this area appears to be necessary.

Example 2

Many individual income taxpayers do not include vital information on the form, or present such information incorrectly. DOR has found that often this is the case with social security numbers, number of dependents and parcel numbers for the renter's credit. Although the instructions do include statements on the importance of these items, the number of recurring taxpayer errors indicates that these statements need to be more prominent.

Example 3

DOR has found that in many instances multistate corporate taxpayers have incorrectly calculated the portion of their income earned in Arizona. Although several pages of instructions are devoted to this subject, the high degree of errors indicates that the corporate apportionment section of the form and the corresponding instructions may be overly complex or confusing.

Example 4

The exemption section on the Arizona individual income tax form is often completed incorrectly. The taxpayer should enter numbers in the blind or over 65 exemption boxes on the Arizona form, but DOR often finds these boxes checked instead. This is because the corresponding boxes on the Federal form require check marks. Since many taxpayers fill out the Federal form first, they check the boxes on the Arizona form where a number should be entered, making it impossible for DOR to determine how many exemptions are claimed. This error would be significantly reduced if the exemption section was designed like the Federal form. Dissimilar Federal and State forms can result in taxpayer confusion.

Although DOR recognizes the need to identify common taxpayer errors, it has not effectively identified causes and made appropriate changes to forms in recent years. Input on forms is solicited from within DOR, but there is no formal system that consistently brings recurring errors to the attention of forms designers.* In addition, recurring errors are not systematically tracked by those units that encounter them, such as the Error Resolution Units.

Format Of Instructions - Current arrangement and format of individual income tax instructions can confuse the taxpayer and lead to errors. The 1984 individual income tax instructions booklet has line-by-line instructions beginning with information for filling out page 2 (back page) of the return. This order was adopted in 1984 in an effort to simplify return preparation for the taxpayer. DOR officials felt it would be easier for the taxpayer to complete the back page of the form first. Although the instructions briefly indicate that the return should be filled in beginning with page 2, clear and specific guidance is not given as to the order in which the taxpayers should complete the return. Additionally, the instructions are not clearly set up in a step-by-step format. Therefore, the potential benefits of the order in the 1984 instructions may not be realized.

In addition, the format of the instructions could be generally improved. The headings, print styles and page format are not designed for the taxpayers' ease of use. Section headings are often not highlighted sufficiently to be distinguished from the narratives. Also, although the instructions are presented in various print styles, the items that need to be highlighted are often in small print, while less important items are in very large boldface print. For example, the heading for the Schedule A instructions (itemized deductions) is very small and unnoticeable, whereas

* DOR currently has three full-time employees working on the design and development of tax forms and instructions. In addition, there is a Forms Committee made up of the Director of the Department, the Deputy Director all assistant directors, selected managers and forms staff. This Committee accumulates pertinent information concerning needed forms revisions for each of the areas and then relays this information to the forms staff for use in the development of the forms.

the heading for an example within that section regarding the calculation to determine the landlord deduction factor for real estate taxes is extremely large. Finally, many pages appear crowded and difficult to read because there is often too much small print and not enough white space. All these problems can make it very difficult for a taxpayer to find specific information when needed.*

In contrast to Arizona, the State of California has an individual income tax instruction booklet designed for easier reading. The instructions take the taxpayer step by step through the process of filling out a form. Various print styles and heading sizes also make it easy for the taxpayer to locate specific information when necessary. Section headings and line numbers corresponding to the tax form are highlighted for easy reference. The Appendix (page 51) compares the first three pages of the 1984 Arizona individual income tax instructions to California's first three pages.

Forms Not Conducive To Data Entry - The format of some DOR forms also does not allow for easy data entry keying. For instance, the information that is keyed from the individual income property tax or rents form is scattered throughout the form, complicating data entry. Another difficulty arises because the field for the taxpayer's telephone number is located just above the social security number on the individual income tax form. Thus, the data entry operator can confuse the telephone number with the social security number. A correct social security number is vital for proper taxpayer identification. In addition, frequent changes to some forms have prevented data entry operators from becoming familiar with the form, therefore reducing efficiency.

Part of the reason for these problems has been a poor system for soliciting input from within the Department regarding changes to forms. In past years processing and Data Entry Units were not sufficiently involved in the forms design process, or their input was not given enough consideration. However, DOR is attempting to improve the way input on

* The 1983 instructions appear to be better formatted than the 1984 instructions. In 1983, headings and print styles were used more effectively to make the instructions more readable.

forms is solicited. Input from units within the Department is now being formally requested, and deadlines for submitting suggestions have been established. This should result in more suggestions from processing and Data Entry Units, and allow for better documentation of the input received. Because these procedures are very recent and will impact the 1985 tax year, we were unable to evaluate their effectiveness.

CONCLUSION

A high percentage of tax returns are referred to DOR's Error Resolution Section, because procedures to detect and monitor errors are inadequate. Further, DOR could reduce the incidence of taxpayer errors and increase its processing efficiency by improving the design of its tax forms and instructions.

RECOMMENDATIONS

1. Key verification of social security numbers by the NCR Unit should be instituted in order to reduce the number of tax returns that are referred to the Error Resolution Section.

2. Formal lines of communication should be improved between processing units that uncover errors and units that make errors. For example, communication between Document Processing Units and the Mail Room should be improved.

3. DOR should make better use of employee productivity reports. Employee performance evaluations should be based on accuracy in addition to speed. Standards for acceptable error rates should be used as a basis for comparison.

4. DOR should monitor the performance of its data entry vendors more closely.

5. DOR should identify recurring taxpayer errors, determine their causes, and modify forms and instructions to correct these problems.

6. DOR tax returns should be designed as similar to Federal forms as possible.

7. Complexity of instructions should be reduced.

   - Instructions should be designed to take the taxpayer step by step through the process of filling out a form.

   - The instructions should be better designed for ease of use, with more noticeable line numbers and section headings, and a more readable page format.

8. Input on forms changes should be solicited from processing and data entry personnel. Forms should be made more conducive to data entry and processing operations, and then modified as little as possible from year to year to promote processing efficiency and to facilitate taxpayer preparation.

FINDING III

DOR NEEDS TO IMPROVE ITS CONTRACT MONITORING PROCEDURES

The Department of Revenue (DOR) does not adequately administer and monitor its outside vendor contracts. Poor monitoring of DOR's data entry contracts resulted in overcharges of approximately $423,000 over a 17-month period. Similarly, inconsistencies in the current temporary personnel services contract will result in a minimum of $28,000 in overcharges over the 1-year duration of the contract.

DOR Incurred Significant Overcharges For Outside Data Entry Services

The Department of Revenue does not properly monitor its data entry services contracts with outside vendors. The Department does not systematically verify the number of keystrokes being claimed by vendors. Furthermore, DOR permits vendors to unilaterally determine the legibility of the tax documents upon which keystroke charges are based and does not monitor data entry errors made by these vendors. Although the Department has taken some preliminary steps to address these problems, further action is needed.

To supplement its in-house data entry capacity, DOR uses outside vendors that have been awarded data entry contracts by the State Purchasing Office. During 1984-85, five such contracts were in effect. However, DOR has the flexibility to decide which of these five vendors it will choose for any specific job.* Such decisions are based on the vendor's prior performance, the number of keypunch stations available and turnaround time.

Poor Verification of Keystrokes - The Department of Revenue does not closely monitor the number of keystrokes for which it is being charged by outside vendors. Billing rates per 1,000 keystrokes are clearly defined in the data entry contracts entered into by State Purchasing and utilized

* During fiscal year 1984-85, DOR used two of the five vendors for data entry.

by DOR. These rates are dependent on the type of text being keypunched (alpha or numeric) and the copy quality of the documents. Even though these data entry contracts clearly stipulate that billings are to be based on keystrokes, one vendor improperly based its billings on the number of fields for which data was being inputted and not on actual keystrokes.* Over a 17-month period (January 1984 thru May 1985) this discrepancy resulted in keystroke overcharges of approximately $423,000.** The Department of Revenue, the Attorney General's Office and attorneys for the vendor have recently tentatively settled this case out of court for $369,000.

This billing discrepancy was not discovered until recently. Over the 17-month period during which DOR was being billed improperly, three individuals were responsible for monitoring outside data entry services. It was not until the latest of these individuals was assigned this task that these billing overcharges were uncovered. The two other individuals who had prior responsibility for outside data entry monitoring did not suspect a problem with vendor billings.

In May 1985 DOR compared billing invoices from the vendor in question (Vendor 1) and the data entry vendor used by DOR for 60 percent of its outside data entry (Vendor 2). This comparison revealed that Vendor 1 was charging significantly more than Vendor 2 for comparable work. When Vendor 1 was queried as to how its data entry billings were generated, billing improprieties were discovered.

<u>Poor Monitoring Of Copy Quality Classifcation</u> - Furthermore, DOR permits data entry vendors to unilaterally evaluate the quality of the tax documents from which data will be inputted. This may also lead to overcharges. In 1984-85 one vendor varied its rates based on copy quality. This vendor determined that, in the aggregate, the tax

* Depending on the particular tax document, the number of keystrokes required to input data into a specific field will vary. All fields are not necessarily filled with data on each return.

** According to the Attorney General's Office these dollar figures indicate an overcharge of approximately 340 percent over the actual costs of the service as stipulated in the contract.

documents received for keypunching were of poor (class C) quality.* This vendor's decision was not reviewed by DOR. As a result, this vendor was able to charge a keystroke rate 25 percent higher than if these documents, in the aggregate, were considered of good (class A) quality and 11 percent higher than if they were of fair (class B) quality.**

Even though many income tax documents recieved by DOR are hand written or printed, this does not automatically place them in the poorest category. Furthermore, according to DOR estimates, approximately 50 percent of these forms are typed and should be considered of good to medium quality. Despite this, DOR has not involved itself in the determination of document quality to ensure that the Department is not being billed at a higher rate than necessary. At minimum, some allowances should be made for the significant number of clearly legible tax documents that can be readily keypunched.

No Monitoring of Keypunch Errors - DOR also does not systematically attempt to monitor the number of keypunch errors made by outside vendors. The data entry services contract stipulates that DOR will not be subject to additional charges for 100 percent key verification if the error rate is greater than two per 10,000 keystrokes. Since DOR has no way of knowing if a vendor's error rate (after 100 percent key verification) is greater than .02 percent, it cannot determine if it is liable for the additional key verification charges. These charges are substantial in that the additional costs for this service range from 50 percent to 100 percent of the base keypunch rate, depending on the vendor.

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* There are three categories of copy quality defined in the contract. These are:

Class A Copy: Clear typed copy that is easy to read and enter,
Class B Copy: Fair copy that is either typed, or written or printed clearly and that is fairly easy to read and enter, and
Class C Copy: Poor copy that is difficult to read and enter.

** DOR has recently received data entry proposals from two vendors for 1985-86. Both of these proposals stipulate that DOR will be charged for keypunching at class B rates.

While no data on keypunch error rates is available, a sizeable number of errors corrected by Income Error Resolution can be attributed to keypunch errors. Auditor General staff conducted a 2-week study of tax documents routed to Individual Income Error Resolution in May 1985. Of the tax document errors corrected by Income Error Resolution staff during this period, 17 percent were attributed to data entry keypunch errors.

A periodic sampling of data entry work performed by outside vendors for keying errors would provide DOR with a monitoring mechanism to ensure that data entry errors do not exceed two per 10,000 keystrokes (after 100 percent verification) and that DOR is not being improperly charged for 100 percent key verification.

Preliminary Steps Taken by DOR to Improve Monitoring - The Department of Revenue has taken some preliminary steps to better monitor data entry billings, however further action is needed. A computer program was recently developed that will allow DOR to tabulate the number of keystrokes required to accomplish a specific data entry job. In sample tests conducted by DOR staff, this program has been found to be accurate within 3 percent. This program enables the Department to monitor keystrokes required for data entry but not for 100 percent key verification of the original entries. Nor can this program determine if the vendor error rate is greater than two per 10,000 keystrokes.

Furthermore, DOR has acknowledged the need to become fully involved in the determination of copy quality and has indicated that it plans to do so in the future. However, the Department has not yet decided how it will implement this process.

DOR Does Not Adequately Monitor Its Temporary Personnel Services Contracts

DOR has also not adequately monitored at least one of its temporary support personnel contracts.* Vendor billing rates for this contract were

* DOR currently has two such contracts: one to provide temporary support personnel for processing sections and the other to provide temporary support personnel for its Taxpayer Services Division. Auditor General staff examined contract provisions and billings for the processing contract only.

incorrectly generated. This will result in a minimum of $28,000 in overcharges over the 1-year life of the contract.

Since 1982 the Department of Revenue has hired an outside vendor to supply temporary support personnel for its tax processing function. Vendor contracts are awarded yearly, and by mutual written agreement the provisions of the contract may be extended for a period up to 1 year. DOR entered into the latest temporary support personnel contract for its processing sections in November 1984.

Incorrect Billing Rates - A review of contract provisions revealed that the vendor has charged an average of 16 cents per temporary employee hour more than the contract allows. This disparity is the result of an average shift differential being included in the billing rate, in violation of the contract stipulations. Apparently, shift differentials for the first, second and third shifts were roughly averaged by the vendor and included in the vendor's employee related expenditure (ERE) markup.*

It is unclear how this overcharge occurred. The DOR employee responsible for monitoring this contract could not recall the circumstances surrounding these billing rates.** It appears that this individual relied on the vendor to generate the billing rates and subsequently approved these rates without verifying their accuracy.

Overcharges - Overcharges have resulted from this contract violation. In the request for proposals, the Department estimated that 175,000 hours of temporary support personnel would be needed through the end of the

* The Vendor's ERE markup includes social security, unemployment insurance, worker's compensation, bonding or liability insurance, incentive bonuses, and employee benefits.

** Until Auditor General staff discovered this disparity in the hourly billing rate, this DOR employee and the vendor maintained that shift differentials were being paid by the vendor out of the ERE markup.

contract year. Since each temporary employee hour is being billed at 16 cents over the billing rate formula in the contract, the overcharges incurred by DOR through the duration of the 1-year contract will be approximately $28,000.*

DOR had to lay off most of its temporary personnel for the last 2 weeks of June 1985 because of budget shortfalls. The detrimental effects of this temporary layoff have been extensive (See Finding I, page 7). Without these overcharges, funds would have been available to allow DOR to keep a number of crucial positions in the processing stream staffed by temporary personnel during this 2-week period.

DOR was informed by the Auditor General staff of these billing rate inconsistencies in April 1985. A subsequent review of the contract documents by a representative from the Attorney General's Office concluded that these overcharges are recoverable. The vendor discontinued utilizing the incorrect billing rates as of August 5, 1985. However, negotiations between DOR and the vendor as to how the department will be reimbursed for the overcharges incurred through August 4 have not been completed. DOR and the vendor are in the process of drafting a letter of agreement clarifying inconsistencies in the billing rates and arranging reimbursement for the overcharges.

CONCLUSION

The Department of Revenue has done a poor job of monitoring its contracts with outside vendors. This has resulted in the Department being significantly overcharged for contracted data entry and temporary support personnel services.

* Because DOR's temporary support personnel needs in the processing sections were greater than expected, the temporary personnel budget was increased by approximately 18 percent. This will further increase the amount of overcharges.

RECOMMENDATIONS

1. DOR should institute better controls to ensure that it is not being overcharged for copy quality, keystrokes and 100 percent verification by data entry vendors.

2. DOR should take immediate steps to correct the billing rate inconsistencies in the current temporary support personnel services contract and to recover the overcharges already incurred.

FINDING IV

THE DEPARTMENT OF REVENUE COULD IMPROVE CONTROL OVER RECEIPTS

The Department of Revenue could improve control over its monetary assets to reduce the risk of theft or loss of revenue. In some areas where revenue is received and processed, control procedures are weak. In addition, some automated changes to taxpayer accounts made by Error Resolution personnel are not adequately controlled, creating the opportunity for theft.

DOR Lacks Adequate Control Over Receipts

Control procedures are weak in at least three areas of the Department where checks, money orders, and currency are received and handled. Moreover, DOR cannot continually ensure that procedures and controls in all areas continue to work effectively, because it does not routinely conduct internal audits.

The Department of Revenue collects monies for taxpayer liabilities, and license applications and renewals in Phoenix and Tucson. The Department of Revenue has seven areas that receive some form of tax payment. Areas receiving payments include the Audit Section, Bingo Section, Collections Division, Licensing Section, Mail Room, Document Processing and the Tucson office. For example, in fiscal year 1985 these areas handled a total of more than $2.4 billion. The majority of these monies were handled through the Mail Room and Document Processing areas. Eventually, all remittances are processed through the Receipt and Financial Control Section within the Department of Revenue for deposit with the State Treasurer's Office. The only Departmental policy regarding receipts is that all monies must be deposited within 48 hours.

Revenue Handling Procedures - Receipt handling procedures within some DOR areas do not appear adequate to ensure timely deposits and to safeguard against possible theft and loss. A review of Bingo, the Mail Room and

Central Processing areas indicates that standardized procedures need to be implemented to strengthen present controls.

Auditing standards describe adequate internal controls over monetary assets. The Codification of Statements on Auditing Standards, an authoritative guide published by the American Institute Of Certified Public Accountants, says that "internal accounting controls include the following: 1) separation of duties; 2) physical control over assets; and 3) internal auditing."

The principle of separation of duties requires that individuals responsible for record keeping cannot simultaneously be responsible for asset custody. Example: a person who collects money should not have sole responsibility for updating accounts and depositing funds. This reduces the chance of employee error, theft or falsification of records.

Physical safeguards over receipts entails maintaining security and custody of funds received. Money and deposits should be protected from theft or loss by ensuring that they are stored in a secure location and cannot fall into unauthorized hands. This reduces the chance for theft or loss by limiting and controlling access.

The following cases illustrate weak internal controls in DOR where revenue is received and handled.

Case I

Since the beginning of February 1985, 209 checks satisfying some form of taxpayer liability were sent to outside vendors by accident.* The checks were supposed to be separated from the documents in the NCR Unit prior to data input. This Unit prepares and encodes checks for deposit. The vendors returned the checks after computer entry of the information on the documents.

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* These vendors provide DOR with data input services during the peak season.

Comment

This case documents a basic weakness in physical control of assets. The checks could have been lost with no possible account of their whereabouts. Also, once the checks leave the Department control over them is lost.

Case II

An employee collects remittances for license fees and penalties. On April 18 and May 2, 1985, the employee processed deposits in excess of $62,000. The same employee keeps all payment journals and updates all accounts. No one validates or verifies the entry until a deposit is made.*

Comment

This case indicates lack of separation of duties. The same employee should not perform multiple tasks regarding remittances. Another employee should verify the payments before a deposit is made.

Case III

Employees in Document Processing receive checks by internal mail courier from other areas outside the capitol complex. The deliveries are left at the Individual Income Tax or Business Tax Document Processing desk. The courier has no specific arrival time. Although a supervisor is generally available to accept deliveries, because of the flexible delivery schedule many times a supervisor is not at the desk. No one signs for or in any way acknowledges receipt of a delivery from the courier.

Comment

This case illustrates a lack of control due to inadequate record keeping and physical security. Because no one documents receiving the delivery, and because it can be left on an unattended desk, there is a potential for abuse or theft. Additionally, since there is no scheduled time for the courier to arrive, no one employee can be assigned the responsibility to receive the payments.

Presently, internal controls are developed independently throughout DOR by the seven areas that handle revenue. Weaknesses may exist in receipt handling because these procedures are not reviewed and approved by people knowledgeable in internal control concepts. Even when written control

* In addition, the $62,000 had been collected and held for an undetermined period of time, which violates DOR's 48 hour deposit requirement.

procedures may be adequate, no independent test is performed to assure that controls are working as intended.*

Establishment of Internal Audit Group - All revenue handling controls could be strengthened by establishing an independent internal audit group. Several states and the Internal Revenue Service utilize such groups.

DOR could benefit greatly from the creation of an internal audit group. An internal audit unit could determine the adequacy of existing procedures and controls, and determine whether they are being adhered to. Eleven of 13 states responding to our survey have internal audit units.**

Utah, a state with similar staff size and operating budget as Arizona's, employes three internal auditors. These individuals report directly to the Commission Chief. The goals of the unit are to test compliance with established procedures. The internal audit office performs operational audits of departmental functions, conducts special investigations of departmental personnel in which violations of state statutes are at issue, tests all automated and manual tax processing systems, and reviews automated data processing programs to ensure that the programs have been designed to include adequate controls and are functioning properly.

Also, within the Internal Revenue Service the regional offices provide an internal audit function for the regional and district offices, reporting directly to the Regional Director. The Quality Assurance Branch (the internal audit group) evaluates procedures to ensure that they are working as intended. Also, the Branch reviews the operational functions of each department to determine if additional training or procedures need to be established. It can independently review a problem or concern, or

* DOR has an internal security investigator. He does not have any auditing experience and concentrates primarily on personnel matters.

** Auditor General staff surveyed 12 western states and five other states based on DOR staff recommendations. The states were California, Colorado, Hawaii, Idaho, Iowa, Kansas, Minnesota, Missouri, Montana, New Mexico, South Carolina, Oklahoma, Oregon, Texas, Utah, Washington and Wyoming. Colorado, Idaho, Oklahoma and Wyoming did not respond to our survey, thus were not included.

investigate problems at the request of a section chief or supervisor at a regional office.

Computer System Changes Are Not Adequately Controlled

In addition, some changes to taxpayer accounts made by the Income Error Resolution Unit on DOR's computer system are not adequately controlled. Procedures need to be developed to reduce the opportunity for theft.

Income Error Resolution - Review of the Income Error Resolution Unit indicates that employee fraud has been committed in the past. Error Resolution employees correct errors on tax forms. After corrections are made a form completes the processing sequence. Corrections can involve changes in tax liability or amount refunded to the taxpayer. In October 1984 the DOR investigator investigated cases in which an individual employee made dollar amount changes in excess of the original refund amounts. One change was for $1,619, the other was for $1,673, totaling $3,292. The employee also made name and address changes to the document, so he received the refunds in the mail. DOR would not have uncovered the employee fraud, except another employee who knew of the incident reported it to Department officials. The abuses identify weaknesses in the internal controls of the electronic data processing (EDP) system where error resolution changes are made.

Since the fraud has occurred, DOR has implemented new controls. Supervisor approval is now required on changes over a certain dollar amount. The computer system flags documents with dollar amount changes over the specified limit. In addition, another control prohibits an employee who makes dollar amount changes from making name and address changes to the same document. The Department has instituted a control whereby the employee who changes the amount on a return can submit a form to make name and address changes on that document. This request must be approved by a supervisor.

Although some controls have been developed, they are still insufficient. Our EDP staff reviewed procedures and determined that additional controls are needed to minimize potential abuse. An employee authorized to change refund amounts should not be allowed to request a name or address change. This separation of tasks would reduce the opportunity for employee abuse.

California, for example, has instituted some additional controls. California's computer system also flags documents with dollar amount changes over the specified limit. However, California uses a lower dollar amount than Arizona's. The lower dollar amount increases the chance of detecting potential cases of abuse. Additionally, in California all error resolution changes are subject to a quality review in which the changes are checked for possible abuse or mistake by the employee.

CONCLUSION

The Department of Revenue needs to improve controls over monetary assets. Internal controls over revenue handling need to be strengthened. An internal audit unit is needed to provide independent review of the Department's activities. Also, EDP system controls need to be reviewed and changed to reduce potential for employee abuse.

RECOMMENDATIONS

1. DOR should establish an internal audit unit within the Director's office. The unit should report directly to the Director of the Department of Revenue. The unit's functions should include: 1) reviewing the adequacy of existing controls and procedures, and 2) testing for compliance. The internal audit staff should have training and experience in accounting and internal controls.

2. The Department should develop uniform, Departmental procedures for revenue handling. Also, the Department should use American Institute of Certified Public Accountants' standards to develop and review internal controls.

3. The Department of Revenue should develop a policy for systematic review of EDP Error Resolution changes above a minimum dollar amount. Also, DOR should implement a computer program that reduces the dollar amount an employee can change on a document without an internal program check by the computer.

OTHER PERTINENT INFORMATION

During the audit we developed pertinent information in the area of Department of Revenue's (DOR) development of tax processing procedures.

DOR Currently Developing Needed Written Procedures For Tax Processing

DOR has paid little attention to the development and implementation of standard processing procedures. DOR management recognized this problem after initiating a task force in December 1984. The original intent of the task force was to familiarize employees with existing processing procedures and to make improvements where needed. This was done by bringing employees from various processing units together for group discussions under the guidance of a consultant hired as a facilitator. However, through these discussions it was revealed that current processing procedures and guidelines were either inadequate or nonexistent. Therefore, task force efforts were focused on developing and flowcharting detailed procedures. Initial task force efforts have concentrated on the individual income and sales tax systems. The Deputy Assistant Director of the Administration Division has been assigned the responsibility to ensure that the new procedures are properly documented.

In addition, the Business Error Resolution Section is currently operating without specific current written procedures on how to correct corporate, sales and withholding tax cases. Rather, memos that describe how to correct a specific type of error are written on an "as needed" basis. In contrast, the Internal Revenue Service (IRS) thoroughly documents procedures for correcting errors on tax returns. According to an IRS spokesperson at the regional office in Ogden, Utah, Error Resolution employees are provided with a line-by-line procedures manual. This ensures that erroneous returns are corrected uniformly and efficiently.

AREAS FOR FURTHER AUDIT WORK

During the course of our audit we identified potential areas for further audit work that we could not pursue due to time constraints. These areas include the following.

- <u>Should the Department of Administration, State Personnel Division create special tax processing positions for DOR?</u>

  Currently all DOR permanent front-line processing employees are hired from lists provided by the State Personnel Division of the Department of Administration. The Personnel Division's job descriptions and associated qualifications for these DOR positions are general enough to encompass all similar clerical positions in State government. However, the specific job tasks required of DOR processing employees are such that these general job descriptions and qualifications may not accurately reflect the demands of the positions. Consequently, the salaries established for some DOR processing positions may not realistically reflect the job skills or level of responsibility. As a result, processing sections have experienced difficulties in obtaining applicants with the needed qualifications to fill their vacancies. Further work is needed to verify the extent of the problem and to determine whether changes in some processing job descriptions, position classifications, qualifications and salaries are required.

- <u>Are DOR's computer systems adequately designed to provide for efficient processing of taxes?</u>

  Corporate and individual income tax computer systems were evolved from manual systems. They were not designed specifically to meet current user needs and do not have the flexibility required to meet frequently changing tax laws. Major program modifications are required each year to implement changes resulting from tax legislation. Due to the large number of major program modifications already made, future changes or improvements in the system would be more complex and time consuming.

In areas where the system is inadequate, processing must be done manually. Further audit work is required to evaluate in detail existing computer systems and to determine if it would be desirable to design new systems.

- <u>Is security at DOR's processing facility adequate?</u>

DOR's processing facility is located in close proximity to areas accessible to the public. On one occasion sensitive tax documents were found in an unsecured, publicly accessible location. Further audit work is needed to determine what steps are necessary to provide better security for DOR processing operations.

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

Bruce Babbitt
Governor

September 24, 1985

Mr. Douglas R. Norton
Auditor General
2700 North Central
Phoenix, Arizona 85003

Dear Mr. Norton:

We have completed our review of the draft report on the Performance Audit of the Processing Section. I believe the following points put into perspective our performance over this audit period and are relevant in this evaluation:

- Income tax processing has substantially improved. This year the first income tax refund warrants were issued the week of January 7th and a turnaround of ten days to two weeks was maintained on processible refunds until the peak of the season in mid-April. Less than one percent of refund returns required over ten weeks to process.

- All monies received between April 7th and April 20th during the 1985 peak were deposited by May 2nd. This meant opening over 600,000 income returns plus approximately 105,000 business tax returns to determine if payments were enclosed.

- Two new computer systems were added to the workload without adding additional full-time employees. Corporate income and withholding taxes were also interfaced to our Accounts Receivable Systems.

- Microfilming of income tax documents began, thus eliminating much internal paper handling and providing a more complete and accessible file for assisting the taxpayers, auditors, and collectors.

- Electronic registers were installed to:

  1. Provide more accurate balancing of monies received before processing returns on the mainframe.

2. Provide better tracking of returns.

3. Provide revenue reports for Accounting and Econometrics to use for revenue forecasting and reconciliation.

We recognize progress must continue in our Processing Section. We generally concur with your findings and recommendations.

Your staff has been very cooperative and helpful in the conduct of the Performance Audit. Its findings and recommendations will help us to improve our processing.

Sincerely,

ARIZONA DEPARTMENT OF REVENUE

JE Hibbs

J. Elliott Hibbs
Director

blm/m2

DEPARTMENT OF REVENUE COMMENTS

PRELIMINARY REPORT OF THE AUDITOR GENERAL

PERFORMANCE AUDIT - TAX PROCESSING SECTION

In general, we concur with the findings of the performance audit and have already adopted, are implementing, or planning implementation of most of the recommendations. However, we question the validity of any comments concerning the accuracy, or reliability, of the EDP Systems since an EDP Audit was not performed to substantiate these findings. All but one comment relating to EDP Systems are based on second-hand information.

Finding I: The Department of Revenue's excessive use of temporary employees impairs tax processing productivity.
Recommendation 1: The legislature should increase the Department of Revenue's permanent processing FTE allocations by at least 30 positions. The cost of these increased FTE allocations should be transferred from the temporary personnel budget.

DOR RESPONSE:

WE AGREE THAT WE NEED MORE PERMANENT FULL-TIME EMPLOYEES. WE CONVERTED 30 POSITIONS FROM TEMPORARY TO PERMANENT ON JULY 1, 1985 AND ARE ASKING THE LEGISLATURE TO CONVERT AN ADDITIONAL 14 POSITIONS NEXT FISCAL YEAR.

Recommendation II: The Department of Revenue should not hire temporary personnel for supervisory, training, and key positions in the processing stream. These positions should be filled with permanent employees.

DOR RESPONSE:

YES. WE WILL CONTINUE TO EXPLORE THE OPTIMUM APPROACH FOR ACHIEVING THIS RECOMMENDATION, GIVEN THE CYCLICAL NATURE OF OUR WORKLOAD.

Recommendation III: The Department of Revenue should institute a two-tier training program to provide permanent staff with more formalized and intensive training while providing temporary personnel with enough knowledge to adequately complete the tasks assigned to them.

DOR RESPONSE:

WE AGREE AND HAVE ALREADY TAKEN STEPS TO STRENGTHEN OUR TRAINING PROGRAMS AND PROCESSING PROCEDURES WITH THE HELP OF THE AGENCY'S TRAINING STAFF. IN ADDITION, WE HAVE CONDUCTED TASK FORCE DISCUSSION MEETINGS TO PROMOTE A BETTER UNDERSTANDING OF OUR SYSTEMS AMONG EMPLOYEES AT ALL LEVELS.

Finding II: DOR could reduce processing errors and correct errors more efficiently. Page 16: Excessive number of tax forms are referred to Error Resolution.

DOR RESPONSE:

WE DISAGREE WITH THIS STATEMENT SINCE ONE MUST EVALUATE THE IMPACT OF SUCH FACTORS LIKE THE COST OF ALTERNATIVE PROCESSING. IN REALITY, IF OUR REFERRAL RATE IS ADJUSTED FOR KEYING ERRORS AND COMPARED TO THE INTERNAL REVENUE SERVICE, WE COMPARE QUITE WELL. THIS ADJUSTMENT IS NECESSARY SINCE THE INTERNAL REVENUE SERVICE USES ON-LINE DATA ENTRY WHICH HAS A SEPARATE ERROR RESOLUTION CYCLE.

Recommendation I: Key verification of Social Security number by the NCR Unit should be instituted in order to reduce the number of tax returns that are referred to the Error Resolution Section.

DOR RESPONSE:

WE WILL ANALYZE THIS RECOMMENDATION. IF IT IS COST EFFECTIVE, WE WILL IMPLEMENT IT.

Recommendation II: Formal lines of communication should be improved between processing units that uncover errors, and units that make errors. For example, communication between Document Processing Units and the Mail Room should be improved.

DOR RESPONSE:

WE ARE ALREADY WORKING ON THIS VIA TASK FORCES, WEEKLY PROCESSING MEETINGS, AND MORE TRAINING.

Recommendation III: DOR should make better use of employee productivity reports. Employee performance evaluations should be based on accuracy, in addition to speed. Standards for acceptable error rates should be used as a basis for comparison.

DOR RESPONSE:

WE ALREADY DO THIS ON A LIMITED BASIS AND WILL WORK TO IMPROVE ON THIS STANDARD.

Recommendation IV: DOR should monitor the performance of its data entry vendors more closely.

DOR RESPONSE:

WE AGREE AND ARE DEVELOPING AN EFFECTIVE WAY TO ACHIEVE THIS.

Recommendation V: DOR should identify recurring taxpayer errors, determine their causes, and modify forms and instructions, to correct these problems.

DOR RESPONSE:

THIS IS ALREADY BEING DONE, BUT WITH THE NUMBER OF LAW CHANGES EACH YEAR, IT IS A NEVER-ENDING TASK.

Recommendation VI: DOR tax returns should be designed as similar to federal forms as possible.

DOR RESPONSE:

WE AGREE AND CURRENTLY DO THIS WHEREVER POSSIBLE. THE COST TO CONVERT TO A FLOW THROUGH TAX RETURN, SIMILAR TO THE FEDERAL, IS EXTENSIVE.

Recommendation VII: Complexity of instructions should be reduced. Instructions should be designed to take the taxpayer step by step through the process of filling out a form.
The instructions should be better designed for ease of use, with more noticeable line numbers and section headings, and a more readable page format.

DOR RESPONSE:

WE STRIVE TO IMPROVE INSTRUCTIONS EVERY YEAR AND AGREE THAT FURTHER IMPROVEMENTS CAN BE ACHIEVED. OUR TAXPAYER ERROR RATE IS 16% COMPARED TO 18.2% FOR CALIFORNIA, WHICH WAS USED BY THE AUDITOR GENERAL STAFF FOR COMPARISON PURPOSES.

Recommendation VIII: Input on forms changes should be solicited from Processing and Data Entry personnel. Forms should be made more conducive to data entry and processing operations, and then modified as little as possible, from year to year, to promote processing efficiency and to facilitate taxpayer preparation.

DOR RESPONSE:

THIS IS CURRENTLY DONE, MODIFYING ONLY TO INCORPORATE LEGAL REQUIREMENTS.

Finding III: DOR needs to improve its contract monitoring procedures.
Recommendation 1: DOR should institute better controls to ensure that it is not being overcharged for copy quality, keystrokes and 100 percent verification by data entry vendors.

DOR RESPONSE:

WE AGREE AND ARE FINALIZING PROCEDURES TO ENSURE THIS IS DONE.

Recommendation II: DOR should take immediate steps to correct the billing rate inconsistencies in the current temporary support personnel services contract and to recover the overcharges already incurred.

DOR RESPONSE:

WE HAVE ALREADY TAKEN STEPS TO RECTIFY THE BILLING RATE INCONSISTENCIES AND ARE FINALIZING THE AGREEMENT FOR RECOVERING THE OVERCHARGES.

Finding IV: The Department of Revenue could improve control over receipts.

Recommendation 1: DOR should establish an internal audit unit within the Director's Office. The unit should report directly to the Director of the Department of Revenue. The unit's functions should include: 1) reviewing the adequacy of existing controls and procedures, and 2) testing for compliance. The internal audit staff should have training and experience in accounting and internal controls.

DOR RESPONSE:

WE AGREE WITH THIS RECOMMENDATION, EXCEPT THAT AN INTERNAL AUDIT GROUP, UNLESS IT WERE QUITE LARGE, COULD NOT DO AN EDP AUDIT. EVEN THE AUDITOR GENERAL, WITH ALL ITS RESOURCES, ADMITS THAT IT CANNOT DO AN EDP AUDIT. IF OUR INTERNAL AUDIT GROUP WERE CHARGED WITH THIS RESPONSIBILITY, IT WOULD REQUIRE PROFESSIONAL SERVICES' DOLLARS TO CONTRACT FOR THIS SOURCE.

WE THINK THE AUDITOR GENERAL STAFF SHOULD, INSTEAD, BE EXPANDED TO DO THIS FOR ALL AGENCIES.

Recommendation II: The Department should develop uniform, Departmental procedures for revenue handling. Also, the Department should use American Institute of Certified Public Accountants' standards to develop and review internal controls.

DOR RESPONSE:

WE CONCUR AND WILL EXPLORE METHODS TO ACCOMPLISH THIS.

Recommendation III: The Department of Revenue should develop a policy for systematic review of EDP Error Resolution changes above a minimum dollar amount. Also, the Department of Revenue should implement a computer program that reduces the dollar amount an employee can change on a document without an internal program check by the computer.

DOR RESPONSE:

WE CONCUR, AND WE WILL INVESTIGATE THIS TO DETERMINE THE BEST APPROACH. IF WE ARE NOT CAREFUL, WE COULD END UP WITH A SYSTEM THAT WOULD HAVE SO MANY CONTROLS THAT WE WOULD NEVER GET ANYTHING PROCESSED.

GENERAL INSTRUCTIONS - FORM 140 FOR YEAR 1984

WHO MUST FILE?

Whether or not you must file a return depends on your income and your filing status.

All Arizona residents, including those under 21 years of age, must follow these rules:

You must file if you are	And your Arizona adjusted gross income in 1984 was at least
Single;	
Under 65	$1,834
65 or over	$3,668
Married Filing a Joint Return;	
Both under 65	$3,668
One 65 or over	$5,502
Both over 65	$7,336
Married Filing a Separate Return;	
Under 65	$1,834
65 or over	$3,668
Unmarried Head of Household;	
Under 65	$3,668
65 or over	$5,502

Even if your income is less than the filing requirements above, you must file a return if the gross receipts from your business or your total rents received are over $5,000. Residents of Arizona must report on their return gross income from all sources (including out-of-state income).

Residents, including military personnel, who leave Arizona for a temporary or transitory stay are considered to be residents during their absence and are taxable on all of their income, regardless of where it is earned.

Arizona Resident
A resident is anyone domiciled in this state. Domicile is the place where you have your true, fixed and principal residence and where you intend to return. The place where you live is presumed to be your domicile and that domicile continues until a change in fact occurs. For purposes of taxation, actual residence is not necessary. Domicile is not changed by moving away for a definite period of time or for a particular purpose. Residency continues until you acquire a new domicile. If you live in Arizona for 9 months or more, you will be presumed to be an Arizona resident.

Resident Working Outside of United States
You must file a return if you are an Arizona resident temporarily employed in a foreign country. If you qualify to exclude any foreign source of income on your federal return, Arizona will also recognize the exclusion.

Military Personnel
The service pay of members of the Armed Forces is subject to income tax only by their state of legal residence. If you are in the service, your place of residency when inducted into the service is normally presumed to be your state of legal residence and remains so until you actually establish residence elsewhere and change your service records. You do not lose your Arizona residency solely by being absent because of military orders.

You are subject to the rules under Arizona Resident above.

If you are a nonresident military person stationed in Arizona because of military orders, you are not subject to Arizona tax on your military pay. However, you and your spouse are subject to Arizona income tax on any other income earned in Arizona. Use Form 140NPR.

Part-Year Resident
You are a part-year resident if you were a resident of Arizona for less than 12 months during 1984. That is, you either moved into or out of Arizona during 1984. A part-year resident must report income from all sources for the period of residency in Arizona and only income from Arizona sources for the period of time as a nonresident. Use Form 140NPR.

Nonresident
Nonresidents must pay Arizona tax on income earned within the state, including wages, rental income, business income, gain on the sale of Arizona property, etc. Interest or dividend income from sources outside Arizona generally is not taxed. See Form 140NPR instructions for details.

NOTE: Nonresidents and part-year residents must meet the above filing requirements for their entire yearly income to determine if a return must be filed (even though nonresidents and part-year residents will not be taxed on their yearly income). Go to Form 140NPR for further information.

Deceased Taxpayer
If a taxpayer dies during the taxable year, the surviving spouse or personal representative may be required to file a final return. You should use the form that would have been used if the person had lived. A joint return with the surviving spouse may be filed for the taxable year in which the taxpayer died. The word "deceased" and the

TAX AMNESTY ENDS MARCH 15

TAX AMNESTY is a one-time-only opportunity for Californians to file past returns and pay delinquent personal income taxes without penalty or prosecution.

California has new laws that significantly increase the chances of tax evaders being caught. Before these new laws are fully enforced, California is providing one last chance for taxpayers to clear up past taxes.

TAX AMNESTY applies to all penalties related to 1983 and earlier. Penalties paid before the start of **TAX AMNESTY** will not be forgiven.

TAX AMNESTY IS AVAILABLE TO ANYONE WHO:

- Did not file a required personal income tax return;
- Did not report all taxable income;
- Overstated deductions, credits and exemptions; or
- Is delinquent in paying personal income tax.

TAX AMNESTY WILL BE GRANTED TO THOSE WHO:

- Complete a **TAX AMNESTY** application
- Complete all past due returns and/or
- Amend any incorrect returns.
- Mail the application, all necessary returns and the required payment by March 15, 1985.

To obtain a **TAX AMNESTY** application and all necessary returns, or to get more information, call the Telephone Assistance number for your area listed on the back page of this booklet.

COMPLETING FORM 540

Completing your state return will be easier if you complete your federal return first!

STEP 1. DO YOU NEED TO FILE A RETURN?

A. Your marital status and your income determine if you must file a tax return.

If you and your spouse are filing together and your income is greater than $10,000 you must file. All other taxpayers must file if their income is greater than $5,000.

You must also file if you and your spouse had preference income greater than $8,000. If you are using filing status 4 (Head of Household) or filing status 5 (Qualifying Widow[er]) you must also file if you had preference income greater than $8,000. All others must file if preference income is greater than $4,000. For a discussion of preference income see page 10.

Note: Even if you are not liable to pay tax and not required to file, you should file for a refund if:

- California state income tax was withheld, or
- you qualify to claim the renter's credit.

New: Even if a refund is expected, you **may become liable for a penalty** of up to $100 if you fail to file a timely return which is required by law. Please see the instructions on page 11 for further information.

B. Deceased Taxpayers—A return must be filed for a deceased taxpayer if a return would have normally been required. For further details see "Filing for a Deceased Taxpayer" on page 12 of this booklet.

C. Military Personnel—Nonresident military personnel serving in California are not taxed on military pay. However, a return may be required if:

- California becomes the permanent residence of the military person, **or**
- Income, other than military pay, is earned by military personnel or spouses in California.

California does not tax the military pay of members of the Armed Forces when stationed outside California on permanent orders.

However, a return may be required if:

- The spouse remains a California resident, **or**
- The military person or spouse has income derived from California sources.

For more information please obtain FTB 1032 (Military Personnel Income Tax Liability).

STEP 2. CAN YOU FILE FORM 540?

Were you a California resident for the entire year? If so you may file the enclosed form, otherwise you must file a Form 540NR.

STEP 3. DETERMINING YOUR FILING STATUS

With some exceptions, the filing status used to figure California taxes will be that claimed on your federal return.

If you are unsure of your filing status, use this section to determine the correct one, and check the appropriate box (1 through 6) on page 1 of Form 540.

Using the wrong filing status will cause you to pay too much tax or be liable for additional tax, penalty, and interest.

Filing Status 1—Single

If you filed a Federal Income Tax Return this year and used Filing Status 1—Single, check Box 1 on Page 1 of Form 540.

You are considered single when: you were not married on the last day of the tax year and do not qualify to use another filing status. This includes a person who has obtained a Final Decree of Divorce or Separate Maintenance. If your Decree of Divorce is Interlocutory you are considered married.

You are considered single for tax purposes if all of the following apply:

- You were married but lived apart from your spouse for the entire year, and
- You provided over ½ the cost of maintaining your home during the year, and
- Your home was the principal home of your child or stepchild for more than six months of the year, and
- This child was your dependent.

Note: See Filing Status 6 if this living arrangement was written into a decree of separation. If you meet all of the above tests, and your dependent child lived in your home ALL year, refer to Filing Status 4.

date of death should be entered after the decedent's name in the address section of the form. If you are filing a joint return, please write "filing as surviving spouse" in the area for spouse's signature. You should include the decedent's income up to the date of death and your income for the entire year.

If there will be a refund, Arizona Form 131 must be attached to the front of the return or your refund will be delayed. In addition, as the surviving spouse or personal representative, you may be required to file a Fiduciary return (Form 141) or an Estate Tax return (Form 74 or 76) for the decedent's estate. For further information, please contact the Arizona Department of Revenue, Estate Tax Section, at 255-4424, or the Fiduciary Unit at 255-4022.

Who Should File a Return?
Even if you are not required to file a return due to the above income limitations, you should file a return for any of the following: (1) for a refund of Arizona income tax withheld from your wages (2) to claim the renter's tax credit (3) to claim the property tax or rent credit for persons over 65 or receiving Supplemental Security Income. These can result in a refund even though you have no taxable income. See the instructions on page 13 for details.

Which Form to File?

THE SHORT FORM, 140A

You can use the Form 140A if you meet all of the following qualifications:

1. You are filing a Federal Form 1040A or 1040EZ for 1984, which means your only income was from wages, salaries, tips, interest or dividends.
2. Your income was under $20,000 or under $40,000 if you are married filing a joint return.
3. You are not taking a credit for taxes paid to other states, a solar energy credit, a groundwater measuring device credit or a credit for estimated tax payments.
4. You are not itemizing deductions.
5. You are not making any additions or subtractions to income <u>other than</u> to add the federal and state income tax refunds received in the current year, to add the Federal Two-Earner Married Couple Deduction, or to subtract the federal income taxes withheld as shown on your current W-2 forms or paid in 1984 for prior years.
6. You were a full-year Arizona resident in 1984.

THE LONG FORM, 140

You must use Form 140 if:

1. You are going to itemize deductions (the largest standard deduction Arizona allows is $1,834 if married filing a joint return, $917 for a single person or married filing separately).
2. You are claiming a credit for taxes paid to another state, a solar energy credit, a groundwater measuring device credit or a credit for estimated tax payments.
3. You have income other than wages, salaries, tips, dividends or interest.
4. You are making additions and subtractions to income such as adding non-Arizona municipal interest, adding amount of early withdrawal of Arizona Retirement System contributions, subtracting interest on U.S. obligations, claiming the military exclusion, claiming the lottery exclusion, claiming foreign tax deductions, taking a subtraction for contributions to the Arizona State Retirement System and a subtraction for Social Security benefits included in federal adjusted gross income.
5. Your spouse is filing a separate return and itemizes deductions.

FORM 140PTC

Some residents over age 65 or those receiving Supplemental Security Income may be eligible to file for the property tax credit. This is a refund that is for rent or property tax payments by low income, elderly persons. If you are NOT required to file an Arizona return, fill out and mail the Form 140PTC to claim your refund. If you <u>are</u> required to file a 140 or 140A return, attach Form 140PTC to the back, enter your property tax credit on Line 30 Form 140 or Line 24 Form 140A and check Box. Do not send the 140PTC separately if you must file a 140 or 140A. You <u>must</u> file by April 15 to receive the credit. See Form 140 PTC instructions to determine if you qualify.

FORM 140NPR

If you are a nonresident or a part-year resident, you must use Form 140NPR (see instructions "Who Must File").

When to File
You should file your return between January 1 and April 15. The earlier you file your return, the sooner your return will be processed. It must be postmarked by April 15 to avoid any penalty and interest.

Filing Status 2—Married Filing Joint Return

Check Box 2 on Page 1 of Form 540 if you and your spouse were married on the last day of the tax year and you both agree to file a joint return. You both must sign the return.

Exception: A husband and wife **may not** use this filing status if one spouse was a resident of California for the entire year, and the **other** was a nonresident for any part of the tax year. This restriction does not apply if either spouse is a member of the Armed Forces on active duty.

Filing Status 3—Married Filing Separate Returns

Check Box 3 on Page 1 of Form 540 if you were married on the last day of the tax year and you choose to or must (because of residency difference) file a separate return. **Separate returns must be filed if *one spouse was a California resident for the entire year, and* the other spouse was a nonresident for any part of the tax year.** When married taxpayers file separately each must:

- Include one-half of all community income on each return.
- Include all separate income on their respective returns.
- Use the same method of figuring deductions. Both filers must either itemize deductions or not itemize.
- Each spouse must enter the other's name and social security number in the spaces provided on Form 540.

Filing Status 4—Head of Household

You qualify for Filing Status 4 only if you were considered not married for tax purposes on the last day of the tax year and from your income provided over one-half of the cost of maintaining a home for a certain other individual.

The chart below is designed as an aid to determine if your situation fits the legal definition of this filing status.

You may use Filing Status 4 if the following applies:

If on the last day of the tax year you were:	And, during the tax year you provided over ½ the cost of maintaining a home for:
1. Married, but lived apart from your spouse for the ENTIRE year.	• your child, stepchild, foster child or adopted child — • who is your dependent AND • lived with you for the entire year.
2. Never married, divorced by final decree or legally separated.	• your child, stepchild, foster child or adopted child — • who lived with you for the entire year, **but** • need not be your dependent, or • your parent who was your dependent, and lived in a home you maintained (not necessarily your home), or • your qualified relative who was your dependent and lived with you for the entire year.

Important: In the space provided next to Box 4 on Page 1 of Form 540, enter the name of the person who qualifies you to use this filing status. You **may not** claim a **dependent exemption credit** on line 9 for this person.

Warning: Money received through "Aid to Families with Dependent Children" or "Unemployed Parent" programs cannot be counted toward your share of the household support. If the total of these payments is more than other amounts you made available for support of the household, you do not qualify for Filing Status 4, Head of household.

Filing Status 5—Qualifying Widow(er) with Dependent Child—

This is identical to and has the same qualifying requirements as Filing Status 5—Qualifying Widow(er) with Dependent Child on Federal Form 1040. Check Box 5 on Page 1 of Form 540 if:

- Your spouse died during either of the two tax years preceding the current tax year.
- You did not remarry by the final day of the current tax year.
- For the year in which your spouse died, you were entitled to file a joint return.
- Your dependent child, stepchild, adopted child, or foster child lived with you for the entire year.
- You paid over one half the cost of maintaining the home for the child.

Filing Status 6—Joint Custody Head of Household

Check Box 6 on Page 1 of Form 540 if, on the last day of the tax year:

- You were married but lived apart from your spouse for the **ENTIRE** year, or, divorced by final decree of dissolution or legally separated by decree of separate maintenance, **AND**
- You furnished over half the cost of maintaining your home from your income for the entire year, **AND,**
- Your home was the principal home of your child, stepchild or descendent of your child during the year for not less than 146 days and not more than 219 days. If this child was married at the end of the tax year, the child must also be your dependent, **AND,**
- You have this living arrangement written into a decree of dissolution or separate maintenance, or an agreement made after proceedings are begun and before the decree is issued.

Enter the child's name on the line provided next to Box 6 on Page 1 of Form 540. You **may not** claim a dependent exemption credit on line 9 for this child.

Warning: Money received through "Aid to Families With Dependent Children" or "Unemployed Parent" Programs cannot be counted toward your share of the household support. If the total of these payments is more than other amounts you made available for support of the household you do not qualify for Filing Status 6, Joint Custody head of household

STEP 4—DETERMINING EXEMPTION CREDITS

There are three types of exemption credits: personal, blind, and dependent. The rules governing these credits closely follow federal law. However, California exemptions are deducted directly from your income tax on line 52 of Form 540; and, unlike federal law, California law does not provide additional credit for persons over age 65. Exemption credits **cannot** be refunded.

Line 7—Personal—A personal exemption credit is allowed each person filing a tax return. The amount is determined by your filing status.

- Single (1) or Married Filing Separate Return (3) = \$40 on line 7
- Married Filing Joint Return (2), Head of Household (4) or Qualifying Widower (5) = \$80 on line 7
- Joint Custody Head of Household (6) = \$60 on line 7

If You Can't File on Time
If you can't finish your return by April 15, you may get an extension. But you still must pay at least 90% of your tax liability, as shown on the final return, by April 15 using Arizona Form 204. Your tax liability equals 90% of the amount of tax on Form 140, Line 24, Form 140NPR, Line 24 or Form 140A, Line 22 MINUS Arizona income tax withheld during 1984, Arizona estimated tax payments for 1984 and credits (see Form 204 and instructions for details). An extension will stop the penalty for late filing; however, the penalty may be added if at least 90% of the tax is not paid by April 15. The interest will accrue during the extension period. You must pay the remaining tax and interest when the return is filed.

If you get a federal extension before April 15, Arizona will allow the same extension but not more than 6 months. Attach a copy of the "granted" (if other than automatic) federal extension (Form 4868 or 2688) to the front of your Arizona return when mailed. You must still pay Arizona 90% of your tax liability by April 15.

If you don't get a federal extension, you can still request an Arizona extension using Form 204 (in this booklet). You must submit Form 204 by April 15. The approved form will be returned to you. Remember, to avoid penalties, you must send 90% of your tax liability with Form 204 before April 15.

If a return is filed late without an extension, both penalty and interest charges will be added to your tax bills. The penalty for filing after April 15 is 5% a month to a maximum of 25% of the amount of tax that you owe. For information regarding the current interest rate, please contact the Arizona Department of Revenue at 255-3381.

It is important to know that if you file your return after April 15 without an extension attached, your renter's tax credit or property tax credit will not be allowed.

Where to File
Use the envelope that came with your return. Mail your return to: Arizona Department of Revenue, Post Office Box 29002, Phoenix, Arizona 85038.

Where to Get Forms
Forms will be mailed directly to you, if you filed a 1983 Arizona return and you checked "Yes" to the question "Do you need a tax form booklet mailed to you next year?" If you do not receive forms, they are available at many banks, post offices and libraries, or you can write to: Arizona Department of Revenue, Attention: Forms, 1700 West Washington, Phoenix, Arizona 85007. Please allow three weeks for forms to arrive.

Rounding Off to Whole Dollars
You may round off cents to the nearest whole dollar. If you round off, do so for all amounts. Eliminate any amount less than 50¢ and increase any amount from 50¢ through 99¢ to the next highest dollar.

Estimated Tax Payments
You are no longer required by Arizona law to make estimated payments as of January 1, 1985, but you may want to make advance payments in any amount if you are:

a. Self-Employed - and have no Arizona tax withheld

b. Employed - and don't have enough Arizona income tax withheld. You may increase your withholding to 15% or 20% of federal tax withheld or you may make advance payments.

c. Retired or anyone else - and don't have any Arizona tax withheld on pensions, dividends and interest income, etc.

If you are due a refund on your Arizona income tax return, you may apply this refund to your next year's estimated tax payments by entering the amount to be applied against 1985 estimated taxes on Line 38.

If You Can't Pay on Time
If your return is completed but you cannot pay the tax you owe, mail the return by April 15 without the money. This will stop the late filing penalty but you will be charged interest on the amount of tax you owe until paid. In accordance with Arizona law, failure to pay taxes due can result in a lien being placed against a taxpayer's real or personal property. Each January 1, interest on unpaid taxes will be added to the principal amount due, and that total amount will accrue additional interest at the legal rate.

What if You Must Change This Year's Return or Made a Mistake on Last Year's Return?
You have four years to amend (change) a return. Use Form 140X. Do NOT file a new return Form 140 for the year to be corrected. If you have been audited by the IRS and a change is made to your federal return, Arizona requires you to file an amended Arizona return for the years changed by the IRS. Use Form 140X and attach a complete copy of the IRS agent's report. Also, if any other changes have been made to your federal return, you must amend your Arizona return. Arizona law requires an amended return within 90 days after the federal change if additional tax is due.

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Line 8—Blind—An exemption credit may be claimed by you and/or your spouse if either or both are visually impaired.

- If you or your spouse is visually impaired enter $13 on line 8
- If both you and your spouse are visually impaired enter $26 on line 8

A medical statement establishing this impairment should be attached to your return the first time this credit is claimed.

This statement must certify that you or your spouse are completely blind or that:

- you or your spouse cannot see better than 20/200 in the better eye with glasses or contact lenses, or
- you or your spouse have a field of vision not more than 20 degrees

Line 9—Dependent— A credit is allowed for each person you list on your return as a dependent. These should be the same as those claimed on your Federal return.

Exception: You **CANNOT** claim a credit for the person who qualified you to use filing status Head of Household (4) or Joint Custody Head of Household (6).

Exception: Though not your dependent or relative, you **may claim** a credit for a high school or elementary school student you supported in your home for at least six months, by written agreement with a charitable organization, which does not reimburse you for the expense.

Note: You cannot deduct the student's support as a charitable contribution.

A. In the space provided at line 9, enter the name and relationship of your dependents.

B. Multiply the number of dependents listed by $13, and enter the result on line 9.

Line 10—Total Exemption Credits—Add lines 7, 8, and 9. Enter the total on lines 10 and 52.

STEP 5—TOTALING YOUR GROSS INCOME

Always round off cents on your return to the nearest whole dollar.

If the amount you are entering on any income line is a loss, enclose that amount in brackets to indicate a negative number. Example [1,000]

Line 12—Wages, Salaries, Tips, etc.—On line 12, enter the total of all wages, salaries, or tips. Generally, this amount should be the same as the amount you entered on line 1 of Federal Form 1040EZ, line 6 of Federal Form 1040A, or line 7 of Federal Form 1040. These amounts should appear in box 10 of Form(s) W-2 issued to you or your spouse by employers.

Note: Actual tips or other compensation received must be included on line 12, even if not included on Form W-2 by your employer.

Attention Social Security recipients! Even though you may be required to report part of the Social Security payments you received as income on your Federal return, California **DOES NOT TAX** any portion of Social Security benefits.

Note: California does **not tax** any portion of unemployment compensation.

Line 13—Interest Income—On line 13, enter all interest income received, including but not limited to interest from securities guaranteed by the Government National Mortgage Association, obligations of other states or their municipalities, and credit union accounts.

Exception: Do not include:

- Interest received on obligations of the U.S. government or its possessions,
- Interest received on bonds of the District of Columbia,
- Interest received on bonds of the State of California and its political subdivisions,
- A percentage of the interest received from mutual funds equal to the percentage of assets the mutual fund has invested in California state and local bonds. The mutual fund must have invested at least 50% of assets in such bonds for any of the interest received to be exempt.

If total interest income is greater than $400, complete Part 1 of Schedule B (540).

Line 14—Dividends—On line 14 enter all dividend income received. Unlike Federal law:

- California has no dividend exclusion,
- California does not allow capital gains treatment of dividends,
- California taxes distributions received from "small business corporations" (Federal subchapter S) as dividends, and,
- California does not allow an exclusion of reinvested dividends from Public Utilities that are received as stock rather than cash.

If total dividend income is over $400, complete Part II of Schedule B 540.

Line 15—Alimony Received—Enter all amounts received in 1984 as alimony or separate maintenance. This amount is the same as that entered on line 11 of Federal Form 1040.

Line 16—Business Income or Loss—Complete and attach part C Schedule C-E-F to your return. Enter the total amount of profits or losses from businesses or professions from line 9 of the part C portion of Schedule C-E-F (Form 540). Please refer to the C-E-F instructions on Page 14.

Line 17—Capital Gain or Loss—Complete and attach either Schedule D or D-2 (Form 540). On Line 17 enter the taxable amount of the gain or loss arising from the sale or exchange of capital assets.

The Schedule D (540) contained in this booklet will serve as a reconciliation between the amount of capital gain or loss reported on line 13 of Federal Form 1040 and the amount you will report on line 17 of Form 540 for the most common and simple capital asset sales.

Schedule D (540) may be used to figure capital gain or loss when:

- The capital gain or loss was not the result of the sale or exchange of a nonproductive asset or small business stock.
- No capital loss carryover is being claimed for California tax purposes.
- The only gains or losses were reported on Federal Schedule D (1040) on lines 1 and 9.
- Assets were not inherited or acquired from a decedent.

If you are not able to use Schedule D (540) please obtain Schedule D-2 (540) to determine the amount to enter on line 17.

Line 18—Supplementary Gains and Losses—Complete and attach **Schedule D-1** (Form 540). On line 18, enter the gain or loss from:

1. The sale or exchange of trade or business property, depreciable and amortizable property, and oil and gas property, and
2. Involuntary conversions.

Line 19—Fully Taxable Pensions and Annuities—On line 19 enter pension and annuity income that is entirely taxable. Pension and annuity income is taxed in full when:

- You did not make any contributions to or pay anything for the pension or annuity.
- The entire contribution you made has been previously recovered tax free.