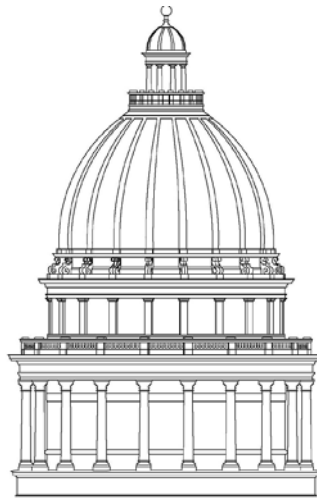


REPORT TO THE
UTAH LEGISLATURE

Number 2018-07



**A Performance Audit of the
Utah State Tax Commission**

July 2018

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah



STATE OF UTAH

Office of the Legislative Auditor General

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AUDITOR GENERAL

July 17, 2018

TO: THE UTAH STATE LEGISLATURE

Transmitted herewith is our report, **A Performance Audit of the Utah State Tax Commission** (Report #2018-07). A digest is found on the blue pages located at the front of the report. The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

John M. Schaff, CIA
Auditor General

JMS/lm

Digest of A Performance Audit of the Utah State Tax Commission

The Utah State Tax Commission's mission is to "...collect revenue for the state and local governments and to equitably administer tax and assigned motor vehicle laws." Our risk assessment identified two areas. The first was the oversight controls that are in place for Utah's income tax credits. The second was the oversight of county assessors' valuation of real and personal property, which are the basis for apportioning property taxes.

Chapter II Tax Credits for Research Activities Need More Oversight

Recent Growth and Fraud Risk Make Oversight Control Critical. Research activities tax credits for corporations and individuals are collectively the second largest income tax credit in Utah with \$64.7 million in claims for the 2015 tax year. A 43 percent annual growth rate in individual credits since 2009 has propelled the tax credit to this high level. The IRS has identified "significant misuse" of federal credits for research activities, raising concern whether Utah has implemented adequate oversight controls.

Research Activities Is the Only Large Utah Tax Credit without Controls. While the Tax Commission collects only the amount of credit claimed in each year, other credits that we reviewed require taxpayers to use a form. Utah's other large individual and corporate tax credits have better controls, requiring either a form, schedule, or certificate to be completed, or requiring auditing of all returns. Therefore, Utah's research activities tax credit is an anomaly since no forms are required for one of Utah's largest tax credits.

Other Entities Use Forms or Other Controls. A similar conclusion regarding weak oversight was drawn when we compared Utah's practice with other states. According to an evaluation study conducted by the Iowa Department of Revenue in 2016, 36 states offer a research tax credit of some kind. We reviewed documentation requirements for research tax credits in states with the largest research and development expenditures as well as other western states. Unlike Utah, all the states we reviewed that had an active credit use a form, schedule, or certificate.

Other States Collect Carry-Forward Amounts and Outcome Metrics. Forms used by the federal government and other states can gather useful data that provides greater insight into credit costs, utilization, and outcomes. Since two of Utah's credit options include a 14-year carry forward, detailing the status and disposition of those carry forwards

is important to show future potential liabilities. In addition, establishing metrics and collecting outcomes via a form can help the Legislature evaluate the tax credits' effectiveness.

Chapter III

Residential Real Property Assessments Need Greater Fairness and Equity

Assessment Levels by County Assessors Are Consistently Below Fair Market Value. Statewide, counties' level of assessment tends to be low. In two counties of the third class, we observed one that tends toward assessing residential real property at fair market value, while the second assessed its property at 93 percent. The latter county's low level of assessment raises concern about the equitable distribution of statewide levies.

Low Assessment Levels Shift the Basic School Levy to the State's Other Taxable Property. When counties have a low assessment level, the value of property that they appraise is undervalued. For 2016, we estimate that the value of residential real property statewide was undervalued by about \$3.8 billion (2.8 percent). Two counties each undervalued their residential real property by over \$950 million. Since levies affecting multiple counties are the only type impacted by different assessment levels, we estimate that \$6.4 million of the Basic School Levy was shifted from counties with low assessment levels to owners of other taxable property. This shift raises concerns about the level of fairness and equity promoted by the Tax Commission's current standards for assessment levels.

A Tighter Allowable Range for Assessment Levels Would Raise the Lowest Counties' Rates. The International Association of Assessing Officers (IAAO) recommends that a tighter allowable range of 95 to 105 percent be adopted when levies affect multiple counties. For each of the past five years, roughly one third of counties would have been affected by the tighter range. This would result in a tax shift where low valued counties would experience an increase and high valued counties would experience a decrease. The total impact of the shift would be about \$1.4 million. Four states have adopted the tighter range recommended by the IAAO. We recommend that the Tax Commission adopt a tighter allowable range for assessment levels on first through third class counties at a minimum, as they account for 91 percent of undervalued residential real property.

Indirect Equalization Can Address Counties' Remaining Appraisal Level Differences. After implementing a tighter allowable range of assessment levels, residential real property would still be undervalued by nearly \$3.0 billion of the \$3.8 billion. After a few years to evaluate the impact of a tighter range on assessment levels, we recommend that the Legislature could consider supplementing the Tax Commission's current process with indirect equalization.

Mandatory Reporting of All Sales Would Improve Data Quality. As this chapter has stressed, the volume and quality of data plays an important role in assessing real property. The Property Tax Division collects data on sales via an optional questionnaire sent to buyers but only 35 percent of buyers respond. Other data sources do not provide sufficient data on remaining transactions. Therefore, we recommend that the Legislature consider requiring disclosure of sales data to ensure adequate volume and quality of data.

Chapter IV Business Personal Property Audits Are Productive but Lack Consistency

Audits Have Been Productive as They Ensure Compliance with Statutory Requirements. Each year, the Tax Commission's Property Tax Division charges counties for 1,000 to 1,200 audits that review one or more tax years. Most audits identify significant reporting that does not comply with statutory requirements, showing that these audits provide value:

- Audits of major accounts that represent the largest one percent of accounts generate more than 20 percent of all misreporting.
- Audits of non-filing accounts identified value that exceeds exemption (\$10,300 for 2016) and generated a tax liability 70 percent of the time.
- Audits of filed accounts that claimed to be exempt identified value that exceeds exemption and generates a tax liability over 50 percent of the time.
- Audits identified accounts overreporting values and overpaying taxes more than 10 percent of the time.

Mandatory Reporting When Adjustments Are Less Than Processing Costs Should Be Eliminated. Administrative rule requires that all findings be reflected in assessment rolls and tax rolls and billed to the taxpayer. Audits of major accounts reporting more than \$1 million in taxable property identified some taxable value adjustments of less than \$200. These adjustments produced about \$2 of additional taxes, which were unlikely to cover all costs associated with processing the adjustment. To be cost effective, the Tax Commission should discuss the cost of processing audit adjustments with county assessors. Then the Tax Commission should amend administrative rules to exclude mandatory reporting of insignificant adjustments.

Several Audit Practices Deviate from Statute, But Benefit to the State Should Be Considered. According to statute, the Tax Commission shall provide audit services for each county, following a legally pre-defined cost sharing arrangement. We observed three practices that deviate from statute:

- Salt Lake County performs its own audits, which reduces the state's costs.
- The number of audits conducted in counties of the same class vary, including some counties receiving no audits.
- Current rates have not been updated since fiscal year 2011, which does not comply with the statutory cost sharing arrangement.

Salt Lake County performing its own audits is a clear benefit to the state, which the Legislature should consider allowing in statute. Since the last two practices do not promote uniformity and equity, we recommend that the Legislature consider a minimum number of audits for various counties, and the Tax Commission update the rates it charges for audits.

REPORT TO THE UTAH LEGISLATURE

Report No. 2018-07

A Performance Audit of the Utah State Tax Commission

July 2018

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Chapter I

Introduction

The Utah State Tax Commission's mission is to "...collect revenue for the state and local governments and to equitably administer tax and assigned motor vehicle laws." Our office was asked to conduct an in-depth budget review of the Tax Commission, which will be released in a separate report. Per office practice, this audit was initiated simultaneously as a companion performance audit, focusing on issues that could improve the administration of Utah's tax system.

Prior audits by our office, the concurrent in-depth budget review of the Tax Commission, and audits of tax oversight functions in other states were critical in establishing audit scope. Our risk assessment highlighted two areas where we felt this audit could provide the most value. The first was the oversight controls that are in place for Utah's income tax credits. The second was the Tax Commission's oversight of county assessors who are responsible for real and personal property assessments that are the basis for apportioning the property tax revenue.

Various Performance Audits of Tax Oversight Functions Were Critical to Identifying Risk Areas

Our office's most recent review of the Tax Commission resulted in a series of reports from 2002 to 2004. Those five performance audits focused primarily on two divisions, Motor Vehicles and Taxpayer Services. Given the time elapsed since these audits, the Legislative Audit Subcommittee determined the agency was due for review and prioritized an in-depth budget review of the Tax Commission in its November 2017 meeting. While the in-depth budget review addresses five of the seven divisions within the Tax Commission, this companion audit was directed towards the performance of the two divisions not specifically addressed in the other report, the Auditing Division and Property Tax Division.

Because our review originated as a companion to the in-depth budget review, no specific concerns served as the impetus for this audit. Thus, we took a broad approach to assessing risk. To identify possible issues, we reviewed reports on tax issues from legislative audit

This performance audit is a companion report to the in-depth budget review of the Tax Commission.

Our office's last audit of the Tax Commission was completed in 2004.

We reviewed reports on tax issues from nine other states to identify common concerns.

offices in nine other states. We noted the following common concerns related to functions of the Auditing Division and Property Tax Division:

- Difficulties measuring the effectiveness of tax preferences, such as tax credits
- Insufficient audit coverage
- Ineffective audit selection practices
- Need for improved appeals processes

During the initial phase of our audit, we met with Tax Commission staff to determine if risk areas identified in other states applied in Utah. At the same time, our initial assessment of the Auditing Division examined their role in tax credit administration, which led us to review the control environment for tax credits at the policy level. Our initial assessment of the Property Tax Division recognized the atypical role the Tax Commission plays as counties assume the primary role for tax assessment. Thus, the standards and oversight practices regarding real and personal property assessments by county assessors became the focus of our review.

The Legislature Periodically Reviews Income Tax Credits

The Legislature's Revenue and Taxation Interim Committee is responsible for reviewing income tax credits offered in Utah to promulgate tax policy. The Legislature establishes tax credits for several reasons: to act as business incentives (e.g. tax credit for development of high-cost infrastructure), encourage specific behaviors (e.g. tax credit for purchase of a heavy duty natural gas vehicle), and provide charitable benefits (e.g. tax credit for employment of a recently deployed veteran).

Each year, the committee reviews one-third of all tax credits, looking at their cost, purpose, and effectiveness. Figure 1.1 shows the magnitude of tax credits for tax year 2015, which was the complete data set available for individual and corporate credits.

Income tax credits are established to act as business incentives, encourage specific behaviors, and provide charitable benefits.

Figure 1.1 Individual and Corporate Income Tax Credits Claimed for Tax Year 2015. Individual filers also claimed \$1 billion via the Taxpayer Tax Credit, which is not included in the totals here because most taxpayers are eligible for it.

Available to Claim	Number of Tax Credits	Amount Claimed
On individual returns	42	\$186,893,402
On corporate returns	25	\$70,416,661
Total	67	\$257,310,063

Source: Utah State Tax Commission 2015 Annual Report of Individual and Corporation Income Tax Credits

Income tax credits reduced state revenue by over \$250 million in 2015, mostly affecting Utah’s Education Fund. Thus, regular review of tax credit controls is critical as education funding is annually a top policy issue in Utah.

According to one Tax Commissioner in a November 2017 meeting of the Revenue and Taxation Interim Committee, a group of employees from all divisions determine whether a form, schedule, or certification process should be required. They consider taxpayer burden (i.e. what information will taxpayers need to provide once the control is in place) and administrative benefit (i.e. how the state will use the information taxpayers provide). Our audit considered the appropriateness of controls currently in place as well as the sufficiency of information collected to enable the Revenue and Taxation Interim Committee in their review.

The Property Tax Division Oversees Counties’ Property Tax Assessment

The second area reviewed during this audit was the Property Tax Division. The division differs from most others as it does not assess or collect taxes directly. Instead, it plays a critical role in ensuring local governments levy taxes fairly. Counties are responsible for assessing real and personal property as well as levying and collecting property taxes. The Property Tax Division provides oversight and support for these functions by carrying out these five responsibilities:

- Provides advice and direction to county officials
- Approves tax rates
- Equalizes assessments between and within counties
- Provides technical assistance and training to counties
- Assesses mines, utilities and other properties as required by law

Income tax credits mostly affect Utah’s Education Fund.

The Tax Commission considers taxpayer burden and administrative benefit when determining appropriate controls for tax credits.

The Property Tax Division ensures local governments levy taxes fairly.

The Property Tax Division engages counties as partners, resulting in a positive working relationship.

To execute these responsibilities, the Property Tax Division has adopted an organizational support approach, working with counties to resolve issues and offer additional assistance as needed. By engaging counties as partners, this approach has significantly improved the relationship between the Tax Commission and counties. This positive relationship was a consistent theme that internal and external stakeholders shared with us throughout the audit.

County assessors throughout the state report a collaborative working relationship with the division, noting that it has greatly improved since the 1990s. The cause of assessment challenges is now discussed together, then adjustments to remedy those problems are decided without implementing unnecessary and excessive changes. The Tax Commission also reports that they are collaborating with counties to implement new technology that will assist counties with real property assessment.

In recent years, the Legislature has taken steps to equalize funding for schools generated by property taxes. For example, in 2015 the Legislature passed Senate Bill 97 entitled Property Tax Equalization Amendments, which guaranteed per student funding for all public schools equal to the amount that was already guaranteed for each student in charter schools. Prior to this bill, charter school funding per student was higher than per student funding in half of Utah public schools.

We examined oversight of real property assessments with the Legislature's equalization focus in mind. Where legislative action has focused on resolving inequities in funding received by schools, our audit focused on equity in how this funding is generated. Specifically, we examined the distribution of the tax burden among counties in regard to the state's Uniform School Fund. We also reviewed the Property Tax Division's role in ensuring accuracy of personal property values, which plays a critical role in fairly distributing tax burdens at the local level.

Audit Scope and Objectives

Guided by tax issues identified in other states, we performed an initial risk assessment that resulted in no compliance concerns. Our focus therefore shifted to examining opportunities to enhance the

The Legislature has taken steps to equalize school funding generated by property taxes.

effectiveness of Utah's tax framework. Thus, this report reviews oversight of tax credits as well as the Property Tax Division:

- Chapter II examines controls for the research activities tax credit.
- Chapter III evaluates oversight of real property assessments.
- Chapter IV assesses personal property audits performed by the Property Tax Division in terms of uniformity and equity.

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Chapter II

Tax Credits for Research Activities Need More Oversight

Tax credits for research activities are among the largest in terms of dollars claimed in recent years by individual and corporate taxpayers in Utah. Growth in individual claims and fraud risk alerts by the Internal Revenue Service (IRS) make review of credit costs and outputs a critical area of oversight and control. However, minimal information is collected about the types of expenses generating the credit and how much is being carried forward to future years, limiting the Legislature’s ability to effectively review the credit and assess its benefit to the state.

Research activities credits in other states and other credits in Utah use specific tax forms to collect data essential for effective oversight controls. Therefore, we recommend that the Utah State Tax Commission (Tax Commission) develop a form that collects critical data about Utah’s research activities tax credits. We further recommend that aggregate credit data should be provided to the Legislature during future tax credit reviews.

The research activities tax credit incentivizes companies to engage in a process of experimentation to develop new products. To qualify, the objective of the research must focus on “discovering information which is technological in nature.” These requirements were established for the federal research credit, on which Utah has based its state credit. For example, a software publisher developing a new program to sell to consumers could claim the credit. The company would track expenses for the project team such as wages and supplies, and then multiply that total by the applicable statutory rate to determine how much they are eligible to claim, offsetting their tax liability.

Unlike research activities credits in other states, Utah’s has no form or similar administrative control to collect critical data.

Claims of the research activities credit by individuals have grown 43 percent annually since 2009.

In 2015, individuals and corporations collectively claimed \$64.7 million of research activities credits.

Recent Growth and Fraud Risk Make Oversight Control Critical

Research activities tax credits for corporations and individuals are collectively the second largest income tax credit in Utah with \$64.7 million in claims for the 2015 tax year. A 43 percent annual growth rate in individual credits since 2009 has propelled the tax credit to this high level. Simultaneously, the IRS has identified “significant misuse” of federal credits for research activities. The federal credit is the basis for Utah’s credit, raising concern whether Utah has implemented adequate oversight controls.

The Legislature has statutory authority to review the cost, purpose, effectiveness, and overall benefit to the state of corporate and individual credits. The credits are relatively complex because of three options whereby qualified expenses can generate credit and the 14-year carry forward provision associated with only two of the options. Critical information about qualified expenses and how much credit is being carried forward as a potential liability remains unknown because Utah collects only the amount claimed for the tax year. The Tax Commission could collect this information via an annual tax form so adequate review and oversight can occur.

Research Activities Tax Credits Are Large Due to Recent Growth

For tax year 2015, taxpayers claimed research activities credits totaling \$64.7 million on individual and corporate tax returns, an increase of 22 percent from the prior year. Figure 2.1 shows how the amount claimed and its growth from 2014 to 2015 compares to other large individual and corporate credits.

Figure 2.1 Research Activities Is Among Utah’s Largest Individual and Corporate Income Tax Credits. This figure shows the individual and corporate income tax credits that exceeded \$2 million in 2014 or 2015 claims. Credits are ranked by 2015 claims.

Individual			
Credit	2014	2015	Growth
1) Taxes Paid to Another State	\$ 73,391,060	\$ 85,191,910	16%
2) Retirement Income	45,260,698	46,522,519	3%
3) Increasing Research Activities	13,336,393	18,563,650	39%
4) Enterprise Zone	13,711,781	15,660,728	14%
5) Solar Project Credit	1,486,789	3,706,573	149%
6) Renewable Residential Energy Systems	1,648,615	3,625,051	120%
7) Historic Preservation	2,386,971	3,328,609	39%
8) Utah Educational Savings Plan	2,886,182	3,009,374	4%
Corporate			
Credit	2014	2015	Growth
1) Increasing Research Activities	\$39,843,451	\$46,100,038	16%
2) Economic Development	\$10,682,331	\$10,426,465	-2%
3) Mineral Production Withholding	\$6,244,300	\$4,312,010	-31%
4) Pass-through Entity Withholding	\$6,065,536	\$2,236,287	-63%
5) Motion Picture Incentive	\$4,973,056	\$1,965,961	-60%

Source: Data from Utah State Tax Commission Website

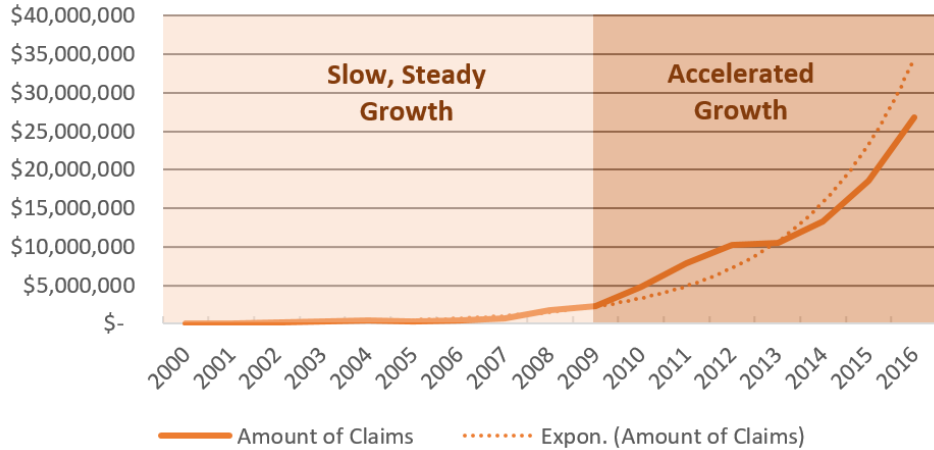
Figure 2.1 shows that the research activities credit for corporations was by far the largest corporate tax credit in 2015. The research activities tax credit for individuals had the highest percentage increase from 2014 to 2015 of the four credits for individuals exceeding \$4 million. Growth of the research activities tax credit for individuals has continued as claims in 2016 rose to \$26.8 million, an increase of 44 percent from 2015. Information on 2016 corporate claims was not yet available when this report was written. Thus, Figure 2.1 shows only 2014 and 2015 data.

Utah’s corporate and individual research activities tax credits were first available for the 2000 tax year. Growth in the research activities tax credits has been fueled largely by individual claims. Figure 2.2 shows that relatively steady growth in individual claims existed prior to 2009, but that growth has accelerated since then.

In 2016, individual claims of the research activities credit grew from \$18.6 million to \$26.8 million.

While individual claims grew steadily from 2000 to 2009, subsequent growth has accelerated.

Figure 2.2 Since 2009, Individual Credit Growth Has Accelerated. Research activities credits claimed by individuals (solid line) has grown to \$26.8 million in 2016. The dotted trendline shows recent growth has been exponential rather than linear.



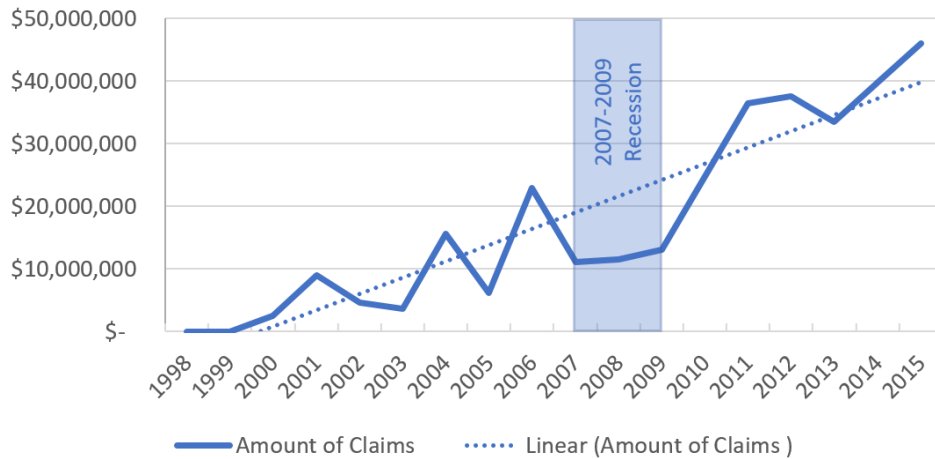
Source: Utah State Tax Commission Website

Through 2009, individual research activities credit claims rose at a steady pace to \$2,220,000. Since 2009, a 43 percent annual growth rate has propelled the tax credit to \$26.8 million for 2016.

Multiple potential causes for the drastic change in growth after 2009 were considered during the audit. First, the shift could be due to 2007 legislation that restructured the tax credit. Second, the Legislative Fiscal Analyst suggested it could be a response to the most recent recession, where improving profits are leading to carry-forward redemption. Because of a lack of data regarding carry forwards and the types of expenses used to claim credits, the cause of the increased growth remains unclear.

Interestingly, growth in corporate claims remained steady rather than accelerating after 2009 like individual claims. Figure 2.3 shows corporate claims of the research activities tax credit over the same period.

Figure 2.3 Growth Trajectory in Corporate Credit Claims Has Remained Steady. Corporate claims over time are characterized by larger year-to-year fluctuations and a more linear growth trajectory. A dotted linear trendline was added to show the overall trend.



Source: Utah State Tax Commission Website

Growth in corporate claims remains steady rather than accelerating after 2009 like individual claims.

The trajectory of corporate credit claims over time has not been as consistently smooth as those for individual claims (Figure 2.2). Year-to-year fluctuations are more prevalent in this figure. In addition, the annual rate of growth after the 2007 to 2009 recession was 23 percent, which is nearly half of the growth in individual claims (43 percent). Along those lines, individual claims did not experience the significant drop for 2007 through 2009 that corporate claims did. Therefore, the differences in growth trajectories and year-to-year variation between individual claims (Figure 2.2) and corporate claims (Figure 2.3) raise some questions about their cause. The cause for growth in each may be different as performance during the recession of 2007 to 2009 was different for the two groups.

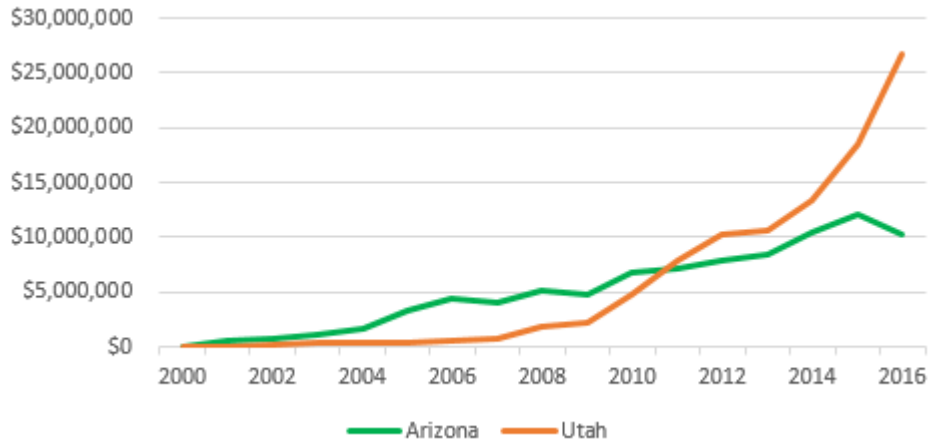
To understand whether Utah’s trend in individual claims was a general trend, we compared Utah’s individual credit growth to Arizona’s. Annually, the Arizona Department of Revenue publishes data on the use of its tax credits, which is shown in the following figure.

Individual research activities credit claims in Arizona did not experience growth acceleration after 2009 like Utah's credit did.

The cause of the increased growth in individual claims remains unclear due to lack of data.

The IRS reports "significant misuse" of the federal research activities credit, which Utah's credit is based upon.

Figure 2.4 Individual Claims in Utah Follow a Different Trajectory Than Arizona. Unlike Utah's fast-growing claims (orange), Arizona's claims (green) follow a more gradual, linear trajectory.



Source: Utah State Tax Commission's Website and the Arizona Department of Revenue's Arizona's Individual and Corporate Income Tax Credit Report (November 2017)

As Figure 2.4 shows, Arizona's individual research activities credit claims did not experience similar growth acceleration to Utah's. Prior to 2009, Utah's growth trajectory appears to be linear at a slower rate of acceleration than Arizona's, but after 2009, Utah's trajectory changes while Arizona's stays the same.

The unknown cause for the recent growth is concerning given the fraud alerts issued by the IRS for the past three years regarding the federal component of research activities tax credits.

Fraud Risks and Improper Claims Necessitate Better Oversight

For the past three years, the IRS has included the federal research activities tax credit in its annual "Dirty Dozen" list because of the credit's high number of improper claims. The IRS compiles this list during the filing season to warn taxpayers about the most common tax scams each year. The 2018 list cites "significant misuse" of the credit, stating that "improper claims for this credit generally involve a failure to participate in or substantiate qualified research activities and/or a failure to satisfy the requirements related to qualified research expenses." Since Utah's credit is modeled after its federal counterpart, improper claim risk from ineligible taxpayers extends to the state level. Auditing Division staff told us that the IRS reports to them any

improper claim it identifies, so the Tax Commission can take appropriate action.

Improper claims of the federal and state credit are primarily found through audits, not through initial processing of returns. To determine whether expenses qualify for the credit, underlying documentation showing the nature of an expense must be reviewed, which aligns with the audit function rather than the processing function.

The Tax Commission's Auditing Division does not know the amount of research activities tax credits that have been improperly claimed. When the division does an audit, auditors review all components of a taxpayers return including individual credits. Similarly, error amounts are tracked at the return level and not for single line items of the return. Thus, the extent that improper claims are or are not being identified is unknown.

The Tax Commission's audit programs are protected under the Government Records Access and Management Act. Therefore, we cannot comment on the details and effectiveness of their audit processes. Although we cannot determine how widespread improper claims are, two public appeals from the Tax Commission's website suggest that improper claims are occurring. These appeals include the Auditing Division's rationale for disallowing these credits. We believe they are indicative of other audit findings regarding research activities credits. The number of improper claims identified through audits is unknown because the division does not track it. They track the reason a tax return was selected for audit (e.g. GenTax® selection, referral from a sales tax audit, etc.), then complete a full audit of the tax return and track the total changes found during the audit, not the changes due to a specific section of the tax return, such as an improper tax credit claim.

In the first audit, the taxpayer claimed a vehicle, which does not meet the definition of "qualified expenses." In addition, the activities the taxpayer performed were not "qualified research" according to statute. Because the credit was disallowed, the taxpayer was required to pay back the amount of the credit plus interest.

The second audit involved a taxpayer who donated some time to a state agency's research project. The taxpayer exceeded the terms of the contract, which resulted in donated time to meet project deliverables.

The Tax Commission does not track the number or dollar value of improper claims.

Two appeals in which the Tax Commission disallowed credits after audits suggest improper claims are occurring.

The costs associated with the donated time were claimed as the research activities credit, which was denied by the Tax Commission.

The remainder of this chapter focuses on the lack of data available to the Legislature. Data on costs, outputs, and outcomes is needed for adequate control and oversight to occur.

Insufficient Data Impairs the Legislature’s Ability To Review Research Activities Credits’ Effectiveness

The Legislature has the statutory responsibility to periodically review the research activities tax credits. Reviewing the costs and effectiveness of the credits is difficult because of the three options that taxpayers have available to claim the credit. The Tax Commission told us that it is possible for a taxpayer to claim one or up to all three options on the same tax return. Each option has different allowable expenses, and the carry forward provisions are not the same for all three. Since taxpayers specify only the amount of credit they are claiming, no data regarding the utilization, types of expenses, or carry forwards is available to assess the costs and outcomes of the credit.

Statue Requires the Legislature to Review the Costs, Purpose, and Effectiveness of the Research Activities Credits. The Legislature is given responsibility in statute to review the research activities credits for corporations and individuals. Figure 2.5 shows that this specific charge has been given to the Legislature’s Revenue and Taxation Interim Committee.

Figure 2.5 The Legislature Has Responsibility to Review the Cost, Purpose, and Effectiveness of Tax Credits. Each tax credit is reviewed every three years; the corporate credit was reviewed in 2017, and the individual credit is due for review in 2018.

Utah Code 59-7-612(8)(d) states:

The Revenue and Taxation Interim Committee shall address in a review under this section:

- i. the **cost** of the tax credits provided for in this section;
- ii. the **purpose and effectiveness** of the tax credits provided for in this section;
- iii. whether the tax credits provided for in this section benefit the state; and
- iv. whether the tax credits provided for in this section should be
 - a. continued;
 - b. modified; or
 - c. repealed.

Source: Utah Legislature’s Website, emphasis added

Without data regarding utilization, carry forwards, and expenses, legislative review of the credit is limited.

The Revenue and Taxation Interim Committee is scheduled to review the individual research activities credit in 2018.

Annually, the Tax Commission publishes reports (shared with the Committee) showing the count and value of claims for the individual and corporate credits. In addition, statements regarding the inherent relationship between research expenditures and economic development are made, but actual numbers documenting the extent of that impact have not been provided. We believe the findings of this audit can lead to more effective reviews of the credit by the Legislature.

Evaluating Credit Costs and Effectiveness Are Complicated by Three Options. The individual and corporate credits each have three options with different allowable expenditures as shown in Figure 2.6. The first two options were established in 1998, while the third was established in 2007. All options require the claimant to engage in a process of experimentation to develop new products with a focus on technology.

Figure 2.6 Individual and Corporate Taxpayers Can Claim up to Three Research Activities Credit Options. While the first two options are available to taxpayers only for increasing research over baseline years, the third option does not consider the amount of research performed in the past.

Utah Code 59-7-612(1)(a) states:

A taxpayer meeting the requirements of this section may claim the following nonrefundable tax credits:

- i. a research tax credit of 5% of the taxpayer's qualified research expenses for the current taxable year **that exceed the base amount** provided for under Subsection (4);
- ii. a tax credit for a payment to a qualified organization for basic research as provided in Section 41(e), Internal Revenue Code, of 5% for the current taxable year **that exceed the base amount** provided for under Subsection (4); and
- iii. a tax credit equal to 7.5% of the taxpayer's qualified research expenses for the current taxable year.

Source: Utah Legislature's Website, emphasis added

As Figure 2.6 shows, the third option is not limited to expenses exceeding the base amount but also includes the base, which is calculated according to the Internal Revenue Code (IRC)¹. This

¹ According to IRC 41(c)(1), "the term 'base amount' means the product of (A) the fixed-base percentage, and (B) the average annual gross receipts of the taxpayer for the 4 taxable years preceding the taxable year for which the credit is being determined." The IRC goes on to detail what fixed-base percentage means when applied to start-up companies.

It is possible for a taxpayer to claim one, two, or all three options on the same year's tax return.

Option iii is a credit for all qualified research expenditures and is not limited to expenses that exceed the base amount.

approach is nearly unique. Michigan is the only other state we are aware of that offers a credit based on all research expenses; the federal credit also does not allow an option based on all research expenditures. In addition to crediting all expenses, another difference is that option three allows for 7.5 percent of expenses rather than 5 percent.

The United States Government Accountability Office's (GAO) report 10-136, titled *The Research Tax Credit's Design and Administration Can Be Improved*, discusses how the third option provides a "windfall" for taxpayers. According to the report, the first two options, like the federal credit, are structured to encourage increases in research. The report states, "the subsidy provided for the marginal spending is the only portion of the credit that affects the taxpayer's research spending behavior." In contrast, the third credit option "...is a windfall to the taxpayer for doing something that it was going to do anyway."

While the third option allows the taxpayer to claim larger amounts of expenses in the current year, the third option is not allowed to be carried forward like the other two options. *Utah Code* 59-10-1012(4)(a)(i) allows the original two options for claiming the research activities tax credit to be carried forward up to 14 years, while subsection (b) prohibits carry forwards for the third option.

Since the allowable expenses and carry-forward characteristics for all three options are different, the extent to which each option is used provides some evidence of their effectiveness. Information about groups of expenses, such as wages, equipment, or contractor services, indicate what the credit is generating. For options one and two, information about when carry-forward credits are being redeemed indicates how effective those expenses were at generating sufficient net income to be offset by the credit.

Utah Collects Only the Amounts That Taxpayers Claim Each Year. In Utah, little is known about the expenses generating the research activities tax credit and the potential liability from previous years' carry-forward amounts. Figure 2.7 shows in green that the Tax Commission collects only the amount claimed by each taxpayer.

Although the third option offers a higher rate, unused credit cannot be carried forward for use in future years.

Figure 2.7 Utah’s Schedule A Requires Taxpayers to Submit Only the Dollar Value of Their Credits. No other information is collected when the credit is claimed on a tax return.

Part 4 - Nonapportionable Nonrefundable Credits (write the code and amount of each credit)		Code	Amount
Code	Code		.00
01 At-home parent credit	13 Carryforward of mach./equip. research credit		
02 Qualified sheltered workshop credit - name:	17 Tax paid to another state (attach TC-40S)		.00
	19 Live organ donation expenses credit		
05 Carryforward of clean fuel vehicle credit	21 Renewable residential energy systems credit		.00
06 Historic preservation credit	25 Combat related death credit		
07 Carryforward of enterprise zone credit	27 Veteran employment tax credit		.00
08 Low-income housing credit	28 Employing persons who are homeless		
10 Recycling market dev. zone credit	63 Achieving a Better Life Experience Prog. credit		.00
12 Research activities credit	AA Military survivor benefits credit		
	AB Student Prosperity Savings Program credit		
Total nonapportionable nonrefundable credits (add all Part 4 credits and enter total here and on TC-40, line 26)			.00

Source: Utah State Tax Commission TC-40 Schedule A

Taxpayers do not indicate which credit option they used or the amount of carry forward they can claim in future years.

Schedule A does not require the taxpayer to provide any information about the credit they claim. Thus, very little data exists for the Legislature’s Revenue and Taxation Interim Committee to evaluate the credits’ costs and effectiveness. In other states, the valuable information discussed in this section is collected in a variety of ways.

Research Activities Is the Only Large Utah Tax Credit without Controls

While the Tax Commission collects only the amount of credit claimed in each year, other credits that we reviewed require taxpayers to use a form. Utah’s other large individual and corporate tax credits have better controls, requiring either a form, schedule, or certificate to be completed, or requiring auditing of all returns. Therefore, Utah’s research activities tax credit is an anomaly since no forms are required for one of Utah’s largest tax credits.

Utah is an anomaly as it offers the research activities credit but does not require that taxpayers use a form, schedule or certificate.

Other Large Tax Credits Require Schedules, Forms, or Certificates

As mentioned, forms, schedules, and certificates serve as administrative controls for other large credits. While forms are generally not submitted with the return, forms and schedules that are submitted can protect state revenue by providing the Tax Commission with key information necessary to validate eligibility during the audit process. Certificates provide the highest level of protection, as eligibility is determined by an external agency before the taxpayer can claim the credit. Figure 2.8 lists the administrative controls in place for large credits.

Figure 2.8 Tax Credit Forms, Schedules and Certification. All but two of the largest tax credits have administrative controls in place for the 2017 tax year. However, the Tax Commission audits 100 percent of solar project tax credit claims, leaving research activities as the only credit without a control.

Since the Tax Commission audits 100 percent of solar project tax credit claims, the research activities credits are the only credits without a control.

	Certificate, Form or Schedule
Individual Income Tax Credits	
1) Taxes Paid to Another State	TC-40S
2) Retirement Income	TC-40C
3) Increased Research Activities in Utah	None
4) Enterprise Zone	Certificate ¹
5) Solar Project	None
6) Renewable Residential Energy Systems	TC-40E ²
7) Historic Preservation	TC-40H ³
8) Utah Educational Savings Plan	TC-675H ⁴
Corporate Income Tax Credits	
1) Increased Research Activities in Utah	None
2) Economic Development	Certificate ¹
3) Mineral Production Withholding	TC-675R
4) Pass-through Entity Withholding	TC-250, Schedules K or K-1
5) Motion Picture Incentive	Certificate ¹

Source: Utah State Tax Commission Website

1 – The Governor’s Office of Economic Development reviews taxpayer claims and issues a certificate for approved credits.

2 – The Office of Energy Development issues the form to claim this credit.

3 – The State Historic Preservation Office issues the form to claim this credit.

4 – The Utah Educational Savings Plan issues the form to claim this credit.

Figure 2.8 shows that most of Utah’s largest tax credits have a form, schedule, or certificate. The only other exception with the research activities credit is the solar project tax credit.

The Auditing Division audits 100 percent of solar project claims because taxpayers mistakenly claim the solar project credit when they should have claimed the renewable residential energy systems credit. No similar compensating control exists for the increased research activities tax credit. Looking at similar sized credits, it is inconsistent with practice that no form, schedule, or certificate is required. We are concerned that oversight of this credit is unacceptable.

Other Entities Use Forms or Other Controls

A similar conclusion regarding weak oversight of the research activities credit was drawn when we compared Utah’s practice with other states. According to an evaluation study conducted by the Iowa Department of Revenue in 2016, 36 states offer a research tax credit

Unlike the largest tax credits, the research activities credit has no administrative control or compensating control.

36 states offer a research tax credit of some kind.

of some kind. We reviewed documentation requirements for research tax credits in states with the largest research and development (R&D) expenditures (shown in Figure 2.9) as well as other western states (shown in Figure 2.10). We found that unlike Utah, all the states we reviewed that had an active credit use a form, schedule, or certificate.

States with the Most R&D Use Forms to Collect Tax Credit Data

Since the tax credit incentivizes research and development, we compared Utah’s tax credit controls to the four states with the most research and development expenditures in 2014, as shown in Figure 2.9. The 2014 statistics regarding research and development (R&D) spending came from a National Science Foundation report published in March 2018. Total R&D amounts include corporate spending as well as federal and nonfederal spending.

All states we reviewed offering a research credit require a form, schedule, or certificate.

Figure 2.9 Most Top R&D States Offer a Credit and Require a Control Form. The following states had the most R&D expenditures for calendar year 2014. Their credit status for the 2017 tax year and corresponding form or schedule are also listed.

State (Rank)	2014 R&D Expenditures (in Millions)	2017 Tax Credit Status (Form/Schedule)
California (1)	98,488	Active (Form 3523)
Massachusetts (2)	21,105	Active (Schedule RC)
Michigan (3)	17,077	Active (Form 4570)
Texas (4)	16,373	Active (Schedule 05-178)

*Sources: R&D Expenditures – National Science Foundation’s Website
Tax Credit Status & Forms – Individual States’ Revenue Department/Tax Commission Websites*

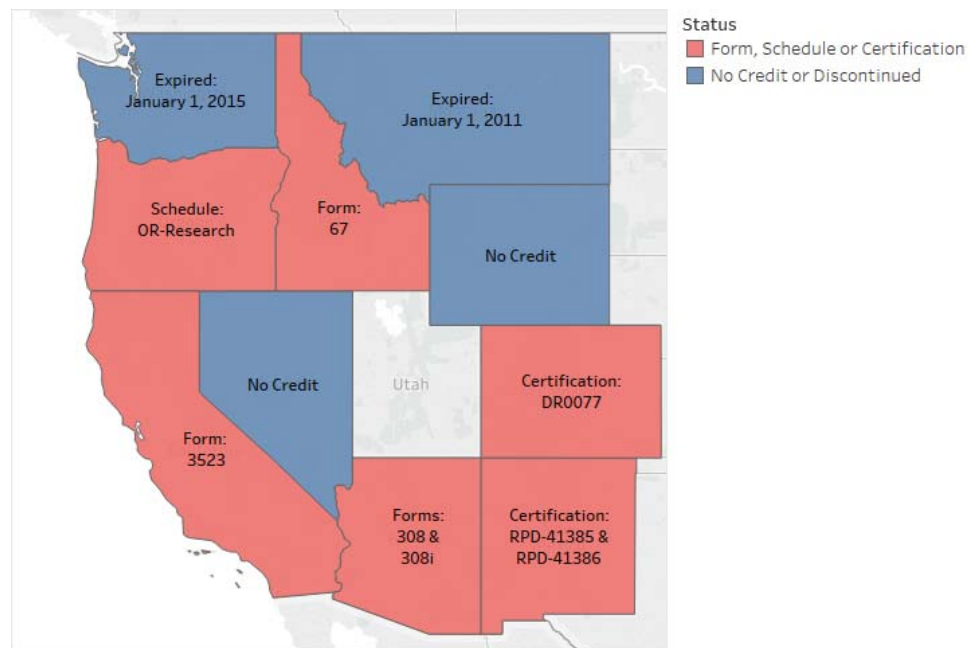
Figure 2.9 shows that the four states with the largest R&D expenditures require a form or schedule from taxpayers to claim their research activities tax credits. This figure rules out any concern that requiring a form or schedule in Utah would place an inordinate burden on taxpayers as the states with the most R&D expenses have that requirement. By requiring a form or schedule, states with sizeable investment in research and development can have data on their research credits that is not available in Utah.

New Mexico and Colorado require a certification before claiming the credit.

Utah's Lack of a Tax Credit Form Is Inconsistent among Western States

Both New Mexico and Colorado require taxpayers to complete a certification process before claiming the research credits in these states; New Mexico's Department of Taxation and Revenue administers certification while in Colorado, enterprise zone administrators perform this function. As shown in Figure 2.10, the remaining western states that offer a research credit require taxpayers to use a form.

Figure 2.10 Western States Offering a Research Activities Tax Credit Require a Form, Schedule, or Certification. This figure shows the credit status in other states for the 2017 tax year. For those currently offering a credit, the documents used to claim the credit are shown for each state.



Source: Auditor Analysis of Research Activities Tax Credit Processes in Other States

Washington and Montana have discontinued their research credits.

Washington and Montana have discontinued their research credits, and Nevada and Wyoming never offered one. The remaining western states still offer a research tax credit and require completion of a control form or certificate to claim the credit.

Our review of other states' research credits suggests that implementation of an administrative control such as a form, schedule, or certificate is a best practice. While certification provides the most protection, the associated administrative burden incurred by a state agency reviewing supporting documentation for every claim may not be feasible. According to *Utah Code* 59-1-210(4), the Tax Commission already has the statutory authority to require that taxpayers use a form prescribed by the Tax Commission. Therefore, we recommend that the Tax Commission develop a form, using features from other states' forms as guidance, which are discussed in the next section. We suggest that taxpayers' completed forms should be submitted to the Tax Commission as they provide important data discussed in the next section.

Other States Collect Carry-Forward Amounts and Outcome Metrics

Forms used by the federal government and other states can gather useful data that provides greater insight into credit costs, utilization, and outcomes. Since two of Utah's credit options include a 14-year carry forward, detailing the status and disposition of those carry forwards is important to show future potential liabilities. In addition, establishing metrics and collecting outcomes via a form can help the Legislature evaluate the tax credits' effectiveness.

Forms in Other States Collect Data Showing the Use of Carry Forward

The cause of high growth in Utah's individual research activities tax credits remains unclear because of minimal data, such as Utah's lack of data regarding carry-forward redemptions. Other states either have taxpayers catalog their prior years' carry-forward amounts (that is, list the carry forward separately by the year it was generated), or they collect only the current year's data on a rolling basis (previous years' carry-forward credits are added to current year credits to calculate total available credits). Since Utah has not collected data in the past, a multi-year catalog approach is appropriate.

Two States Require Taxpayers to Catalog Historical Credit Use. Arizona and New Mexico utilize a schedule to report claimed and carry-forward amounts of prior years' research activities. Data

Certification is not feasible for Utah's research activities credit due to its administrative burden.

Carry-forward amounts are potential liabilities that could impact future cost and should be understood.

collected by Arizona allows for precise calculations because the disposition of all prior credits is disclosed as shown in Figure 2.11.

Figure 2.11 Arizona Collects the Status of Prior Years' Carry Forward Expenses. Individuals report the original credit amount and how much was used or carried forward for each tax year from 2003 through 2016. Taxpayers are directed to include the form with their return.

Part 7 Available Post-2002 Credit Carryover					
	(a) Taxable Year	(b) Original Credit Amount	(c) Amount Previously Used	(d) Available Carryover: Subtract column (c) from column (b).	
38	2003	00	00	00	
39	2004	00	00	00	
40	2005	00	00	00	
41	2006	00	00	00	
42	2007	00	00	00	
43	2008	00	00	00	
44	2009	00	00	00	
45	2010	00	00	00	
46	2011	00	00	00	
47	2012	00	00	00	
48	2013	00	00	00	
49	2014	00	00	00	
50	2015	00	00	00	
51	2016	00	00	00	
52	Total Available Post-2002 Carryover: Add lines 38 through 51 in column (d). Enter the total.			52	00

Source: Arizona Department of Revenue's Website – Form 308i

Similar to Utah's 14-year carry-forward period, Arizona allows unused credits to be carried forward 15 years. With the data collected by the required form (in Figure 2.11), the Arizona Department of Revenue is provided a comprehensive picture of potential liabilities generated by unclaimed credits being carried forward.

Arizona's Department of Revenue compiles this information into an annual report called *Arizona's Individual and Corporate Income Tax Credit Report*. Separate tables are compiled for the individual and corporate credits and report the following statistics for current and prior years:

- Number of taxpayers claiming the credit
- New credit generated
- Total credit available
- Amount of credit used
- Amount of credit carried forward
- Amount of credit forfeited

These statistics summarize the status of unclaimed credits being carried forward. If the Legislature requires the Tax Commission to

Arizona's 2016 form collected the status of all credits generated from 2003 to 2016.

Using collected carry-forward data, Arizona annually provides various statistics about existing carry-forward amounts.

begin collecting carry-forward data, we recommend a similar approach since Utah lacks historical use data.

Other States Create Data Sets by Collecting Carry-Forward Amounts Each Year. In California and Idaho, taxpayers are not required to disclose the status of all prior years' credits. Instead, they use a rolling approach and rely on the following amounts from the taxpayer:

- Carry-forward credit from prior tax return
- Credit generated by current tax year expenses
- Total credit available from current expenses and carry forward
- Credit claimed on current return
- Credit carry forward for future years

With these five amounts, the department overseeing the state's revenue can have a basis to calculate and audit carry forwards. Specifically, they can calculate how much has been forfeited as the allowable period for carry forwards expires. Since Utah's credit has been ongoing for several years, we believe that this method does not address Utah's needs as well as the one adopted by Arizona.

Metrics Are Collected and Reported for Other Tax Credits

The purpose of the research activities tax credit is to promote economic development, as is the case with other tax credits. For example, statute requires that the Governor's Office of Economic Development (GOED) report on specific outcomes, such as jobs created or the amount of new investment, for the enterprise zone tax credit. Other states and the federal government collect details regarding the types of research expenses that are generating their credits for research activities.

Like Utah's enterprise zone tax credit, we recommend that the Legislature specify the metrics that this credit is supposed to generate. As discussed earlier, the research activities tax credit's third option in statute includes all research as opposed to increases over a base amount. Understanding the extent to which credits are generated by base versus incremental research and whether qualified expenses are for wages, equipment, or contracted services can help the Legislature evaluate the research activities tax credit's effectiveness.

Using the rolling approach that other states use to collect only current tax year data would not help Utah recreate historical carry forward liabilities.

The Legislature has established metrics that help evaluate the effectiveness of other economic development tax credits.

Like the research activities credit, the enterprise zone tax credit also incentivizes business activities within Utah.

The Enterprise Zone Tax Credit Is an Example of a Utah Credit with Metrics Established in Statute. During the Legislature’s 2016 General Session, House Bill 31 specified performance metrics for Utah’s enterprise zone tax credit. The bill required the following metrics be reported annually to the Legislature’s Revenue and Taxation Interim Committee:

- Each development zone credits awarded
- New full-time employee positions created
- The amount of credits awarded for rehabilitating buildings
- Investments in a plant, equipment, and depreciable property

Collectively, these metrics demonstrate the effect of the credit. Figure 2.12 summarizes the tax credit metrics now reported by GOED.

Figure 2.12 Required Report on the Enterprise Zone Tax Credit Enables the Legislature to Assess Its Effectiveness. Statute specifies the information below must be reported to the Legislature for each calendar year starting with 2016.

Calendar Year 2016		
Outputs:	Number of projects	422
	Total credits awarded	\$4,634,000
Outcomes:	Jobs created	60
	Private investment	\$55,932,200

Source: Governor’s Office of Economic Development Annual Report for Fiscal Year 2017

Based on the metrics in Figure 2.12, the Legislature can assess the extent to which the state benefits from the tax credit relative to its costs. Prior to House Bill 31, no metrics were required to be reported, which is currently the case for the research activities tax credit. As discussed in the next section, the forms currently used by the IRS and other states collect pertinent data that the Tax Commission could aggregate and provide to the Legislature as it evaluates the credits for research activities.

Forms Used by the Federal Government and Other States Collect Information on Qualified Expenses. Information on what expenses generate research activities credits indicate the extent each option is being utilized. We reviewed the forms that the federal government and other states use for the research activities tax credits. They collect expense information that can be grouped by category. For the first option in Figure 2.6, in-house research activities that generated the credit can be broken down into the following groups:

For example, the Legislature can evaluate whether the benefits of the enterprise zone tax credit outweigh credit costs.

Taxpayer data collected via forms allows the federal government to identify how much credit is generated in-house or by contracted services.

- Wages
- Supplies
- Costs to rent or lease computers

In addition, expenses for contracted services, which are the allowable expenses for the second option in Figure 2.6, can indicate the extent that this option is being utilized.

Utah's third option allows a credit for all qualified research expenses for the current taxable year. Other states already require taxpayers to report base amounts of research conducted so the expenses that exceed that amount can be calculated. Utah could modify other states' forms to collect information on the amount of credit taxpayers claim for each of the three options.

Throughout this chapter, we have discussed the size of tax credits for research activities compared to other Utah credits. Recent growth in individual claims is currently unexplained because minimal information is collected on the credit. Utah's lack of a form for data collection is inconsistent with its other large credits and the practices of other states offering their own research activities credit.

Therefore, we recommend that the Tax Commission develop a form for the research activities tax credits capable of collecting data regarding carry-forward data and usage statistics. Then as the Legislature conducts future reviews of Utah's income tax credits, the Tax Commission should provide aggregate carry forward and usage statistics from the data collected via its research activities credit forms.

Recommendations

1. We recommend that the Tax Commission develop a control form for the research activities tax credit that tracks unused credits carried forward for use in future years and the amounts of expense by category that generated the credit.
2. After a form is adopted, we recommend that the Legislature request aggregate data regarding carry forward and usage statistics for the research activities tax credits when the Legislature conducts future tax credit reviews.

Developing a form and collecting credit data should help policy makers understand the reasons for recent accelerated growth and evaluate the credit's effectiveness.

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Chapter III

Residential Real Property Assessments Need Greater Fairness and Equity

Historical trends show that county assessments of residential real property are generally low relative to fair market value. Some counties are consistently at the bottom of the Utah State Tax Commission's (Tax Commission) allowable range. We estimate that low assessment levels reduce residential real property values statewide by about 2.8 percent, which is \$3.8 billion. We further estimate that low assessment shifts \$6.4 million of the tax burden associated with the Basic School Levy to other counties or other taxable property.

If the Tax Commission adopted a tighter range of allowable assessment levels by county assessors, one quarter of that shift can be addressed by raising the lowest assessment levels. After using a tighter allowable range for a few years, the Legislature could eventually consider and implement an additional process called indirect equalization² that is recommended by the International Association of Assessing Officers (IAAO). Further improvements could be made if the Property Tax Division's processes were based on mandatory reporting of all data rather than the current 35 percent of sales data voluntarily submitted.

According to *Utah Code* 59-1-210.7, the Tax Commission is charged to oversee county assessors and ensure "that all assessments of property are just and equal, according to fair market value, and that the tax burden is distributed without favor or discrimination." As this chapter focuses on low assessment levels of residential real property, we make the assumption that all other taxable property is valued at fair market value. While property tax equalization occurs in many varieties, this chapter focuses on addressing inequities due to differences in the accuracy and precision of appraisals by Utah's 29 county assessors.

The Tax Commission provides oversight to evaluate if counties assess property at fair market value.

² According to IAAO, "when indirect equalization is used, appraisals are not adjusted. Instead, indirect equalization involves an oversight agency estimating total taxable value, given the legally required level of assessment or market value."

Assessment Levels by County Assessors Are Consistently Below Fair Market Value

Statewide, counties' level of assessment tends to be low. In two counties of the third class, we observed one that tends toward assessing residential real property at fair market value, while the second assesses its property at 93 percent of fair market value. The latter county's low assessment level raises the concern that statewide tax levies affecting multiple counties are not equitably distributed.

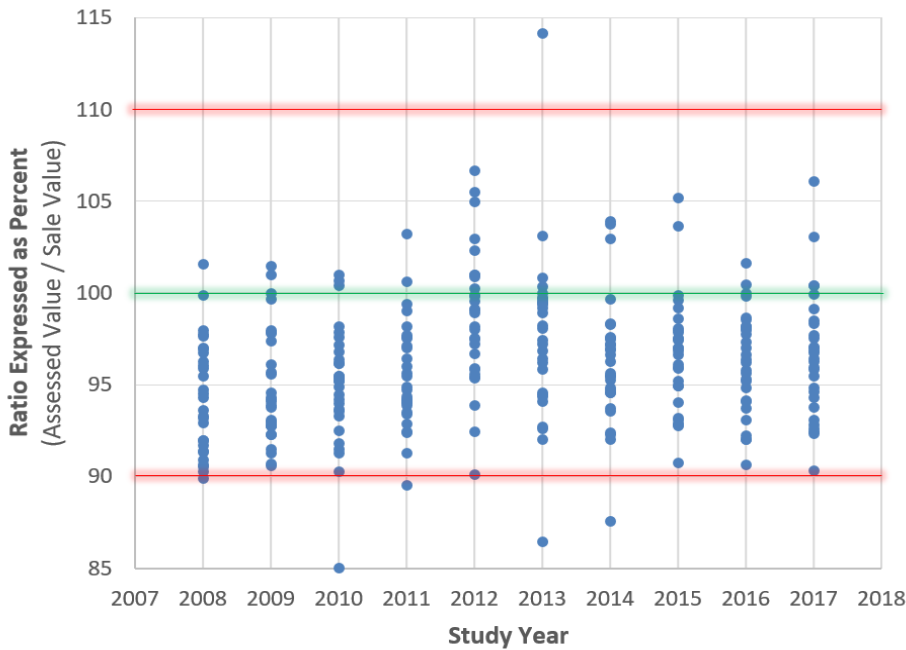
Assessment Levels for Residential Real Property Tend to be Low

To evaluate county assessments, the Property Tax Division calculates an assessment-to-sales price ratio for each county's sold properties. Individual sales may be excluded or adjusted if factors that distort the sales price are identified, such as a related party transaction. County-level statistics are based on appropriate assessment-to-sales ratios and evaluated against statewide standards.

Figure 3.1 shows the average sales ratio for residential properties in Utah's 29 counties over the past ten years. In addition to county averages, the ratio of 100 percent represents fair market value (the legal level of assessment) and is highlighted in green as it is the statutory goal. The two red lines reflect Utah's current standard that counties' average assessment levels must be within 10 percent of the legal level of assessment, which will be discussed later in this chapter.

To evaluate the performance of county assessors, The Property Tax Division compares the assessed value of a property to its actual sale price.

Figure 3.1 Counties' Average Real Property Valuations are Consistently Low. For the past ten years, most counties have appraised residential real property below fair market value.



Source: USTC Property Tax Division's Assessment/Sales Ratio Studies 2008-2017
 Note: The six data points that fall outside the standard indicated by the red lines complied with a second standard stipulated in Administrative Rule 884-24P-27(2)(a)(ii) that accounts for data quality and relies on a 95 percent confidence interval to determine compliance.

As Figure 3.1 shows, counties' average ratios have gravitated around 95 percent rather than the fair market value of 100 percent. Property Tax Division staff told us that assessors face political pressure to keep assessments conservative, which results in assessments falling below rather than around the 100 percent ratio. Recognizing these pressures, we are concerned that some counties may consistently generate lower appraisals than their peers, which could inequitably shift the tax burden associated with statewide levies.

Some Counties' Assessment Levels Are Consistently Low

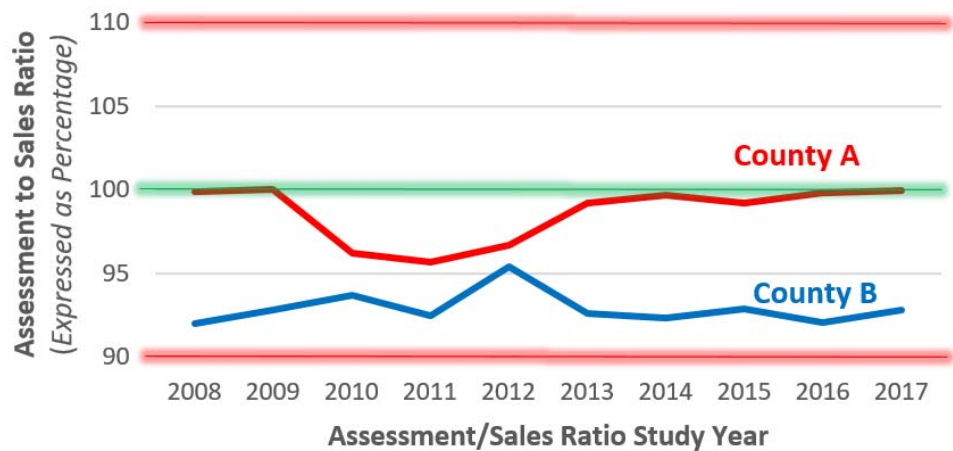
To understand whether low data points are the result of year-to-year fluctuations or part of a consistent trend, we looked at individual trends for Utah's 29 counties over the past ten years. Figure 3.2 shows an example of the average assessment-to-sales ratio for two counties of the third class. Like Figure 3.1, the legal level of appraisal (fair market value) is shown in green, and the Tax Commission's standard for central tendency, which is a county's average ratio, is in red.

Appraisals for residential property have consistently been low throughout the state.

County assessors face political pressures to keep property valuations lower than fair market value.

County B's overall assessment level has consistently stayed between 92 and 94 percent of fair market value, except in 2012.

Figure 3.2 Third Class Counties Exhibit Different Assessment Levels. Solid lines represent each county assessor's average ratio for residential real property assessments over the past 10 years.



Source: The Property Tax Division's Assessment/Sales Ratio Studies 2008-2017

While both counties comply with the Tax Commission's standards on average assessment, the levels of assessment occurring in the two counties are quite different. Over the past 10 years, County A has trended towards a fair market value assessment of its residential properties. The only exception is from 2010 through 2012 when County A's assessment level temporarily dipped. In contrast, County B has followed a consistent trend of its own, hovering between 92 and 94 percent except in 2012. The trend of County B has been closer to the lower limit of the Tax Commission's standard (90 percent) than to fair market value (100 percent).

When we discussed this county with Property Tax Division staff, they pointed out that this is one instance where political pressure exists to keep assessment levels low. Therefore, the assessment standards that the Tax Commission establishes in rule are critical, as they establish a floor as to how low property assessments can go. Tightening those standards appears to be a good remedy that county assessors could rely on to have their assessments better represent fair market value while minimizing the potential backlash from constituents.

Low Appraisal Levels Shift the Uniform School Fund's Tax Burden to Other Counties

From 2013 to 2017, the county assessor for County B discounted residential real property by about seven percent annually relative to County A's assessor. The potential impact of these different levels of

Tightening standards in administrative rule could promote assessments closer to fair market value.

assessment among county assessors has been noted by the Legislative Fiscal Analyst's Office. In its annual Compendium of Budget Information (COBI), the following statement was made regarding counties that did not comply with current assessment standards: "If a county is not in compliance it means that taxpayers in that individual county are not paying their fair share of the Uniform School Fund."

While all counties have been compliant with current standards for several years, differences in assessment levels and corresponding questions about fairness and equity still exist.

Along with County A, Salt Lake County's level of assessment over the past 10 years has been trending toward fair market value, achieving 100 percent for 2016 and 2017. The assessment level in Salt Lake County is important as it is Utah's largest county in terms of residential real property values by a considerable margin. Although Salt Lake County assesses its residential real property at fair market value, this assessment level is relatively high compared to some other counties. Therefore, property owners in Salt Lake County are among those shouldering additional tax burden for the Basic School Levy from counties with low assessment levels.

County B is one of four counties that have consistently achieved assessment levels below 95 percent, which is the level that counties appear to gravitate around, as shown in Figure 3.1. For the past five years, these four counties have generated assessment levels below 95 percent in either four or five those years. The consistently low level of assessment is concerning as it diminishes the perceived fairness and equity of the Basic School Levy, which is a statewide levy apportioned to Utah's 29 counties.

Low Assessment Levels Shift the Basic School Levy to the State's Other Taxable Property

When counties have a low assessment level, the value of property that they appraise is undervalued. For 2016, we estimate that the value of residential real property statewide was undervalued by about \$3.8 billion (2.8 percent). Two counties each undervalued their residential real property by over \$950 million. Since levies affecting multiple counties are the only type of levy impacted by different assessment levels, we estimate that \$6.4 million of the Basic School Levy was shifted from counties with low assessment levels to owners of other

Since Salt Lake County and County A assess residential real property at fair market value, their taxpayers shoulder additional Basic School Levy tax burden from counties with low assessment levels.

Low assessment levels by county assessors reduce the taxable value of residential real property by \$3.8 billion.

taxable property. This shift raises concerns about the level of fairness and equity promoted by the Tax Commission’s current standards for assessment levels.

Low Assessment Levels Reduce Residential Real Property Values by about \$3.8 Billion

Figure 3.3 shows the amount of residential real property that is being undertaxed because of the low assessment levels by county assessors depicted in Figure 3.1. This figure shows the taxable value reported by county assessors, the percent difference that their assessments deviate from fair market value, and the amount of taxable value needed to equalize Utah’s six county classes.

Figure 3.3 Low Assessment Levels Underreport \$3.8 Billion in Taxable Value. This figure shows the 2016 value assessed by county assessors, the percent adjustment that would generate fair market value, and the taxable value adjustment required.³

County Class*	County Assessor Taxable Value (in millions)	Adjustment to Fair Market	Taxable Value Adjustment (in millions)
1st Class	\$ 51,259	0.0%	\$ 0
2nd Class	51,985	4.4%	2,276
3rd Class	23,441	5.1%	1,201
4th Class	7,985	3.5%	283
5th Class	2,116	1.9%	41
6th Class	882	0.0%	0
Statewide	\$ 137,668	2.8%	\$ 3,801

Source: Property Tax Division’s 2016 Annual Statistical Report & Auditor Analysis of 2017 Sales Ratio Study
* County classification was based on the Lieutenant Governor’s Office’s certifications for 2016, which were the most recent when this report was written.

The largest impact in Figure 3.3 occurs in second- and third-class counties. One county in each of these two classes was undervalued between \$950 million and \$1 billion. Collectively, the two counties account for 51 percent of the statewide amount that was undervalued. The magnitude of these gaps is caused by the taxable value of the county’s residential real property and low assessment level.

³ Methodology Note: These differences are estimated according to the IAAO’s *Standards on Ratio Studies (April 2013)* that stipulates when and the extent that adjustments are statistically supported. The adjustments to fair market were not based on a county’s average assessment level. Instead, they were based on the confidence interval associated with that average. The confidence interval considers the quantity and quality of sales data that was used to generate county level statistics.

Statewide residential real property values are about 2.8 percent low, which reduces total taxable value by \$3.8 billion.

A Shift of \$6 Million of Basic School Levy Revenues Results from Low Property Values

Differences in assessment level from county-to-county affect statewide levies that apply to multiple counties, such as the Basic School Levy. For 2016, the Basic School Levy rate was 0.001675. Therefore, the \$3.8 billion in undervalued property in Figure 3.3 produced a tax burden of \$6.4 million that was shifted to other owners of property subject to tax.

Individual counties' share of the \$6.4 million varies. For example, County B from Figure 3.2 had a level of assessment for 2016 that was 7.4 percent below fair market value. Based on the value assessed by the county assessor, County B would have been responsible for \$1.7 million of the \$6.4 million shift. This shift in tax burden can be reduced with a tighter allowable range for assessment levels and indirect equalization, which are discussed in the next two sections. The counties that had to shoulder this tax burden shift include County A from Figure 3.2 and Salt Lake County, both of which had assessment levels close to fair market value.

Our concern is whether the current standards for residential real property assessment are commensurate with the high level of precision county assessors exhibit in their assessments. County assessor offices have become more sophisticated in their modeling, appraisal techniques, available data, and data analysis systems. Therefore, we believe current standards are outdated relative to assessors' capabilities.

A Tighter Allowable Range for Assessment Levels Would Raise the Lowest Counties' Rates

The IAAO recommends that a tighter allowable range of 95 to 105 percent be adopted when levies affecting multiple counties exist. For each of the past five years, roughly one third of counties would have been affected by the tighter standard. This would result in a tax shift where low valued counties would experience an increase and high valued counties would experience a decrease. The total impact of the shift would be about \$1.4 million. Four states have adopted the tighter range recommended by the IAAO.

Low residential real property values of \$3.8 billion shift \$6.4 million in tax burden for the Basic School Levy other taxable property.

We believe current standards are outdated, as county assessors are more sophisticated in their appraisal techniques.

The IAAO recommends a 95 percent to 105 percent standard for level of appraisal when a tax levy affects multiple counties.

A tighter range would not place undue burden on county assessors, as they have been 100 percent compliant with the current standard since 2010.

IAAO Suggests a Tighter Allowable Range For Levies Affecting Multiple Counties

According to *Utah Code* 59-2-704.5(2), the IAAO is the subject matter authority regarding appraisal methodology, and the Tax Commission should consider the standards it recommends. When a levy is assessed against property in multiple counties, the IAAO recommends indirect equalization, which will be discussed later in this chapter. As a prerequisite for indirect equalization, the IAAO's *Standards on Ratio Studies (April 2013)* recommends an assessment range of 95 to 105 percent. Regarding the tighter allowable range, the IAAO says

Oversight agencies should adopt performance standards that are as close to the legally required level as can be justified *given the local situation* [emphasis added] and taking into account the factors discussed herein.

Utah's counties have met the real property assessment standards established for residential, commercial, and vacant land since 2010. With 100 percent compliance, the metric indicates that there are no issues with meeting the current standard. Therefore, we believe that adopting a standard with a tighter range would not put an undue burden on county assessors. Instead, we believe that the tighter range would begin to equalize residential real property values in counties with the lowest assessment levels.

A Tighter Range Would Affect Second-Class Counties the Most

If the Tax Commission had adopted the 95 to 105 percent range recommended by the IAAO, Figure 3.4 shows the frequency that counties in each of the six classes would have been affected over the past five years.

Figure 3.4 A Tighter Standard Would Affect Second Class Counties More Frequently. The following chart shows how frequently county assessment levels in the past five years would not meet the 95 to 105 percent standard.

Class*	Counties	Affected by 95 to 105 Standard					Five-Year Frequency
		2017	2016	2015	2014	2013	
1st Class	1	0	0	0	0	0	0%
2nd Class	4	2	2	3	2	2	55%
3rd Class	6	1	3	2	3	1	33%
4th Class	9	4	2	2	1	3	27%
5th Class	5	2	2	2	2	2	40%
6th Class	4	1	0	0	1	0	10%
Statewide	29	10	9	9	9	8	31%

Source: USTC Property Tax Division's Assessment/Sales Ratio Studies 2013-2017

** County classification was based on the Lieutenant Governor's Office's certifications for 2016, which were the most recent when this report was written.*

As Figure 3.4 shows, roughly a third of Utah's 29 counties would have been affected by the tighter standard in any given year. In addition, the second-class counties would have had the highest frequency of being affected by the 95 percent standard.

As alluded to earlier, the financial impact to counties varies depending on the amount of residential real property in the county and its assessment level. A group of four counties including County B from Figure 3.2 were consistently below the 95 percent standard for four or five of the years presented in Figure 3.4. These four counties account for 18 of the 45 instances where counties would be affected by the tighter standard because they consistently have low assessment levels.

Conversely, 10 counties would have never been affected by the tighter standard, and an additional seven counties were affected in only one of the five years. This group of counties is largely unaffected because their assessment levels were consistently closer to fair market value than the group of four. From a frequency perspective, the tighter standard would have had a profound effect on the four counties that consistently assessed real property below the 95 percent level. However, over half of counties would have been unaffected or minimally affected by the change.

Figure 3.3 identified about \$3.8 billion in residential real property that was undervalued for the 2016 tax year. If the nine counties in Figure 3.4 affected by the proposed 95 percent standard had raised their assessment levels to the proposed standard, \$833 million in

Roughly one third of counties would have been affected by the tighter range in each of the past five years.

Four counties account for 18 of the 45 instances in the past five years where a tighter standard would have affected a county's assessment level.

Over the past five years, 10 counties would have been unaffected by a tighter standard, and seven additional counties would have been affected in one of the five years.

A tighter allowable range would address \$833 million of the \$3.8 billion in low residential real property values.

taxable value would have been added. This additional property value would have reduced the \$6.4 million tax burden shift for the Basic School Levy by \$1.4 million. As counties likely would exceed that standard to some degree, we believe that the tighter standard would have addressed about a quarter of the underreported property in 2016. At a minimum, adopting a tighter range for first through third class counties is important, as 91 percent of the undervalued residential real property identified in Figure 3.3 resides in these classes.

Some Other States Have Adopted A Tighter Acceptable Range

In 2013, the IAAO published its *Ratio Study Practices in the United States and Canada: Results of 2013 Survey*. This report listed state responses to the question, “What are your ratio study standards for acceptable level of appraisal?” That study showed that four states (Colorado, Iowa, Texas, and Wyoming) have adopted the 95 to 105 percent standard for their levels of assessment. Colorado, Iowa, and Wyoming also require mandatory disclosure of all sales data, which will be discussed later in this chapter. In addition, Idaho has adopted a similar standard that applies only to the apportionment of funds for the Boise School District. Texas adopted the tighter range as it faces a statewide challenge of equitably apportioning an education tax levy across multiple jurisdictions.

In Texas, the primary purpose of the state’s Property Value Study is “to help ensure equitable distribution of state funding for public education.” Because the state uses the Property Value Study to ensure that school districts have approximately the same amount of funding per student regardless of the tax base in a jurisdiction, they cannot rely solely on property values as appraised by each county appraisal district. Thus, they adhere to the 95 to 105 percent standard and apply indirect equalization, which will be discussed in the next section.

We recommend that the Tax Commission amend *Administrative Rule 884-24P-27(2)(i)* to prescribe a five percent range as the allowable level of assessment by county assessors in counties of the first through third classes at a minimum. As this section has detailed, this action is recommended by the IAAO as part of a comprehensive solution to address different levels of assessment by county assessors.

County assessors have also shown no issues complying with the current standard for several years; therefore, we believe it is

Four states have adopted the 95 to 105 percent assessment standard IAAO recommends.

The IAAO recommends a tighter allowable range for assessment levels as part of a comprehensive solution that includes indirect equalization.

appropriate to promote better assessment levels by tightening Utah's standard. Applying the tighter range to first through third county classes at a minimum is necessary, as those three classes account for 91 percent of underreporting values. A lack of quality data, which will be discussed later in this chapter, could be a basis for excluding fourth through sixth class counties from the tighter standard. If the Tax Commission tightens the assessment level standard, then the Legislature can consider indirect equalization that can cost-effectively adjust for any remaining differences in counties' assessment levels.

Indirect Equalization Can Address Counties' Remaining Appraisal Level Differences

After implementing a tighter allowable range of assessment levels, residential real property would still be undervalued by nearly \$3.0 billion of the \$3.8 billion. To address the remaining undervalued property, Utah's current equalization process could be supplemented with a process recommended by the IAAO called indirect equalization. This process is applied only to levies that affect multiple counties, such as the Basic School Levy, and promotes greater fairness and alleviates some political pressure associated with raising assessment levels. A tighter range of allowable assessment levels should be utilized for a few years; then we recommend that the Legislature could consider supplementing the Tax Commission's current process with indirect equalization. This is a process recommended by the IAAO to further reduce the adverse effects of counties' different assessment levels on the Basic School Levy.

Indirect equalization does not require additional costly adjustments to individual property appraisals by county assessors' staff. Instead, the IAAO describes the process as follows:

The most common use of indirect equalization is to enable proper funding distribution, particularly for school districts. Such equalization provides an estimation of the proper tax base (acknowledging statutory constraints such as agricultural use value) despite appraisals that are higher or lower than legally required levels in certain jurisdictions.

The mechanics of this process are best described in the IAAO's *Standard on Ratio Studies (April 2013)*. Other states (see the Texas example earlier in this chapter) have adopted indirect equalization to

Indirect equalization estimates the proper tax base rather than using additional costly adjustments to individual property appraisals.

address different assessment levels among counties and taxing jurisdictions.

A problem that county assessors face is the political pressure that can exist to keep appraisals as low as statute allows. Regardless of the standard established by the Tax Commission, some counties may still try to be at the bottom of that range. The IAAO states that indirect equalization is a process designed to address this inherent challenge:

Indirect equalization results in fairer funding apportionment because the overall appraisal levels of the taxing jurisdictions tend to vary. If there were no equalization, the extent that a jurisdiction under- or overestimated its total tax base would result in over- or under-apportionment of funds. ... By adjusting governmental payments, tax rates, or partial exemptions, *indirect equalization encourages taxing jurisdictions to keep their overall tax bases close to the required level* [emphasis added].

Helping county assessors to overcome political pressures and addressing differences in assessment level that will inherently exist are good reasons to consider adopting indirect equalization.

We recognize to some extent the magnitude of change that adding indirect equalization to Utah's current process would entail. Therefore, the tighter range of allowable assessment levels should be utilized for a few years to document its full impact. Then, we recommend that the Legislature could consider evaluating the use of indirect equalization as the next step to further equalize the adverse effects of different assessment levels among counties. Recognizing that the majority of undervalued property will not be addressed by narrowing the assessment level gap with tighter standards, the Legislature should consider evaluating indirect equalization.

Mandatory Reporting of All Sales Would Improve Data Quality

As this chapter has stressed, the volume and quality of data plays an important role in assessing real property. The Property Tax Division collects data on sales via an optional questionnaire sent to buyers. This data is incomplete as only 35 percent of buyers respond.

After a few years of using a tighter allowable range for assessment levels, the Legislature could consider supplementing the Tax Commission's current processes with indirect equalization.

Only 35 percent of buyers respond to the division's questionnaire collecting information about their recent purchase of real property.

The questionnaire asks for information necessary to determine if the sale was an arms-length, fair market value transaction and thus appropriate for inclusion in the data set. For example, if a buyer purchased a home from a family member at a low price, the sale is not an arms-length transaction and would be excluded to avoid distorting the data. The questionnaire asks for the following:

- Sales price
- Type of property
- Method of financing

Buyer responses serve as the primary data source for the annual Assessment to Sales Ratio Study. However, they also utilize other sources of data when available, such as multiple listing service (MLS) data. However, division staff report that the MLS data does not cover the rural areas of the state and sales that did not utilize a real estate agent's services.

The low response rate to the optional questionnaire reduces the quality of the data. Other states have adopted mandatory sales disclosure laws to address this limitation. According to a 2009 survey conducted by the IAAO, 37 states require disclosure of sales data, including 8 out of 11 western states. IAAO's *Standard on Property Tax Policy* states that "legally mandated disclosure of sales prices to local and state assessment jurisdictions is necessary to ensure the quality and availability of [sales] information." Arizona's sales disclosure practices may serve as an implementation guide for Utah.

First, Arizona law stipulates that both the buyer and seller must attest to an affidavit of property value, mitigating the problems associated with self-reporting. The affidavit must be signed, notarized, and submitted to the county recorder. In addition, the Arizona affidavit informs buyers and sellers that failure to complete the affidavit "constitutes a class 2 misdemeanor and is punishable by law."

Quality data is critical to the division's oversight of county assessments. Optional questionnaires produce less reliable data than data produced because of mandatory disclosure requirements in other states. Thus, we recommend the Legislature consider establishing this requirement in statute to ensure the division has the tools necessary to exercise appropriate oversight.

The IAAO recommends requiring disclosure of sale prices, which is already the practice in 37 states.

Utah Code 59-2-704.5 stipulates how Utah's standards should be developed and requires that the Legislature review those standards on a five-year cycle. According to the timetable established in statute, 2018 interim would be the next time that the real property assessment standards should be reviewed. Based on the information provided in this chapter, there should be discussion about how the current standards could be improved and refined.

Recommendations

1. We recommend that the Tax Commission adopt a tighter allowable range for county assessors' level of assessment by amending *Administrative Rule 884-24P-27(2)(i)* to prescribe a five percent range for counties of the first through third classes at a minimum.
2. After using a tighter range of allowable assessment levels for a few years, we recommend that the Legislature could consider supplementing the Tax Commission's current process with the indirect equalization process recommended by the International Association of Assessing Officers (IAAO) to further reduce the adverse effects of counties' different assessment levels on the Basic School Levy.
3. We recommend that the Legislature consider requiring the disclosure of sales data via an affidavit for all real property sales transactions to ensure the Property Tax Division has the volume and quality of data necessary to oversee real property assessment.

Chapter IV

Business Personal Property Audits Are Productive but Lack Consistency

The Tax Commission's *Publication 20* defines business personal property subject to taxation as "...everything not treated as real property, including: furniture, fixtures, machinery, equipment, supplies." Audits of business personal property have identified important misreporting by taxpayers. However, we also identified regular occurrences of findings with insignificant amounts, which are not cost effective to implement. We believe that the administrative rule requiring they be reported and billed to taxpayers should be amended.

Statute states that the Utah State Tax Commission (Tax Commission) shall provide audit services for each county. The Tax Commission has deviated from statute by allowing Salt Lake County to perform its own audits, which reduces state costs. Greater control by counties has also resulted in counties of similar size requesting vastly different numbers of audits; some counties are not audited at all.

We recommend that the Legislature consider updating statute to allow counties to do their own audits under the oversight of the Tax Commission. In addition, a minimum number of audits should be required for counties, depending on size. Finally, the Tax Commission last updated the audit rates charged to counties in fiscal year 2011 and should update them to reflect current costs.

Audits Have Been Productive as They Ensure Compliance with Statutory Requirements

Each year, the Tax Commission's Property Tax Division (division) charges counties for 1,000 to 1,200 audits that review one or more tax years. Most audits identify significant reporting that does not comply with statutory requirements, showing that these audits provide value:

- Audits of major accounts that represent the largest one percent of accounts generate more than 20 percent of all misreporting.

Business personal property includes furniture, fixtures, machinery, equipment, and supplies.

Business personal property audits also educate taxpayers, promoting future compliance.

- Audits of non-filing accounts identified value that exceeds exemption (\$10,300 for 2016) and generated a tax liability 70 percent of the time.
- Audits of filed accounts that claimed to be exempt identified value that exceeds exemption and generates a tax liability over 50 percent of the time.
- Audits identified accounts that overreported values and overpaid taxes more than 10 percent of the time.

These audit findings can serve to educate taxpayers for greater compliance in the future.

Audits of Major Accounts Generate Over 20 Percent of Value Adjustments

Each division audit reviews one to five years of business personal property tax reports. For audits that reviewed 2016 and 2015 tax years respectively, the division audited 1,457 and 1,743 taxpayer accounts. The audits identified significant misreporting as shown in Figure 4.1.

Figure 4.1 Business Personal Property Audits Identified Large Value Adjustments. This figure shows the taxable value reported by taxpayers and corresponding audit adjustments. Rather than offsetting each other, positive and negative adjustments were combined in the total audit adjustments. The net adjustments show the bottom line effect of all adjustments.

Tax Year	Audits Conducted	Taxpayer Assessed Value	Total Audit Adjustments*	Net Audit Adjustments
2016	1,457	\$ 1,285 Million	\$ 152 Million	\$ 140 Million
2015	1,743	\$ 901 Million	\$ 172 Million	\$ 161 Million

Source: The Property Tax Division's Audit Data

** To avoid reductions in taxable value from cancelling out some value increases, the amount shown in total changes is the aggregate changes regardless of direction.*

Figure 4.1 shows that over \$150 million in taxable value adjustments were identified each year. Those adjustments include reductions to business-reported taxable values. Therefore, we included the final column for net change which reports the bottom line impact of audits.

The division recommends that counties select major accounts for audit, which has been effective guidance. In 2016 and 2015, the top one percent of accounts by size were reviewed to understand the impact of major account audits. In 2016, the top 15 accounts

Each year, audits identify over \$150 million in underreporting and overreporting of taxable value.

Based on guidance from the Property Tax Division, counties select major accounts for audits.

represented \$33 million in misstatements, which was 21 percent of all changes for the year. In 2015, the top 17 accounts represented \$41 million in misstatements, which was 24 percent of all changes for the year. In each case, the largest one percent of accounts yielded over 20 percent of misstatements.

Most Audits of Non-Filing Businesses Identify A Tax Liability as Property Values Exceed Exemption

The division also focuses on non-filing accounts. Regardless of whether they are exempt or not, businesses are statutorily required to self-report their personal property value and then remit payment of any tax liability by May 15th. According to the Tax Commission’s *Publication 20*, “If a business fails to provide the required information, the assessor must impose a penalty of \$25 or 10 percent of the tax due, whichever is greater.” The property value will be estimated if the business ignores a second written notice.

The division emphasizes audits of businesses failing to file tax reports. Figure 4.2 shows 2016 statistics that illustrate the effectiveness of auditing businesses that failed to file.

Figure 4.2 Non-Filing Taxpayers Frequently Exceed the Exemption Threshold. The adjustments column shows the value of taxable personal property identified in audits of non-filing businesses. Most had sufficient taxable property to exceed the exemption threshold of \$10,300 for the 2016 tax year.

Range	Audit Count	Total Adjustments
\$10,300 or Less (Exempt)	67	\$ 300,036
\$10,300 to \$100,000	116	3,975,868
Over \$100,000	38	11,125,168
Total	221	\$ 15,401,072

Source: Property Tax Division’s Personal Property Audit Database

These statistics show that 70 percent of audits involving non-filing businesses (154 of 221) identified sufficient taxable property to exceed exemption and generated a tax liability. In 38 cases, the value of personal property exceeded \$100,000, including three audits each identifying business personal property exceeding \$1 million.

Businesses must report and pay their personal property tax by May 15th each year or receive a penalty.

Audits found 70 percent of non-filers had taxable value that exceeded the exemption threshold and thus owed taxes.

Half of Exempt Account Audits Invalidate the Claimed Exemption

According to statute, a business in 2016 with less than \$10,300 in personal property was exempt from paying taxes. While the temptation might exist to forego auditing business that claim the value of their accounts is exempt, recent statistics show they are worth auditing.

For 2015 and 2016, half of the audits of businesses that claimed the exempt status found sufficient additional property to refute the businesses' claims. For 2016, audits of accounts with exempt assessments found that 45 percent (160 of 359) of exempt status claims were invalid because their post-audit value of personal property exceeded \$10,300. For 2015, the rate that audits of exempt assessments were proven invalid was 57 percent (200 of 354).

For 2016, two audits of exempt businesses were particularly concerning. Although businesses claimed that their personal property was worth less than \$10,300, subsequent audits identified more than \$800,000 worth of taxable property for each business. Using the 2016 statewide average property tax rate of 0.011763, each business would have avoided paying over \$9,400 in property taxes if they had not been audited.

Some Audits Found that Businesses Overreported Their Taxable Value

Personal property audits are conducted to review taxpayer compliance with statutory reporting requirements. Sometimes, business personal property audits find that businesses overreported their property's taxable value and incurred an unwarranted tax liability. For the 2016 tax year, 1,154 audits of businesses reporting a taxable value were conducted. Auditors found reductions in taxable value in 145 (13 percent) of those audits. Collectively, those audits resulted in reduced taxable value of \$6.2 million.

Two businesses benefited significantly from their audits. One audit reduced the taxable value of business personal property by almost \$2.8 million. A second audit determined that the business had no taxable property even though the business reported nearly \$500,000 in taxable personal property.

Audits identified two businesses that claimed to be exempt but actually had taxable value exceeding \$800,000.

In 2016, taxpayers had overreported their taxable value and thus overpaid in taxes in 10 percent of all audits conducted.

In instances like those just discussed, audits benefited individual taxpayers by identifying a reduction in the value of their taxable property that led to a lower tax liability. When additional taxable property is identified, all property owners subject to property taxes benefit by the tax burden being more equitably distributed. The next section discusses an area needing improvement, where it is not cost effective to report and bill for insignificant audit adjustments.

When additional taxable property is identified, all property owners benefit because the tax burden is then distributed more equitably as a result.

Mandatory Reporting When Adjustments Are Less Than Processing Costs Should Be Eliminated

Administrative rule requires that all findings be reflected in assessment rolls and tax rolls and billed to the taxpayer. Audits of major accounts, reporting more than \$1 million in taxable property, identified taxable value adjustments of less than \$200. These adjustments produced about \$2 of additional taxes, which were unlikely to cover all costs associated with processing the adjustment.

We believe that the cost of processing those adjustments exceeds any additional tax that would be claimed. We recommend that the Tax Commission discuss the cost of processing audit adjustments with county assessors and determine a threshold where audit adjustments should require no further action. Currently, only one percent of audits involving accounts with tax liabilities result in no changes. Similar treatment should occur when an account's exempt status is confirmed or change does not exceed the processing cost. To be cost effective, the Tax Commission should amend administrative rule to exclude these insignificant adjustments from reporting requirements.

Administrative Rule Requires That All Audit Adjustments Are Reported

The process for any adjustment identified during an audit is prescribed in *Administrative Rule* 884-24P-42(1), which requires the following three steps:

- (a) If an audit reveals an incorrect assignment of property, or an increase or decrease in value, the county assessor *shall* correct the assessment on the assessment roll and the tax roll [emphasis added].

County assessors must change the tax roll to reflect any increases or decreases found during an audit and then mail a notice to the taxpayer.

(b) A revised Notice of Property Valuation and Tax Changes or tax notice or both *shall* be mailed to the taxpayer for the current year and any previous years affected [emphasis added].

(c) The appropriate tax rate for each year *shall* [emphasis added] be applied when computing taxes due for previous years [emphasis added].

The rule also states that “assessors shall not alter results of an audit without first submitting the changes to the commission for review and approval.” We are concerned about how this rule applies to those accounts where adjustments do not yield an additional tax liability that exceeds the cost to process the adjustment.

Revenue from Insignificant Adjustments Does Not Offset Reporting Costs

During the review of major accounts, adjustments of \$6, \$11, and \$176 were made to three 2016 accounts with self-reported values exceeding \$1 million. Relative to the taxable value that was reported by the business, these amounts are insignificant. The statewide average property tax rate for 2016 was 0.011763. Therefore, the largest adjustment for \$176 dollars would yield \$2.07 in tax. To paraphrase a statement by one assessor, hopefully we use common sense and acknowledge that it is not worth the cost of printing, postage, and staff time to go after such small adjustments. We recommend that the Property Tax Division meet with county assessors to determine what that amount is, which would be used for exempting audit changes from the reporting requirement.

To provide some context regarding the frequency of relatively small audit findings, Figure 4.3 shows the frequency with which audits identify adjustments within various ranges. Due to issues with businesses underreporting business personal property values and claiming to be exempt, Figure 4.3 shows only those businesses that reported a business personal property exceeding the exemption.

Administrative rule says that assessors shall not alter the results of an audit without the review and approval of the Tax Commission.

One assessor commented that small adjustments are not worth the cost of printing, postage and staff time to implement.

Figure 4.3 Most Audits Identify Adjustments Exceeding \$5,000. Percentages are based on 795 audits of the 2016 tax year where businesses declared taxable value that exceeds the exemption level of \$10,300.



Source: Auditor Analysis of USTC Property Tax Division Data

Only one percent of audits in Figure 4.3 resulted in no change being identified by the Property Tax Division’s auditors. According to administrative rule, these are the only audits where county assessors are not required to adjust their assessment and tax rolls.

Figure 4.3 shows that 50 audits (6 percent) produced adjustments of \$1,000 or less. These adjustments would generate less than \$12 in taxes based on the average property tax rate statewide (0.011763). Similarly, 136 audits (17 percent) identified between \$1,001 and \$5,000 in additional property, which generates between \$12 and \$59 in taxes.

Depending on county assessors’ cost to process adjustments, this figure gives some sort of context as to what percent of adjustments generate revenue that is insufficient to cover their processing costs. Similarly, we believe it is reasonable to include the 199 audits discussed earlier in this chapter where the exempt status of an account was confirmed. Any additional property discovered during these audits will not affect the account’s tax liability, and therefore should not require adjustments by county assessors.

We believe that it is important to consider whether tax implications are insignificant or not when reporting and billing for adjustments. Therefore, we recommend that the Tax Commission

Adjustments of \$1,000 in taxable value would generate less than \$12 in taxes based on the average property tax rate statewide.

We recommend that the Tax Commission amend administrative rule to limit mandatory reporting of insignificant adjustments.

amend *Administrative Rule* 884-24P-42 to limit mandatory reporting of audit adjustments to those that exceed an insignificant value that is equivalent to the cost of processing.

Several Audit Practices Deviate from Statute, But Benefit to the State Should Be Considered

According to statute, the Tax Commission shall provide audit services for each county, following a legally pre-defined cost sharing arrangement. We observed three practices that deviate from statute:

- Salt Lake County performs its own audits, which reduces the state's costs.
- The number of audits conducted in counties of the same class vary, including some counties receiving no audits.
- Current rates have not been updated since fiscal year 2011, which does not comply with the statutory cost-sharing arrangement.

Salt Lake County performing its own audits is a clear benefit to the state, which the Legislature should consider allowing in statute. However, the last two practices do not promote uniformity and equity, which is the objective of personal property audits.

Statute Requires that the Tax Commission Provide Audits and Counties Contribute Funds

The Property Tax Division's *Standards of Practice* regarding personal property valuation states that "the overall objective of an audit program is to promote uniformity, equity, and proper reporting." To promote uniformity and equity, responsibility for personal property audits is placed squarely on the Tax Commission. *Utah Code* 59-2-705 (1) states that:

The commission shall provide the services of qualified personal property appraisers for the purpose of auditing taxable personal property accounts *in each county* [emphasis added].

The phrase "in each county" means that rather than the 29 counties doing audits differently, the Tax Commission should provide

The Tax Commission deviates from statute in three ways, yielding mixed results.

As counties play a greater role in the audit program, audit utilization has become less uniform and equitable.

consistency by performing those audits. Or, in the case of Salt Lake County, the Legislature should consider allowing the Tax Commission to provide oversight to counties that conduct their own audits.

To cover the cost of Tax Commission's services, *Utah Code* 59-2-705(2) stipulates a 70/30 cost sharing with counties. Counties are required to contribute 30 percent of the cost of their audits to the Tax Commission. To allow counties to budget for those costs, the Tax Commission is required to provide counties with an estimate of their audit costs by May 1 of each year for the following fiscal year. As the following sections will describe, current practices are not adhering to these statutory provisions.

Salt Lake County Reduces State Costs by Doing Its Own Audits

Since at least May 2004, the Property Tax Division's *Standards of Practice* has authorized Salt Lake County to do its own personal property audits. As discussed in the previous section, this practice differs from the statutorily prescribed practice. According to the Salt Lake County Assessor, the county began doing its own personal property audits 20 years ago because of its high volume. In addition, there were disagreements in how insignificant audit findings should be reported, which was discussed earlier in this chapter.

A benefit of Salt Lake County doing its own audits is that the state's costs are reduced. Salt Lake conducted 680 audits during 2017. In comparison, the Tax Commission conducted 1,076 audits for the other 28 counties. The Salt Lake County assessor's office accounted for 39 percent of all personal property audits conducted in the state. If the Tax Commission were to provide those audits for Salt Lake County as prescribed in statute, the Property Tax Division would require additional staff. This additional cost to the state is unnecessary based on the Tax Commission's positive assessment of the county's audits.

Property Tax Division staff told us that they work closely with county staff, so the quality of work is not the issue. Staff performing the audits are also licensed property appraisers who have been trained by the Tax Commission to assess business personal property. Considering the cost savings to the state and the Tax Commission's oversight of county audits, we recommend the Legislature formalize this practice in statute.

The Property Tax Division has authorized Salt Lake County to do its own audits.

In 2017, Salt Lake County performed 39 percent of the personal property audits in the state.

Property Tax Division staff have no concerns regarding the quality of audits in Salt Lake County.

The Number of Audits Conducted in Counties of the Same Class Vary Significantly

Statute groups counties of similar sizes into classes. Figure 4.4 shows the range of audits conducted for counties within each of Utah’s six county classes. As Utah’s only county of the first class, Salt Lake County was excluded from the table with 680 audits during 2017.

Figure 4.4 A Broad Range of Audits Are Conducted in Counties of the Same Class. The range of audits conducted in counties of each class are shown. To provide some context, the amount charged by the Property Tax Division for audits is shown.

County Class	High Count	Amount Charged	Low Count	Amount Charged
2nd Class	350	\$ 36,750	24	\$ 420*
3rd Class	103	11,845	9	945
4th Class	27	3,105	0	0
5th Class	10	1,150	0	0
6th Class	10	1,150	0	0

Source: Property Tax Division Data
 * The Property Tax Division billed the county for 4 of the 24 audits, as the county performs some audits.

Large differences in the extent that audits are being used demonstrate a lack of uniformity that is concerning. In the second-class counties, fifteen times more audits are being conducted for the highest county relative to the lowest county. Also, three classes had a county that received no audits in 2017. However, the Property Tax Division told us that in these instances the division can still go and audit the county’s process for administering personal property taxes.

Guidance from the Property Tax Division states that “though periodic audits of all accounts is ideal, it is often not practical.” For the three counties with no audits, the practice falls well short of that guidance and statute, which requires that audit be performed in each county.

Like Utah, broad guidance regarding audit counts was observed in Colorado, New Mexico, and Oregon. However, Washington and California were more prescriptive. Washington statute states that “the department of revenue shall audit statewide at least one-half of one percent of all personal property accounts listed each calendar year.”

In California’s Assessor’s Handbook Section 506, *Property Tax Audits and Audit Program*, the State Board of Equalization has

Property Tax Division guidance states that periodic audits of all accounts are ideal.

Unlike Utah, Washington and California have prescribed minimum levels of audit coverage.

prescribed the number of audits that each of California's 58 counties should conduct on an annual basis. In addition, the handbook prescribes that half of the audits should be selected randomly from the pool of largest taxpayers in the county. Specifically, that pool's size is set so that each of the largest taxpayers is audited every four years. A copy of the schedule specifying this information is included in Appendix A.

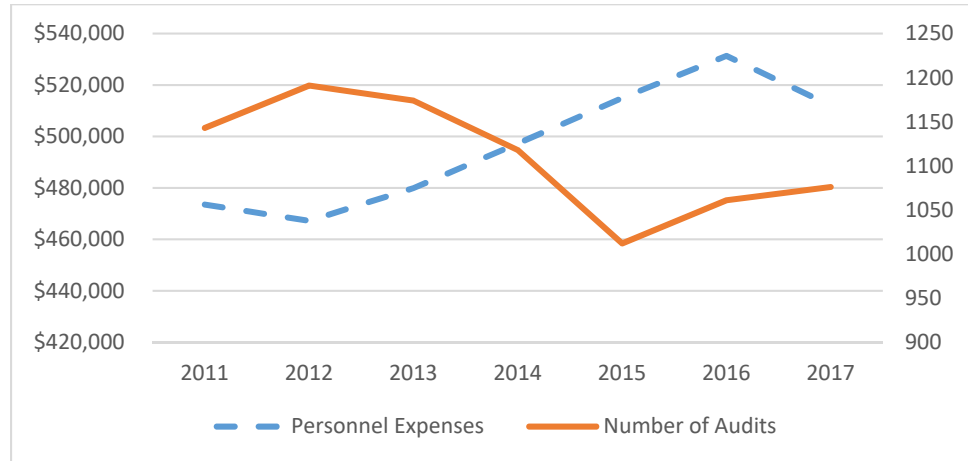
As Figure 4.4 has shown, the level of audit coverage occurring among counties varies widely. To provide some context, current county cost for an audit is \$105 or \$115 depending on county location. Therefore, a county spending about \$1,000 receives 8 to 10 division audits. Thus, we recommend that the Legislature consider a minimum level of audit coverage for all counties. The Property Tax Division should help develop that standard by reporting to the Legislature on a best practice based on discussion with county assessors.

Current Rates Should Be Updated

Since fiscal year 2011, the Property Tax Division has assessed the same rates to counties for audits of business personal property accounts. As personnel costs have increased and audit counts have decreased, rates should be higher to reflect the 70/30 cost sharing arrangement in statute. Figure 4.5 shows how personnel costs have trended over time. To provide some context, we added the number of audits completed each year.

Per audit rates charged to counties have not been updated since 2011.

Figure 4.5 Since 2011, Personnel Costs Have Increased and Number of Audits Completed Has Decreased. While the costs of staff have been increasing, the number of audits they produce are decreasing.



Source: Personnel Expenses – Division of Finance’s FINET Data Warehouse; Number of Audits – Personal Property Audit Data from the Property Tax Division

Figure 4.5 shows that personnel costs and the number of audits completed each year on average are moving in opposing directions. However, both indicate that the current rates, which were set in fiscal year 2011 according to the 70/30 cost sharing provision in statute, should be higher to currently comply with statute.

In 2011, the Property Tax Division reports completing 1143 audits. By 2017, the number of audits dropped to 1076 while staffing levels remained constant. The drop of 67 audits over six years represents a six percent decrease. Consequently, a six percent increase in rates would be required to account for the decrease in audits alone.

The other key factor in determining rates is the division’s personnel expenses for the personal property section. For fiscal year 2017, personnel accounted for 95 percent of the division’s costs. Personnel costs have grown from \$473,537 in fiscal year 2011 to \$512,013 in fiscal year 2017. This change represents an eight percent increase that also needs to be reflected in rates. Between the six percent increase associated with decreasing audits and the eight percent increase associated with personnel costs, we estimate that an increase of at least 15 percent is needed.

Utah Code 59-2-705(2) stipulates a 70/30 cost sharing with counties. Since fiscal year 2011, the Property Tax Division has

Current rates charged to counties are too low to comply with the statutory cost-sharing provision.

An increase of at least 15 percent to current rates is necessary to comply with statute.

assessed the same rates, which were calculated to be consistent with the 70/30 cost sharing arrangement in statute when they were initially set. As costs have increased and audit counts have decreased, we recommend that the Tax Commission's Property Tax Division update its rates charged to counties to reflect prevailing costs and audit output.

Recommendations

1. We recommend that the Property Tax Division work with county assessors to determine the costs to process business personal property audit adjustments.
2. We recommend that the Tax Commission amend *Administrative Rule 884-24P-42* to avoid mandatory reporting of audit adjustments that do not exceed counties' processing costs.
3. We recommend that the Legislature consider amending statute to allow counties to perform on-site audits under the oversight of the Property Tax Division.
4. We recommend that the Legislature consider promoting consistency by requiring a minimum number of audits annually for counties of similar size.
5. We recommend that the Property Tax Division revise the rates charged to counties for personal property audits to comply with the 70/30 cost sharing provision in *Utah Code 59-2-705(2)*.

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Appendix A

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Appendix A

California's Minimum Required Annual Property Tax Audits by County

The following is the breakdown of business personal property audits required for California's 58 counties:

<i>APPENDIX B: MINIMUM ANNUAL PROPERTY TAX AUDITS</i>				
County (1)	* Significant Number of Audits (2)	Pool of Taxpayers with Largest Assessments (3)	Annual Audits Required	
			From Pool of Largest Assessments (4)	From Pool of All Other Taxpayers (5)
Alameda	387	774	193 (194)	194 (193)
Alpine	1	2	0 (1)	1 (0)
Amador	6	12	3	3
Butte	41	82	20 (21)	21 (20)
Calaveras	4	8	2	2
Colusa	13	26	6 (7)	7 (6)
Contra Costa	175	350	87 (88)	88 (87)
Del Norte	7	14	3 (4)	4 (3)
El Dorado	22	44	11	11
Fresno	220	440	110	110
Glenn	4	8	2	2
Humboldt	24	48	12	12
Imperial	40	80	20	20
Inyo	12	24	6	6
Kern	139	278	69 (70)	70 (69)
Kings	25	50	12 (13)	13 (12)
Lake	7	14	3 (4)	4 (3)
Lassen	5	10	2 (3)	3 (2)
Los Angeles	1,686	3,372	843	843
Madera	28	56	14	14
Marin	45	90	22 (23)	23 (22)
Mariposa	6	12	3	3
Mendocino	22	44	11	11
Merced	74	148	37	37
Modoc	2	4	1	1
Mono	2	4	1	1
Monterey	77	154	38 (39)	39 (38)
Napa	54	108	27	27
Nevada	18	36	9	9
Orange	1,014	2,028	507	507
Placer	61	122	30 (31)	31 (30)
Plumas	3	6	1 (2)	2 (1)
Riverside	283	566	141 (142)	142 (141)
Sacramento	200	400	100	100
San Benito	15	30	7 (8)	8 (7)
San Bernardino	283	566	141 (142)	142 (141)
San Diego	584	1,168	292	292
San Francisco	303	606	151 (152)	152 (151)
San Joaquin	179	358	89 (90)	90 (89)
San Luis Obispo	57	114	28 (29)	29 (28)
San Mateo	217	434	108 (109)	109 (108)
Santa Barbara	216	432	108	108
Santa Clara	675	1,350	337 (338)	338 (337)
Santa Cruz	40	80	20	20
Shasta	40	80	20	20

Source: Appendix B from California's Assessor's Handbook Section 506: Property Tax Audits and Audit Program

County (1)	* Significant Number of Audits (2)	Pool of Taxpayers with Largest Assessments (3)	Annual Audits Required	
			From Pool of Largest Assessments (4)	From Pool of All Other Taxpayers (5)
Sierra	2	4	1	1
Siskiyou	10	20	5	5
Solano	62	124	31	31
Sonoma	107	214	53 (54)	54 (53)
Stanislaus	112	224	56	56
Sutter	23	46	11 (12)	12 (11)
Tehama	11	22	5 (6)	6 (5)
Trinity	1	2	1 (0)	0 (1)
Tulare	98	196	49	49
Tuolumne	8	16	4	4
Ventura	128	256	64	64
Yolo	59	118	29 (30)	30 (29)
Yuba	16	32	8	8

* When the significant number of audits does not result in an even number, a determination must be made on how to split the odd number audit. For example, in a county with 118 in the pool of taxpayers with the largest assessments and 59 significant number of audits, the county assessor may conduct 29 audits from the pool of the taxpayers with the largest assessments and 30 audits from among any other taxpayer in the county in the first year, or vice versa. In this example, the only issue would be to meet the requirement of auditing 118 of the taxpayers with the largest assessments in the county within a four-year cycle.

Source: Appendix B from California's Assessor's Handbook Section 506: Property Tax Audits and Audit Program

The following definitions are provided in the handbook to clarify the terms significant number of audits and pool of taxpayers with the largest assessments. Clarification about how businesses are selected from the pool of largest assessments is also provided.

- **Significant Number of Audits:** A county assessor is required to annually conduct a significant number of audits of the books and records of taxpayers engaged in a profession, trade, or business who own, claim, possess, or control locally assessable trade fixtures and business tangible personal property.
- **Audits of Taxpayers in the Pool of Largest Assessments:** Fifty percent of the annual significant number of audits must be conducted on taxpayers from the pool of taxpayers with the largest assessments in the county. The number of taxpayers in this pool is 50 percent of the county's annual significant number of audits multiplied by four. The taxpayers in this pool are subject to an audit once every four years. Although the number of taxpayers in this pool does not change, the actual taxpayers in the pool may change from year to year as businesses close, open, grow, or reduce.

Agency Response

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State of Utah

GARY R. HERBERT
Governor

SPENCER J. COX
Lieutenant Governor

Utah State Tax Commission

JOHN L. VALENTINE
Commission Chair

MICHAEL J. CRAGUN
Commissioner

ROBERT P. PERO
Commissioner

REBECCA L. ROCKWELL
Commissioner

BARRY C. CONOVER
Executive Director

July 12, 2018

John Schaff, CIA
Legislative Auditor General
W315 Utah State Capitol Complex
Salt Lake City, UT 84114-5315

RE: Performance Audit of Utah State Tax Commission

Dear John:

Thank you for allowing us to review the draft Performance Audit of Utah State Tax Commission. We appreciate the outstanding effort that you and your staff put into this audit. The Tax Commission personnel working with your staff were definitely impressed by the thorough research, professionalism, and in-depth understanding of work we do by the auditors involved. It was a job very well done.

Auditing Division Response

We agree that tighter controls could be implemented by the Tax Commission over the use of the Research Activities Tax Credits. The use of a form to calculate the current credits that include a description of the purpose of the research and provides details regarding the expenses used to calculate the credit would be beneficial. The form could also be used to reconcile the amount of any credit carry forward to the current year including (1) the year those credits were earned, (2) the amount of credit earned in the current tax year, (3) the amount of credit used in the current tax year, and (4) the amount of credit available to carry forward to future years. Capturing this information would allow the Tax Commission to report the data regarding the carry forward and usage statistics for the Research Activities Tax Credits to the Legislature.

Property Tax Division Response

We agree fully and support the conclusions and recommendations contained in the performance audit conducted by the Office of the Legislative Auditor General. We believe that implementation of the recommendations contained in the audit will improve the property tax system and create more equal opportunities for all taxpayers in Utah. In terms of the recommendation to adopt a tighter allowable range for level of assessment by local county assessors, the division believes that we can implement this recommendation in counties of the first through fourth class at this time. To clarify, this tighter range will be for overall county-wide residential property to address the equity in contribution to the state basic levy. The current

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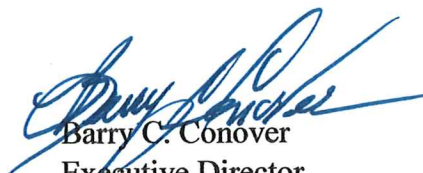
If you need an accommodation under the Americans with Disabilities Act, email taxada@utah.gov, or call 801-297-3811 or TDD 801-297-2020. Please allow three working days for a response.

Office of the Utah Legislative Auditor General

John Schaff
July 12, 2018
Page 2

standards will continue to apply to subclasses of residential property within a given county and other classes of property such as commercial, vacant or secondary residential.

Sincerely,



Barry C. Conover
Executive Director
Utah State Tax Commission