Department of Revenue
Tax Processing

Performance Audit
September 2011

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Office of the State Auditor

Dianne E. Ray, CPA
State Auditor

September 2, 2011

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Department of Revenue tax processing system, including functions performed by both the Department of Revenue and the Department of Personnel & Administration, Division of Central Services. 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, and the responses of the Department of Revenue and the Department of Personnel & Administration, Division of Central Services.

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Glossary of Terms and Abbreviations

Central Services – Department of Personnel & Administration's Division of Central Services

Department – Colorado Department of Revenue

e-filing – Electronic filing

e-payment – Electronic payment

OCR – Optical Character Recognition

RAS – Revenue Accounting System

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DEPARTMENT OF REVENUE
TAX PROCESSING
Performance Audit, September 2011
Report Highlights

Dianne E. Ray, CPA
State Auditor

Department of Revenue
Department of Personnel & Administration

PURPOSE

Assess the Department of Revenue's (the Department) tax processing system, called the "tax pipeline," for opportunities to increase efficiency and effectiveness, reduce state expenditures, and produce greater value for taxpayers and the State of Colorado.

BACKGROUND

- The Department is statutorily responsible for managing Colorado's tax system, including processing tax returns, depositing tax payments into the State's treasury, issuing tax refunds, distributing sales tax money to the appropriate entities, and resolving taxpayer problems.
- Since 1982, the Department has procured data entry and imaging services for tax documents from the Department of Personnel & Administration.
- The Department collected $10.2 billion for all taxes in Fiscal Year 2011 and annually processes about 4.3 million paper tax documents and 2.5 million checks. Operating the tax pipeline costs the Department approximately $4.2 million per year.

OUR RECOMMENDATIONS

The Departments of Revenue and Personnel & Administration should:

- Determine which Department should implement new technology for the tax pipeline and eliminate positions no longer needed.
- Maximize the Department of Revenue's use of the Department of Personnel & Administration's Division of Central Services for outgoing mail processing and warrant printing, and reallocate or eliminate staff no longer needed.
- Establish a plan and specific performance measures for increasing e-filing and e-payment rates, including seeking additional statutory e-filing and e-payment mandates.

EVALUATION CONCERN

The tax pipeline involves highly inefficient and costly manual processes that could be improved with the implementation of newer and more sophisticated technology.

KEY FACTS AND FINDINGS

- The tax pipeline relies heavily on manually intensive processes that can take weeks to complete. Technology exists that could automate most of the processes in the tax pipeline, from opening and sorting paper tax documents that arrive in the mail to imaging those documents, extracting data from the documents to upload to the Department's tax systems, and processing checks for deposit.

- Implementation of new technology in the tax pipeline would improve efficiency and allow for reductions or reallocations of full-time-equivalent staff.

- The Department is not fully utilizing Central Services within the Department of Personnel & Administration, as required by statute, for services including: (1) processing outgoing mail, (2) processing warrants (checks), and (3) printing tax-related documents.

- Additional action could be taken to maximize taxpayers' use of e-filing and e-payment in Colorado. Current state law leaves it up to the taxpayer, in most cases, to choose whether to file and pay taxes electronically. The Department could achieve greater efficiencies and cost savings by seeking statutory authority to mandate e-filing and e-payment for other types of taxes that are not currently required to be filed or paid electronically.

COST SAVINGS

In total, we were able to identify potential annual cost savings of at least $2.1 million, including savings of $574,000 for implementing new technology and updating processes in the tax pipeline, and $1.5 million if the Department can take additional actions that encourage taxpayers to increase their use of e-filing.

For further information about this report, contact the Office of the State Auditor
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Department of Revenue Tax Processing

Purpose and Scope

Article 35 of Title 24 of the Colorado Revised Statutes gives the Department of Revenue (the Department) responsibility for managing Colorado's tax system. Generally, managing Colorado's tax system includes processing tax returns, depositing tax payments into the State's treasury, issuing tax refunds, distributing sales tax money to the appropriate entities, and resolving taxpayer problems. In addition, the Department is responsible for intercepting income tax refunds to pay debts owed to other state agencies, and distributing tax information to the public and tax professionals. The Department's responsibilities related to collecting, recording, and depositing tax payments, including fine and fee revenue received for delinquent tax payments, are collectively known as the "tax pipeline." Processing payments received is also referred to as remittance processing. Since tax revenue is a primary funding source for state programs and services, it is important that the Department collect and deposit tax revenue quickly and efficiently to maximize the State's total collections and interest earnings. In addition, tax information is highly sensitive, and it is critical that the Department maintains the confidentiality, integrity, and availability of taxpayer data. In Fiscal Year 2010, the State's total collections for all tax types were about $10.2 billion.

Due to the tax pipeline's importance to the State, the Office of the State Auditor conducted a performance audit of the tax pipeline, including reviewing processes that compose the tax pipeline and assessing the overall efficiency and cost-effectiveness of the tax pipeline. The audit also reviewed the availability and use of electronic filing (e-filing) for Colorado taxpayers. Specifically, the audit was performed to meet the following objectives:

- Review the efficiency, effectiveness, and timeliness of the tax pipeline, including remittance processing.

- Determine whether opportunities exist for the Department to expand the types of tax returns filed electronically and to increase the rate of e-filing and e-payments in Colorado. Tax documents and payments filed electronically reduce the volume of paper documents and checks that must be processed through the tax pipeline and are less expensive to process than paper returns and checks.

As part of the audit, we reviewed tax pipeline processes and statutes, and analyzed budget documents and requests. We conducted interviews with personnel from the two key stakeholders in tax document and payment processing, the Department of Revenue and the Department of Personnel & Administration's Division of Central Services (Central Services). We also interviewed local certified public accountants and tax preparers for information about the availability and use of e-filing, and we compared Department e-filing statistics and practices to all 50 states and the U.S. Internal Revenue Service. The audit work was performed between February and June 2011 and was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Summary of Findings

We reviewed the tax pipeline and each of the steps in the process of receiving paper tax documents via mail, processing the documents, depositing tax payments, and imaging the documents for archival purposes. We also reviewed the Department's capabilities for processing electronic filings, the types of taxes for which e-filing is available, and the rate of e-filing for the major tax types. Overall, our audit found that the Department's operations related to income and business tax (including sales taxes) processing and payments are outdated, inefficient, and not cost-effective and that taxpayer use of e-filing has not reached its fullest potential. By updating these processes, the Department stands to improve efficiency, reduce costs, and improve the accuracy and timeliness of income and business tax processing. When feasible, we quantify potential cost savings for each area where we recommend improvements. However, in some cases, the cost savings depend upon how the Department and Central Services choose to implement the audit recommendations. In total, we were able to identify potential annual cost savings of at least $2.1 million. These cost savings are described in the bullets below. In all cases, cost savings can only be realized if both the Department and Central Services make significant changes and eliminate outdated processes and associated full-time-equivalent (FTE) staff. Specifically, we identified concerns in three areas:

- **Tax Return and Payment Processing—**Technology exists that could automate most of the processes in the tax pipeline, from opening and sorting paper tax documents that arrive in the mail to imaging those documents, extracting data from the documents to upload to the Department's tax systems (GenTax and the Revenue Accounting System), and processing checks for deposit. We reviewed the tax pipeline and found that the Department's tax pipeline process is antiquated and inefficiently divided between two state departments—the Department and the Department of Personnel & Administration (Central Services). Specifically, the tax pipeline relies heavily on manually intensive processes that can take weeks to complete and, in some cases, does not use the most up-to-date technology that would eliminate many of the manual processes and the need for much of the manual data entry, and prevent costly data entry errors. We found estimated cost savings of $574,000 annually in the tax pipeline process based on manual inefficiencies. However, even greater cost savings can be achieved if the Department and Central Services work together to identify the optimal technical advances, location, and structure of all the tax pipeline processes. In order to fully recognize the benefits of updating the tax pipeline, both the Department and Central Services will need to eliminate outdated, manual processes and reduce associated FTE in order to realize a net cost savings for the State.

- **Central Services—**Section 24-30-1101 et al., C.R.S., requires that all departments and agencies under the Executive Branch use Central Services for printing, data entry, mail-related services, imaging, and other administrative support functions. We found that the Department is not fully utilizing Central Services for some of these services. Specifically, we found that the Department currently performs the following services that could possibly be provided more cost efficiently by Central Services: (1) processing outgoing mail, (2) processing warrants (checks), and (3) printing tax-related documents. The Department has not requested nor has Central Services performed a cost savings analysis to determine if Central Services could be performing the services currently performed by the Department at a cost savings to the State.

- **E-Filing and E-payment—**We found that while the Department offers many choices to taxpayers for filing taxes electronically (e-filing) and making tax payments electronically (e-payment) and has the capability to process many taxes electronically, ultimately, current laws leave it up to the taxpayer, in most cases, to choose whether to file and pay taxes electronically. We found that there are additional actions the Department could take to encourage taxpayer use of e-filing and e-payment in Colorado. It is important to note that even if taxpayers e-file their tax return, they are not necessarily obligated to pay any taxes due by e-payment. In total, we estimate that the Department could save approximately $1.5 million annually if taxpayers increased their use of e-filing from 75 percent for individual income tax, 15 percent for corporate income tax, 28 percent for partnership income tax, and 25 percent for sales taxes to 80 percent for all tax types listed. While the Department does not currently know how much less expensive an e-payment (e.g., electronic funds transfer or credit card payment) is than processing paper checks, it is likely the Department would also experience cost savings in staff time needed to process paper checks, and some additional costs of imaging and depositing those paper checks.

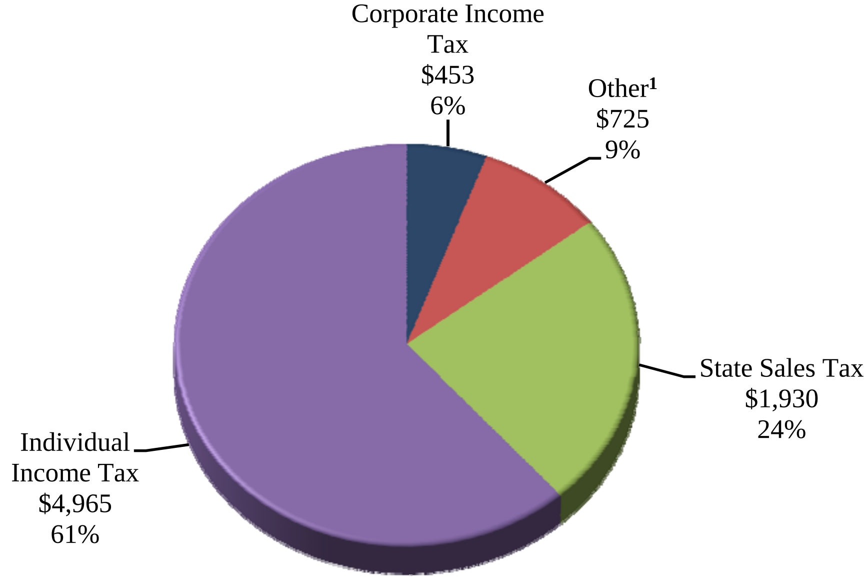
These issues are discussed in more detail below.

Background

Individuals and corporations can file income taxes by mailing paper tax forms to the Department or by submitting e-filings, which is a procedure for filing tax returns through the Internet. Businesses have the option to file some business taxes online, such as sales taxes, through the Department's website. Additionally, for some taxes, such as estimated severance tax and wage withholding, when tax liability exceeds $50,000 annually, e-filing or e-payment has been mandated by the State. However, not all business taxes can be filed online, such as employment and some excise taxes, which must be filed using paper tax documents. The Department hopes to develop online e-filing applications for these types of taxes in the future.

In Fiscal Year 2010, the State's tax collections totaled about $10.2 billion. Of this amount, about $8.1 billion represents collections for the General Fund; the remainder represents collections made on behalf of other government entities, such as local governments and the Highway Users Tax Fund. The following table shows Fiscal Year 2010 tax collections by type of tax.

Department of Revenue
General Fund Revenue Collections by Tax Type
(In Millions)
For Fiscal Year Ended June 30, 2010



Source: Department of Revenue, Fiscal Year 2010 Collections Report.
[1]Other tax includes items such as severance tax, estate and trust income tax, and fuel tax.

As noted previously, the "tax pipeline" refers to the Department's process for accurately and efficiently turning paper documents and payments into electronic data and depositing tax revenue into the State's treasury as quickly as possible to maximize the State's interest earnings. According to the Department, the tax pipeline staff annually process approximately 4.3 million paper tax documents and 2.5 million checks worth more than $5.5 billion in tax revenue for all tax types.

Since 1982, processing of tax payments and documents has been conducted by staff within both the Department's Division of Central Department Operations and Central Services. The following is a high-level overview of the tax pipeline.

- **Incoming Mail Processing—**Tax documents that are not filed electronically arrive at the Department via mail. The mail is sorted for further processing.

- **Document and Payment Preparation—**Department staff sort the contents of the mail based on the type of tax and documentation and whether or not they contain a payment. Tax documents and payments are then distributed to different operational sections within the Department and prepared for data entry and payment processing.

- **Remittance Processing—**Department staff in this section utilize check processing hardware and software to prepare the checks for deposit with the bank and capture the accompanying tax document information for upload into the Department's tax processing systems.

- **Data Entry—**Most tax documents are then sent from the Department's Denver office to Central Services in Pueblo for data entry.

- **Error Resolution—**Once data entry is complete, Central Services transports the tax documents back to the Department's Denver office, where staff resolve any errors detected by the Department's tax processing systems. Once errors have been resolved, the documents not imaged in the Department's remittance process are again packed up and sent to Central Services for imaging in Pueblo.

- **Imaging—**Central Services scans the documents into image files for archival and research purposes, and then packages the documents for shipment back to the Department's Denver office for quality control.

- **Tax Document Retention and Quality Control—**As part of the quality control component of the process, Department staff compare the images to the paper documents to ensure that the image files are correct. Original paper documents are tracked and securely destroyed; the Department retains images for 10 years.

We provide a more detailed flowchart of this process in the discussion related to Recommendation No. 1 later in this report.

In Fiscal Year 2010, the Department spent approximately $2.1 million on data entry and scanning services provided by approximately 31.25 Central Services FTE. The total cost of the tax pipeline, including data entry and imaging, was approximately $4.2 million in Fiscal Year 2010.

Tax Document and Payment Processing

The Lean Government Act (House Bill 11-1212), which was passed during the 2011 Legislative Session, asks state departments to continually and rapidly improve state government processes by eliminating non-value-added processes and resources and developing actionable plans to increase efficiency and effectiveness. These plans can include changing processes to decrease staff time, inventory, defects, overproduction, complexity, delays, or excessive movement. Plans should include clear timelines and performance measures for making process improvements and for reallocating or removing resources, reducing expenditures, and producing greater value. Further, these process improvements should lead to increased efficiency and sustainability and should allow for long-range planning, including collaboration among the various departments.

We reviewed the Department's tax pipeline processes and found two main issues that prevent the tax pipeline from being efficient and cost-effective. First, the tax pipeline relies heavily on inefficient and antiquated manual processes, and second, the process is inefficiently divided between the Department and Central Services.

Manual Inefficiencies

Since 1963, the Department has been tasked with the collection of taxes and licensing fees. Over the years, the Department developed processes that allowed it to process tax documents and payments as efficiently as it could, including procuring data entry and imaging services from Central Services. However, over time, many of the processes involved in the tax pipeline have become outdated, and manual processes that used to be the only way to get things done can now be automated. To take advantage of many technologies available to automate its processes, the Department first needed to update the applications it used to process taxes. The Department began implementation of the GenTax system in 2007 as the first step towards its goal of improving the tax pipeline. However, since implementing GenTax, the Department has not worked with Central Services to assess what technology it possessed that could have automated additional parts of the pipeline and reduced processing time for tax documents.

The Department has taken some action towards trying to update the technology in the tax pipeline. Specifically, the Department reports that, in 2002, it performed an Imaging Feasibility Study. Five years later, in 2007, the Department issued a Request for Information to get a better understanding of the most recent technological improvements in this field. In 2008, the Department submitted a decision item during its annual budget process requesting funding for a new system to automate the pipeline, which included both hardware and software. However, due to budget limitations, the Department has been unable to procure its own technology that could automate most of the processes in the tax pipeline, from opening and sorting paper tax documents that arrive in the mail to imaging those documents and payments, extracting data from the documents to upload to the tax system, and preparing checks for deposit. Even though tax documents and payments are processed within the allowable time as dictated by statute, the implementation of new technology could reduce risks and make the process more efficient and timely. Specifically, the tax pipeline currently consists of several manual processes, described below, that are both time intensive and costly. We believe that updating these manually intensive processes could result in a minimum savings to the state of $574,000 annually. These savings are highlighted below.

- **Incoming Mail Processing—**The first part of the tax pipeline involves processing and sorting all incoming mail at the Department's Denver office. First, mailroom staff run mail through a machine that opens the envelopes and sorts them by whether or not they contain a payment. The mail is then placed into bins for further sorting by hand. Staff manually go through the bins and remove all tax documents and payments from the envelopes and hand sort the documents first by tax type, then by document type. The Department utilizes eight FTE, staff from other sections, and temporary staff to open and sort about 4 million pieces of mail every year at a cost of $508,000. Although we were unable to identify specific cost savings in this area, it is likely that an updated pipeline would result in significant cost savings in the incoming mail process.

- **Document and Payment Preparation—**In this section of the tax pipeline, staff spend time preparing paper tax documents for payment processing and eventually data entry. Preparation can involve manually cutting documents down to the appropriate size, cleaning or repairing tax documents that are dirty or torn, creating identifying documentation for loose checks, and assigning tax account numbers to new businesses that have sent in tax payments. The Department estimates that 11 FTE in its Income and Business Tax Clearing Sections spend up to 25 percent of their time manually cutting and resizing documents that are processed with accompanying payments, for an estimated cost to the Department in Fiscal Year 2010 of approximately $125,800. Further, in Fiscal Year 2010, an additional five FTE in the Department's Registration Control Section spent approximately 40 percent of their time creating identifying documentation for about 15,000 to 20,000 loose checks each month, before the checks could be processed for deposit. With the implementation of imaging at the beginning of the pipeline, staff would no longer have to create identifying documentation for payment processing, as staff will be able to work on identifying where the payment should be applied by working with the image in the tax processing database. We estimate that this could result in annual savings of $77,000. According to the Department, each year it processes approximately 4.3 million paper tax documents and 2.5 million checks worth more than $5.5 billion in tax revenue for all tax types.

- **Data Entry—**Most tax documents are shipped from the Department's Denver office to the Central Services facility in Pueblo, where staff data enter the tax filing information into a Department of Revenue-owned software application that then uploads the data into the Department's tax systems. In Fiscal Year 2010, the Department paid Central Services about $1.7 million to enter data from about 4.3 million paper tax documents. Data entry is not only costly, it is also prone to errors. In addition, for the Department to meet statutory deadlines related to how quickly tax documents must be processed, the Department sends the paper tax documents back and forth between the Department's Denver office and Central Services' Pueblo facility on two different occasions.

We found that the Department could be capturing savings in data entry costs if it was to utilize a service already offered by Central Services known as Optical Character Recognition (OCR). Central Services reports that it has used OCR software for other state agencies to eliminate 70 to 80 percent of data entry. OCR software recognizes characters on a scanned document and puts them into a format that can be uploaded to other computer systems or databases.

We found that Central Services does have OCR software that can be used as an alternative to manually entering the tax information. The Department is not currently using the OCR services at Central Services, even though use of this technology would eliminate the need to transport tax documents to Pueblo twice and would likely reduce data entry for those documents by about 70 percent. Due to the fact that Central Services was unable to sufficiently evaluate the tax documents in the OCR process and provide us with a fee for OCR services for the Department, we were unable to calculate specific savings for the use of OCR. However, use of OCR would likely reduce the need for data entry by 70 percent as well as eliminate one of the trips to Pueblo.

- **Error Resolution—**The Department utilizes 21 FTE and 14 temporary staff to review and correct errors that are detected by the Department's tax processing systems. These errors most often are caused by taxpayers submitting the wrong information but in some cases can also be caused by data entry errors. The Department estimates that staff spend approximately 70 to 75 percent of their time researching and correcting errors made by taxpayers and 25 to 30 percent of their time correcting and fixing data entry errors. In Fiscal Year 2010, we estimate that staff time spent correcting data entry errors cost the Department approximately $371,500. Regardless of whether the errors are caused by taxpayers or through data entry, staff must compare paper tax documents to the information in GenTax and the Revenue Accounting System to make corrections. Data entry errors can be significantly reduced by utilizing newer technology.

- **Imaging—**After the Department has finished reviewing tax documents, it once again packages and sends the documents, not previously imaged at the Department, to Central Services for imaging. Central Services images the documents and then repackages them to be sent back to the Department for quality control, archiving, and eventual destruction.

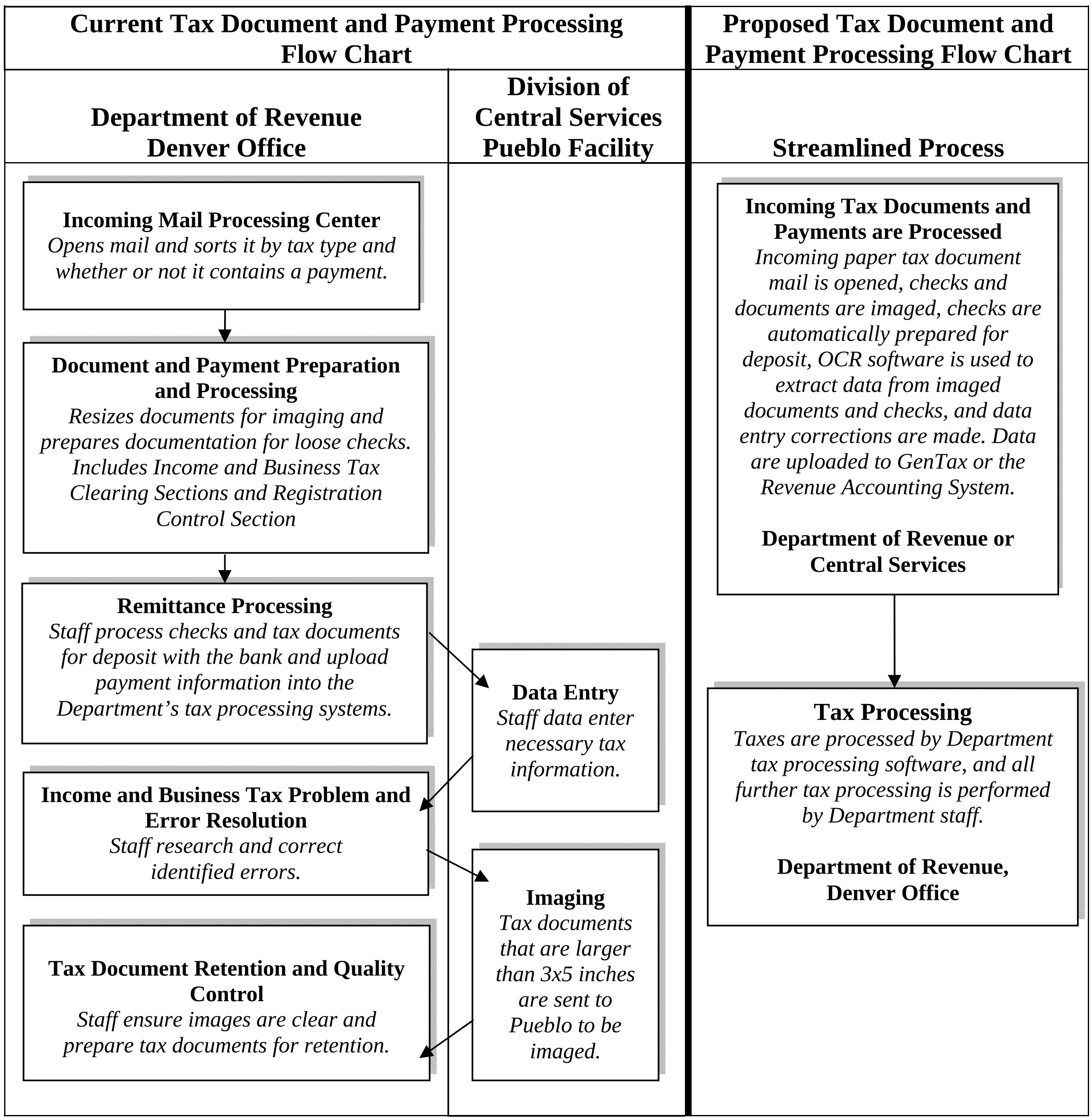
Technology is available that can open mail, scan the tax documents and checks (without the need for resizing), use OCR and other software to extract the data on the documents and upload that data directly into the appropriate information system (such as GenTax), and prepare the checks for deposit. This technology eliminates most of the need for manual processing of incoming mail, reduces data entry needs from 100 percent of all tax documents to about 30 percent of tax documents, and reduces the number of errors that come from data entry. Implementation of new technology, either at the Department or at Central Services, would greatly reduce the number of FTE whom the Department would need to dedicate to processing incoming mail, preparing documents and checks for imaging, data entering tax information into GenTax, and resolving errors related to manual data entry. Further, the use of newer technology would allow for a reduction in data entry staff at Central Services. The Department and Central Services have a responsibility to maximize the use of state resources by processing tax documentation and payments in the most efficient manner possible.

Divided Operation of Tax Pipeline

House Bill 11-1212 incorporated lean government principles into state law by requiring, among other things, state agencies to examine their activities and take action to eliminate non-value-added processes and resources, and make improvements to processes that will increase the value of state services, decrease staff time, and reduce delays and duplicative processes. We reviewed the tax pipeline and found inefficiencies at each stage in the pipeline process. In addition, we found that the pipeline process as a whole is inefficiently split between two different departments, the Department of Revenue and the Department of Personnel & Administration's Division of Central Services. The tax pipeline process has evolved to its current inefficient state as the result of both technology outpacing the Department's ability to upgrade equipment and software and the result of state law requiring that Central Services provide all data entry and imaging services. Earlier, we discussed how technology could eliminate a number of inefficiencies in the tax pipeline. While these technologies could be implemented at either or both Departments, we believe that the maximum efficiency can only be gained by having a single state agency process the incoming tax document mail, image the documents and checks, use newer technology to extract the data from the documents, and deposit the checks. Transporting documents back and forth between two cities and two different departments for this purpose is time-consuming.

The following two flowcharts compare the current tax pipeline process to what the process could be if appropriate technologies discussed earlier are implemented.

Comparison of Current Tax Pipeline Process and Potential Updated Process



Source: Office of the State Auditor's analysis of information from the Department of Revenue and Central Services.

The two key stakeholders in the current tax pipeline process, the Department and Central Services, agree that the tax pipeline is not only outdated but is also costly and highly inefficient. The implementation of new technology, as previously discussed in the Manual Inefficiencies section of this report, would greatly improve the efficiency of the process and allow for reductions or reallocations of FTE. However, only one of the Departments should implement the technology since duplication would not be cost-effective to the State. The type of technology purchased and the benefits and cost savings to the State would be very different based on which department implements the technology.

The Department estimates that it would need $2 million to implement the technology necessary to automate the tax pipeline. Alternatively, Central Services has some of the technology needed already, but it has not yet put together a comprehensive estimate of what additional equipment or technology might be needed to automate these aspects of the tax pipeline. This cost information is an important element for consideration of where to locate the tax pipeline. As of today, neither stakeholder has secured the necessary funds to purchase and implement the technology that could bring tax document and payment processing into the 21st century. Further, although the Departments are currently engaged in discussions about how to upgrade and streamline the tax pipeline processes, neither the Department nor Central Services has yet to come to agreement as to where the new technology and processes should be housed, nor which Department should incur the accompanying cuts in appropriated funds and allocated staff. Both the Department and Central Services report that they have the responsibility and the capability to implement the technology that can dramatically improve tax processing functionality.

The Department and Central Services will need to resolve where the processes will reside and ensure that the technology is placed at the department where the most efficiencies and the greatest cost savings can be achieved for the State as a whole. For example, it is possible that other state agencies or local governments could benefit from the new technology needed to update the tax pipeline process, which could indicate that the technology is best suited for Central Services. However, if such technology does not have a broader statewide use, then it may be better suited for the Department of Revenue. Further, the Department and Central Services should consider any negative impacts that implementation of new technology at either location could have on the State, such as loss of services or unsustainable fee increases at Central Services, increased risk to taxpayer payments, or potential loss of interest due to delayed bank deposits.

In order for cost savings to the State to be realized, reductions in allocated funds and staff will have to be considered at both Departments once new technology is implemented. No matter where the new technology is implemented, both Departments would have to evaluate their current staffing levels. For example, if technology is implemented at the Department of Revenue, the Department would greatly reduce its use of Central Services; specifically, it would eliminate the use of data entry by approximately 70 percent and would no longer require any imaging or transportation services to and from Central Services' Pueblo location. Under this scenario, Central Services would need to eliminate data entry, imaging, administrative, and other document handling staff accordingly, and the Department could also reduce the number of staff who are currently opening and sorting mail, resizing tax documents, and packaging tax documents to ship to Central Services in Pueblo. Further, the Department could reduce the number of staff handling data entry errors that will be minimized through the use of new technology. The Department would also need to eliminate or reduce these positions in order to realize cost savings to the State if the new technology was implemented at Central Services. Under this scenario, Central Services should also evaluate staffing needs for data entry and reduce FTE and spending accordingly.

We estimate that implementation of new technology could reduce the amount of time it would take the Department to process tax documents and payments by up to 98 percent. New technology could also result in better service for Colorado taxpayers and maximized interest earnings for the State. In short, advances in technology have made the tax pipeline antiquated and inefficient. If the State is to realize cost savings now and in the future, it is imperative that new technology be purchased and implemented at either the Department or Central Services.

Recommendation No. 1:

The Departments of Revenue and Personnel & Administration should streamline the tax pipeline processes by:

a. Determining which Department should perform the tax document and payment processing activities, including processing incoming mail, depositing checks received, imaging tax documents and payments, and uploading data extracted from those documents into GenTax and the Revenue Accounting System.

b. Working with the Governor's Office of State Planning and Budgeting and the Joint Budget Committee to procure funding for the necessary equipment and software to update the tax pipeline processes.

c. Working with the Governor's Office of State Planning and Budgeting and the Joint Budget Committee to include in the budget process positions to eliminate or reallocate and expenses to reduce at the Department of Revenue or the Division of Central Services that will no longer be needed with the implementation of the new tax pipeline processes.

Department of Revenue Response:

Agree. Implementation date: July 2012.

a. The Department of Revenue will work in collaboration with the Department of Personnel & Administration to determine the most cost-effective way to proceed with performing tax document and payment processing activities. This will include a comprehensive review and cost analysis for implementation of this processing at either Department, including the overall cost to the State.

b. The Department will work with the Department of Personnel & Administration, the Governor's Office of State Planning and Budgeting, and the Joint Budget Committee, as appropriate, to procure the funds necessary to implement the identified solution for the tax pipeline process.

c. The Department will work with the Governor's Office of State Planning and Budgeting and the Joint Budget Committee to develop a budget that will include, as appropriate, the elimination or reallocation of expenses based on the identified solution for the tax pipeline process.

Department of Personnel & Administration Response:

Agree. Implementation date: July 2012.

The Department of Personnel & Administration will work in collaboration with the Department of Revenue to determine the most cost-effective way to proceed with performing tax document and payment processing activities. This will include a comprehensive review and cost analysis for implementation of this processing at either Department, including the overall cost to the State. The Department will then work with the Department of Revenue, the Governor's Office of State Planning and Budgeting, and the Joint Budget Committee, as appropriate, to implement the identified solution for the tax pipeline process.

Central Services

Section 24-30-1101, et al., C.R.S., requires Central Services to provide centralized services for all state agencies. Central Services was established to eliminate redundant administrative processes at individual state agencies, thereby creating savings through economies of scale. In keeping with that mandate, Central Services provides a full range of services, including printing, mail processing, data entry, imaging, state warrant (check) issuing, and online services, such as requesting business cards or new state employee identification badges.

For the State to maximize the savings it can achieve through centralizing state services, all departments must maximize their use of the services offered by Central Services. In the event that Central Services is unable to provide a requested service or a department is able to procure the same service at a net savings to the State, statute (Section 24-30-1104, C.R.S.) allows Central Services to grant the department a waiver from using its services. Unless a department has a waiver, it should be using Central Services for all of its printing, mailing, data entry, imaging, and online services. Some cities and counties also take advantage of the discounted rates for mail processing and printing offered by Central Services. For example, Central Services provides both mail services and printing services, such as form letters, brochures, and reports, for the City and County of Denver, including all of the outgoing mail that is generated by the city's tax processing software.

During our review of the tax pipeline, it came to our attention that, currently, the Department is not maximizing its use of services offered by Central Services. Specifically, we found that the Department performs the following tasks that could be performed more efficiently by Central Services.

- **The Department Processes All of Its Own Outgoing Mail.** In Fiscal Year 2011, the Department processed approximately 4 million pieces of mail, costing approximately $1.6 million in postage. This mail ranged in size from an ounce to 50 pounds, at an average postal rate of 39.6 cents per piece of mail. The majority of this mail is automatically generated by the GenTax system in zip code order. While the mail is printed in zip code order, it must be further presorted by hand in order for the Department to obtain a discounted postal rate. This hand sorting is performed by 0.5 FTE. By contrast, Central Services has equipment that automatically presorts outgoing mail, by zip code, which saves the State about 6.2 cents per piece of mail based on mailing a 1-ounce letter at the standard rate of 44 cents. We estimate that if Central Services had processed the Department's mail in Fiscal Year 2011, the Department at a minimum could have eliminated or reallocated the 0.5 FTE who is currently sorting the 4 million pieces of outgoing mail by hand. Further, greater savings could be obtained by merging the two outgoing mail rooms, one at the

Department and the main facility at Central Services, into only one outgoing mail room, reducing the number of duplicative staff and resources. Our discussions with Central Services indicate that it has the capacity and expertise needed to take over outgoing mail services for the Department.

- **The Department Prints and Prepares for Mailing All Warrants (Checks) for Payment of Tax Refunds.** In Fiscal Year 2010, the Department printed and prepared for mailing about 630,400 warrants out of the GenTax system. Central Services offers a warrant printing service for all agencies in the state. Because of economies of scale, adding the Department's volume of warrant printing and mailing to Central Services would reduce the overall cost of printing and mailing warrants for all agencies in the state, including the Department. Our discussions with Central Services indicate that it has both the capacity and expertise needed to print and mail all warrants for the Department.

- **The Department Prints Tax-Related Documents.** In Fiscal Year 2011, the Department's various tax systems generated about 4 million printed tax-related documents, such as letters informing taxpayers of updates made to their accounts or delinquent tax notices. The Department does not currently have a waiver from Central Services to print these documents in-house. Our discussions with Central Services indicate that it has both the capability and expertise needed to print and mail these documents for the Department. As stated, Central Services already performs similar services for the City and County of Denver by printing and stuffing the city's tax documents into envelopes, and then sorting and mailing the documents.

Each of these services is offered by Central Services and could provide the Department with significant savings in time and money. Due to the fact that Central Services did not perform a cost savings analysis before it gave the Department waivers to process its own mail, we were unable to determine if the services could be performed at a cost savings to the State. Further, the Department's practice of performing these services itself has been costly to the State in terms of the higher cost to other state departments because Central Services was not performing the work. Specifically, Central Services has a certain amount of fixed overhead costs that are spread across the cost of each service it provides. Therefore, the higher volume of services that can be provided using the same fixed infrastructure, the lower the per-service overhead cost assigned to each department. In addition, the Department and Central Services could avoid costs associated with duplicative software and hardware upgrades in the future.

Recommendation No. 2:

The Department of Revenue should maximize its use of Central Services for outgoing mail processing and warrant printing, and reallocate or eliminate staff who are currently performing this work.

Department of Revenue Response:

Agree. Implementation date: July 2012.

The Department of Revenue agrees that Central Services has an efficient and effective print and mail operation and has the technology to automate mail sorting. The Department has performed our own outgoing mail processing for the last 20 years due to security concerns, need for program and mail type tracking, and the priority given to mailing warrants, titles, licenses, and other official documents. Since most taxes are now on the new GenTax system and Central Services has a proven track record with processing GenTax mail and warrants for the City and County of Denver, we believe it is possible to outsource printing and mailing activities to Central Services. Before doing so, Central Services and the Department will work together to reach a cost-effective, mutually beneficial arrangement addressing the priority given to titles and licenses, tracking by type of mail piece for budget allocation purposes, and maintaining a cost-effective and secure process.

Department of Personnel & Administration Response:

Agree. Implementation date: July 2012.

The Department of Personnel & Administration will work with the Department of Revenue to provide a detailed analysis of Department of Revenue service needs that Central Services can provide and determine how the Department of Revenue can save money using the services of Central Services. Both departments will then establish a joint team to work on the migration process for those services that are identified. The Department will work with the Department of Revenue, the Governor's Office of State Planning and Budgeting, and the Joint Budget Committee, as appropriate, to implement the resulting budgetary and personnel changes.

E-Filing and E-Payment

One of the Department's primary business activities is processing tax filings and collecting and depositing the associated tax payments for the State. Tax filings come to the Department in two different formats: either the taxpayers or tax preparers file paper tax documents, or they file the documents electronically. Electronic filing, or e-filing, is an online procedure for filing tax returns through the Internet that generally eliminates the need for taxpayers to submit paper tax documents. Most taxpayers who e-file or file by paper are also allowed to make tax payments electronically, either through the use of a credit card, electronic check, or electronic funds transfer, which is referred to as e-payment. Taxpayers can also elect to receive their tax refunds via electronic funds transfer rather than by warrant or paper check. It is important to note that for most tax types, taxpayers who e-file are not currently required to also make their tax payment or receive their tax refund electronically.

In 1986, the U.S. Internal Revenue Service (IRS) piloted a program with tax preparers in three states to e-file federal individual income tax returns (refunds only). During that year, 25,000 federal tax returns were filed through the pilot program. Since that time, the IRS has expanded its e-filing options nationwide. In 1995, the State followed the IRS' lead on e-filing and began a pilot program allowing e-filing for individual state income tax returns. During the first year, 108,000 Colorado taxpayers used e-filing to submit their individual income tax returns. Since it first introduced e-filing, the Department has improved and expanded e-filing options to include corporate income tax, sales tax, and some state business taxes, including trust and fiduciary taxes. Of the approximately 2.2 million individual income tax returns that the Department has processed in Fiscal Year 2011, approximately 75 percent of those were filed through some form of e-filing. By contrast, only about 25 percent of all sales tax returns (filed either monthly or quarterly) were e-filed. E-filing for a majority of the sales tax returns filed with the Department has only been available since the fall of 2010 and was expanded in the spring of 2011 and again in August 2011.

We reviewed the use of e-filing in Colorado and found that it has not reached its fullest potential. The following table provides specific data on the use of e-filing for income and sales taxes from January 2011 through June 2011.

Department of Revenue Income and Sales Tax E-Filings Compared to Total Number of Tax Filings January 2011 Through June 2011			
Type of Tax Filing	**Total Number of Tax Filings**	**Number of Tax Filings E-Filed**	**Percentage of Tax Filings that Were E-Filed**
Individual Income Tax	2,169,242	1,619,567	75%
Corporate Income Tax	25,433	3,931	15
Partnership Income Tax[1]	150,671	42,272	28
Sales Tax	892,807	220,322	25
Total	**3,238,153**	**1,886,092**	**58%**

Source: Office of the State Auditor's analysis of information from the Department of Revenue.
[1] Partnerships are defined as any partnership, joint venture, common trust fund, limited association, pool or working agreement, limited liability company, or any other combination of persons or interest.

As shown in the table, thus far in Calendar Year 2011, 75 percent of individual income taxes were filed electronically, while only 15 percent of all corporate income taxes, 28 percent of all partnership income taxes, and 25 percent of all sales tax filings were filed electronically.

Electronic payment of taxes may also result in cost savings for the State. While the Department has improved the accessibility of e-filing and awareness about e-filing in Colorado, we believe that increased use of e-filing and e-payment could result in benefits for Colorado taxpayers. In most cases, taxpayers who e-file and elect to receive their refunds electronically receive their tax refunds more quickly than those who submit paper returns. According to the Department, most tax refunds for e-filers are processed within 20 days, whereas refunds for taxpayers who submit paper filings can take up to 75 days to be processed. Additionally, there are significant cost savings that the Department could realize if e-filing and e-payment are maximized. The table below shows the cost to the Department of processing paper forms versus processing an e-filed tax document for several types of taxes processed by the Department. The table also shows the estimated overall cost savings that the Department would realize if Colorado was able to achieve an e-filing rate of 80 percent across all types of taxes shown.

Department of Revenue Comparison of Costs to Process Tax Documents Submitted Through Paper vs. E-Filing By Type of Tax Document Calendar Year 2010				
Tax Type	**Cost Per Unit for Paper Filing**	**Cost Per Unit for E-Filing**	**Percentage Savings Per Unit from E-Filing**	**Estimated Total Dollar Savings if 80 Percent of Documents are E-Filed**
Individual Income Tax	$5.11	$2.45	52%	$308,099
Corporate Income Tax	14.33	12.19	15	35,129
Partnership Income Tax[1]	14.33	12.19	15	167,487
State Sales and Use Tax[2]	$3.27	$2.28	30	977,973
Total Estimated Savings				**$1,488,688**

Source: Department of Revenue study of the cost of processing paper versus e-filed tax documents.
[1] Partnerships are defined as any partnership, joint venture, common trust fund, limited association, pool or working agreement, limited liability company, or any other combination of persons or interest.
[2] State sales tax estimated savings are based on an estimate of the total tax filings for Calendar Year 2011. In the fall of 2010, the Department of Revenue added new e-filing capabilities for sales taxes. Therefore, we annualized the filings data from January through June 2011 to develop an estimate of the total number of state sales tax filings for an entire year.

As shown, if Colorado were to achieve an 80 percent e-filing rate for each type of tax shown in the table above, the State would experience annual savings of about $1.5 million in the cost of processing these tax filings. In addition, e-filing reduces the amount of time Department staff spend correcting data entry errors that result from the current process that involves manually entering data from paper tax forms. This issue was discussed in Recommendation No. 1 of this report.

While the Department does not have information on the cost of processing checks versus the cost of processing electronic payments, in Fiscal Year 2011 only about 33 percent of the 3.9 million payments received were made electronically. Increasing the use of e-payments would not only reduce staff time needed to process checks, but also result in funds being deposited in the State Treasury more quickly. In Fiscal Year 2011, the total value of payments received was about $11.2 billion.

Colorado's implementation of the GenTax system has removed all of the State's barriers to maximizing the availability of e-filing and e-payments for Colorado taxpayers. Advances in technology have also removed barriers to taxpayers by making e-filing and e-payments more accessible to a larger population of taxpayers. For example, taxpayers in Colorado have several tools available to assist them in e-filing and e-payments, including:

- Software packages available for purchase that assist taxpayers with calculating their tax obligations and facilitate submission of the state tax return online for a fee. While not all software packages are compatible with the State's tax processing system, the Department continues to work with software vendors to help them make their software packages compatible.

- Revenue Online, a free web-based system offered by the Department that allows individuals and businesses to e-file income taxes and the most commonly filed types of business taxes, such as sales tax. On August 29, 2011, an extensive expansion of electronic services was added to Revenue Online to improve and expand the electronic filing and payment options available to taxpayers and businesses. While Revenue Online allows taxpayers to e-file their tax returns, the system is not intended to be tax preparation software, so individual and corporate income taxpayers are encouraged to complete their federal and state income tax returns on paper for reference before using the online application.

- Certified public accountants who can be hired to complete and submit taxpayers' tax returns online.

- Options that allow multiple forms of electronic payments, including credit card payments, electronic checks, and electronic funds transfers.

The Department could consider additional tools used by other states to further increase taxpayers' use of e-filing. Specifically, we found that a number of other states, as well as the federal government, have implemented mandates requiring certain tax filers to file electronically. As a result of these mandates, both the federal government and these other states have reported increased use of e-filing. For example, in the early 2000s, Minnesota began implementing increasingly stricter e-filing requirements, including a mandate that tax practitioners who file 500 or more returns use e-filing for all returns. Two years later, Minnesota reduced this threshold to 100 returns, which increased the number of tax filers who filed electronically. Further, since 2001, Minnesota has required all taxpayers to submit sales and withholding tax payments and filings electronically and made all business taxes eligible for e-filing. To further encourage tax preparers to file electronically, Minnesota implemented a small fee to file taxes in paper format.

The IRS has recently enacted similar requirements for tax filers and has set a goal of achieving 80 percent of all taxes filed electronically. While Colorado legislatively mandates some e-filing and e-payments, such as wage withholding for annual tax liabilities greater than $50,000 and for severance withholding and estimated taxes, further legislative mandates could increase the savings the Department realizes when businesses use e-filing or e-payments. Specifically, the Department feels that legislative mandates for sales, fuel, cigarette, and tobacco taxes would greatly reduce the number of tax documents and payments that would have to be processed in the tax pipeline, as outlined in the previous section. Colorado has not legislatively mandated the use of e-filing for businesses that pay sales taxes or for tax preparers and tax preparation firms that file income taxes on behalf of taxpayers.

As discussed throughout this report, the State's new focus on lean government has set the expectation that state government agencies will make additional efforts to streamline inefficient processes and increase the value and timeliness of services provided. One step the Department has already taken towards lean government principles was to reduce the number of tax forms and booklets printed and mailed to taxpayers. In Fiscal Year 2010, the Department mailed booklets to only 25 percent of individual income taxpayers, those who had not e-filed in the past, or those who requested a booklet. The Department implemented this change more than 10 years ago and since that time has continued to increase the number of tax types for which booklets and forms are not automatically sent out to taxpayers. The Department estimates that for tax year 2011, the reduction in printing and mailing costs for all targeted tax types will result in a savings of $99,400.

Recommendation No. 3:

The Department of Revenue should work to increase e-filing and e-payment rates by:

a. Working with stakeholders to establish a clearly defined plan for increasing e-filing and e-payment rates. The plan should include specific performance measures and goals for increasing the use of e-filing and e-payment.

b. Working with stakeholders and members of the General Assembly to evaluate possible statutory mandates that require the use of e-filing and e-payment for key types of tax filings, taxpayer groups, and tax preparers, and to implement a small filing fee for tax preparers who want to continue to file paper forms.

Department of Revenue Response:

a. Agree. Implementation date: December 2011.

The Department acknowledges and appreciates the comments of the State Auditor concerning the success we have experienced to date in gaining taxpayer acceptance and utilization of the e-filing options we offer. The Department agrees to continue to work with stakeholders in an effort to further increase the adoption rates surrounding both e-filing and e-payments. The Department has been working with our stakeholders for years to encourage voluntary e-filing and e-payment and has been able to reach 75 percent compliance in the area of individual income tax filing. We are confident that we will experience similar taxpayer adoption rates in regard to sales tax as taxpayers become more familiar with and more comfortable with filing their returns electronically. The following is a sample of some of the things the Department has done to encourage taxpayers to use these services. We have publicized in tax booklets and form instructions, press releases, events, interviews, and public service announcements; partnered with all levels of government to make promotional materials available to their customers; and partnered with major employers, school districts, local governments, and state payroll to get income tax e-file information out to employees.

b. Agree. Implementation date: May 2012.

The Department of Revenue has been able to develop online tools and get individual income tax e-filing to 75 percent and sales tax e-filing to 25 percent through outreach with the taxpayers and organizations such as the Colorado Society of Certified Public Accountants. We agree that the e-filing and e-payment goals outlined in this audit report would be more attainable if the legislature were to mandate the use of e-filing and e-payments for the majority of the taxpaying public. The implementation date depends on whether or not the legislature decides to sponsor a bill of this nature and whether or not it passes. The Department does not have the authority to mandate e-filing or e-payment without legislative action.

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