PERFORMANCE AUDIT

DEPARTMENT OF REVENUE

PROPERTY AND SPECIAL TAX DIVISION

Report to the Arizona Legislature
By the Auditor General
March 1986
86-2

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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

March 24, 1986

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

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Revenue, Property and Special Tax Division. This audit is a limited review conducted in response to the January 21, 1986 resolution of the Joint Legislative Oversight Committee.

After noting the progress the Department has made in achieving greater uniformity of property valuation, the report identifies areas for improvement. An updated system for valuing commercial and industrial property based on costs is needed, and statutory equalization authority needs to be clarified. In addition, DOR should involve county assessors more effectively in the preparation and use of sales ratio studies.

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

Respectfully submitted,

Douglas R. Norton

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SUMMARY

The Office of the Auditor General has conducted a limited review of the Department of Revenue (DOR), Property and Special Tax Division. This review was conducted in response to a January 21, 1986, resolution of the Joint Legislative Oversight Committee, and in accordance with Arizona Revised Statutes §§41-2351 through 41-2379.

The Property and Special Tax Division exercises general supervision over Arizona's property tax laws to ensure that all property is uniformly valued for State property tax purposes. Uniformity is needed to ensure that the tax burden is fairly distributed and to prevent lawsuits charging property tax discrimination and possible resultant tax refunds. Further, State and county aid is often allocated to local governments or school districts based on assessed values. Equitable valuations are needed for fair distribution of this aid.

Improvements Can Be Made
In The Property Tax Division (see Finding, pages 5 through 18)

The Department of Revenue, Property and Special Tax Division is generally effective, however, some improvements are needed. The Division's current system for valuing property based on costs is outdated. Also, statutes on uniformity and equalization are unclear and have led to confusion. In addition, county assessors lack confidence in DOR's method of monitoring property valuations.

The Department's construction cost system is inadequate. A construction cost system generates cost-based valuations primarily for commercial/industrial property based on such factors as materials, location and size. The existing system, originally developed in the mid 1960s, is outdated and has generated valuations that are substantially less than market values. An updated system is currently being developed by DOR in cooperation with the county assessors, however, lack of resources may hinder its development and use. For example, DOR

lacks sufficient resources to conduct a reappraisal of all commercial/industrial properties. This reappraisal is necessary to ensure that reliable data is used in the new system. Further, the system will have to be periodically updated with new cost data to remain effective. Because accurate valuations are essential, funding for the development and implementation of a new construction cost system, including reappraisals and periodic updates, should be considered by the Legislature.

Equalization authority needs clarification. Confusion exists because both the Department of Revenue and the Board of Tax Appeals appear to have equalization authority by statute. A 1985 Maricopa County Court decision pointed out this confusion and upheld DOR's authority to issue valuation directives by voiding four Board equalization orders. However, the Board of Tax Appeals has appealed this decision. Because DOR has more resources to devote to equalization analysis and research, it is better suited to carry out the equalization function. Therefore, the Legislature should consider clarifying equalization authority by giving DOR full equalization authority, while retaining the power to hear and decide appeals in the Board of Tax Appeals.

County Assessors may lack confidence in DOR's sales ratio studies as a result of insufficient involvement in their development and use. DOR uses these studies to monitor the accuracy of valuations by measuring the relationship between appraisals and market value. Based on these studies, DOR establishes adjustment factors for those property classes within a county that are not appraised near market value. Increased cooperation between the assessors and DOR regarding the preparation and use of sales ratio studies may strengthen relations and increase confidence in the studies. Further, DOR should consider supplementing sales ratio studies with on-site appraisals when sales data is inadequate. In addition, the time frame for adjusting assessments based on DOR factors may be insufficient to ensure equity between parcels within classes. This is because assessors historically have not had enough time to determine where specific valuation adjustments need to be made. Instead, adjustment factors have generally been applied across-the-board for certain classes of property. While this addresses uniformity among classes and among

counties, it can perpetuate inequity among parcels. Therefore, alternatives to the current time schedule should be considered to address these problems. Options include:

- Applying adjustment factors to the following year's valuations instead of the current year's.

- Basing adjustment factors on prior years' valuations.

- Moving deadlines for preliminary valuations to an earlier date.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a limited review of the Department of Revenue (DOR), Property and Special Tax Division. This review was conducted in response to a January 21, 1986, resolution of the Joint Legislative Oversight Committee, and in accordance with Arizona Revised Statutes §§41-2351 through 41-2379.

Arizona's Property Tax System

Three entities administer Arizona's property tax system. DOR's Property and Special Tax Division is responsible for general oversight of the system. The State Board of Tax Appeals has full power to equalize the valuation of all property throughout the State, and to hear and decide all appeals resulting from Department of Revenue decisions. County assessors, who are statutorily designated as deputy directors of the Department of Revenue for State property tax purposes, are responsible for determining the valuation of all locally assessed property within their counties.

The Property and Special Tax Division exercises general supervision over Arizona's property tax laws to ensure that all property is uniformly valued for State property tax purposes. Property appraisal duties are divided between the State and counties, with the majority of property being appraised by the county assessors. The Division values centrally assessed properties (i.e., utilities, communication companies, railroads, pipelines and mining properties). County assessors, are responsible for appraisal of locally assessed properties (i.e., vacant land, residential, and commercial and industrial classes).

The Property and Special Tax Division supervises the assessors' appraisal activities by:

- adopting standard appraisal methods and techniques,
- preparing and maintaining manuals and a construction cost system,
- performing audits,

- educating and training county assessor staff, and
- coordinating data processing activities.

In addition, the Division provides appraisal assistance to county assessors through regional representatives. Assistance consists of aid on complex appraisals, review of valuation changes, and review of new policies and procedures with the assessors. Division personnel also prepare and present cases to the various appeal boards.

Staffing And Budget - For fiscal year 1985-86, the Property and Special Tax Division was authorized 80 full-time equivalent (FTE) positions, although eight of these were not funded. The Division has an approved General Fund budget of $2,734,500. Table 1 shows actual expenditures for fiscal year 1983-84, estimated expenditures for fiscal year 1984-85, and the approved budget for fiscal year 1985-86.

TABLE 1

DOR PROPERTY AND SPECIAL TAX DIVISION
ACTUAL EXPENDITURES
FISCAL YEARS 1983-84 AND 1984-85
AND BUDGET FOR FISCAL YEAR 1985-86
(UNAUDITED)

	Actual 1983-1984	Actual 1984-1985	Approved 1985-1986
FTE Positions	78.0	72.0	80.0(1)
Expenditures:			
Personal Services	$1,727,800	$1,692,400	$1,897,300
Employee Related	366,600	367,400	398,600
Professional And Outside Services	332,100	175,000	226,200
Travel			
In State	88,200	72,200	100,000
Out Of State	12,500	11,200	15,500
Other Operating	82,100	109,100	57,500
Equipment	8,200	1,200	9,400
OPERATION SUBTOTAL	2,617,500	2,428,500	2,704,500
ADOT Mapping Service	30,000	30,000	30,000
Omnibus Tax Relief		350,000	
Railroad Tax Claims Settlement		6,409,000	
TOTAL	$2,647,500	$9,217,500	$2,734,500

(1) Eight of these positions were not funded.

Source: State of Arizona Appropriations Report 1985-86, and DOR Budget Request 1986-87

Scope of the Audit

Our audit of the Department of Revenue, Property and Special Tax Division was a limited review. It focused on the relationship of the various entities involved in the administration of the State's property tax system and the use of sales ratio studies. Specifically, detailed work was conducted on the adequacy of DOR's construction cost system, the clarity of equalization authority, and DOR's use of sales ratio studies.

Several significant studies have been completed during the last four years on Arizona's property tax system.

9-82 - "Study of Land Valuation Issues" by the International Association of Assessing Officers

1-83 - "Toward Full Cash Value" by the Governor's Task Force on Assessment Practices

5-85 - A cash equivalency study on Commercial Property in Maricopa County by Joseph M. Davis and Associates

6-85 - "Final Report on Equalization of Commercial and Industrial Real Property Assessments in the State of Arizona" by Ronald B. Welch and Robert H. Gustafson

We reviewed each of these studies during our audit. Since these reports addressed many of the current topics of interest, we were able to limit our review. In addition, they provided information that we incorporated into our report. In general, these studies form a valuable framework for strengthening Arizona's Property Tax system.

The Auditor General and staff express appreciation to the Director of DOR and the staff of the Property and Special Tax Division for their cooperation and assistance during the course of our review.

FINDING

IMPROVEMENTS CAN BE MADE IN THE PROPERTY TAX DIVISION

The Department of Revenue (DOR), Property and Special Tax Division is generally effective, however, some improvements are needed. The Division's current system for valuing property based on costs is outdated. Also, statutes on uniformity and equalization are unclear and have led to confusion. In addition, county assessors lack confidence in DOR's method of monitoring property valuations.

Property Valuations Are Becoming More Uniform

Arizona property valuations are moving toward greater uniformity. Uniformity in valuations is necessary to ensure that the tax burden is fairly distributed and to prevent lawsuits. Therefore, DOR began to work toward this goal more aggressively in 1982. As a result, improvements in Statewide uniformity have been made over the last five years.

Necessity For Uniform Valuations - Arizona needs uniform valuations within and among classes of property and counties for several reasons. Uniformity within legal classes is needed so State grant-in-aid to school districts is distributed fairly. Equalization within counties is also required for county aid programs for school districts. State aid for local government services is also based on assessed values. Equalization among classes is needed so the tax burden is not unfairly shifted from undervalued classes of properties.

In addition, the Federal Railroad Revitalization and Regulatory Reform Act of 1976 protects railroads, airlines and motor carriers from excessive taxation. Federal law generally protects interstate transportation companies from property tax burdens greater than owners of other commercial and industrial property. Noncompliance with Federal law could result in serious consequences if locally assessed commercial and industrial properties were undervalued with respect to centrally valued

railroad and airline properties. For example, $7 million had to be appropriated for fiscal year 1984-1985 to pay railroads a court settlement on overpaid property taxes. Similar actions are being considered by other State property owners contending property tax discrimination. If locally assessed commercial and industrial properties continue to be undervalued, millions of additional dollars could be lost.

Improvements Have Been Made - The Department of Revenue has made important strides toward ensuring uniformity among property values in Arizona. In 1979, DOR began using sales ratio* studies to monitor local assessment performance in order to achieve uniformity. Beginning in 1982, DOR adopted a more aggressive stance to ensure uniformity among classes of properties within counties and among counties. As a result, if a county's property valuations are not at acceptable levels DOR directs the county assessor to apply factors to their valuations to meet the required standard.

In 1985, two nationally known property tax experts noted that Arizona appears to have made considerable progress in the area of equalizing property values.** In addition, these two experts predicted that Arizona will be ranked among the best, if not the best, in the nation in the 1987 Census of Governments for intercounty coefficients of dispersion*** for similarly classified property. In fact, DOR staff have been nationally recognized for their accomplishments in the property tax field. The Department and its staff have received three awards from the International

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* Sales ratio is appraised value divided by the sales price. Increasing sales ratios indicate that valuations are approaching market value. DOR considers a sales ratio of 80 percent to approximate the point at which nominal sales price equals full cash value.

** Welch and Gustafson, "Equalization of Commercial and Industrial Real Property Assessments in the State of Arizona," June 1985

*** The coefficient of dispersion shows the variation of a group of sales ratios around their median. According to a DOR official, a coefficient of dispersion less than .25 is acceptable for commercial property. For residential property, .1 to .15 is acceptable.

Association of Assessing Officers (IAAO) since 1981, in recognition of their efforts to improve assessment administration in Arizona. Further, the DOR employee responsible for the design and maintenance of sales ratio studies in Arizona is a nationally recognized expert in sales ratio studies and has authored several assessment-related publications.

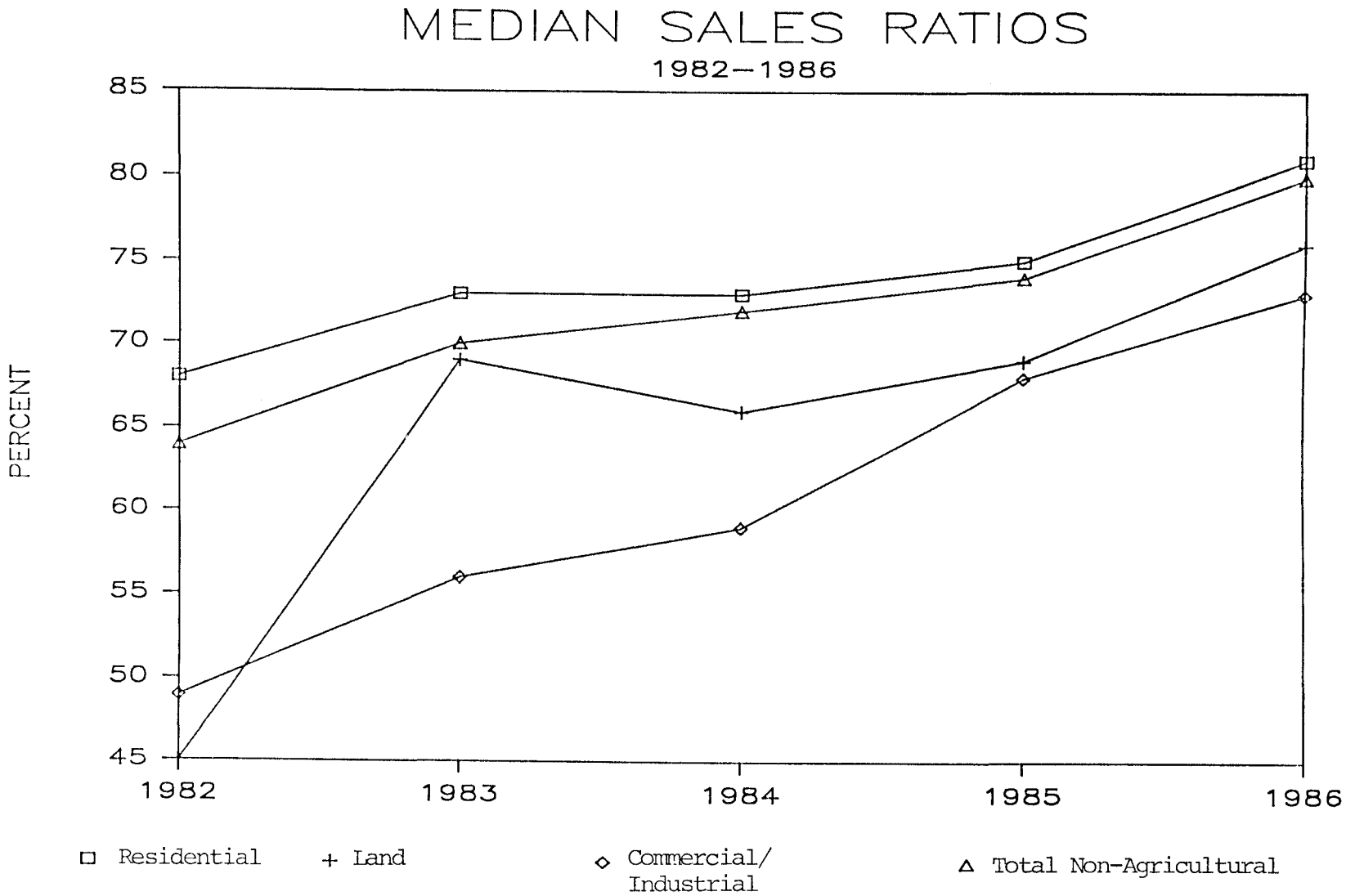
Improvements in Statewide uniformity have been made for all property classes over the last five years. Median sales ratios have improved, moving closer to 80 percent, as shown in Figure 1. In addition, coefficients of dispersion have been moving toward more acceptable levels over the past five years, as shown in Figure 2. These Figures indicate a five-year trend that property valuations are moving closer to market value and are more uniform.

Construction Cost System Is Inadequate

The Property Tax Division lacks an updated construction cost system. A new construction cost system was purchased, but due to problems with implementation, was never used. Although efforts to develop an acceptable system are currently under way, lack of resources may hinder its development and use.

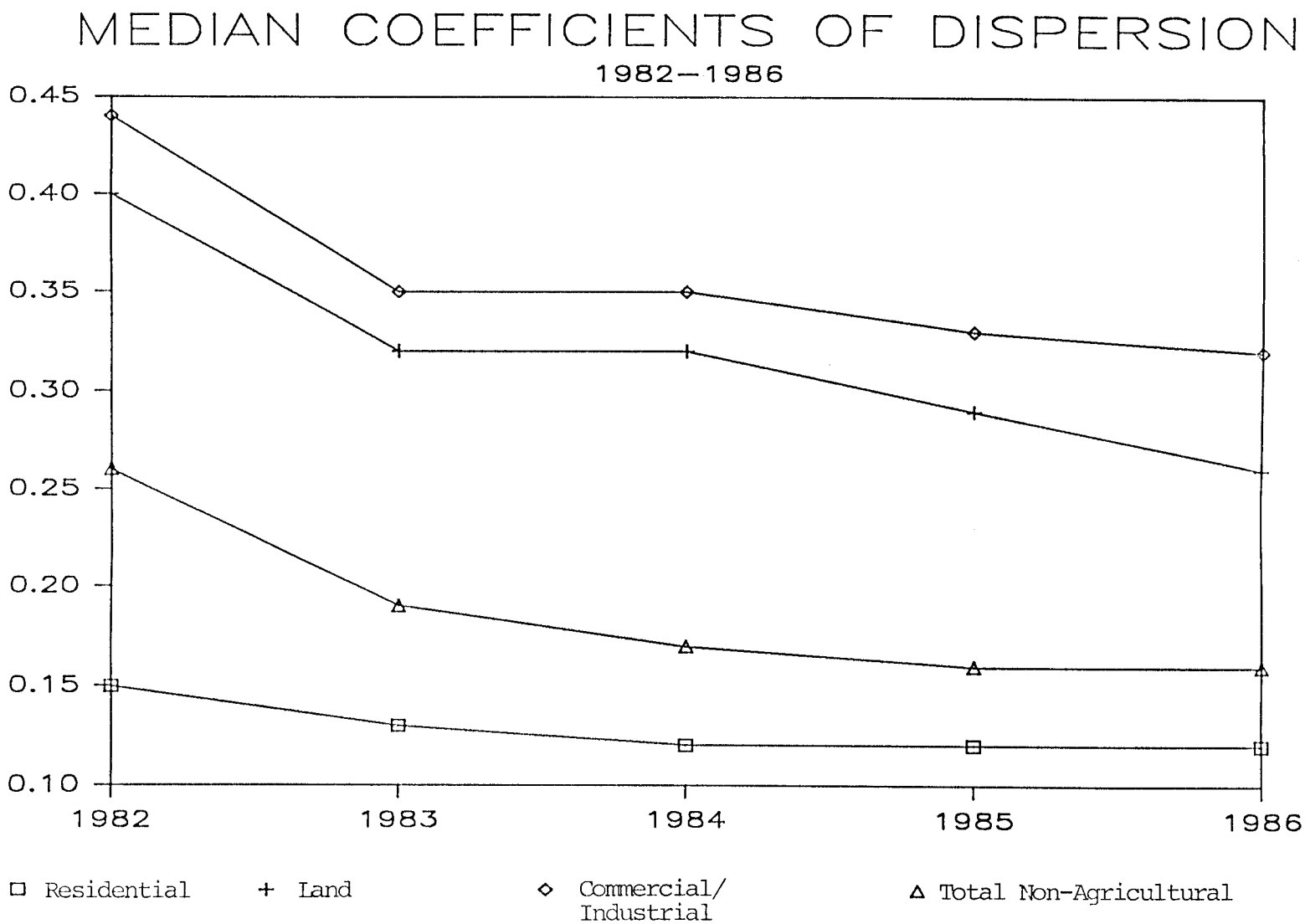
A construction cost system is essential, especially for commercial/industrial properties. Such a system allows appraisers to value buildings based on cost data relating to such factors as materials, quality, location, condition and size. Field appraisers gather specific information on a building and input it into the system, which generates a valuation. With the current use of the cost method for commercial/industrial valuations, a construction cost system with current cost data and property information is essential to determine accurate, full cash valuations.

FIGURE 1



Source: Compiled by Auditor General staff from Department of Revenue Sales Ratio Data

FIGURE 2



Source: Compiled by Auditor General staff from Department of Revenue Sales Ratio Data

Construction Cost System Purchased But Never Used - DOR contracted for a new construction cost system which was eventually abandoned. DOR and two legislative investigations revealed that the Department's construction cost system, originally developed in the mid 1960s, was not generating equitable valuations.* Therefore, the purchase of a new commercially developed construction cost system was considered in 1981. After evaluation of all timely submitted proposals, the E.H. Boeckh Company was awarded the contract to develop a new construction cost system. The Department paid $253,950 for this system in fiscal year 1982-83. However, several problems were discovered after tests were run on the new system.

- Extensive modification to the system would be required to facilitate its use.

- A concerted training effort would be required to qualify Department and county appraisers to use the system.

- Some of the cost values generated by the system were not consistent with local market construction costs.

In addition, the system was very complex and took far more time to generate assessments than the system it was to replace. Furthermore, the county assessors were reluctant to use this new system because, in their opinion, it was not adequately tailored to Arizona and construction methods used in Arizona. Consequently, in 1985 the Department decided not to implement this Boeckh system due to the many problems identified.

* According to a 1983 Governor's Task Force Report on Assessment Practices, commercial and industrial values are low because of the antiquated model used for cost method appraisals. As a result, the existing system has created valuation problems and resulted in cost-generated value estimates that are substantially less than market values.

System Under Development May Be Hindered By Lack Of Resources - Although development of an updated construction cost system is being undertaken, resources may not be adequate to implement the system. Presently, a committee consisting of county assessors and DOR personnel has been formed to address the development of a system. This new system will integrate parts of the Boeckh system, DOR's current system, and input from DOR's technicians and the county assessors. Additional funds are needed to develop and implement this new system. In the 1986-87 budget $980,000 was requested for this new system. The bulk of these funds is for programming the automated portion of the system.

However, even if this money were appropriated, additional resources would be necessary to implement the new system. All properties would need to be reappraised under the new cost system to ensure that their proper characteristics were included. Failure to do this would result in inaccurate valuations. It appears that most county assessors lack the resources to undertake the needed comprehensive review. Although the Department is aware of the need for reappraisal, it also currently lacks the resources to accomplish this reexamination. The Legislature approved eight full-time equivalent (FTE) positions for this purpose in fiscal year 1985-86, but no funding was provided.

Moreover, DOR may lack the resources to make necessary revisions in the future. Construction cost systems should be modified with updated cost data at least annually, to reflect changes in construction methods and costs. Presently, the Division has one FTE responsible for updating the system. The Division requested two FTEs in the 1986-87 budget request to assist in updating the cost data. However, this updating is merely an across the board percentage adjustment applied to cost data. The adjustment factor for the 1986 tax roll is 155 percent and will be applied to 1978 cost data. Use of across the board factors of such a magnitude is generally inaccurate. For example, if a square foot of cement cost $1 in 1978, DOR would use a 1986 cost of $1.55. The actual cost of cement may be significantly different. The system will become obsolete unless current cost data is incorporated into the system annually. This could be done by DOR or a contract service.

Equalization Authority Needs Clarification

Equalization authority needs clarification. Statutes appear to place equalization authority under both the State Board of Tax Appeals and The Department of Revenue. This has created confusion in roles and responsibilities, and may strain relations between the two agencies.

Equalization is not defined in the statutes. However, equalization is defined by the IAAO as:

> . . . the process by which an appropriate governmental body attempts to ensure that all the property under its jurisdiction is assessed at the same assessment ratio or at the ratio or ratios required by law.

IAAO further states that the power that defines an equalization body is:

> . . . the authority to apply a flat, across-the-board factor adjustment to the assessments on all the properties in a group concerning which an assessment bias has been discovered.

By statute, equalization authority appears to be placed under the Board of Tax Appeals and the Department of Revenue. Arizona Revised Statutes (A.R.S.) §42-171 reads:

> The board [of Tax Appeals] shall have full power to equalize the valuation of all property throughout the state and to hear and decide all appeals from decisions of the department of revenue.

Under A.R.S. §42-141, the Department of Revenue is charged with ensuring that all property is uniformly valued for state property tax purposes. According to A.R.S. §42-141, the Department shall:

> . . . exercise general supervision over county assessors in the administration of the state property tax laws of the state for the purpose of insuring that all property is uniformly valued for state property tax purposes.

DOR ensures uniformity of values through the use of adjustment factors based on assessment ratios. Historically, DOR's adjustment factors have generally been applied by County assessors across-the-board. DOR's statutory authority to ensure uniformity and DOR's use of adjustment factors implies equalization as defined by the IAAO.

This lack of clarity in equalization authority has led to confusion over roles and responsibilities, and may have strained relationships. This confusion is exemplified by a 1985 court action brought by the Department of Revenue against the Board of Tax Appeals in the Maricopa County Superior Court, in which the Court upheld DOR's authority to issue valuation directives based on its own guidelines. DOR claimed that four 1985 Board equalization orders were outside the Board's authority. The equalization orders instructed four counties to ignore the market adjustment factors in the Department's directives dated December 31, 1984. The Court's decision voided the four equalization orders in question. The Board of Tax Appeals has appealed this decision. The decision stated that:

> If the Board has [the power to reject the guidelines and directives of the Department . . . and determine for itself, by its own methods, what full cash value is], we would have to assume that the legislature has empowered two state agencies to perform the same task. This would create a confused and redundant system of taxation. The case before this Court shows the effect of such confusion when counties are subjected to contradictory edicts from two state agencies.

The Department of Revenue is best suited to carry out the equalization function in Arizona. DOR has significantly more resources devoted to the property tax area than the Board of Tax Appeals. The Board currently has a total staff of six FTEs, including three property appraisers. DOR currently has at least 40 property appraiser and examiner positions out of a total of 72 FTEs. The process of equalization requires considerable analysis and research, which requires staff resources. Therefore, for the Board to effectively perform equalization functions, its resources would have to be significantly increased. This could lead to duplication of effort between the Board and DOR.

If equalization authority is placed under DOR, an avenue for assessors and property owners to challenge DOR actions is still needed. The Board of Tax Appeals can effectively provide for this, without the need for court action. Existing statutes give the Board the full power to "hear and decide all appeals from decisions of the department of revenue." However, in order to eliminate existing confusion over equalization authority, the power to ". . . equalize the valuation of all property throughout the state . . ." should be taken from the Board and given to the Department. The Board should retain full authority to review the Department's equalization orders for compliance with the law if so requested by a county. House Bill 2332 currently being considered by the Legislature places equalization authority under DOR.

County Assessors Lack Confidence In Sales Ratio Studies

Assessors lack confidence in DOR's sales ratio studies. This may be due to inadequate assessor involvement in the development and use of the studies. Furthermore, assessors expressed concern over insufficient time to adequately implement DOR factors and make adjustments based on sales ratio studies.

DOR uses sales ratio studies to monitor whether valuations of property classes are equal within counties and among counties in Arizona. DOR's sales ratio studies monitor valuations by measuring the relationship between appraisals and market values. The data for market values come from sales prices reported on Affidavits of Real Property Value. The appraisals of these properties are the valuations set by the county assessors. From sales ratio information, DOR establishes adjustment factors for those classes of properties within a county that are appraised below or above market value.*

* Market value is set by DOR at a target ratio of 80 percent of nominal sales price. For example, if an average property in a class sells for $100,000, valuations in that class should average $80,000. DOR sets market value at this target ratio to eliminate non-real estate considerations from the sales price, such as financing and personal property. This is to arrive at statutorily required full cash value.

Use of sales ratio studies is a standard practice in property tax monitoring. Generally, property experts support the use of sales ratio studies. In fact, at least 40 states use sales ratio studies in some manner. According to the IAAO:

> "The uses of assessment-ratio studies can be as wide-ranging as concerns about assessment accuracy. Assessors use assessment-ratio studies to determine the need for a general reappraisal, to establish priorities for reappraisal of selected groups of properties, to identify potential problems with appraisal procedures, to trend appraisals between reappraisals, to adjust sales prices for time, and to develop depreciation factors."

Inadequate Assessor Involvement - County assessors may generally lack confidence in sales ratio studies because of insufficient involvement in their development and use. For example, several county assessors express concern over the sales data used in the sales ratio studies, especially for the commercial/industrial class. They sometimes believe that sales data may be insufficient for effective use in the studies. Examples of specific questions relating to sales data include:

- Whether there are enough sales in some classes and areas for valid ratios to be possible,
- Whether the sales are adequately screened and verified, and
- Whether the sales are properly grouped.

Some of the assessors' concerns may be valid. For example, the concern that there are insufficient sales in some areas to support sales ratio studies may be supported by consultants' analyses. These experts point out the need to supplement sales ratio studies with actual on-site appraisals when sufficient sales data is lacking. In addition, it is unclear whether DOR has sufficient staff to screen and verify all sales data.* In the summer of 1985 DOR agreed to screen all commercial sales

* Screening of sales data is important to ensure that sales included in the studies are valid arms length transactions. Further, sales with unique aspects such as inclusion of a large amount of personal property, or unusual creative financing may distort the studies. Such sales need to be adjusted or discarded.

and assessors agreed to screen all residential sales. However, screening of sales is a time consuming activity. According to a DOR employee, in the past DOR staff did commercial/industrial sales screening as time permitted. The Director of DOR stated the Department will meet its commitment to screen these sales in the future. However, county assessors are concerned that DOR may not have the resources to do this screening timely or adequately.

Some of the concerns assessors have may be due to a lack of communication between the assessors and DOR. This is indicated by the fact that property tax experts generally have a high regard for DOR's sales ratio studies. Therefore, closer coordination between DOR and county assessor staff may improve the preparation and use of sales data and sales ratio studies. Increased cooperation may lead to better relations between the assessors and DOR, and greater confidence in the studies.

Insufficient Time To Respond To Factors And Appeals - Assessors indicate that they need more time to adequately implement factors derived by DOR from the results of the sales ratio studies. Insufficient time may perpetuate uniformity problems within classes. There are several possible options to increase the time available to implement adjustments.

November 30 is the deadline for counties to send their valuations to DOR. DOR then completes its sales ratio reports and determines factors for counties where ratios indicate over- or under-valuations. The counties must make adjustments based on these factors and send out all property valuation notices by the statutory deadline of February 1.*

* Due to county delays in getting valuations and affidavits of sale to DOR, and DOR delays in completing sales ratio studies, the February 1 deadline has been missed by several counties over the past two years. If notices are sent out late by counties, it reduces the time for taxpayer appeals. All appeals must be completed by July 25. Last year the Board of Tax Appeals heard 4,000 cases. The counties and DOR need adequate time to respond to these appeals.

Historically, due to time constraints, the system has not allowed the counties to research and determine where specific adjustments need to be made. As a result, the factors have generally been applied across the board for affected classes within market areas or entire counties. While this addresses the uniformity and equality between and among classes and counties, it does not address the uniformity and equality of one parcel of property to another within a class. Due to county assessors' lack of confidence in data validity and verification of sales, the assessors would like the time to determine exactly which properties in a class are inaccurately valued and adjust those rather than applying a percentage increase or decrease to all properties in that class. In addition, they would like to be able to apply factors to smaller areas such as neighborhoods or submarket areas.

Time pressure could be eased if DOR factors were applied to the following year's valuation, instead of the current year's. This would give county assessors almost a full year to apply DOR factors instead of just one month or less. (House Bill 2332 contains a provision providing for equalization orders and revisions to be applied in the following tax year.) An alternative to this would be for DOR to provide midyear factors to counties during the course of a year, based on prior years valuations. DOR already conducts sales ratio studies four times per year. Another alternative would be to simply move the deadline for valuations being sent to DOR from November 30 to an earlier date.

CONCLUSION

Although DOR's property tax system is generally working well, several improvements could increase its efficiency and effectiveness. The existing construction cost system is outdated. Statutes relating to equalization authority are not clear. Further, county assessors lack confidence in DOR's sales ratio studies.

RECOMMENDATIONS

1. The Legislature should consider funding for development and implementation of an updated construction cost system, including resources for computer automation, reappraisal of all properties and annual revision of the system.

2. The Legislature should consider giving full equalization authority to DOR, while maintaining full authority to hear and decide appeals in the Board of Tax Appeals.

3. DOR should more closely coordinate with county assessors on the preparation and use of sales data and sales ratio studies. Further, DOR should consider the use of on-site appraisals, where appropriate, to supplement sales ratio studies.

4. Alternatives for increasing the length of time assessors have to implement DOR valuation factors should be studied and an improved time frame should be established.

AREA FOR FURTHER AUDIT WORK

During the course of our review we identified one potential issue that we could not pursue due to time constraints.

- Is DOR's Division of Property and Special Taxes understaffed?

  Many county and DOR employees have stated that staff levels in assessors' offices and in the Division of Property and Special Taxation are not adequate. With low county staffing levels and budget constraints, there appears to be no alternative to DOR taking an active role in helping assessors with necessary appraisal work, such as the review of commercial/industrial properties in preparation for the new construction cost system. Further, DOR functions such as screening affidavits of sales, updating the construction cost manual, auditing county assessors and conducting on-site appraisals may be understaffed. Overall staffing in the Division has remained relatively constant over the past five years, while DOR's total authorized FTEs have increased by more than one-third.

  Further audit work, or analysis on the part of DOR, is needed to clearly establish the staffing levels required within the Division of Property and Special Taxes. Although the Division generates little direct revenue to the State,* total property tax revenues in Arizona will total more than $1.3 billion for fiscal year 1985-86. This figure, combined with the potential liability resulting from equity considerations, makes adequate staffing at the State level important.

* The State property tax rate is only 40 cents per $100 of assessed valuation, while the average total primary tax rate in Arizona is $7.44.

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

Bruce Babbitt
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MAR 1986
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AUDITOR
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March 21, 1986

Mr. Douglas R. Norton
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Dear Mr. Norton:

I have reviewed the report draft of your performance audit of the Division of Property and Special Taxes of the Department of Revenue. I generally agree with the findings and recommendation contained in your report. The problems cited are real and we are addressing them. Your recommendations are constructive, and I believe they are directed toward desirable improvements.

My following comments are intended to clarify several issues to permit a broader understanding by readers of this report:

Recommendation 1

The Legislature should consider funding for development and implementation of an updated construction cost system, including resources for computer automation, reappraisal of all properties and annual revision of the system.

Comment

The importance of an accurate and current construction cost system for valuation of property cannot be overemphasized. Your report cited consequences of failure to develop and implement an updated construction cost system. It should be noted that funding for that purpose has been requested in this Department's 1986-87 budget. If that funding is made available, the new system will be implemented for 1988 and the underlying inequities which exist because of the need for an updated system can be addressed. Some of the inequities are being alleviated through use of sales ratio studies, but large parcel variances between commercial properties will generally

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Recommendation 1

Comments (continued)

continue until a reliable construction cost system is implemented. While we anticipate developing the computerization by January 1988, the needed recanvassing of commercial/industrial properties will occur later as we acquire and train needed personnel.

Recommendation 2

The Legislature should consider giving full equalization authority to DOR, while maintaining full authority to hear and decide appeals in the Board of Tax Appeals.

Comment

We believe that uniformity and equity for all taxpayers would be served by implementing the recommended revisions to the equalization process.

Recommendation 3

The Department of Revenue should more closely coordinate with county assessors on the preparation and use of sales ratio studies. Further, DOR should consider the use of on-site appraisals, where appropriate, to supplement sales ratio studies.

Comment

The Department of Revenue has made substantial efforts to involve the county assessors in the sales ratio process and to recognize and be responsive to their legitimate concerns.

When the sales ratio system was first developed in 1979, input was sought from the assessors and the State Board of Tax Appeals. Educational programs for assessors and their staffs have been conducted to teach them how to effectively use sales ratio studies. Modifications to the system have been made several times since then in response to the assessors' recommendations. A joint committee of assessors and DOR staff was established in 1985 to review sales ratio studies and their use, and to make recommendations for improvements. The assessors' recommendations made through that committee have largely been implemented. Enhancements adopted include extension of the time period for commercial and industrial sales to 30 months. The Department stands ready to consider

Recommendation 3

Comments (Continued)

additional constructive suggestions for improvements to the system. It should also be noted that assessors were given the opportunity to review sales in the system to evaluate their status as "usable" or "not usable" for sales ratio purposes, and to request changes as appropriate after that evaluation. In 1986, six counties, including Maricopa and Pima, made a request to change the status of numerous commercial and industrial property sales, of which at least 95 percent were approved by the Department.

Through agreement with the assessors, and consistent with recommendations contained in the Welch/Gustafson Report to the Legislature (June 1985), the assessors now have primary responsibility for screening all residential property and vacant land sales. The Department of Revenue has taken full responsibility for screening commercial and industrial property sales. In response to that commitment, a staff team has been assigned to complete the screening of commercial and industrial sales during the last quarter of the 1985-86 fiscal year and into the first month of the 1986-87 fiscal year. That schedule will permit the assessors sufficient time afterwards to review the commercial and industrial property sales to be used for the initial sales ratio reports produced in September 1987. (This reshuffling of DOR resources has the drawback that our ability to assist some counties on reappraisal projects will be reduced.)

Your report noted that ". . . county assessors are concerned that DOR may not have the resources to do this screening timely and adequately." While existing Department resources are being diverted from other projects to screen commercial and industrial sales now, additional personnel will be required to perform those screenings in the future. The Department's budget request for 1986-87 includes requested funds for a permanent program of sales analysis.

Recommendation 4

Alternatives for increasing the length of time assessors have to implement DOR valuation factors should be studied and an improved time frame should be established.

Comment

The Department of Revenue agrees that the time frame should be lengthened for assessors to effectively implement measures required to assure compliance with legal standards of value.

House Bill 2332, as amended, provides for revised equalization procedures and time frames as you recommend. The bill alters the equalization process and allows time for assessors to be involved prior to implementing equalization orders so that valuation factors can be placed in a fashion that produces the greatest level of uniformity between classes and between parcels within classes of property.

We appreciate your recognition of the improvements in property valuation performance achieved as a result of the Department's active role in assuring that property values are established at more equitable levels of market value. Those results, particularly for the 1983 and 1985 tax years, are depicted very significantly in the graphs included in your report.

Your staff conducted this audit under stringent time constraints and we commend them for their professionalism and their insight in identifying the core issues affecting performance of the Division of Property and Special Taxes in administering the property tax.

Sincerely,

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

blm/e39a