



**REPORT OF  
THE  
STATE AUDITOR**

**STATE OF COLORADO  
DEPARTMENT OF REVENUE  
SALES TAX PERFORMANCE AUDIT  
JULY 1999**

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July 23, 1999

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the collection and distribution of state and local sales taxes by the Department of Revenue. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, and recommendations, along with the responses of the Department of Revenue.

A handwritten signature in black ink, reading "J. David Barba".

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**Sales Tax Performance Audit  
Department of Revenue  
July 1999**

**Authority, Purpose, and Scope**

This performance audit was conducted under the authority of Section 2-3-103, C.R.S, which authorizes the Office of the State Auditor to conduct performance audits of all departments, institutions, and agencies of state government. The audit was undertaken at the request of the Executive Director of the Department of Revenue, who asked the State Auditor to help resolve concerns of Larimer County regarding its 1998 sales tax receipts. After a preliminary review of Larimer County's receipts, we decided to expand the audit to an evaluation of the Department's sales tax collection and distribution processes. The audit was conducted in accordance with generally accepted government auditing standards. Our procedures included reviewing documentation, interviewing staff of the Department of Revenue, analyzing data, and discussing the sales tax process with county representatives. Audit work was conducted between April 1999 and July 1999.

The purpose of the audit was to evaluate the Department's processes for collecting and distributing sales taxes, including the following: (1) sales tax processing; (2) business registrations; and (3) customer service. We did not review the areas of enforcement and compliance, except as issues arose in our review of collections and distributions. We examined the processing of over 500 taxpayer accounts as part of our analysis of the Department's sales tax operations. We reviewed the results of a survey prepared by Colorado Counties, Inc. to determine county satisfaction with the Department's operations. We used Larimer County as a case study to determine the effects of the Department's policies on local jurisdictions. Our investigation included a cross section of taxpayer accounts from Larimer County.

This report contains 23 recommendations for improving sales tax-related operations. The following summary provides highlights of the comments, recommendations, and agency responses contained in the report.

**Sales Tax Management**

The Department collected almost \$2 billion in sales taxes in Calendar Year 1998. This is about 50 percent more than that received only five years ago. Of this amount, about \$372 million was collected on behalf of more than 200 local taxing jurisdictions, and \$227 million on behalf of special districts. The importance of effective tax collection and distribution operations at the Department cannot be overstated.

*For further information on this report, contact the Office of the State Auditor at (303)866-2051.*

We found that the Department needs to completely overhaul its sales tax management system. Despite the significant rise in collections, the Department's processes for, and resources dedicated to, managing sales taxes have changed little over the past 20 years. Processing and distribution methods are inefficient and archaic. As sales tax growth continues, we are concerned that the Department lacks the ability to administer local sales taxes effectively.

We recommend that the Department undertake a comprehensive evaluation of its sales tax management system and implement a plan for improvement that satisfactorily addresses the current and future needs of local jurisdictions.

### **Sales Tax Processing**

Accurate distribution of sales taxes to the correct state and local government authority is a key outcome of the Department's sales tax processing systems. During the audit we found pervasive problems with the collection and processing of sales taxes, as follows:

- Through our testwork, we identified about \$16.7 million in sales tax revenue remitted in the period from 1994 through March 1999 that is currently held in suspense status. More than \$4 million in the suspense accounts has been there since 1996. Sales tax returns are held in suspense until problems with a taxpayer's filing are resolved. Suspense accounts are buried within the State's major sales tax account and are identifiable only through special data runs. Prior to our audit, the Department was not aware of the volume of transactions in suspense status. We found the \$16.7 million from two special reports that the Department generated at our request. The Department's preliminary investigation indicates that accounts coded with an 800 may include accounts with payments that need to be resolved and distributed to local jurisdictions and the State (as the code was intended); delinquent accounts; and accounts that have actually been resolved and distributed, but left in suspense in error.
- Key information, such as county and city sales information, is not captured. As such, counties and cities do not have adequate information to forecast future sales or estimate sales tax revenue, and the Department does not have adequate information to determine if sales taxes collected on behalf of counties and cities are reasonable.
- The Department does not perform basic math verifications of county or city sales tax. Math checks compare the payment amount as reported on the tax return with the amount that the business should have paid. Math checks are only being performed for amounts entered for the state and special districts.
- In examining a sample of Larimer County accounts, we found that 14 out of 362 accounts tested (about 4 percent) did not use the new tax rate when calculating the amount of tax due. Of the approximately \$206,000 in additional tax due Larimer County identified through

sample testing, \$132,000 was related to businesses applying the incorrect tax rate. The Department lacks the ability to recalculate taxes owed for all filers because it does not collect complete information on sales and does not perform math checks on county and city data.

- Notices are not being sent to businesses that fail to file a sales tax return as expected. Out of 120 accounts tested, we identified 21 that should have received non-filer notices. However, notices were not sent to 7 of these accounts.
- Basic reasonableness tests are not being conducted. These simple tests would determine whether collection amounts and distributions to taxing authorities appear appropriate. Of the approximately \$206,000 that the Department confirmed is due to Larimer County, our analytical review identified about \$74,000 in sales taxes due but not collected. These were for accounts where the amounts received were not reasonable given amounts received in prior periods.
- The Department has not identified or addressed errors made in calculating the statutory 3 1/3 percent vendor fee. In one test, 6 out of 120 taxpayers had calculated the vendor fee incorrectly. While the net amount of error (overs and unders) was less than \$20 in our sample, the error rate could be substantial for the thousands of returns processed by the Department.
- We found numerous problems with the tax returns submitted by taxpayers that file via spreadsheet. Spreadsheet filers are generally the largest taxpayers in the State and account for a substantial amount of tax revenue. The most significant problem is that these taxpayers do not have to provide taxable sales information. This severely limits the Department's ability to review the accuracy of the return. Also, out of 15 taxpayer accounts tested, 10 did not complete the form properly, 14 reported different business locations compared to the Department's records, and 9 did not submit taxes due for all applicable taxing authorities according to the Department's records.
- Sales tax returns are not filed electronically; rather, the Department manually processes more than one million sales tax returns a year, inherently resulting in errors. Electronic filing would eliminate manual data entry of lengthy spreadsheet returns and reduce the risk of error.
- The Department does not consistently process payments received for a local government whose taxes are not collected by the Department. Payments may be forwarded to the local jurisdiction, refunded to the business, or credited to the business's account with the State.
- We found duplication of effort in the editing process and the maintenance of tax rate tables. Several areas within Revenue are responsible for maintaining and updating sales tax information on separate databases. These areas are independently researching and making



changes to the same information. However, these changes are not being communicated between the areas.

- Clear direction needs to be provided to businesses on how to report sales information correctly. Some taxpayers failed to report any sales information, some reported combined sales for all business locations, and some reported sales information on a location-by-location basis. This impacts the accuracy of sales information maintained and disseminated by the Department.

In the following report, we provide recommendations for improving sales tax processing procedures.

### **Sales Tax Registration**

All businesses located in Colorado that sell tangible personal property at the retail or wholesale level must acquire a sales tax license from the Department of Revenue. Businesses also register trade names of a company with the Department. The following items highlight issues identified in the sales tax registration process. These issues could result in taxes being collected or distributed to the wrong jurisdiction or not being collected at all.

- Taxpayer accounts are established without all required information. We were informed of duplicated accounts, branches set up as single businesses, and incorrect addresses.
- The Department does not have standard procedures for accurately distributing taxes received from businesses that have relocated during a tax period.
- Account changes are not made uniformly. Whenever a taxpayer changes basic information, separate systems for income, sales, severance, withholding, or any other tax account must be changed independently.
- Verification of business locations is inadequate. In one test, 3 out of 60 businesses had a different business address from that recorded in the Department's records.
- The Department does not have a process to notify businesses of changes in county or city boundaries.

In the report, we provide recommendations for improving management of sales tax registration.

### **Customer Service**

Counties, cities, and special districts rely heavily on the Department to ensure that amounts collected and distributed are accurate, complete, and timely. An important part of the tax collection and

distribution process is customer service. During the audit, we found areas where customer service could be improved:

- Counties, cities, and special districts are not receiving basic sales information from the Department. Monthly reports are distributed to the counties and cities but these contain limited information. Additional information, such as state sales statistical information and analytical information, is either not provided or is only provided at the request of a local jurisdiction.
- Statutes relating to confidentiality issues are being narrowly interpreted by the Department to mean that local governments may access only their own local tax information. This directly impacts the Department's ability to provide on-line information regarding sales taxes to counties and cities. Electronic access to payment information could greatly enhance a local jurisdiction's ability to analyze sales data.
- We found that counties are generally dissatisfied with the amount of time it takes to get a satisfactory response from the Department. In some cases a response could take weeks or months. The Department does not (1) track the number and type of inquiries and complaints it receives; (2) monitor response time; (3) provide status reports to local jurisdictions regarding inquiries; and (4) prioritize the most significant requests.
- There is a general lack of understanding of the responsibility of the Department and of local jurisdictions. According to statutes, the Department is responsible for sales tax collections for local jurisdictions. Frustration with inadequate attention to local tax collection has resulted in at least one county assuming significant responsibility for collections. A duplication of effort can occur when there is a lack of clarity regarding the responsibility of the Department and local governments.

We recommend that the Department improve its policies and procedures relating to customer service.

In the past the Department has addressed sales tax management issues on an adhoc basis. The Department's approach has not worked. As sales tax growth continues, strains on Department resources, operations, and information systems will only be magnified. The Department needs to take immediate steps to address the problems we have identified, or it will not be prepared to handle sales tax collections and distributions in the future.

The Department of Revenue agrees with our recommendations. The Department's responses can be found in the recommendation locator.

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	24	The Department of Revenue should undertake a comprehensive evaluation of its sales tax management system and implement a plan for improvement that satisfactorily addresses the current and future needs of local jurisdictions.	Agree	6/30/00
2	31	<p>The Department of Revenue should immediately improve its management of accounts held in suspense status to eliminate the backlog and to ensure timely distribution to the State, counties, cities, and special districts. Specifically, the Department should:</p> <ul style="list-style-type: none"> <li>a. Develop a separate account on the State's accounting system to track the dollar amount of sales tax payments for which there is insufficient data to distribute in the future. The Department should use this information to monitor, control, and distribute these sales tax payments.</li> <li>b. Capture sales tax payments for which there is insufficient data to distribute in the aggregate and on a filer-by-filer basis.</li> <li>c. Reallocate staff resources to manually identify, control, and distribute the backlog of accounts held in suspense status, acquiring additional temporary resources, if necessary.</li> <li>d. Develop systems, procedures and controls over the resolution and distribution of taxpayer accounts held in suspense status.</li> </ul>	Agree	9/30/99
			Agree	7/31/99
			Agree	10/31/99
			Agree	10/31/99

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
3	34	The Department of Revenue should require all businesses to report sales tax information, including gross sales, net taxable sales, and tax rates, for all applicable taxing authorities on sales tax returns. The Department should capture this tax information and make it available, for tracking and forecasting purposes, to counties, cities, and special districts through standard statistical reports.	Agree	10/31/99
4	35	The Department of Revenue should perform the same basic verification of taxes, via the math audit, for county and city sales taxes that it performs for state sales taxes.	Agree	1/01/00
5	37	<p>The Department of Revenue should verify that it is collecting the correct amount of sales tax by:</p> <ul style="list-style-type: none"> <li>a. Recalculating taxes owed for all filers for each taxing jurisdiction.</li> <li>b. Obtaining missing information to recalculate taxes owed for all accounts in Larimer County not previously reviewed due to incomplete information. This information should be obtained for at least the 250 largest accounts.</li> <li>c. Sampling sales tax accounts in other counties and cities that have recently implemented tax increases to determine whether similar problems with applying correct tax rates exist in these jurisdictions. If so, the Department should work with these counties and cities to identify methods for investigating and resolving tax collection issues.</li> </ul>	Agree	1/31/00

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
6	39	The Department of Revenue should initially evaluate the criteria by which non-filer notices are generated and periodically review changes in criteria to ensure the proper level of notification is maintained.	Agree	6/30/00
7	41	<p>The Department of Revenue should develop analytical review techniques to test the reasonableness of sales tax payments received. These should include at a minimum:</p> <ul style="list-style-type: none"> <li>a. Comparison between the current and prior month's payment.</li> <li>b. Comparison between the last period with an old tax rate and the first period with a new tax rate for jurisdictions implementing changes in tax rates.</li> <li>c. Comparison between the same month's payment in the current and prior year.</li> </ul>	Agree	6/30/00
8	42	The Department of Revenue should apply basic analytical procedures for at least the 250 largest accounts in Larimer County to determine if additional revenue is owed to the County.	Agree	1/31/00
9	43	The Department of Revenue should establish procedures to verify the accuracy of the vendor's fee deduction. These procedures should include edits for detecting miscalculations that result in over- or underpayment of sales tax and should ensure vendor's fees for late filers are consistently deposited in the State's General Fund.	Agree	1/31/00

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
10	45	<p>The Department of Revenue should improve spreadsheet filing processes to reduce errors and improve sales tax collections by:</p> <ul style="list-style-type: none"><li>a. Disallowing the vendor's fee when spreadsheet filers persistently submit incomplete or inaccurate returns.</li><li>b. Implementing procedures to detect errors on spreadsheet returns. This should include identifying discrepancies in branch locations and ensuring complete remittance of taxes due for each taxing jurisdiction.</li><li>c. Developing an electronic format, including applicable tax rates for each taxing authority by location, for spreadsheet filers.</li></ul>	Agree	6/30/00
11	48	<p>The Department of Revenue should pursue electronic filing for sales taxes. As an intermediate step, the Department should utilize available technology to develop electronic filing options for spreadsheet filers. Large businesses should be required to file in this manner.</p>	Agree	6/30/00
12	49	<p>The Department of Revenue should return payments to taxpayers when they remit taxes to the Department in error.</p>	Agree	1/31/00

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
13	50	The Department of Revenue should address duplication in sales tax processing and information systems by: <ul style="list-style-type: none"> <li>a. Modifying its system to perform math audits after initial edits have been completed.</li> <li>b. Abandoning the maintenance of separate tax rate information databases.</li> </ul>	Agree	1/31/00
14	52	The Department of Revenue should clarify instructions on how to report sales information accurately and expand training for those taxpayers that have multiple locations.	Agree	11/30/99
15	55	The Department of Revenue should obtain all information necessary to properly establish a new sales tax account. This includes street address, other tax identification numbers, telephone number, and information about any main offices. Information should be requested for missing data.	Agree	1/31/00
16	57	The Department of Revenue should develop policies and procedures regarding distribution of taxes received from businesses that have relocated during a taxing period.	Agree	1/31/00
17	57	The Department of Revenue should evaluate the feasibility of developing a computer interface among the various tax systems that is capable of locating and listing all accounts maintained by the Department for a single taxpayer.	Agree	6/30/01

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
18	59	The Department of Revenue should investigate system improvements that would provide the capability for electronic identification of taxing jurisdictions by using street addresses.	Agree	6/30/00
19	59	The Department of Revenue should work with the General Assembly to assign responsibility to taxing jurisdictions for notifying the State when boundaries change. The Department's tax rate notification system should be utilized to notify taxpayers of the changes in taxing jurisdiction.	Agree	6/30/00
20	63	<p>The Department of Revenue should improve information available by working with local governments to develop a standard comprehensive reporting package. At the minimum, the package should include:</p> <ul style="list-style-type: none"> <li>a. State statistical information.</li> <li>b. Expansion of the current distribution report to include county and city taxable sales.</li> <li>c. Variance reports showing payments that vary significantly from the same period in the prior year.</li> <li>d. Reports showing the amount of payments due from filers who have underpaid taxes in addition to businesses that have failed to file a return.</li> <li>e. Reports listing those businesses that have registered a trade name but have not applied for a sales tax license.</li> </ul>	Agree	1/31/00

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## RECOMMENDATION LOCATOR

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<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Agency Response</b>	<b>Implementation Date</b>
21	65	The Department of Revenue should seek clarification of confidentiality statutes that would enable counties and cities to have electronic access to sales tax data.	Agree	1/31/01
22	66	The Department of Revenue should improve its customer service by :  a. Tracking inquiries by number and type.  b. Monitoring response time.  c. Providing status reports to users.  d. Developing a policy to prioritize the most significant requests.	Agree	6/30/00
23	68	The Department of Revenue should work with local governments to set forth roles, responsibilities, and expectations for all areas of sales tax collection. All agreements should be documented in writing in the form of a Memorandum of Understanding.	Agree	6/30/00

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# Overview

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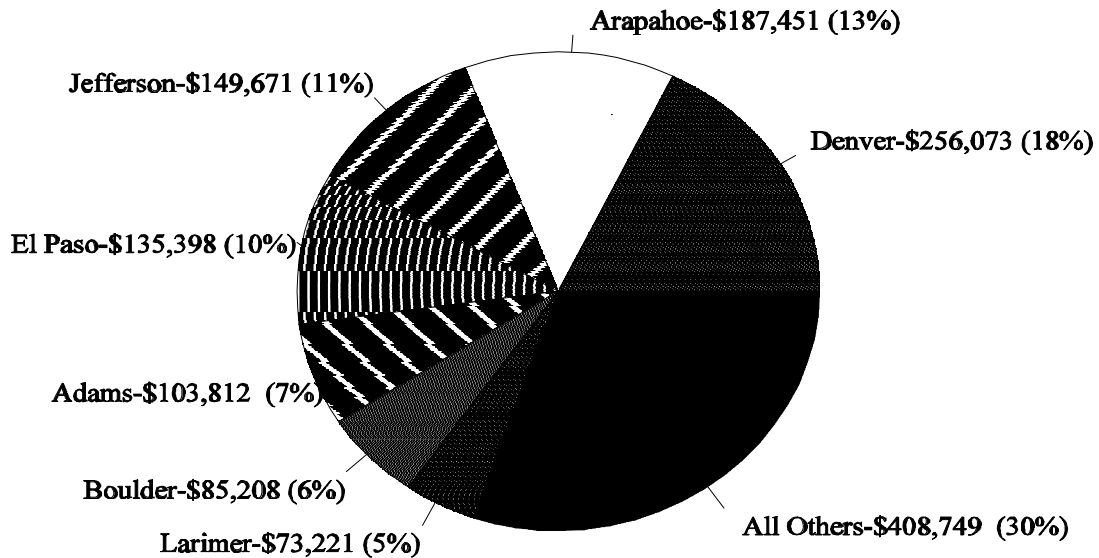
The Taxation Group within the Department of Revenue is statutorily responsible for collecting, administering, and distributing state, county, selected city, and special district sales taxes. According to Section 29-2-106(2), C.R.S., "The collection, administration, and enforcement of any countywide or any city or town sales tax... shall be performed...in the same manner as the collection, administration, and enforcement of the Colorado state sales tax." Each local jurisdiction sets its tax rate and determines what types of transactions are subject to its tax. With more than 200 local jurisdictions, this creates a very complicated tax system to administer. Collections of sales taxes reached almost \$2 billion in Calendar Year 1998. This is about 50 percent more than that received only five years ago.

The importance of sales tax revenue to local jurisdictions cannot be overstated. On the average, sales taxes account for about 9 percent of a county's revenue. However, this varies widely from county to county because some counties do not assess a sales tax. For other counties sales tax revenue accounts for more than 50 percent of their total revenue. Sales taxes are being increasingly relied upon as a major source of revenue to fund capital projects as well as ongoing operations. The ability of local jurisdictions to predict their tax revenue is essential to cash management practices, allocation of resources, and funding decisions.

## State Sales Tax

State sales tax revenue accounts for about 20 percent of the State's General Fund revenue. The Department collected about \$1.4 billion in state sales tax in Calendar Year 1998. State sales are taxed at a rate of 3 percent. The chart on the following page shows what geographic areas contributed significantly to the State's sales tax revenue in Calendar Year 1998.

### State Sales Tax Collections in Calendar Year 1998 (In Thousands)



**Source:** Office of the State Auditor's analysis of Revenue data (Office of Tax Analysis' Statistical System). Sales tax collections as of April 27, 1999.

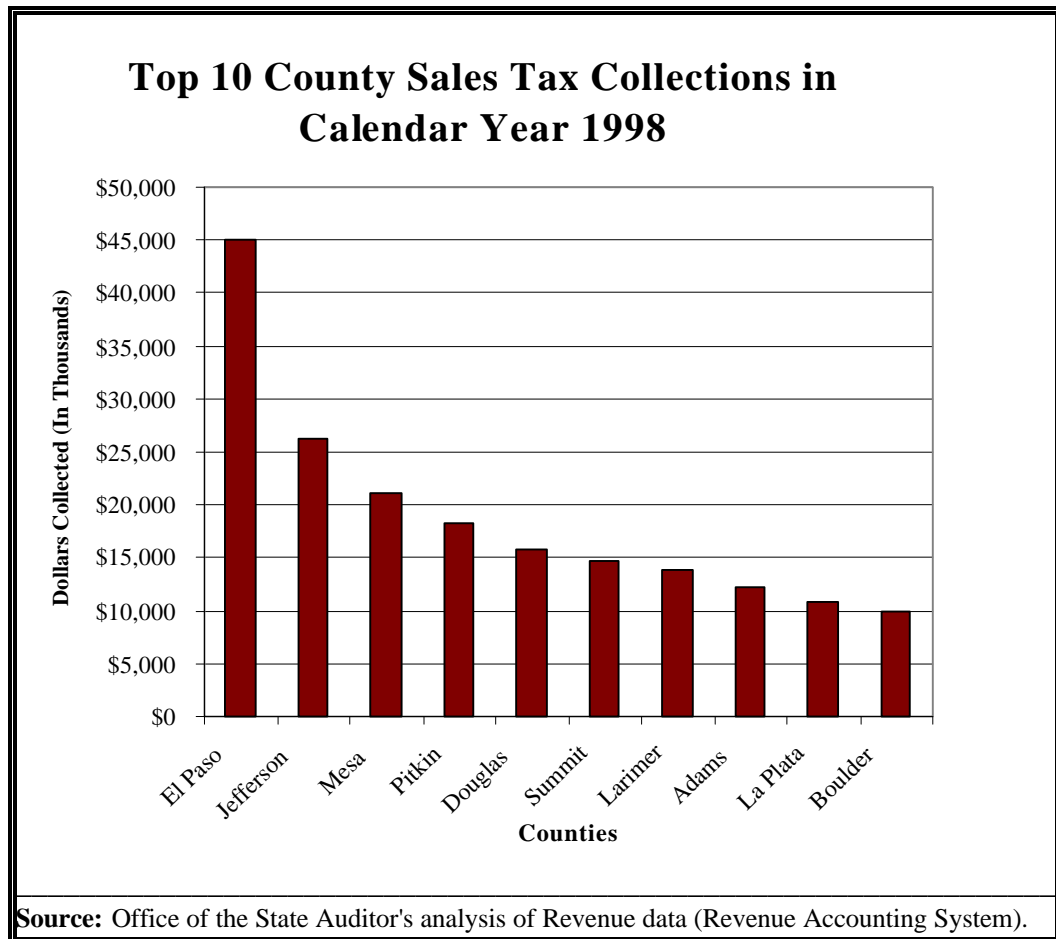
## State-Administered Local Sales Taxes

In addition to administering state sales tax, the Department also acts as the collection agent for the following taxing districts:

- Regional Transportation District
- Scientific and Cultural Facilities District
- Denver Metropolitan Major League Baseball Stadium District
- 46 counties that collect county sales tax
- 159 cities that do not collect their own city sales tax

## County Sales Taxes

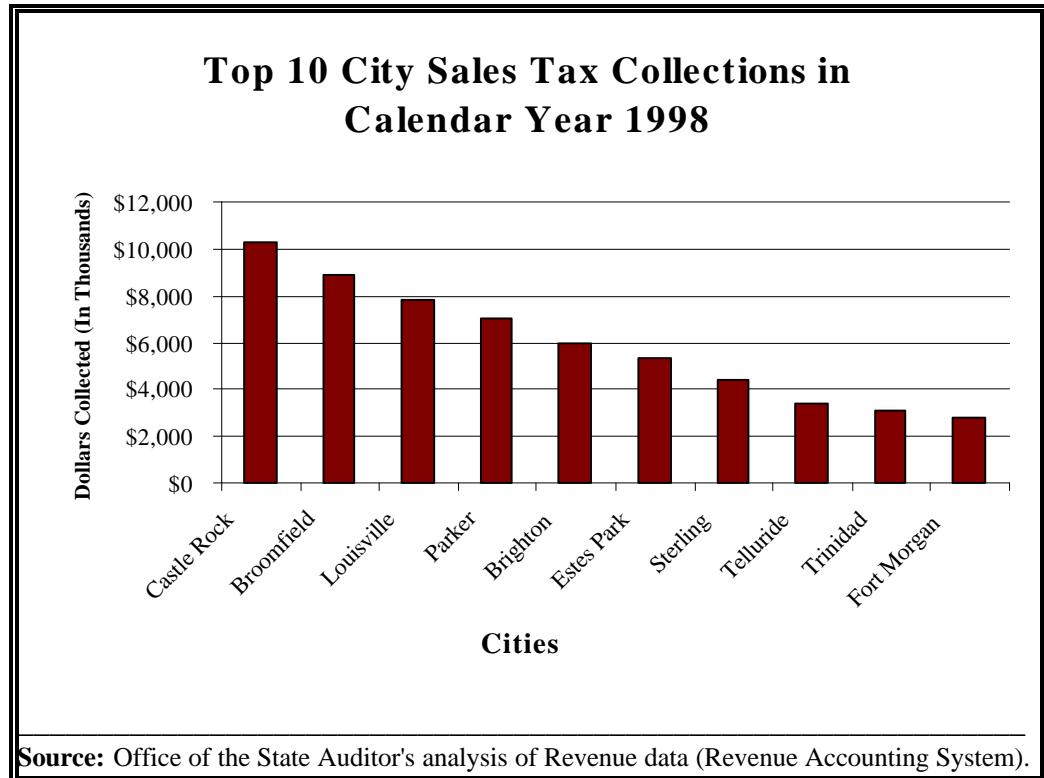
The State administers the collection and distribution of sales tax for all counties that assess a county sales tax. Currently 46 counties have implemented sales tax. Sales tax revenue for these counties amounted to more than \$255 million in Calendar Year 1998. The following graph displays the ten largest counties in terms of collections in Calendar Year 1998.



## City Sales Taxes

The State collects for cities in a similar manner as that for counties. In Calendar Year 1998 more than \$117 million was collected and distributed to cities. The majority of the cities are required to administer their taxes through the State. These are referred to as statutory cities. Cities that have designated themselves as home rule by public vote may administer their own city tax. Currently there are 159 statutory cities and

48 home rule cities that collect sales taxes. The graph that follows displays the ten largest cities in terms of collections in Calendar Year 1998, excluding home rule cities.



## Taxable Sales

Most transactions are taxable. However, the State allows some exemptions from sales tax for items such as food purchased for home consumption, machinery, and gas and electricity for use in the home. Counties and cities may or may not allow similar exemptions. The amount of sales after the allowable exemptions are deducted is referred to as taxable sales. The Department maintains taxable sales information as well as gross sales information.

## Sales Tax Collection and Distribution Process

The majority of sales tax processing occurs through what the Department refers to as the "pipeline." The term pipeline is used to describe the entire process from the time a return is received until it is ready to be archived on microfilm. The Department collects the local sales taxes on the 20<sup>th</sup> of the month for sales made in the preceding filing period. Approximately on the 10<sup>th</sup> working day of the following month, a

distribution is made to all applicable local districts, counties, and cities for the taxes collected on their behalf. The process involves several areas, which are described as follows:

<b>Departmental Area</b>	<b>Function</b>
<b>Cash &amp; Document Processing Division - 146.9 FTE</b>	Contains several sections that are charged with processing sales tax payments.
Mailroom	Opens and sorts the mail.
Business Tax Clearing Section	Initially reviews return for completeness.
Remittance Processing Section	Separates the return from the check and deposits the checks to the State Treasury.
Data Entry Section	Enters sales and payment amounts from the sales tax return into the Department's records.
Error Resolution Area	Resolves errors through the use of an automatic electronic edit process.
Microfilm Unit	Archives tax returns on microfilm.
<b>Taxpayer Services Division - 78.4 FTE</b>	Distributes sales taxes to counties, cities, and special districts, as well as acts as the customer service liaison for counties and cities.
<b>Office of Tax Analysis - 6 FTE</b>	Publishes sales information based on the statistics gathered from tax returns.
<b>Tax Audit and Compliance Division - 217.7 FTE</b>	Performs taxpayer audits.
<b>Tax Conferees - 6 FTE</b>	Settles cases when the interpretation of tax laws is in dispute.

More than one million sales tax returns were received by the Department in Calendar Year 1998, which is an increase of nearly 65 percent over the last ten years. As shown in the following table, sales tax returns are filed at varying intervals, depending upon the size and nature of the business.

<b>Frequency of Sales Tax Filing Based Upon Tax Liability</b>	
<b>Expected Tax Liability</b>	<b>Remittance Frequency</b>
<b>&lt; \$15.00</b>	<b>Annually</b>
<b>\$15.00 - \$300.00</b>	<b>Quarterly</b>
<b>\$301.00 +</b>	<b>Monthly</b>

**Source:** Department of Revenue.

In addition to the filing frequencies in the above chart, there are also businesses whose sales are sporadic or seasonal. These businesses are classified as irregular filers. A typical irregular filer would be a coffee shop opened for the summer in a mountain resort town. The State also attracts businesses for special events such as county festivals and sporting shows. These businesses obtain single- or multiple-event licenses. Similar to irregular filers, special-event filers will not be expected to remit taxes in future periods.

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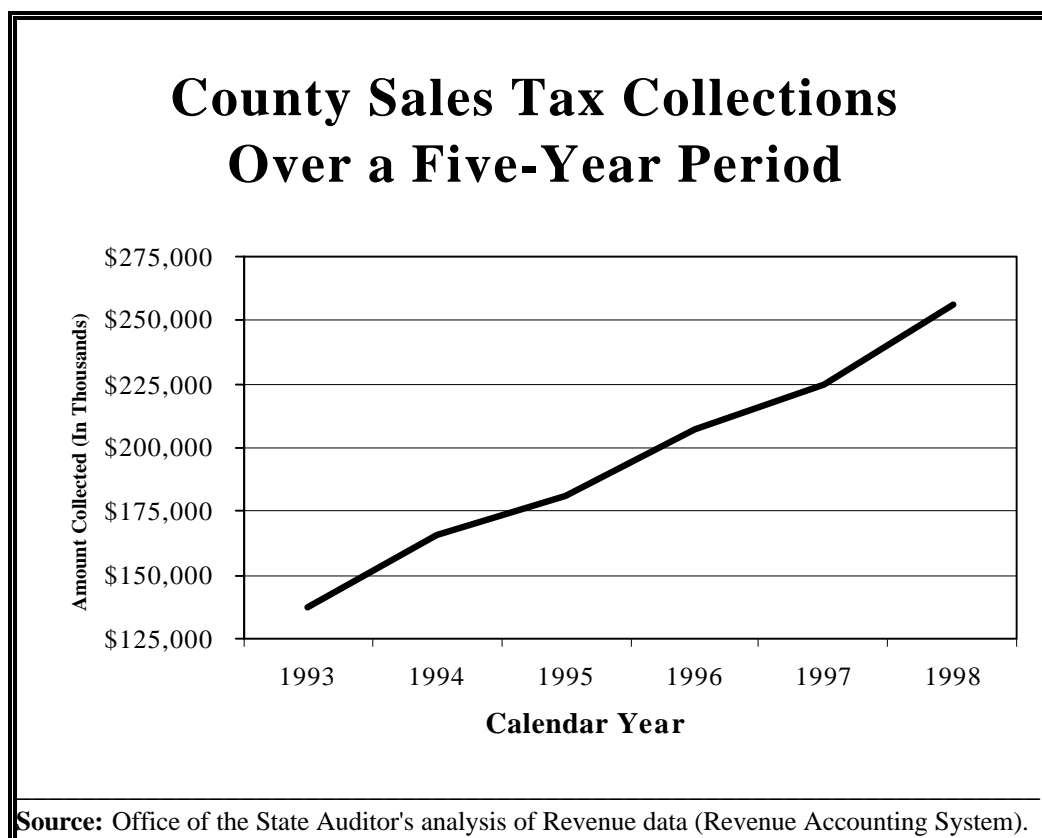
# Sales Tax Management

## Chapter 1

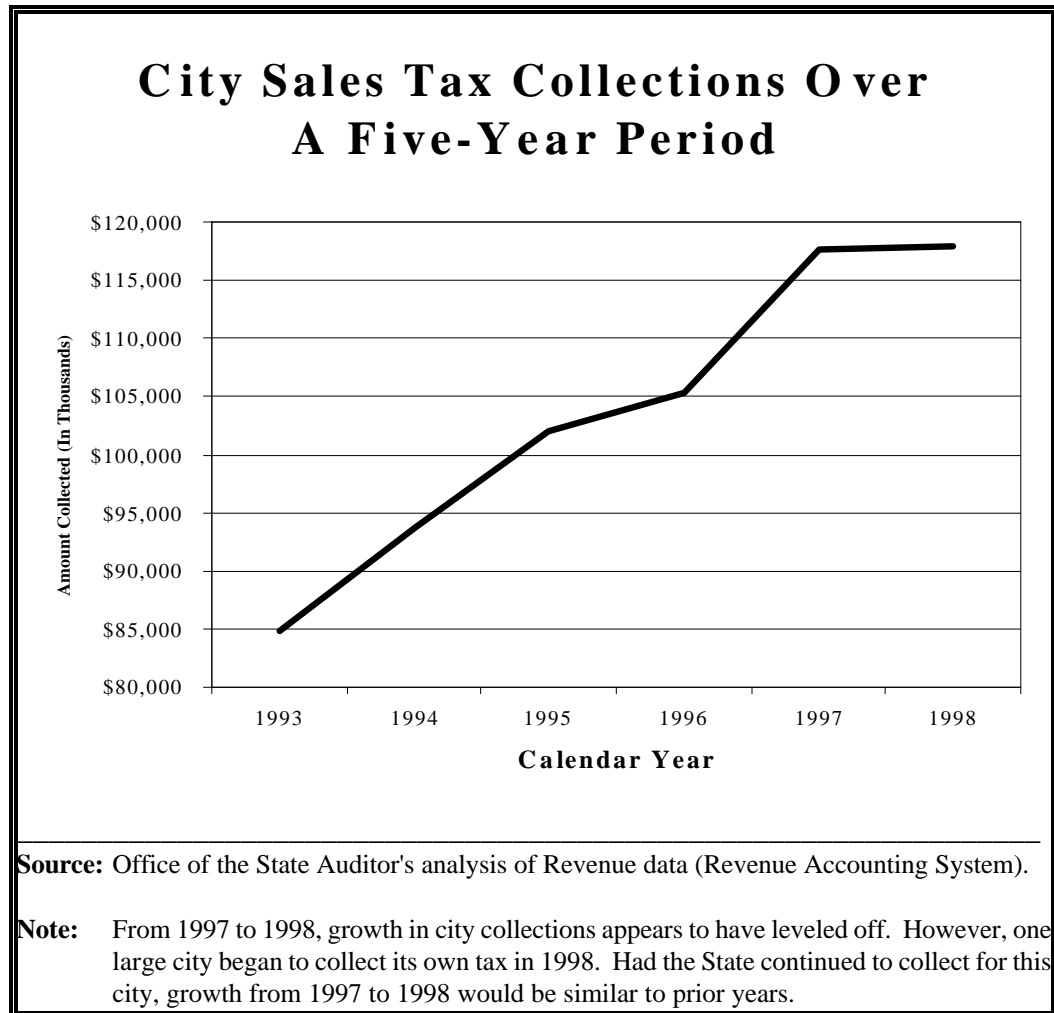
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### Background

Counties, cities, and special districts in Colorado increasingly rely on sales taxes to carry out day-to-day operations and make capital improvements. As a result, both the number of counties and cities that assess sales taxes and the volume of local collections has increased significantly over time. Increases in county and city sales tax collections during the past five years are shown in the following two charts:







In 1998 the Department of Revenue collected about \$372 million on behalf of more than 200 local taxing jurisdictions, and \$227 million on behalf of special districts. The volume of local government sales taxes has heightened Department responsibilities for tax collection and distribution. The importance of effective tax collection and distribution operations at the Department of Revenue cannot be overstated.

## **The Department's Sales Tax Management System Needs an Overhaul**

Our audit evaluated the Department's processes for collecting and distributing sales taxes. We concluded the Department needs to completely overhaul its sales tax management system. Despite the significant rise in collections, the Department's processes for, and resources dedicated to, managing sales taxes have changed little

over the past 20 years. Processing and distribution methods are inefficient and archaic. As sales tax growth continues, we are concerned that the Department lacks the ability to administer local sales taxes effectively.

Our audit was undertaken at the request of the Executive Director of the Department of Revenue, who asked us to help resolve concerns of Larimer County regarding its 1998 sales tax receipts. In July of 1998, a year ago, Larimer County contacted the Department regarding its concerns. Larimer County had increased its sales tax rate from .25 percent to .65 percent effective January 1, 1998. By July of 1998, it became apparent that sales tax collections were significantly less than projected. According to county estimates, sales tax revenue was short by about \$600,000. The Department investigated Larimer County's concerns for nine months. However, the Department was unable to provide the County with a satisfactory response.

Upon looking into Larimer County's concerns, we decided to conduct a comprehensive audit of sales tax collections and distributions. We discovered substantial problems having statewide implications:

- **Lack of oversight.** As discussed in Chapter 2, we found about \$16.7 million in sales tax accounts held in suspense status. We also found substantial problems with the accuracy and completeness of sales tax collections. We have identified about \$206,000 in potential revenue owed to Larimer County. The Department believes that about \$205,000 of this is collectible and \$1,000 is owed but uncollectible. Inaccuracies directly impact state and local government revenue. Additionally, we found errors and procedural problems in sales tax account information as discussed in Chapter 3. This information is critical for determining correct tax distributions to counties, cities, and special districts.
- **Lack of procedures.** As discussed in Chapter 2, procedures to verify the accuracy of sales taxes due are limited. Non-filing taxpayers are not consistently identified so that taxes owed are collected. Analytical review to determine whether sales tax collections and distributions are reasonable does not occur. We found errors in county and city distributions that should have been obvious to the Department, had adequate review procedures been in place.
- **Lack of automation.** As discussed in Chapter 2, sales tax returns are not filed electronically; rather, the Department manually processes more than one million tax returns a year, inherently resulting in errors. Additionally, comprehensive automated edits to identify errors are limited. As discussed in Chapter 3, tax information systems lack computer interfaces, resulting in

maintenance of inconsistent business account information and duplication between automated systems.

- **Lack of customer service.** As discussed in Chapter 4, the Department has not addressed county and city concerns satisfactorily. Information provided to local taxing authorities for monitoring purposes is not adequate. Confidentiality issues and unclear local authority compound customer service issues.

In the past the Department has addressed sales tax management issues on an adhoc basis. The Department's approach has not worked. As sales tax growth continues, strains on Department resources, operations, and information systems will only be magnified. The Department needs to take immediate steps to address the problems we have identified, or it will not be prepared to handle sales tax collections and distributions in the future.

## **Develop and Implement a Comprehensive Plan to Improve Sales Tax Management**

This report contains comprehensive recommendations to assist the Department with improving its management of sales taxes. Using these recommendations, the Department should analyze its resources and operations from top to bottom to address the concerns we have identified. The Department should then prepare a strategic plan to streamline and update its processes for collecting and distributing sales taxes that address ever-increasing demands.

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### **Recommendation No. 1:**

The Department of Revenue should undertake a comprehensive evaluation of its sales tax management system and implement a plan for improvement that satisfactorily addresses the current and future needs of local jurisdictions.

### **Department of Revenue Response:**

Agree. The Department agrees with this recommendation and will undertake a comprehensive evaluation of its sales tax management system and develop and implement recommendations that satisfactorily address the current and future needs of local jurisdictions by June 30, 2000.

This effort will include the following: capacity analysis, review of organizational roles and responsibilities, and review of current sales tax management policies and practices, including distribution processes to local jurisdictions. Local jurisdiction concerns and issues that are being identified now in concert with Colorado Counties, Inc. will be used to guide recommendations.

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# Sales Tax Processing

## Chapter 2

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### Background

Accurate distribution of sales taxes to the correct state or local government authority is a key outcome of the Department's sales tax processing systems. Sales tax revenue represents a significant percentage of the total revenue generated by many local governments in the State. Counties, cities, and special districts depend on sales tax revenue to help pay for their operations. Although there are a few counties that do not collect any sales tax, on the average sales tax revenue is nearly 20 percent of the total county revenue for the largest ten counties. Sales tax revenue exceeds 50 percent of the total county revenue for two of these ten counties. As a result, these government jurisdictions are understandably concerned that the Department process and distribute sales taxes accurately and promptly.

Our audit identified significant problems with the Department's collection and distribution of state and local government sales taxes. We identified problems with the manner in which the Department allocates taxes and reviews accounts for accuracy. In addition, there are serious inefficiencies and inconsistencies in the tax collection and distribution process. From our limited testwork of 500 accounts from four different test samples of filers in Larimer County, the Department confirmed that \$206,000 in sales taxes that we identified should be collected and distributed to Larimer County. It is possible that after the Department conducts additional review and analysis for Larimer County filers as we recommend later in this chapter, additional sales tax dollars belonging to Larimer County will be identified.

The problems with the Department's sales tax collection and processing are pervasive. The Department must take immediate action to address the issues we have identified, as we explain below.

### Resolve Taxpayer Accounts Held in Suspense Status

Through our testwork, we identified about \$16.7 million in sales tax revenue remitted in the period from 1994 through March 1999 that is currently held in suspense status.

More than \$4 million in the suspense accounts has been there since 1996. Sales tax returns are held in suspense until problems with a taxpayer's filing are resolved. Suspense accounts are buried within the State's major sales tax account and are identifiable only through special data runs. Prior to our audit, the Department was not aware of the volume of transactions in suspense status. We found the \$16.7 million from two special reports that the Department generated at our request.

The first data report accumulated all of the problem payments into an "800" account. The 800 code is used by Department staff to place taxpayer returns that contain incomplete information into suspense status. Once information is obtained, the tax return is processed, amounts distributed to the proper state or local jurisdiction, and the amount is transferred out of the suspense account. The 800 code report identified about \$13.6 million in taxpayer accounts held in suspense status. The second special report generated for our audit accumulated returns that were "out of balance," i.e., the tax returns did not match the cash remittance, also due to incomplete information. These returns had payments that exceeded the liability recorded on the return. According to the Department's procedures, out of balance amounts totaling \$3.1 million, should have been coded as 800, but many were not. The Department was only able to generate the out of balance report for the period from January 1996 through July 1999.

The following table presents the amount posted and the amount remaining in suspense since 1994:

<b>Monies Held by the State in Suspense Status</b>				
<b>Calendar Year</b>	<b>Accounts Held in Suspense</b>		<b>Total Annual Amount Held in Suspense</b>	<b>Total Cumulative Amount Held in Suspense</b>
	<b>Other Problem Accounts</b>	<b>Out of Balance Accounts</b>		
1994	\$559,961	*	\$559,961	\$559,961
1995	\$631,718	*	\$631,718	\$1,191,679
1996	\$2,457,334	\$391,303	\$2,848,637	\$4,040,316
1997	\$3,102,118	\$642,471	\$3,744,589	\$7,784,905
1998	\$5,069,940	\$1,039,521	\$6,109,461	\$13,894,366
1999**	\$1,749,821	\$1,016,967	\$2,766,788	\$16,661,154

**Source:** Office of the State Auditor's analysis of Revenue data (Revenue Accounting System).

\* Amounts not available for 1994 and 1995.

\*\* Amounts through March 1999 for problem accounts, and through July 1999 for out of balance accounts.

Our review indicates, as can be seen above, the amount remaining in suspense each year has increased dramatically. By 1999, the cumulative amount remaining in suspense increased to \$16.7 million. As discussed below, we are uncertain as to what portion of this \$16.7 million belongs to the State, counties, cities, and special districts.

### **Immediate Action is Needed to Resolve Accounts Held in Suspense Status**

Recognizing the importance of suspense accounts to local jurisdictions and the State, we asked the Department to conduct an immediate investigation. While the total amount in suspense is not material in relation to the almost \$2 billion collected each year, amounts held in suspense can be significant to local jurisdictions. Further, suspense accounts represent a substantial risk to the State in terms of misallocation and misappropriation of taxpayer's funds.

We understand that resolving the accounts will not be a simple matter, because the 800 report itself is about 12 inches thick, with thousands of accounts needing review

and resolution. According to Department staff, the unwritten procedure for 800 accounts is to resolve issues with taxpayers and then transfer amounts out of the 800 account to the proper jurisdiction, be that State or local. However, it now appears that there was a breakdown in controls over use of the 800 code, and that untangling the 800 accounts will require months of work. The Department's preliminary investigation indicates that accounts coded with an 800 may include accounts with payments that need to be resolved and distributed to local jurisdictions and the State (as the code was intended); delinquent accounts; and accounts that have actually been resolved and distributed, but left in suspense in error.

Once again, we cannot overstate the importance of tight controls over suspense codes. Misuse of codes increases the risk that monies due to local governments will not be distributed on a timely basis, that amounts received will be reported inaccurately for TABOR purposes, and that misappropriation could occur. TABOR requires that excess revenue be returned to the taxpayer. Suspense accounts are included in state revenue until amounts are allocated to the proper jurisdiction. Holding amounts in suspense that are eventually determined to be due to local jurisdictions will result in an overstatement of TABOR revenue. If the State refunds excess revenue to taxpayers, as it has in recent years, the State will return more dollars than it should. Similarly, if local jurisdictions are not receiving sales tax distributions, their revenue will be understated. If these jurisdictions are also refunding excess revenue to taxpayers, they will refund less dollars than they should.

The Department needs to take immediate steps to resolve taxpayer accounts held in suspense and establish controls over the use of suspense accounts. Specifically, the Department needs to:

- **Establish an account in the State's accounting system to allow separate tracking of sales tax payments held in suspense.** The Department did not know about the large amount of sales tax payments held in suspense, because it does not record such payments in a separate account on the State's accounting system. Rather, it lumps all taxes paid in the State's sales tax account and uses a coding system to flag suspense accounts. This system buries amounts held in suspense, reducing the ability of management to track and monitor the disposition of unresolved amounts. Establishing a separate account would enable the Department to better monitor the resolution of unidentified sales tax payments.
- **Capture information on suspense account sales tax data in the aggregate and on a filer-by-filer basis.** The only way the Department can resolve a suspense account is by researching taxpayer accounts manually. Since the Department posts thousands of sales tax filings annually, this is a time-



consuming, labor-intensive process. The Department needs to approach the suspense problem by generating reports that accumulate data for particular filers. Then the Department can work with individual filers on all problems identified.

- **Redirect resources to manually identify, research, and resolve accounts held in suspense status.** As stated earlier, resolving suspense account problems is a tedious, labor intensive process. The Department will need to reallocate its resources and/or acquire additional temporary resources to expedite resolution.
- **Develop systems, procedures and controls over suspense accounts.** Problems with taxpayer accounts held in suspense are caused by a number of deficiencies in the current system. These include lack of automated systems that include edit checks, absence of review, insufficient training, and lack of written procedures.

Because of the potential significance to local jurisdictions, the Department has agreed to resolve these accounts and report to us no later than October 31, 1999. At that time we will perform subsequent testing to ensure that the appropriate distribution was made to local jurisdictions as applicable.

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## **Recommendation No. 2:**

The Department of Revenue should immediately improve its management of accounts held in suspense status to eliminate the backlog and to ensure timely distribution to the State, counties, cities, and special districts. Specifically, the Department should:

- a. Develop a separate account on the State's accounting system to track the dollar amount of sales tax payments for which there is insufficient data to distribute in the future. The Department should use this information to monitor, control, and distribute these sales tax payments.
- b. Capture sales tax payments for which there is insufficient data to distribute in the aggregate and on a filer-by-filer basis.
- c. Reallocate staff resources to manually identify, control, and distribute the backlog of accounts held in suspense status, acquiring additional temporary resources, if necessary.

- d. Develop systems, procedures and controls over the resolution and distribution of taxpayer accounts held in suspense status.

### **Department of Revenue Response:**

- a. Agree. This recommendation has been partially implemented. A new liability code identified as unallocated sales taxes was created on July 12, 1999 and is in use. Since July 1, 1999 sales tax payments for which there is insufficient data to distribute will be transferred into the new separate account. Any payment, whether from an extra payment form, or as an excess payment on a return, posts to this liability code. The system generates regular reports identifying all additional payments posted to this liability code. In addition, this same process will be used with any liability code when money is received but the tax liability cannot be identified. Full implementation is slated by September 30, 1999.
- b. Implemented. All payments now post to the new liability code by taxpayer account. This allows the Department to identify individual payments and process them. In addition it will allow the Department to identify recurring problem taxpayers. The system will regularly generate reports of aggregate balances of the liability code as a whole. Implemented by July 1999.
- c. Agree. The Department has established plans to resolve the unallocated sales tax backlog, and work has begun on this effort as of July 16, 1999. Some accounts will require cooperation and response from taxpayers. This effort should be completed no later than October 31, 1999.
- d. Agree. This effort will be completed no later than October 31, 1999.

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## **Improve Procedures to Ensure All Sales Taxes Are Collected**

There are significant gaps in the Department's sales tax processing and collection practices. As a result, the Department cannot be confident that it is collecting all the sales taxes it should. Specifically, we found the Department does not (1) capture information on taxable sales and other sales tax information for all businesses; (2) subject county and city information to a math audit; (3) verify the accuracy of sales tax owed to all taxing authorities; (4) consistently identify and notify businesses that fail to submit required sales tax returns; or (5) apply basic analytical procedures

to be sure taxes collected are reasonable. We discuss each of these issues in more detail below.

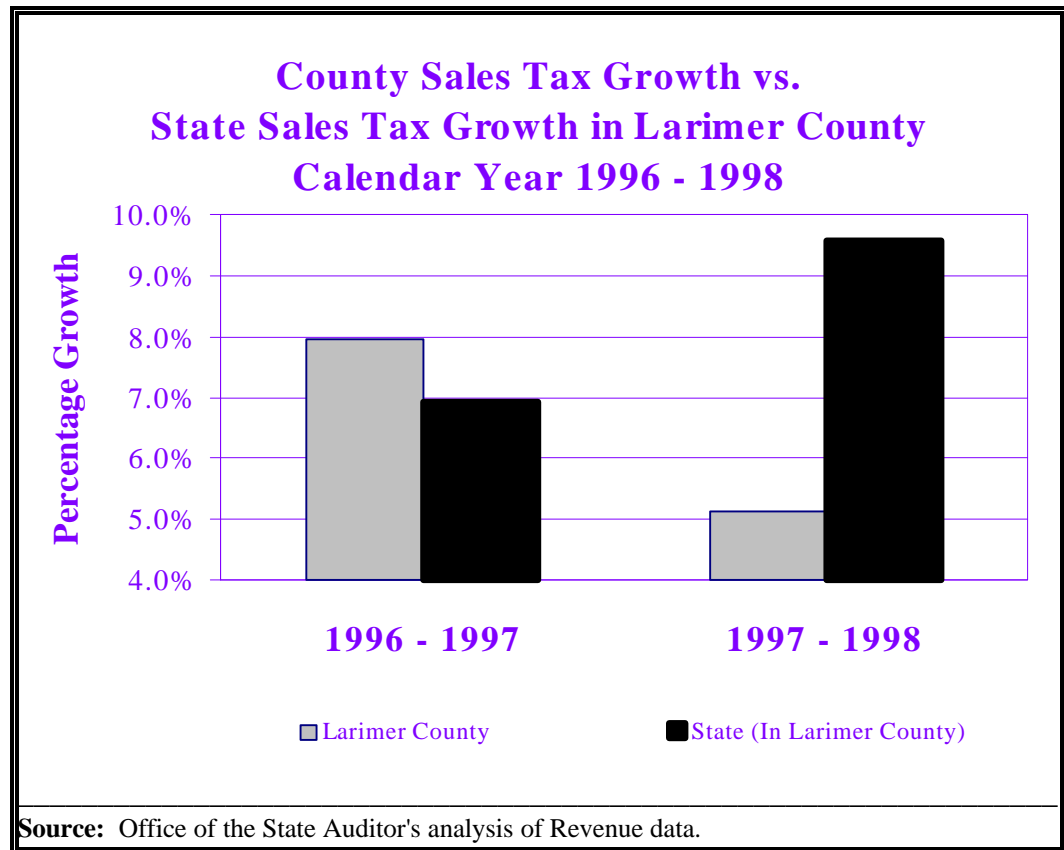
## **Capture Key Sales Tax Information for All Businesses**

Taxpayers calculate sales tax by multiplying the applicable tax rate for the State, county, city, or special district by the net taxable sales. Other information, such as vendor's fee, penalty, and interest, as applicable, must be included to calculate the final payment due. Prior to September of 1998 the Department did not capture taxable sales for county and city taxing authorities. Since September of 1998 the Department has captured net taxable sales information for all taxing authorities from businesses that complete standard sales tax returns. However, the Department does not capture county and city sales information from businesses that file via spreadsheet. 250 businesses representing some of the State's largest businesses file via spreadsheet.

Since large businesses that file via spreadsheet are not required to provide county and city sales information, the Department lacks crucial information. Counties and cities do not have adequate information to forecast future sales or estimate sales tax revenue, and the Department does not have adequate information to determine if sales taxes collected on behalf of counties and cities are reasonable.

## **Lack of Complete Sales Information Impacts Collections When Tax Rates Change**

The absence of complete county and city sales information significantly affects the Department's ability to monitor sales tax collections when local tax rates change. Further, the ability of local governments to project sales tax revenue under the new tax rate is affected. This was apparent during our review of sales tax collection for Larimer County. Larimer County increased its tax rate from .25 to .65 percent effective January 1, 1998. However, Larimer County sales tax revenue was \$600,000 less than expected. The following chart displays the increase in growth for tax receipts from Larimer County for both the State and county:



The Department reports that it will begin to capture key sales tax information for all taxing jurisdictions from all filers, including spreadsheet filers, beginning July 1999. The Department should make sales tax information available to taxing authorities, including counties and cities, through its statistical reporting process. This will ensure that local government authorities have the most current, relevant data available for sales tax monitoring and forecasting.

### **Recommendation No. 3:**

The Department of Revenue should require all businesses to report sales tax information, including gross sales, net taxable sales, and tax rates, for all applicable taxing authorities on sales tax returns. The Department should capture this tax information and make it available, for tracking and forecasting purposes, to counties, cities, and special districts through standard statistical reports.

### **Department of Revenue Response:**

Agree. This recommendation is partially implemented. The Department required as of July 1999 that all taxpayers provide the additional information on gross and net taxable sales. Reports will be available to local jurisdictions by October 31, 1999.

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## **City and County Data Should Be Subjected to Math Audits**

A math audit is used by the Department to compare the payment amount that is reported on a sales tax return with the amount that the business should have paid. This calculation is done automatically by a computer application that extracts data from the Department's "Revenue Accounting System." If the amount that is calculated is different from the amount submitted by the business, the amount will be reviewed by the Taxpayer Services Division. Currently the math audit is conducted on only the amounts that are entered for state and special district tax information.

The Department does not perform math checks for county or city sales tax. Consequently, this information is not reviewed at the same level of detail as other taxes. In addition, the Department is not performing many basic accuracy checks of county and city tax information. This can cause significant problems to go undetected.

According to Department personnel, a new math audit process will be in operation by the end of 1999 and will perform edits of the information submitted for every jurisdiction.

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### **Recommendation No. 4:**

The Department of Revenue should perform the same basic verification of taxes, via the math audit, for county and city sales taxes that it performs for state sales taxes.

### **Department of Revenue Response:**

Agree. The Department has developed and is testing and refining a new math audit to apply the same math verification to all jurisdictions. These changes will be completely implemented by January 1, 2000. The new math audit

includes reasonability checks by comparing the sales and taxes between jurisdictions on the returns.

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## **Verify the Accuracy of All Sales Taxes Owed**

Of the \$206,000 confirmed as additional tax due Larimer County, \$132,000 was due to businesses applying the incorrect tax rate. We reviewed sales taxes collected on behalf of Larimer County for January 1998. In one of our samples we found that 14 of 362 accounts (about 4 percent) did not use the new tax rate when calculating the amount of tax due. Further, we found that of these 14 accounts, 5 continued to apply the incorrect tax rate for the entire year.

Because these problems were not identified early, some amounts may not be collectible. In our samples, three of these accounts are now either closed or in bankruptcy. The Department believes that \$1,000 owed by one of these three businesses will not be collected.

Larimer County is not the only county or city in the State that has recently implemented tax rate changes. Since 1996 Boulder, Douglas, Garfield, Larimer, Los Animas, Rio Grande, and Sedgewick counties have all implemented tax rate changes. In addition, several cities also had rate changes in this time frame. There is a possibility that similar problems with applying correct tax rates are also occurring in these counties and cities. The Department should focus its auditing efforts, considering legal statutes of limitation, on samples from these counties.

The Department lacks the ability to recalculate taxes owed for all filers because it does not collect complete information on sales, as we have already explained. Therefore, it does not systematically verify that businesses do indeed apply the correct tax rate when submitting their tax returns. If the Department had recalculated taxes owed, it would have recognized that some businesses in Larimer County were applying the incorrect tax rate. It could have then immediately notified these businesses to collect the correct tax.

Once the Department begins to capture complete sales tax information, it will have the capability to verify that all filers are calculating the correct amount of tax. It should implement procedures during sales tax processing to recalculate sales tax for all filers for each taxing authority under the correct tax rate. The Department indicates that it plans to begin verifying the sales taxes owed for all taxing authorities, as we suggest, by January 2000.

In the meantime, the Department will need to go back and recalculate taxes for filers in Larimer County not included in our review. Additionally, it will need to sample tax returns from other counties and cities that have recently implemented tax increases to determine whether taxes are also owed to these counties and cities. The Department will then need to work with these counties and cities to expand analysis of additional accounts to identify uncollected sales taxes.

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### **Recommendation No. 5:**

The Department of Revenue should verify that it is collecting the correct amount of sales tax by:

- a. Recalculating taxes owed for all filers for each taxing jurisdiction.
- b. Obtaining missing information to recalculate taxes owed for all accounts in Larimer County not previously reviewed due to incomplete information. This information should be obtained for at least the 250 largest accounts.
- c. Sampling sales tax accounts in other counties and cities that have recently implemented tax increases to determine whether similar problems with applying correct tax rates exist in these jurisdictions. If so, the Department should work with these counties and cities to identify methods for investigating and resolving tax collection issues.

### **Department of Revenue Response:**

- a. Agree. The Department is currently in the process of testing and refining a new math audit process (see Recommendation No. 4) which calculates the tax for all jurisdictions based upon the entered net taxable sales for each jurisdiction. The revised math audit will be implemented for all jurisdictions (see Recommendation No. 13a) in January 2000.
- b. Agree. This recommendation has been partially implemented. The Department has reviewed and addressed Larimer County accounts for January through July 1998. These accounts will be reviewed for the period August 1998 through April 1999 by January 2000.
- c. Agree. The Department will implement sampling for other jurisdictions that have recently changed tax rates by January 2000. The Department will sample the 21 jurisdictions that had tax rate changes within the last two

years. The new math audit process will identify taxpayers that use incorrect tax rates for future changes.

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## Consistently Identify and Notify Businesses That Fail to Submit Required Sales Tax Returns

Each month, the Department sends about 2,000 notices to businesses that fail to file a sales tax return as expected. The Department uses these notices to assist with collecting taxes owed. Additionally, it uses the notices to detect taxpayers with compliance problems. As a result, the Tax Audit and Compliance Division may audit the taxpayer or take other compliance action.

Our review determined that the Department is not generating non-filer notices for all taxpayers that should receive them. We reviewed a sample of 120 accounts to evaluate whether tax processing procedures are operating as intended. We identified 21 accounts in the sample that should have received non-filer notices. However, the Department did not send non-filer notices to seven of these accounts.

The Department is not consistently notifying non-filer taxpayers for the following reasons:

- **The Department does not identify non-filers that have established an account, but paid no taxes in the past.** The Department identifies taxpayers who should file sales tax based on past filing history. If a taxpayer has never filed a return, but has set up an account, the Department does not identify the taxpayer to send the non-filer notice. The Department needs to use registration information to target these taxpayers who have never filed.
- **The Department cannot identify non-filers with multiple locations who have paid some, but not all, of their state sales taxes.** As long as a taxpayer pays state sales tax for one of its locations, the Department's system assumes that the taxpayer has paid all state sales tax owed for each location. The Department needs to modify its system or develop procedures to detect partial state payments for businesses with multiple locations.
- **The Department does not consistently apply criteria to make sure that all taxpayers that fail to submit tax returns receive non-filer notices.** The Department may change the criteria used to generate non-filer notices. For example, between February 1996 and May 1998 the Department decided not to send non-filer notices to quarterly filers. Prior and subsequent to these dates



quarterly filers did receive notices when they did not file a return. A history of changes in criteria is not maintained for future reference.

- **The Department judgmentally sends out selected notices from the computer-generated non-filer list.** The non-filer system generates a list of non-filers based on specific criteria. From the initial non-filer list generated, the Department manually reviews the list and selects which accounts from the list will actually receive a notice. This procedure was developed to eliminate erroneous notices.

Because the Department does not maintain a history of criteria used and the judgment involved, it was not possible for us to determine the reason the seven accounts in our sample did not receive a notice. However, based on our review, these were active accounts with a consistent payment history and should have received a notice.

The Department cannot be sure that is collecting all applicable state, county, city, or special district tax if it is not consistently notifying all non-filers that owe taxes. It is imperative that the Department take steps to identify and collect taxes for non-filers as discussed above.

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## **Recommendation No. 6:**

The Department of Revenue should initially evaluate the criteria by which non-filer notices are generated and periodically review changes in criteria to ensure the proper level of notification is maintained.

### **Department of Revenue Response:**

Agree. This recommendation will be included in the sales tax management review in Recommendation No. 1 as part of a comprehensive review and improvement effort to be implemented by June 30, 2000. It will also periodically review changes in criteria to ensure the proper level of notification is maintained. The Department will develop a central index to all documentation concerning changes and justification for changes in criteria. This "history" index will aid research into what criteria were in effect at the time notification or non-notification of taxpayers concerning non-filing status occurred. The Department will ensure all accounts meeting criteria will be sent notices.

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## Evaluate the Reasonableness of Tax Collections by Applying Basic Analytical Procedures

During our audit we noted that the Department does not conduct simple reasonableness tests at the account level on sales tax collections to determine whether collection amounts and distributions to taxing authorities appear appropriate. The Department spent over nine months looking into tax collections and distributions for Larimer County, but did not use reasonableness tests during its investigation. Simple reasonableness tests at the account level can be automated, making them cost-efficient and relatively inexpensive to implement. By generating exception reports, the Department can identify and follow up on accounts, significantly improving tax collections for government jurisdictions.

We used several reasonableness tests to analyze accounts in Larimer County. Our analysis covered the 50 largest accounts in the county. Of the \$206,000 that the Department confirmed is owed to Larimer County, our analytical review identified about \$74,000 in sales taxes due but not collected. We conducted a number of simple tests, including the following:

- **Month-to-month comparisons.** A comparison of tax paid for the current month with tax paid the prior month will identify unusual tax payments in a specific month, as demonstrated in the chart below:

Filing Period	Amount Paid
January 1998	\$4,000
February 1998	\$4,100
March 1998	\$90
April 1998	\$4,050

In the chart above, it appears that the taxpayer's payments for March are too low. Follow-up is needed to make sure all applicable taxes have been collected.

- **Comparisons when tax rates change.** Comparisons are especially useful when new tax rates are implemented, as shown in the following chart:

Filing Period	Tax Rate	Amount Paid
November 1997	1 %	\$2,000
December 1997	1 %	\$2,100
January 1998	2 %	\$2,050
February 1998	2 %	\$4,000

In the chart above, it does not appear that the taxpayer applied the new tax rate until February 1998. As a result, the county received \$2,000 less in sales taxes for January than it should have. By performing this test, the Department could identify taxpayers that did not apply the sales tax increase and follow up to collect the appropriate tax amount.

- **Prior period current year comparisons.** This comparison reviews the amount of tax paid by the taxpayer in the current month with the amount paid for the same month in the prior year, as shown in the chart below:

Filing Period	Amount Paid
January 1997	\$3,000
January 1998	\$325

In this chart it appears that the taxpayer's January 1998 sales tax payment is much too low. Again, by analyzing this information, the Department could identify accounts for further investigation and follow up with the taxpayer to make sure it collects the full sales tax amount.

The Department needs to implement automated reasonableness tests, such as those above, to make sure it is collecting all appropriate taxes on behalf of counties, cities, and special districts. Additionally, it needs to expand analytical review of past sales tax collections for Larimer County until the County's tax collection issues are resolved. Systematic error detection would identify collection problems immediately, improving customer service and reducing inquiries from local governments.

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## Recommendation No. 7:

The Department of Revenue should develop analytical review techniques to test the reasonableness of sales tax payments received. These should include at a minimum:

- a. Comparison between the current and prior month's payment.
- b. Comparison between the last period with an old tax rate and the first period with a new tax rate for jurisdictions implementing changes in tax rates.
- c. Comparison between the same month's payment in the current and prior year.

### **Department of Revenue Response:**

Agree. This recommendation will be incorporated as part of the review of sales tax management processes identified in Recommendation No. 1, and will be implemented by June 30, 2000.

### **Recommendation No. 8:**

The Department of Revenue should apply basic analytical procedures for at least the 250 largest accounts in Larimer County to determine if additional revenue is owed to the County.

### **Department of Revenue Response:**

Agree. The Department of Revenue will develop and implement these basic analytical procedures for the largest 250 accounts in Larimer County by January 2000.

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## **Address Errors in Vendor Fee Calculations**

Businesses may recover costs for preparing sales tax returns by deducting a vendor fee equal to  $3 \frac{1}{3}$  percent of the amount of tax assessed. The business may only deduct the vendor fee if it files its tax return on time. Counties and cities may or may not allow similar vendor fees for their local sales tax.

Our audit found errors in calculating vendor fees that have not been identified or addressed by the Department. In one sample (120 returns) we selected to test the Department's basic tax processing procedures, six taxpayers had calculated vendor fees incorrectly. The net amount of the miscalculations identified in our sample (overs and unders) was less than \$20. Given the thousands of returns processed by the Department over a period of time, vendor fee errors could be substantial. The Department failed to detect the following:

- **Businesses that deducted vendor fees when the tax return was late.** Businesses are not allowed to retain the fee if they do not mail their return by the 20<sup>th</sup> of the month for the previous filing period. However, some businesses deduct the fee even when they file late.
- **Businesses that calculated the vendor fee incorrectly.** Businesses make errors in calculating the fee. The Department's edit system does not identify vendor fee miscalculations in all instances.
- **Revenue due to the State's General Fund from vendor's fee.** Statutes provide that when a tax return is late, the State's General Fund, not the taxpayer or the local jurisdiction, receives the vendor's fee. The Department's systems and processes do not handle this allocation accurately. As a result, we cannot determine the impact on the State's General Fund. If all disallowed vendor fees were distributed to local jurisdictions, assuming that about .5 percent of filers are late, the State's General Fund would have been shorted by about \$60,000.

To correct these problems and improve the accuracy of vendor fee calculations, the Department needs additional edits. These edits should address the errors discussed above.

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## **Recommendation No. 9:**

The Department of Revenue should establish procedures to verify the accuracy of the vendor's fee deduction. These procedures should include edits for detecting miscalculations that result in over- or underpayment of sales tax and should ensure vendor's fees for late filers are consistently deposited in the State's General Fund.

## **Department of Revenue Response:**

Agree. The Department will review the programs and systems involved, change any edits that already exist if warranted, and adopt edits to correct the problems found, especially those identified in this recommendation by January 2000. It should be noted the Department utilizes thresholds under which it is not fiscally responsible to send out bills or to work accounts. It is possible that the accounts identified in this recommendation could have fallen beneath such a threshold.

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## Substantial Improvements to Spreadsheet Filing Processes Are Needed

According to the Department, there are about 250 taxpayers that file sales tax returns via spreadsheets out of about 8,000 taxpayers that would be eligible to file in this manner. Spreadsheet filers are generally the largest taxpayers in the State and account for a significant amount of tax revenue for state and local taxing authorities.

Our audit concluded that the current spreadsheet filing process is fraught with problems. As noted earlier, the most significant problem is that the Department does not require spreadsheet filers to provide taxable sales information. This severely limits the ability to review the accuracy of the return. From 15 spreadsheet filers reviewed, we found overlapping problems in the following areas:

- **There were 10 filers that submitted forms that were not completed properly.** These filers failed to either submit the summary sheet, provide all required information, or use the correct format. Additionally, filers omitted entire sections from their returns. Spreadsheet returns include a separate section for each type of tax collected (state, county, city, or special district). When an entire section is missing, the Department cannot distribute the tax to the correct jurisdiction without further information.
- **There were 14 filers that reported different branch locations than maintained on Department records.** There were four instances where the return indicated that a particular branch was physically located in a different city than noted by the Department. For example, the return indicated the branch was in Alamosa, while Department records indicated the branch was in Gunnison. There were nine instances where the return indicated a branch existed in a specific location, but the Department had no record of the branch. There were eight instances where Department records indicated the existence of the branch, but the business did not report any information for that branch on its return. This may mean that either the Department may need to close the branch account or the taxpayer failed to report and pay taxes for the branch. If information on branch existence and location maintained in its records is not accurate, the Department cannot be sure it is collecting all applicable taxes and distributing taxes to local jurisdictions appropriately.
- **There were 9 filers that did not submit taxes due for all applicable taxing authorities, according to the Department's records.** Taxpayers with branches in multiple locations are often subject to different taxes in different locations. The taxpayer must keep track of the taxes owed to each authority

in each branch location. For example, a branch located in Parker will be subject to State, Douglas County, and City of Parker sales tax. We found instances in which the business reported partial information. The taxpayer reported only taxes owed for the State and Douglas County, but not taxes owed for the City of Parker. These situations indicate that the Department may not be collecting all taxes due local jurisdictions.

These problems all resulted in errors impacting state and local sales tax collections. They indicate a serious lack of control over spreadsheet filers. Primarily, information is not required to perform simple recalculations to verify accuracy. As stated previously, spreadsheet filers account for a significant amount of state, county, and city sales tax revenue. The Department needs to immediately implement controls to improve the accuracy of returns and collections submitted via spreadsheet by:

- **Disallowing the vendor's fee for spreadsheet filers that submit incomplete or inaccurate returns.** Filers should not be rewarded with a vendor's fee, designed to cover the cost of preparing returns, if they do not complete their returns accurately or provide all required information.
- **Implementing procedures to detect errors on spreadsheet returns.** Edits should identify instances where branch addresses reported on returns do not agree with Department records, as discussed above. Further, the Department should implement follow-up procedures to ensure staff resolve branch-address discrepancies.
- **Developing an electronic format, including applicable tax rates for each taxing authority, for spreadsheet filers.** As discussed further in the following comment, electronic filing could be as simple as creating a standardized disk that applies tax rates by branch location.

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## **Recommendation No. 10:**

The Department of Revenue should improve spreadsheet filing processes to reduce errors and improve sales tax collections by:

- a. Disallowing the vendor's fee when spreadsheet filers persistently submit incomplete or inaccurate returns.
- b. Implementing procedures to detect errors on spreadsheet returns. This should include identifying discrepancies in branch locations and ensuring complete remittance of taxes due for each taxing jurisdiction.

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- c. Developing an electronic format, including applicable tax rates for each taxing authority by location, for spreadsheet filers.

### **Department of Revenue Response:**

- a. Agree. The Department is currently rewriting the procedures for spreadsheet filers to ensure better control of the program. The new procedures will incorporate disallowing the vendor's fee when spreadsheet filers persistently submit incomplete or inaccurate returns. The new procedure will be fully implemented by June 30, 2000.
- b. Agree. An on-line system has been created to generate a new spreadsheet format whenever a taxpayer adds or deletes branches from their account. When the Department modifies the taxpayer's account to add or close locations, the taxpayer will immediately be sent a revised spreadsheet format. This spreadsheet template can also be issued to any taxpayer attempting to file using an unapproved spreadsheet format. This on-line system can be utilized to issue a sample format when taxpayers inquire about the spreadsheet program. Additionally, all spreadsheet filers will be incorporated into the math audit process and non-filer notices will generate for branches that have no filings. The new procedure will be fully implemented by June 30, 2000.
- c. Agree. This recommendation will be implemented by June 30, 2000.
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## **Implement Electronic Filing Options**

The State currently offers electronic filing options for income taxes. Income taxes may be filed by telephone, over the Internet, or through the use of a specialized software program that files federal and state income taxes at the same time. However, similar options are not offered for sales tax filings. Sales tax information must be entered manually into Department information systems from physical tax returns.

The Department has made efforts in the past to move toward electronic filing. Several years ago House Bill 93-1120 was passed allowing electronic filing as an option for business tax filing. Later, one large business developed an electronic data interchange program, anticipating that other taxpayers could also use the program. The Department reports that other filers did not use the program because of the costs involved.



The Department needs to reconsider electronic filing options. Electronic filing will not only produce long-term cost savings but will enable the Department to handle increased workloads in the future without additional resources. A simplified electronic filing system should be cost-beneficial to filers. One state we contacted estimated that it saves about \$250,000 annually by providing electronic filing options. However, another state indicated that they are losing money because filing is not mandatory and has resulted in little taxpayer participation.

Electronic filing would impact the Department's workload most significantly in the following areas:

- **Data Entry Section.** Some of the returns for spreadsheet filers number more than 25 pages, all requiring manual input into the Department's records. With the extensive amount of data entry required, there is a great potential for error. Electronic filing would eliminate the need for data entry of the return.
- **Microfilm Unit.** Currently the Department maintains copies of tax returns on microfilm. When a copy is needed, someone must locate the return on film, copy it, and send it to the requestor. Electronic filing would potentially allow users to access information on-line and reduce the burden on the Microfilm Unit.
- **Error Resolution Area.** Electronic filing could be designed to assist the taxpayer in submitting the return accurately by incorporating edits into the filing program. The filing program could also require input of certain information, which is not possible through a manual system. For example, if a business were set up to pay a certain tax, such as city tax, the filing system would prompt the taxpayer to complete required tax information for the city tax before the filing could be completed.

Implementing an electronic filing system for sales taxes will require funding and expertise. It will not happen immediately. However, there are intermediate steps the Department can take to move toward electronic filing.

Earlier in this chapter we suggested that the Department consider electronic filing options for its 250 spreadsheet filers. These filers already maintain their returns in an electronic format on their own computer systems. The Department could avoid manual data entry of lengthy spreadsheet returns by requiring spreadsheet filers to submit returns on disk for uploading or through the Internet. The Department could provide the same option for its other sales tax filers.

Every day, more and more transactions are being handled electronically. Large businesses have the technology, expertise, and resources to make use of such options

when made available. The establishment of electronic filing options, with a requirement that large businesses file electronically, would significantly improve the tax collection process.

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### **Recommendation No. 11:**

The Department of Revenue should pursue electronic filing for sales taxes. As an intermediate step, the Department should utilize available technology to develop electronic filing options for spreadsheet filers. Large businesses should be required to file in this manner.

#### **Department of Revenue Response:**

Agree. The Department has pursued several options in electronic filing over the last nine years. The pilot Electronic Data Interchange (EDI) program for large filers was begun in 1992. The Department has identified a goal of making web filing as well as an electronic format for spreadsheet filers available to sales tax filers by June 30, 2000. During the 2000 General Assembly session, the Department will pursue legislation through the Governor's Office.

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## **Eliminate Inefficiencies and Duplication**

During our review we noted several areas where the Department could eliminate inefficiencies and duplication. Each of these areas is discussed below.

### **Develop Efficient Practices for Handling Payments Outside of the Department's Collection Authority**

Occasionally, a business erroneously remits sales taxes that are due a local government whose taxes are not collected by the Department. For example, a business may remit taxes for the City of Loveland. Loveland recently began collecting its own sales tax. The Department's practices for handling these instances are inconsistent. For example:

- **Payments may be forwarded to local jurisdictions.** Sometimes the Department processes the payment and then forwards it to the local taxing jurisdiction. In these cases the Department is taking administrative responsibility for transactions it is not authorized to handle. Our audit found

40 instances totaling over \$25,000 in which the Department forwarded payments directly to jurisdictions as explained above.

- **Businesses may request a refund.** In other instances the Department notifies the taxpayer that it does not collect the tax for a particular jurisdiction. The business may request a refund or a credit against future state sales taxes. If a refund is requested, the Department sends the taxpayer a refund claim form. When the Department receives the form, it processes the refund.
- **Businesses may request a credit.** When the Department notifies the taxpayers of the payment error, the taxpayer may request a credit. The Department then sends the taxpayer a letter and asks the taxpayer to make an adjustment on the following month's return.

By utilizing any option other than refunding the money to the taxpayer, the Department is assuming unnecessary responsibility for local tax dollars and complicating the tax collection process.

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## **Recommendation No. 12:**

The Department of Revenue should return payments to taxpayers when they remit taxes to the Department in error.

### **Department of Revenue Response:**

Agree. The Department will ensure that taxes remitted to the Department in error are handled in a consistent and efficient fashion. The Department does not identify the distribution of sales tax receipts prior to deposit of the remittance, due to the time required and the resultant impact on cash flow, and cannot return the original remittance to the taxpayer. The Department will instead continue to refund to the taxpayer any local tax paid to the Department in error upon completion of a claim for refund form. This is consistent with prior State Auditor Office recommendations. The Department will discontinue forwarding remittances to local jurisdictions. This new policy will be in place by January 2000.

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## Duplication in Sales Tax Processing and Information Systems

We identified two instances of duplication occurring during the Department's processing of sales tax returns. First, we found duplication in the Department's editing process. When the Department receives a sales tax return, it enters both sales and payment information into a single electronic file. From this file, the payment information is uploaded into the Revenue Accounting System and sales information is uploaded into the Statistical System. Distinct edits are performed in each of these systems. Before the file is uploaded into the two systems, the math audit is generated from the single electronic file. The math audit is not reviewed for at least two weeks because of the time involved in retrieving returns from the Microfilm Unit, whereas the edits in the two systems happen immediately. Staff following up on the math audit indicated that in one instance there were about 25 items to research. After researching the errors, staff found that all of these had been previously resolved. If the one electronic file that creates the math audit were generated after initial edits have been performed in the two systems, the math audit would not generate errors that have already been detected and resolved.

Second, we found duplication in the Department's maintenance of tax rate tables. The Department maintains information on tax rate history for all counties and cities in the State, including home rule cities that administer their own local sales taxes. This information is maintained in two databases, although one would be sufficient to meet user needs. One database is used to publish rate information to the public; the other is used to create customized reports for the Taxpayer Services Division. Keeping both tax table databases current requires extra effort. When changes are made to one, the changes must be communicated to the individual managing the other so that both are up to date.

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### Recommendation No. 13:

The Department of Revenue should address duplication in sales tax processing and information systems by:

- a. Modifying its system to perform math audits after initial edits have been completed.
- b. Abandoning the maintenance of separate tax rate information databases.

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## Department of Revenue Response:

- a. Agree. The new math audit procedure identified in Recommendation No. 4 will address this recommendation. It will be implemented by January 2000.
- b. Implemented. As of July 1, 1999, the Department has combined the two separate tables and now maintains all tax rate information in one database. All reports and forms are printed from this table.

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## Clarify Sales Reporting Requirements

Sales tax returns not only provide the Department with information for payment distributions but also provide important sales information. The Department's Office of Tax Analysis uses sales information to track gross sales, retail sales, wholesale sales, and taxable sales. These sales data are important economic indicators.

Our audit identified inconsistencies in sales reporting among taxpayers with multiple locations. Some taxpayers failed to report any sales information, some reported combined sales for all business locations, and some reported sales information on a location-by-location basis. Although these inconsistencies do not directly affect the accuracy of payments, they affect the accuracy of sales information.

The Office of Tax Analysis reviews the sales information every month to correct errors identified through edits on its statistical system. The reviews attempt to identify taxpayers who failed to report sales or who reported duplicate sales. Additionally, the reviews consider the reasonableness of all sales in excess of a specific threshold. The Office uses the information to identify economic trends and to publish reports. The Office can prepare reports presenting sales information in various ways, including aggregate sales, sales summarized by county or city, or sales summarized by types of sales.

Inconsistent sales reporting by taxpayers adds to the Department's workload, since staff must investigate errors. Additionally, inconsistent sales reporting impacts the Department's ability to verify taxes due, as we discussed previously in this chapter. The Department verifies taxes due by multiplying net taxable sales by the appropriate tax rate for the taxing authority. If sales information is not reported correctly, the Department will not be able to verify the tax calculation.

The Department needs to provide clear direction to businesses on how to report sales information correctly. In conjunction with clarifying instructions, the Department could provide additional training on reporting sales information in its classes offered to taxpayers on tax return preparation.

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### **Recommendation No. 14:**

The Department of Revenue should clarify instructions on how to report sales information accurately and expand training for those taxpayers that have multiple locations.

### **Department of Revenue Response:**

Agree. The Department of Revenue will review the instructions on the sales tax return to determine areas that should be clarified. If clarification is necessary, taxpayers can be notified of the change at the time that they receive their new coupon books in January and on January returns that are printed at the Department (parent and branch, wholesale, seasonal accounts). Implementation is scheduled for November 1999. The sales tax return will be reviewed for ease of completion as part of the sales tax management review identified in Recommendation No. 1. The Department's current efforts to educate taxpayers includes highly publicized training classes held frequently in the metro Denver and regional service centers, reference guides, video tapes for loan, industry specific seminars, and periodic newsletters.

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# Sales Tax Registration

## Chapter 3

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### Background

All businesses located in Colorado that sell tangible personal property, such as vehicles, computers, and furniture, at the retail or wholesale level must acquire a sales tax license from the Department of Revenue. A separate license must be obtained for each business address if more than one exists. The license is proof that a business is authorized to make tax-free purchases of merchandise for resale and collect sales tax from its customers.

Businesses also register trade names of a company with the Department. Every person, general partnership, or other organization doing business in Colorado under any name other than the personal name of the owner or owners is required to register and annually renew the business trade name with the Department.

### Significant Deficiencies Exist in the Management of Sales Tax Registrations

As part of our audit, we reviewed the Department's sales tax registration procedures. Overall, we identified significant gaps in the Department's management of sales tax registration. Specifically, (1) taxpayer accounts are established without all required information; (2) procedures to allocate sales taxes received from businesses that have relocated during a tax period are inadequate; (3) account changes are not made uniformly; and (4) verification of business locations is inadequate.

### Taxpayer Accounts Are Established Without All Required Information

During our review we noted that taxpayer accounts have been established without all required information. When we investigated, Department staff told us that this happens frequently because, although there are standard procedures for setting up accounts, taxpayers fail to provide all needed information and because of the volume, follow-up is not routinely done. Accounts can be established in a number of ways.

First, a business can set up an account through the Registration Control Section of the Department using a Business Registration Form. The form contains basic information such as name, address, and any existing sales tax account numbers. Alternatively, the Department also allows accounts to be set up without the form upon receipt of information received via telephone calls, letters, the initial sales tax return, payment checks, and walk-ins. While these alternative methods are customer-friendly, oftentimes Revenue staff are not obtaining all the information required on the Business Registration Form. Because of the volume of new accounts (some 50,000 created during Calendar Year 1998 alone), serious problems are created.

Among the problems identified during our investigation:

- **Duplicated accounts.** Staff informed us of multiple accounts being present on the sales tax system for a single business location. Without an account number, a search for an existing account often fails due to the limitations in the Taxpayer Registration System software. For instance, a check may be received without an account number. If the taxpayer's name cannot be located in the system, a new account is created. Past due notices may be issued on the unused duplicate accounts, causing Department personnel additional time and effort to research the problem.
- **Branches set up as single businesses.** Staff also told us that the various branch locations of a business are not always grouped with the main business account when assigned an account number. This occurs when the related accounts are not provided. For businesses that file for all locations on a single spreadsheet (spreadsheet filers), a branch set up with an unrelated number may result in both the main office and the branch filing for the branch location. Conversely, it could result in no return being filed for that branch.
- **Incorrect addresses.** Incorrect address data can result in taxes being collected for the wrong county and/or city. We noted that 6 of 15 spreadsheet returns in our sample indicated a general delivery address instead of a street address. Without a street address, it is not possible to determine whether the business is physically located within county or city limits. We also found 3 out of 60 accounts had different addresses than are contained in the Department's records. Although these differences were not so great that taxing jurisdictions changed, there is the potential that there are other address problems that do affect taxing jurisdictions and ultimately the distribution to the counties and/or cities.



Finally, when it establishes a new account, the Department does not require a telephone number. Lack of phone numbers results in delays in responding to questions and validating information.

The Department should require that regardless of the method of establishing an account, all basic information be obtained. Follow-up should be done to verify the accuracy of the initial information and a request made for any missing data. To be able to cross-check the data provided, the taxpayer should also provide any other Colorado tax identification numbers for that location and the main office if applicable.

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### **Recommendation No. 15:**

The Department of Revenue should obtain all information necessary to properly establish a new sales tax account. This includes street address, other tax identification numbers, telephone number, and information about any main offices. Information should be requested for missing data.

### **Department of Revenue Response:**

Agree. The Department receives remittances from taxpayers on outdated returns that omit account information and other information. To maximize cash flow, remittances are deposited as quickly as possible. Accounts are created “on the spot” in order to deposit the remittance and record the remittance to a specific taxpayer for a specific liability. Requesting information from the taxpayer and awaiting a response prior to deposit will result in unacceptable delays. The Department will, however, devise a process to ensure that missing data is requested from the taxpayer and included in their account information. This process will be implemented by January 2000. In addition, a project request has been approved for using the Internet for taxpayer registration. This provides an exciting opportunity to provide greater customer service and ensure accuracy and completeness of information gathered.

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## **Procedures Are Needed for Accurate Distribution of Taxes Received From Businesses That Have Relocated During a Tax Period**

When a business moves its location during the month, a portion of the taxes collected may be due to one jurisdiction and the remainder due to another. We found that the Department does not have an effective method of determining mid-month changes and allocating taxes paid to the appropriate jurisdiction. The Department's policy is to make mid-month changes in distribution only at the request of the county/city affected. However, a county or city may be unaware of the relocation of a business to its area. The sales tax form does not provide instructions to the taxpayer on how to report mid-month changes, and the Department's automated systems are unable to handle this type of situation. Department personnel must contact the taxpayer, explain the information needed, and then manually adjust the distribution. This is a slow and tedious process.

The Department is informed of address changes by the taxpayers. This information could be used to make changes to the account so that sales taxes are properly allocated. In addition, the tax return instructions could be modified to inform the taxpayer on how to report mid-month changes.

On the basis of our discussions with staff from the Taxpayer Services Division and the Registration Control Section, we noted that some of the problems associated with address changes stem from a lack of communication between these two divisions. Both areas can make address and other types of information changes to tax accounts. The Taxpayer Services Division is responsible for making the adjustment to its internal systems to reallocate taxes to another jurisdiction. We found that the Registration Control Section does not inform the Taxpayer Services Division when it learns of a business address change. Also, address change reports are not generated on a routine basis. Because the Department does not have records on the number of address changes that are made annually, we could not determine the full extent of this problem.

If manual allocation is not feasible, the Department must develop a methodology that is equitable. For example, if a business relocates on the 15<sup>th</sup> of the month, it may not be representative of the sales tax collections to allocate half to one jurisdiction and half to another.

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**Recommendation No. 16:**

The Department of Revenue should develop policies and procedures regarding distribution of taxes received from businesses that have relocated during a taxing period.

**Department of Revenue Response:**

Agree. The Department will improve the current accounting policies and procedures for taxpayers who move between jurisdictions during a taxing period. The Department will formalize this process, as the Revenue Accounting System does not have the flexibility to apply different jurisdictions to a single period for a taxpayer's account. This will be implemented by January 2000.

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**Account Changes Are Not Made Uniformly**

A taxpayer may be responsible for the payment of various types of taxes, such as income, sales, and severance. Currently a taxpayer's accounts are set up and maintained through various separate computer applications that capture information relevant to a specific type of tax. Applications containing information on a single taxpayer are not linked, causing the Department staff to have to duplicate entry of common information (such as name, ID number, address). Currently whenever a taxpayer changes basic information, separate systems for income, sales, severance, withholding, or any other tax account must be changed independently. This creates errors, increases staff time, and adds to taxpayer frustration.

We understand that it may be some time before the Department develops a state-of-the-art integrated sales tax system. However, in the interim, the Department could investigate the cost/benefit of uploading changed information to each system.

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**Recommendation No. 17:**

The Department of Revenue should evaluate the feasibility of developing a computer interface among the various tax systems that is capable of locating and listing all accounts maintained by the Department for a single taxpayer.

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## **Department of Revenue Response:**

Agree. This has been a long standing goal of the Department. Several attempts have been made to make progress toward evaluating the feasibility of an integrated tax system. A decision item will be developed for submission in Fiscal Year 2001 to obtain funding for a feasibility study.

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## **Verification of Business Locations Is Inadequate**

With the growth in the State's population, cities are annexing additional parcels, special districts are expanding, and new special districts are being created. The boundaries of many taxing jurisdictions are changing. For instance, many cities have annexed residential and business developments into their boundaries, and several new cities have been incorporated in the last few years. As stated previously, the business address of a company determines the sales taxes to which its goods or services are subject. It is critical that the proper location of each business be identified.

We selected a sample of 60 businesses that would owe sales tax, including restaurants and retail establishments, from the phone book. Three out of the sixty businesses in our sample had a different business address than the information contained in the Department's sales tax account records. While none of these involved a change in taxing jurisdiction, the potential for error exists. As noted earlier, our test of spreadsheet filers did find incorrect addresses that resulted in sales taxes being paid to the wrong jurisdiction.

The Department's computer system has edits that allow it to determine if county and city information is incompatible. However, it cannot detect a problem if a business is located outside of the boundaries of the city listed. The computer system is also incapable of determining whether a business located in a city that spans more than one county has designated the correct county.

As the boundaries of taxing jurisdictions continue to change, it will become increasingly important for the Department to have the capability to identify taxpayer jurisdictions by street address alone. Improvements in the Department's current computer system are needed to provide this crucial function. Technology already exists in this area. As we understand, counties use a computerized system for motor vehicle registrations that automatically enters the city and county when a street

address is entered. This system is updated periodically when boundaries change or new housing developments are constructed.

## **Notification of Boundary Changes Is Needed**

Cities and counties are currently required to notify the Department of rate changes at least 45 days prior to the effective date. However, statutes do not currently require cities and other taxing jurisdictions to notify the State of boundary changes. The State, therefore, cannot notify taxpayers of boundary changes and ensure proper payment of taxes. Without any notification, the taxpayer may not be aware of the change and, thus, may not collect or pay the appropriate city sales tax.

The Department has a system in place to notify taxpayers of new tax rates. This same system can be used to notify businesses of boundary changes and the taxes that must be collected for each taxing jurisdiction.

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### **Recommendation No. 18:**

The Department of Revenue should investigate system improvements that would provide the capability for electronic identification of taxing jurisdictions by using street addresses.

#### **Department of Revenue Response:**

Agree. This recommendation is a high priority project for Fiscal Year 2000. A plan for system improvements will be developed by June 30, 2000.

### **Recommendation No. 19:**

The Department of Revenue should work with the General Assembly to assign responsibility to taxing jurisdictions for notifying the State when boundaries change. The Department's tax rate notification system should be utilized to notify taxpayers of the changes in taxing jurisdiction.

#### **Department of Revenue Response:**

Agree. The Department will work through the Governor's Office to collaborate with the Colorado Municipal League and Colorado Counties, Inc. to propose legislation requiring local taxing jurisdictions to notify the

Department of all boundary changes. Legislation will be pursued during the 2000 General Assembly.

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# Customer Service

## Chapter 4

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### Background

In 1998 the Department of Revenue collected about \$372 million on behalf of more than 200 local jurisdictions, and \$227 million on behalf of special districts. Counties, cities, and special districts rely heavily on the Department to ensure that amounts collected and disbursed are accurate, complete, and timely. An important part of this process is customer service. As we have already explained, we found serious problems in the processing and distribution of sales taxes. Local government jurisdictions are understandably concerned that the Department is not responding promptly to their requests for information.

Our audit found that (1) information provided to local taxing authorities for monitoring purposes has not been adequate; (2) confidentiality statutes need to be clarified; (3) communications need to be improved; and (4) roles and responsibilities of the State and local governments need to be clearly defined.

### Provide Better Information to Local Governments

The Department does not provide basic information to counties, cities, and special districts regarding their sales taxes. In the absence of information, local governments are unable to review their tax receipts reports without significant effort. Monthly reports are distributed to the cities and counties, but these contain limited information. These include (1) a distribution report that shows the detail supporting the distributions to the city or county; (2) an open/close report that lists accounts opened or closed during the month for that jurisdiction; and (3) a non-filer report that lists those businesses that did not file a return for the period. Other reports are available only upon request. Through discussions with county representatives, we were informed that the Department has not consistently informed them of the type of information that is available. Additionally, we found that key information was missing.

While the above reports are useful, we found the following problems:

- **The Department provides state sales statistical information only when requested by a local government.** If such information has been requested, the Office of Tax Analysis provides state statistics on a monthly basis to counties and on a quarterly basis to cities. This information shows state gross, retail, wholesale, and taxable sales summarized by county/city. This information is useful in understanding what has been reported and collected for state-level sales and should be provided uniformly to the jurisdictions. Comparisons of county/city sales data to state sales data help to identify any unusual trends.
- **The Department does not capture county and city taxable sales (discussed more thoroughly in Chapter 2).** This limits the ability of local jurisdictions to determine the overall reasonableness of their distribution payment. The primary information that the Department provides to local governments is the dollar amount of sales taxes remitted by local businesses. Local governments are not provided with the amount of sales made in their jurisdiction and the local tax rate that was used. Since basic county sales information is not captured, it is not possible to determine whether the sales tax is mathematically accurate.
- **The Department does not provide any analytical information to local jurisdictions.** For example, the Department could provide historical tax information (prior year, same month) for each business in a jurisdiction. Simple analytical information can easily be used to identify potential underpayments of taxes.
- **The Department does not provide a listing of businesses that have made partial payments or show the amount of additional taxes that are owed.** This would allow counties and cities to track those amounts that were not yet collected.
- **The Department does not provide a listing of businesses that have registered for a trade name but have not applied for a sales tax license.** The county or city could then evaluate whether the business performs activities that should be subject to sales tax.

According to the results of the survey prepared by Colorado Counties, Inc., 5 out of the 23 counties responding indicated that additional information such as reports produced by industry type, additional reporting about licensed businesses within its



boundaries, and standard reporting tools that provide analytical capabilities would be useful in monitoring their collections.

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### **Recommendation No. 20:**

The Department of Revenue should improve information available by working with local governments to develop a standard comprehensive reporting package. At the minimum, the package should include:

- a. State statistical information.
- b. Expansion of the current distribution report to include county and city taxable sales.
- c. Variance reports showing payments that vary significantly from the same period in the prior year.
- d. Reports showing the amount of payments due from filers who have underpaid taxes in addition to businesses that have failed to file a return.
- e. Reports listing those businesses that have registered a trade name but have not applied for a sales tax license.

### **Department of Revenue Response:**

Agree. The Department of Revenue has begun a joint project with the county officials through Colorado Counties, Inc. to improve communications between the Department and the counties. This group has agreed to a comprehensive study to identify information necessary on reports that are required by the local jurisdictions. Existing reports will be modified and new ones created to provide the agreed upon information. This recommendation will be implemented in concert with Recommendation No. 4, concerning a new math audit process and expanded statistical information, by January 2000.

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## Confidentiality Issues Need to Be Resolved

Pursuant to Section 39-21-113, C.R.S.,

Except in accordance with judicial order or as otherwise provided by law, the executive director of the department of revenue and his agents, clerks, and employees shall not divulge or make known in any way any information obtained...or disclosed in any document, report, or return...

However, Section 29-2-106(4)(c), C.R.S., states that the Executive Director of the Department may provide additional information to a county concerning the collection and administration of county sales tax if a Memorandum of Understanding has been executed between the county and the Department.

The Department has interpreted these statutes narrowly to mean that local governments may access only their own local business tax information and not any information reported for other jurisdictions. This creates problems, because large businesses with several locations remit taxes for all jurisdictions on the same return. For example, a county cannot receive information from a business that files via spreadsheet for a chain store, since it has locations in more than one county. Information regarding a chain store location is provided to a county only for the store that is located within the county. Counties stated that they cannot tell if a specific branch or store is remitting in a wrong district, because they do not have access to the entire return for the particular business.

The Department's interpretation of the statutes directly impacts its ability to provide on-line information regarding sales taxes to counties and cities. The Department has the capability of providing on-line access for information about sales tax payments, but does not have the capability to limit electronic access to only businesses within the local jurisdiction's boundaries. Electronic access to payment information could greatly enhance the county's ability to analyze sales data, because information from several filing periods can be reviewed at one time. In addition, electronic access would provide the counties and cities with current data, instead of data from the previous month.

According to the results of a recent survey prepared by Colorado Counties, Inc., on-line access was by far the area of greatest concern. More than half of the 23 counties responding indicated that on-line access would give them greater ability to monitor their collections.

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## Recommendation No. 21:

The Department of Revenue should seek clarification of confidentiality statutes that would enable counties and cities to have electronic access to sales tax data.

### Department of Revenue Response:

Agree. The Department will work through the Governor's Office during the 2000 General Assembly session to clarify the confidentiality statutes by developing a policy position, seeking an Attorney General's Opinion, or proposing legislation. If new legislation is required, the Department through the Governor's Office will collaborate with the Colorado Municipal League and Colorado Counties, Inc., to recommend changes to the statute. Once the confidentiality issue is resolved, the Department will develop plans by January 2001 to enable local jurisdictions to have on-line access to sales tax data.

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## Develop Systems to Improve Customer Service

The Department needs to make overall improvements in its customer service. Counties and cities cannot satisfy their statutory requirements if information cannot be efficiently obtained from the Department. Local jurisdictions have 90 days from the time they receive their sales tax payment to review the accompanying distribution report and communicate any errors to the Department. The purpose is to ensure that errors are identified and corrected in a timely manner. This places a significant burden on the counties and cities to determine the accuracy of the data within a relatively short time frame. This effort is hampered by the lack of key information from the Department and the inability of the counties and cities to access the Department's detailed records on-line. As a result, the local jurisdictions must contact the Department directly to research tax returns, contact businesses, and resolve issues. Two individuals within the Taxpayer Services Division are responsible for handling county and city inquiries. Department staff informed us that depending on the amount of research involved, a response could take weeks or months.

We identified four areas where the Department could improve customer service:

- **Track inquiries.** The Department does not track the number and type of inquiries and complaints it receives. Tracking would help the Department get

a handle on the volume involved as well as determine whether its other efforts to improve service were effective. In addition, tracking would give the Department an idea of areas in which it could target education or other efforts.

- **Monitor response time.** The Department does not monitor response time. Response time can be an important indicator of customer satisfaction. During the course of the audit, we observed that counties are generally dissatisfied with the amount of time it takes to get a satisfactory response from the Department. In fact, one county reported that it took almost two years before the Department took action on a non-filer that the county had reported. If the response time were monitored, the Department could establish performance benchmarks, measure results, and use the information to improve response time.
- **Provide status reports.** The Department does not respond until it has a complete answer, which may mean a delay of several months. As an example, a county may question whether a business in its area should be paying sales taxes. First, the Taxpayer Services Division determines whether a sales tax account has been established. If an account is not located, the inquiry is forwarded to the Tax Audit and Compliance Division. Depending upon their schedule and agent availability, staff may not be able to visit the business for several months. During the course of this process, the county is not contacted to update the status of the inquiry. The Department needs to establish guidelines for its staff on updating local governments on the status of an inquiry.
- **Prioritize the most significant requests.** The Taxpayer Services Division has an unwritten policy to respond to the simplest requests first. This policy leaves the larger, complex issues where higher dollars may be involved to take second priority. Inquiries may not be forwarded on a timely basis to the Tax Audit and Compliance Division and taken into account when planning future audits. Delays can also result in the inability to collect taxes owed.

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## **Recommendation No. 22:**

The Department of Revenue should improve its customer service by :

- a. Tracking inquiries by number and type.

- b. Monitoring response time.
- c. Providing status reports to users.
- d. Developing a policy to prioritize the most significant requests.

### **Department of Revenue Response:**

Agree. The Department will develop a system to track inquiries from the local governments regarding their sales tax distributions. The tracking system will monitor response times and will indicate where each inquiry has been referred for resolution (Compliance, Field Audit, etc.), as well as provide status reports. In order to expedite the local governments' inquiries, the Department will research the possibility of having these inquiries submitted by alternative methods such as diskette, e-mail, or a specially formatted paper document. The Department will work with local governments through the Colorado Municipal League and Colorado Counties, Inc. to develop specific criteria with mutually agreed upon priorities for these inquiries. The tracking system will be implemented by June 30, 2000.

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## **Clarifying Roles and Responsibilities Would Help Improve Customer Relations**

During our audit we noted a general lack of understanding of the responsibility of the Department and of local jurisdictions. By statute, the responsibility for sales tax collections for counties, cities, and special districts (other than home rule cities) rests squarely on the shoulders of the Department of Revenue. However, as the number of local governments assessing taxes has steadily grown, the Department has reported increasing difficulty in handling its responsibilities. Over the last six years, the number of counties the Department collects sales taxes for has increased from 40 to 46.

Frustration with inadequate attention to local tax collection has resulted in at least one county assuming significant responsibility for collections. The Department has allowed the county to request returns from the businesses, send out additional non-filer notices, analyze data that the Department has provided electronically, and perform license inspections. The county stated that it was able to collect about \$400,000 in additional sales tax revenue in the first year it assumed additional responsibility for its sales taxes.

It is inefficient for local governments to assume responsibilities on an ad hoc basis. A great deal of duplication of effort can occur when there is a lack of clarity regarding the responsibility of the Department and of local governments. Two counties have taken on additional responsibility and have spent significant resources developing their own systems to ensure the accuracy of their sales tax collections.

There is clearly an important role for local jurisdictions to play in the collection process. According to Section 29-2-106(4)(b), C.R.S., the:

department of revenue shall furnish the governing body of each municipality and county a monthly listing of all returns filed by the retailers in such municipality or county. The governing body of such municipality or county shall notify the...department of revenue within ninety days of any retailers omitted from the listing.

Local governments are better able to determine what businesses are within their jurisdictions and, therefore, can play an important part in ensuring the completeness of the businesses remitting taxes. In addition, local governments could perform their own reasonableness tests as an added control over the accuracy of collections if they received sufficient information from the Department. The Department needs to work with local governments to better define roles and responsibilities and set forth performance expectations.

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### **Recommendation No. 23:**

The Department of Revenue should work with local governments to set forth roles, responsibilities, and expectations for all areas of sales tax collection. All agreements should be documented in writing in the form of a Memorandum of Understanding.

### **Department of Revenue Response:**

Agree. The Department of Revenue will work in conjunction with the Colorado Municipal League and Colorado Counties, Inc. to set forth roles and responsibilities and expectations for all areas of sales tax collection. Together with these two groups, the Department will determine the need to seek appropriate legislation that will benefit local jurisdictions and enable them to more accurately monitor their sales tax distribution concerns. The current Memorandum of Understanding that all taxing jurisdictions sign in order to receive their distribution reports will be modified to incorporate agreed upon changes. This recommendation will be implemented by June 30, 2000.

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