



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

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Michigan
Office of the Auditor General
REPORT SUMMARY

Performance Audit

Report Number:
271-0230-05

Individual Income Tax Return Processing

Department of Treasury

Released:
January 2007

In 1967, the Michigan Legislature approved Act 281, P.A. 1967, the Income Tax Act (Sections 206.1 - 206.532 of the Michigan Compiled Laws), which prescribed a State tax on personal income. The Department of Treasury's Return Processing Division (RPD) administers the Act. RPD is responsible for collecting and processing individual income tax (IIT) returns; correcting or disallowing questionable or erroneous IIT returns; initiating letters of inquiry and explanation to taxpayers; initiating assessments for IIT deficiencies, penalty, and interest; and issuing refunds for IIT overpayments.

Audit Objective:

To assess the Department's effectiveness in using data available from external sources to identify unreported IIT and initiate assessments in a timely manner.

Audit Conclusion:

We concluded that the Department's use of data available from external sources to identify unreported IIT and initiate assessments in a timely manner was not effective. Our assessment disclosed two material conditions (Findings 1 and 2).

Material Conditions:

RPD had not established a comprehensive system of automated data comparisons to sufficiently validate the accuracy of certain income tax deductions claimed by taxpayers on their Michigan IIT returns. Also, RPD did not use all of the procedures available within its current system of automated data comparisons to validate the reasonableness of income tax deduction amounts claimed by taxpayers on their IIT returns. As a result, RPD could not ensure the propriety of significant State income tax deductions claimed by

taxpayers for tax years 2001 through 2004. (Finding 1)

RPD did not consistently utilize its process to identify taxpayers who failed to file annual returns or who did not remit the appropriate IIT as required by the Income Tax Act. As a result, the State incurred a potential loss of income tax revenue totaling at least \$10.2 million from nonfilers for one tax year and a cumulative \$9.5 million from underreporters for three tax years within our audit period. (Finding 2)

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Audit Objective:

To assess the effectiveness of the Department's efforts to ensure that it processed IIT returns in an accurate and timely manner.

Audit Conclusion:

We concluded that the Department's efforts to ensure that it processed IIT returns in an accurate and timely manner were moderately effective. We noted reportable conditions related to penalties

and interest for late returns, refund interest, penalties and interest for underpayment of estimated tax, manually reviewed refund approvals, limited review of returns, and two-dimensional (2-D) bar-coded return management control (Findings 3 through 8).

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Agency Response:

Our audit report includes 8 findings and 11 corresponding recommendations. The Department's preliminary response indicates that it agrees with 10 of the recommendations and partially agrees with 1 recommendation.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: <http://audgen.michigan.gov>



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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

January 11, 2007

Mr. Robert J. Kleine
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

This is our report on the performance audit of Individual Income Tax Return Processing, Department of Treasury.

This report contains our report summary; description of program and agency; audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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GLOSSARY

Glossary of Acronyms and Terms

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Description of Program and Agency

Individual Income Tax (IIT) Program

In 1967, the Michigan Legislature approved Act 281, P.A. 1967, the Income Tax Act (Sections 206.1 - 206.532 of the *Michigan Compiled Laws*), which prescribed a State tax on personal income. The Income Tax Act was enacted for the purpose of meeting deficiencies in State funds. IIT is calculated based on taxpayers' federal adjusted gross income* (AGI). For tax year 2005, IIT was levied at a rate of 3.9% of federal AGI with a \$3,200 exemption allowance per person.

Income earned by Michigan residents, as well as income derived within Michigan by nonresidents, may be subject to IIT. All persons subject to IIT whose federal AGI exceeds their personal exemption allowance are required to submit an IIT return on or before the fifteenth day of the fourth month after the close of the tax year. Persons generally must file quarterly estimates with payment if their estimated liability for the tax year is over \$500. For tax years 2002 through 2004, taxpayers filed approximately 5 million IIT annual returns each year.

Approximately 75% of IIT collected is credited to the State's General Fund. The remaining 25% is credited to the State's School Aid Fund. In fiscal year 2003-04, IIT accounted for 29% of total taxes collected by the Department of Treasury during the fiscal year. The IIT amounts collected from and refunded to taxpayers during fiscal year 2001-02 through fiscal year 2004-05 were as follows:

<u>Fiscal Year</u>	<u>Gross IIT Collections</u>	<u>IIT Refunds</u>
2001-02	\$8,143,614,000	\$1,403,244,000
2002-03	\$8,112,271,000	\$1,559,739,000
2003-04	\$8,210,062,000	\$1,603,818,000
2004-05	\$8,577,490,000	\$1,621,178,000

Return Processing Division (RPD)

The Department of Treasury's RPD administers the Income Tax Act for consistent and uniform compliance by the persons subject to IIT. RPD is responsible for collecting and processing IIT returns; correcting or disallowing questionable or erroneous IIT returns;

* See glossary at end of report for definition.

initiating letters of inquiry* and explanation to taxpayers; initiating assessments* for IIT deficiencies, penalty, and interest; and issuing refunds for IIT overpayments. Also, RPD computes and initiates assessments for deficiencies disclosed by the federal Internal Revenue Service.

RPD's Income Tax Section had 45 employees as of September 30, 2004 and expended approximately \$2.4 million in fiscal year 2003-04.

* See glossary at end of report for definition.

Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up

Audit Objectives

Our performance audit* of Individual Income Tax (IIT) Return Processing, Department of Treasury, had the following objectives:

1. To assess the Department's effectiveness* in using data available from external sources to identify unreported IIT and initiate assessments in a timely manner.
2. To assess the effectiveness of the Department's efforts to ensure that it processed IIT returns in an accurate and timely manner.

Audit Scope

Our audit scope was to examine the program and other records of the Individual Income Tax Program within the Return Processing Division (RPD). Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures, performed from May through December 2005, included examination of tax records and activities for the period January 1, 2002 through November 30, 2005.

To establish our audit objectives and to gain an understanding of IIT return processing activities, we conducted a preliminary review of RPD's operations. This included discussions with RPD staff regarding their functions and responsibilities and examination of tax records, applicable statutes, policies and procedures, reports, and other reference material.

To assess the Department's effectiveness in using data available from external sources to identify unreported IIT and initiate assessments in a timely manner, we reviewed the availability and utilization of information for various match programs and analyzed the results. Also, we matched tax data provided to RPD by the federal Internal Revenue

* See glossary at end of report for definition.

Service with State tax data maintained by RPD to identify nonfilers and underreporters and analyzed the results.

To assess the effectiveness of the Department's efforts to ensure that it processed IIT returns in an accurate and timely manner, we identified RPD's methods for processing tax returns, including the computerized audit functions. Also, we analyzed and tested tax returns and RPD procedures relating to processing IIT returns, adjusting and resolving erroneous tax returns, assessing penalties and interest, and issuing refunds.

Per Section 205.28 of the *Michigan Compiled Laws*, certain aspects of tax auditing and collection, particularly audit selection criteria, are protected, nonpublic data. As a result, this report summarizes weaknesses in the collection and processing of IIT returns and does not report some of our audit results in detail. We have separately reported specific weaknesses in processes and systems to the Department of Treasury management in accordance with generally accepted government auditing standards.

Our audit methodology excluded activities relating to collection of IIT revenue. A separate audit report of the Receipts Processing Division, Department of Treasury (#2714705), examined collection and receipting activities relating to IIT.

We use a risk and opportunity based approach when selecting activities or programs to be audited. Accordingly, our audit efforts are focused on activities or programs having the greatest probability for needing improvement as identified through a preliminary review. By design, our limited audit resources are used to identify where and how improvements can be made. Consequently, our performance audit reports are prepared on an exception basis.

Agency Responses and Prior Audit Follow-Up

Our audit report includes 8 findings and 11 corresponding recommendations. The Department's preliminary response indicates that it agrees with 10 of the recommendations and partially agrees with 1 recommendation.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of Management and Budget Administrative Guide procedure 1280.02 require the Department of Treasury to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

We released our prior performance audit of the Individual Taxes Division, Department of Treasury (#2723096), in July 1997. We did not follow up the three prior audit recommendations as they were not within the scope of this audit.

COMMENTS, FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS IN USING EXTERNAL DATA TO IDENTIFY UNREPORTED INDIVIDUAL INCOME TAX (IIT) AND INITIATE ASSESSMENTS

COMMENT

Audit Objective: To assess the Department of Treasury's effectiveness in using data available from external sources to identify unreported IIT and initiate assessments in a timely manner.

Conclusion: **We concluded that the Department's use of data available from external sources to identify unreported IIT and initiate assessments in a timely manner was not effective.** Our assessment disclosed two material conditions*:

- The Return Processing Division (RPD) had not established a comprehensive system of automated data comparisons to sufficiently validate the accuracy of certain income tax deductions claimed by taxpayers on their Michigan IIT returns. Also, RPD did not use all of the procedures available within its current system of automated data comparisons to validate the reasonableness of income tax deduction amounts claimed by taxpayers on their IIT returns. (Finding 1)
- RPD did not consistently utilize its process to identify taxpayers who failed to file annual returns or who did not remit the appropriate IIT as required by the Income Tax Act (Finding 2).

Per Section 205.28 of the *Michigan Compiled Laws*, certain aspects of tax auditing and collection, particularly audit selection criteria, are protected, nonpublic data. As a result, this report summarizes weaknesses in the collection and processing of IIT returns and does not report some of our audit results in detail. We have separately reported specific weaknesses in processes and systems to the Department of Treasury management in accordance with generally accepted government auditing standards.

* See glossary at end of report for definition.

FINDING

1. Validity* of Income Tax Deductions

RPD had not established a comprehensive system of automated data comparisons to sufficiently validate the accuracy of certain income tax deductions claimed by taxpayers on their Michigan IIT returns. Also, RPD did not use all of the procedures available within its current system of automated data comparisons to validate the reasonableness of income tax deduction amounts claimed by taxpayers on their IIT returns. As a result, RPD could not ensure the propriety of significant State income tax deductions claimed by taxpayers for tax years 2001 through 2004.

The development and implementation of automated comparisons between deduction amounts claimed by taxpayers on their returns and third-party information would help ensure that IIT return information is accurate.

RPD designed a procedure to validate the reasonableness of one of the deduction items included within our review. However, RPD did not use the procedure during our audit period. For another deduction item, the Department received detailed information from third parties that RPD could use to verify the accuracy of the amounts claimed by individuals on their IIT returns. However, RPD had not implemented a process to fully use this information. Subsequent to our audit fieldwork, RPD informed us that it had increased its efforts to use this information to validate the reasonableness, and verify the accuracy, of taxpayer deduction items.

RECOMMENDATIONS

We recommend that RPD establish a comprehensive system of automated data comparisons to sufficiently validate the accuracy of certain income tax deductions claimed by taxpayers on their Michigan IIT returns.

We also recommend that RPD use all of the procedures available within its current system of automated data comparisons to validate the reasonableness of income tax deduction amounts claimed by taxpayers on their IIT returns.

* See glossary at end of report for definition.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendations and indicated that it has initiated a process to identify and compare certain third-party information to income tax deductions claimed by taxpayers on their IIT returns. The Department expects to complete its analysis of the results of these additional comparisons by December 31, 2007 and, depending on the results of this project, it will expand the scope of such comparisons using third-party information.

The Department indicated that it does currently utilize data comparison procedures to identify the reasonableness of certain income tax deduction amounts on taxpayers' IIT returns. However, the Department also indicated that it will expand its current procedures to include testing of third-party information on a sample basis to determine whether additional automated data comparisons could be effective. The Department will complete its analysis by December 31, 2007.

FINDING

2. Delinquent Taxpayers*

RPD did not consistently utilize its process to identify taxpayers who failed to file annual returns or who did not remit the appropriate IIT as required by the Income Tax Act. As a result, the State incurred a potential loss of income tax revenue totaling at least \$10.2 million from nonfilers for one tax year and a cumulative \$9.5 million from underreporters for three tax years within our audit period.

Section 206.315 of the *Michigan Compiled Laws* mandates that every person required to make a return for any taxable period under the federal Internal Revenue Code shall also file a State return with the Department. Also, Section 205.24 of the *Michigan Compiled Laws* requires that, if a taxpayer fails or refuses to file a return or pay a tax within the time specified, RPD, as soon as possible, shall assess the tax against the taxpayer and notify the taxpayer of the amount of the tax.

Our review of taxpayer records noted:

- a. RPD did not identify all of the individuals who did not file a Michigan IIT return for one or more years in our audit period. As a result, we estimated that for

* See glossary at end of report for definition.

one of the tax years within our audit period, the State potentially lost at least \$10.2 million of income tax revenue.

In general, the statute of limitations for RPD to assess a tax deficiency is four years from the due date of the return or the date the return was filed, whichever is later. If the taxpayer does not file a return, Section 205.27a of the *Michigan Compiled Laws* provides RPD with an unlimited time period to assess the deficiency. However, untimely assessment of tax deficiencies generally has a negative impact on collection potential, which would result in lost revenue to the State. The timely identification of potentially delinquent taxpayers would increase the likelihood of collecting outstanding deficiencies.

Department administrators informed us that the timing of efforts to identify delinquent taxpayers is prioritized in conjunction with other income tax recovery projects.

In December 2005, an administrator within the Department's Discovery and Tax Enforcement Division informed us that the Division began identifying and contacting taxpayers who failed to file Michigan IIT returns for one of the tax years in our audit period. The administrator indicated that a letter of inquiry was sent to a test mailing of 500 potentially delinquent taxpayers on November 14, 2005. RPD informed us that it will consider the results of this test mailing to determine how often to perform this identification and inquiry to potentially delinquent taxpayers.

- b. RPD had not identified all taxpayers who underreported adjusted gross income (AGI) on their IIT returns during one or more tax years in our audit period. As a result, we estimated that for three tax years within our audit period, the State potentially lost approximately \$9.5 million of State income tax revenue, exclusive of any applicable penalties and interest assessments.

The starting point for calculating Michigan income tax liability is AGI, as reported on the federal IIT return. The federal Internal Revenue Service provides the State with information reported on Michigan federal taxpayer returns in electronic format. Using this federal data, we identified approximately 15,000 taxpayers who underreported AGI on the State IIT when compared with the AGI reported by the taxpayers on their federal returns for tax years 2001, 2002, and 2003. The individual differences between federal

and State reported AGI for these 15,000 taxpayers ranged from \$2,391 to \$8,760,152, which calculated to a range of \$100 to \$367,926 in State income tax revenue.

As of April 15, 2006, RPD's ability to assess tax deficiencies for tax year 2001 was negatively affected by the statute of limitations. As mentioned in item a., the timely identification of potentially delinquent taxpayers would increase the likelihood of collecting any outstanding deficiencies.

RECOMMENDATION

We recommend that RPD consistently utilize its process to identify taxpayers who fail to file annual returns or who do not remit the appropriate IIT as required by the Income Tax Act.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation and indicated that it has identified Michigan residents who did not file an IIT return for 2002. The Department will complete its follow-up of these potentially delinquent taxpayers by May 31, 2007 and, depending on the results of this project, it will expand this process to include subsequent tax years.

The Department also indicated that it will use Internal Revenue Service information to identify discrepancies between AGI by comparing federal and Michigan income tax returns for a specific tax year. The Department indicated that, depending on the results of this effort, it will incorporate this process into its routine compliance activities no later than December 31, 2008.

EFFECTIVENESS OF EFFORTS TO ENSURE ACCURATE AND TIMELY PROCESSING OF IIT RETURNS

COMMENT

Audit Objective: To assess the effectiveness of the Department's efforts to ensure that it processed IIT returns in an accurate and timely manner.

Conclusion: We concluded that the Department's efforts to ensure that it processed IIT returns in an accurate and timely manner were moderately

effective. We noted reportable conditions* related to penalties and interest for late returns, refund interest, penalties and interest for underpayment of estimated tax, manually reviewed refund approvals, limited review of returns, and two-dimensional (2-D) bar-coded* return management control* (Findings 3 through 8).

Per Section 205.28 of the *Michigan Compiled Laws*, certain aspects of tax auditing and collection, particularly audit selection criteria, are protected, nonpublic data. As a result, this report summarizes weaknesses in the collection and processing of IIT returns and does not report some of our audit results in detail. We have separately reported specific weaknesses in processes and systems to the Department of Treasury management in accordance with generally accepted government auditing standards.

FINDING

3. Penalties and Interest for Late Returns

RPD had not developed and implemented a process that identified, notified, and initiated assessment action against certain taxpayers who did not include the required penalties and interest with applicable Michigan IIT returns. As a result, we estimate that RPD failed to identify \$7.9 million of penalties and interest due to the State applicable to tax year 2002 through 2004 returns filed and paid after April 15.

Section 206.315 of the *Michigan Compiled Laws* provides that income tax returns and payments are due by the fifteenth day of the fourth month after the end of the tax period. This date is April 15 for taxpayers who use the calendar year as their filing period. For taxpayers granted a filing extension, Section 206.311 of the *Michigan Compiled Laws* requires that taxpayers calculate and remit, on or before the original filing date, the estimated tax due.

If the estimated tax payment is less than the final determined tax liability, Section 205.23 of the *Michigan Compiled Laws* generally provides that a penalty of 10% of the tax deficiency, and interest at the rate of one percentage point above the adjusted prime rate*, be added to the deficiency from the original filing date until paid.

If the taxpayer fails to make the estimated tax payment, Section 205.24 of the *Michigan Compiled Laws* provides that a penalty of 5% of the final determined tax

* See glossary at end of report for definition.

liability be added if the failure is for not more than 2 months, with an additional 5% penalty for each additional month for which the tax and penalty is not paid, to a maximum of 25%. In addition to the penalty, interest at the rate of one percentage point above the adjusted prime rate is to be added on the unpaid tax from the original filing date until paid.

Our analysis of returns for tax years 2002 through 2004 disclosed that approximately 216,000 taxpayers filed their income tax returns after April 15 and remitted approximately \$126 million in payments with these returns. However, RPD's computerized audit program* did not always identify taxpayers whose payments did not include the applicable penalties and interest.

Our review of a random sample of 75 returns disclosed:

- a. Taxpayers did not include penalties and interest of \$5,639 that applied to 43 (57%) of the 75 returns.
- b. Taxpayers remitted the applicable interest but did not include penalties of \$1,880 that applied to an additional 13 (17%) of the 75 returns.

RECOMMENDATION

We recommend that RPD develop and implement a process that identifies, notifies, and initiates assessment action against certain taxpayers who do not include the required penalties and interest with applicable Michigan IIT returns.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation and indicated that it has modified its procedures for identifying and initiating collection of unpaid penalties and interest on delinquent IIT taxes. The Department indicated that it will implement these procedure modifications by December 31, 2006.

* See glossary at end of report for definition.

FINDING

4. Refund Interest

RPD did not analyze and implement changes to its manual review process for Michigan IIT refund returns to reduce the processing time and the associated payment of interest. Within our audit period, we estimate that RPD paid approximately \$2.5 million of refund interest, net of interest earned by the State on the delayed refunds. In addition, we identified approximately 89,000 unprocessed refund returns on which we estimate that RPD will pay interest of approximately \$0.8 million, net of interest that the State will earn on the delayed refunds.

Section 205.30 of the *Michigan Compiled Laws* requires that RPD credit or refund an overpayment of taxes to a taxpayer who has filed a claim for a refund. Also, RPD must add interest to the refund if the refund is not issued to the taxpayer within 45 days after the claim is filed or 45 days from the date established by law for filing the tax return, whichever is later. Section 205.23 of the *Michigan Compiled Laws* requires that RPD pay interest at an annual rate of one percentage point above the adjusted prime rate.

RPD's computerized audit program initially analyzes all IIT returns for completeness, mathematical accuracy, and compliance with predefined processing rules. RPD's computerized audit program annually processes approximately five million Michigan IIT returns. The computerized audit program identifies, for manual review by an RPD processing clerk, IIT returns that are incomplete, mathematically inaccurate, or not in compliance with the predefined processing rules.

The following chart shows by tax year the total number of manually reviewed refund returns and the number of manually reviewed refunds to which RPD added interest, along with the corresponding percentage:

<u>Tax Year</u>	<u>Total Number of Manually Reviewed Refund Returns</u>	<u>Number of Manually Reviewed Refunds to Which RPD Added Interest</u>	<u>Percentage of Manually Reviewed Refunds to Which RPD Added Interest</u>
2001	430,367	124,652	29%
2002	427,740	152,996	36%
2003	443,666	163,484	37%
2004	301,949	41,948	14%
Total	<u>1,603,722</u>	<u>483,080</u>	30%

Although RPD issued many refunds quickly (especially those not selected for manual review by RPD's computerized audit program), 13,840 manually reviewed refunds took over one year and an additional 3,257 manually reviewed refunds took over three years from the date that RPD received the refund return. RPD informed us that a contributing factor in the delay of refunds was the untimely taxpayer response to RPD's request for additional information. However, RPD could have limited this delay by finalizing its review of a return for which the taxpayer failed to respond within a predetermined length of time. During our audit period, RPD allowed tax returns with a request for additional information to sit idle until the taxpayer provided a response. Our review of 10 refund returns for which RPD requested additional information from the taxpayer indicated that RPD received the taxpayer's response within one month in at least 6 of the 10 instances. In addition, RPD took between two and seven months to request the additional information and another one week to nine months after RPD received the taxpayer's response to finalize and issue these 6 refunds.

We determined RPD's average time to issue refunds requiring manual review for tax years 2001 through 2004:

Filing Method	Average Number of Days to Issue Refunds			
	Tax Year 2001	Tax Year 2002	Tax Year 2003	Tax Year 2004(1)
E-File*	27 days	44 days	43 days	35 days
Telefile*	34 days	61 days	(2)	(2)
2-D bar-coded paper	101 days	95 days	125 days	57 days
Regular paper	112 days	129 days	135 days	66 days
Combined weighted average	100 days	107 days	111 days	57 days

(1) Between tax years 2003 and 2004, RPD incorporated technological improvements within the data entry process and its computerized audit program. These changes resulted in a 33% reduction in the number of refund returns that required RPD's manual review.

(2) Telefile was not a filing method option after tax year 2002.

* See glossary at end of report for definition.

As of September 28, 2005, RPD had not completed its manual processing of approximately 89,000 total income tax returns claiming a refund for tax years 2001 through 2004. Our review of these unprocessed returns disclosed:

- a. RPD retained for an average of 158 days approximately 36,000 tax year 2004 returns claiming refunds totaling approximately \$26 million.
- b. RPD retained for an average of 264 days approximately 32,000 tax year 2003 returns claiming refunds totaling approximately \$26 million.
- c. RPD retained for an average of 480 days approximately 14,000 tax year 2002 returns claiming refunds totaling approximately \$9 million.
- d. RPD retained for an average of 622 days approximately 7,000 tax year 2001 returns claiming refunds totaling approximately \$6 million.

RPD informed us that it did not have sufficient resources to process IIT refunds requiring manual review within the time frame necessary to avoid paying interest on the refunds. In addition, RPD prioritized its resources to process returns of the most recently completed tax year rather than amended returns and returns relating to prior tax years.

RECOMMENDATION

We recommend that RPD analyze and implement changes to its manual review process for Michigan IIT refund returns to reduce the processing time and the associated payment of interest.

AGENCY PRELIMINARY RESPONSE

The Department agrees that it should reduce the processing time and payment of interest for manually reviewed refund returns. The Department indicated that it annually processes nearly five million IIT returns and processes approximately 97% of these returns within 45 days, without the payment of interest. The Department also indicated that interest payments to taxpayers for the remaining returns (3%) amount to an average of only \$5 per return. In addition, the Department indicated that returns on which it pays interest are generally those that require manual review or additional correspondence from the taxpayer, which extends processing time. Also, the Department indicated that these returns can

often result in audit recoveries from the taxpayer that exceed the interest amount that the Department is required, by law, to pay. The Department further indicated that it has implemented system enhancements that it believes will annually reduce the number of returns on which interest is due and has recently implemented additional procedures that will allow it to significantly reduce backlogs* of returns by December 31, 2006.

FINDING

5. Penalties and Interest for Underpayment of Estimated Tax

RPD's processes did not ensure that certain taxpayers who underpaid their estimated tax throughout the year included the required penalties and interest with their annual returns. Also, RPD used a different dollar threshold than is required by statute in its application of penalties and interest on the amount owed. As a result, RPD failed to assess an estimated \$195,000 of penalties and interest due to the State from approximately 3,600 taxpayers applicable to tax year 2003. RPD acknowledged that this situation also existed for taxpayers during the other tax years in our audit period.

Section 206.301 of the *Michigan Compiled Laws* provides that taxpayers who expect to owe over \$500 with their annual returns must pay quarterly installments of estimated tax. If a taxpayer does not make sufficient quarterly installments, Section 205.23 of the *Michigan Compiled Laws* provides that interest at the rate of one percentage point above the adjusted prime rate is to be added to the tax due. Interest is calculated for the number of days the installment remains unpaid. In addition, a penalty of 10% of the tax due is to be added for failing to make sufficient estimated payments or 25% for failing to make any estimated payments. However, if the current tax year is the first period for which the taxpayer is subject to the estimated payment requirement, the penalty provisions do not apply.

The Department enables taxpayers to voluntarily compute and remit any applicable penalties and interest with their tax returns. Alternatively, RPD computes and assesses the penalties and interest due for taxpayers who fail to submit or underpay required estimated payments.

* See glossary at end of report for definition.

RPD's computerized audit program identified taxpayers who failed to submit the applicable penalties and interest. However, RPD procedures required that it initiate assessments for penalties and interest only when a taxpayer's overdue tax liability significantly exceeded the dollar threshold at which statutes require the application of penalties and interest.

RECOMMENDATIONS

We recommend that RPD's processes ensure that certain taxpayers who underpay their estimated tax throughout the year include the required penalties and interest with their annual returns.

We also recommend that RPD adhere to the dollar threshold required by statute in its application of penalties and interest on the amount owed.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendations and indicated that it will implement revised procedures related to penalties and interest on underpayments of estimated taxes by December 31, 2006.

FINDING

6. Manually Reviewed Refund Approvals

RPD bypassed its refund transaction approval process designed to help ensure the propriety of certain IIT refunds selected for manual review. In addition, RPD needs to enhance its refund transaction approval process to help ensure the propriety of certain IIT refunds selected for manual review. As a result, certain manually reviewed refunds may not have received the required independent secondary review prior to issuance. In addition, RPD policy did not require a periodic secondary review for a sample of a certain segment of manually reviewed refunds.

RPD used a transaction approval process within the IIT System* to provide security over the issuance of IIT refunds selected for manual review. In general, the refund transaction approval process progresses through a ladder of approval levels until the highest level of approval needed for issuance is obtained. Based on the amount of the refund, RPD categorized Michigan IIT refunds into six categories

* See glossary at end of report for definition.

and specified the necessary approval level for each category. For smaller dollar value refunds (lowest dollar category) that are selected for manual review, only one RPD staff member reviews and approves the refund for issuance. The highest category requires six RPD staff members to approve the refund. During the three tax years 2002 through 2004, RPD manually reviewed over 1.17 million refunds that totaled approximately \$456 million.

Our examination of the refund transaction approval process disclosed the following management control weaknesses:

- a. RPD did not ensure that its second lowest category of IIT refunds received the independent secondary review established by the ladder of approval levels within the refund transaction approval process.

We identified refunds in which the same RPD staff member was the initial reviewer and sole approver of the refund. In all of these instances, RPD assigned the staff "peer reviewer" status. Peer reviewers serve as additional supervisors during designated times, reviewing and approving the second lowest category of refunds for which they were not the initial reviewer. However, RPD informed us that its work load generally required that its staff also continue to function as initial reviewers. With an increased approval threshold, peer reviewers have the ability to initiate and approve refunds in the lowest two categories. Therefore, only one individual reviewed and approved a portion of the issued refunds for these categories.

Our review did not identify any refunds in excess of the lowest two categories for which the same person was the initial reviewer and sole approver. However, RPD acknowledged that this situation could occur and indicated that it would implement IIT System changes to address this weakness.

- b. RPD needs to enhance its internal control over manually reviewed refunds by periodically selecting a sample of its lowest dollar category of manually reviewed refunds and performing a secondary review. The lowest dollar category accounted for \$370 million (81%) of the \$456 million manually reviewed refunds issued during the three-year period we reviewed. A periodic secondary review of this category would provide RPD with additional assurance that RPD staff properly conducted their manual reviews in accordance with established RPD policy.

During our audit fieldwork, RPD informed us that it had implemented a procedure that required its supervisors to examine their staff members' work, on a sample basis, and that it designed this examination to include refunds in its lowest category.

RECOMMENDATIONS

We recommend that RPD adhere to its refund transaction approval process designed to help ensure the propriety of certain IIT refunds selected for manual review.

We also recommend that RPD enhance its refund transaction approval process to help ensure the propriety of certain IIT refunds selected for manual review.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendations and indicated that it will implement revised procedures related to manually reviewed refund approvals by December 31, 2006.

FINDING

7. Limited Review of Returns

RPD should analyze the dollar effect on IIT revenue to assess when it should implement its limited review procedures on selected IIT returns.

Periodically analyzing and maintaining documentation of its analysis of IIT returns subjected to limited review procedures would provide RPD with data regarding the impact of the process on State revenues. Such analysis would provide a basis for determining whether to continue the procedures not only on IIT returns at various times, but on all returns meeting certain conditions.

RPD's computerized audit program initially subjects all IIT returns to predetermined audit parameters. RPD informed us that it implemented the limited review procedures because the volume of returns requiring manual review exceeded its capacity to fully review the backlog of returns before it was required to pay interest on refunds. In addition, RPD informed us that its last analysis, conducted in 1999, indicated that there was minimal impact on IIT revenue to the State from limiting its

review procedures on the returns included in the limited review process. However, RPD administrators could not provide us with documentation of this analysis.

RECOMMENDATION

We recommend that RPD analyze the dollar effect on IIT revenue to assess when it should implement its limited review procedures on selected IIT returns.

AGENCY PRELIMINARY RESPONSE

While the Department does not disagree with the recommendation, it does not believe it is necessary to modify its procedures regarding its limited IIT return review process at the present time.

FINDING

8. Two-Dimensional (2-D) Bar-Coded Return Management Control

RPD's data entry process did not minimize the ability of its staff to make inappropriate changes to Michigan IIT paper returns encoded with a 2-D bar code. As a result, RPD could not ensure the validity of income tax return data entered into its 2-D Return System and subsequently transferred to the IIT System.

Section 18.1485 of the *Michigan Compiled Laws* requires that the Department establish and maintain an internal accounting and administrative control system. An effective internal control system generally includes a separation of duties between the initial input and subsequent verification of data entry; independent review of changes made during the verification process; and a process to identify returns to which changes were made. In addition, subjecting returns to independent verification helps to ensure that appropriate changes, such as name, address, and social security number corrections handwritten on the return by the taxpayer, are not overlooked.

Our review of RPD's data entry of 2-D bar-coded IIT returns disclosed:

- a. RPD had not restricted the establishment of multiple usernames* for employees. A 2-D Return System control prohibited the same employee username from both initiating and verifying the entry of return information.

* See glossary at end of report for definition.

However, RPD bypassed this control when it established multiple usernames for two individuals within the unit responsible for the data entry of 2-D bar-coded returns. These two employees were able to initiate the data entry of the returns under one username and subsequently verify the data entry of the same returns using their second username.

Our examination of RPD return batching reports for the month of April 2005 noted 48 instances in which a batch of 2-D bar-coded IIT returns were both entered and also verified by one of the two employees having multiple usernames. Of these 48 instances, 23 batches contained returns claiming a refund. The total number of returns included within these 23 batches was 1,010.

We selected a random sample of 50 returns from the 23 batches of returns claiming a refund. Although our review did not identify any instances of inappropriate changes, RPD should limit employees to a single username to help ensure that the established control requiring independent verification operates effectively.

RPD informed us that it had established multiple usernames for the two individuals in an effort to expedite the data entry process with available staffing resources.

- b. RPD did not restrict the verifier from making changes to returns and did not require the independent review of changes made by the verifier during the verification process. Employees responsible for verifying the initial data entry were able to change taxpayer return information, including name, address, and social security number, without an independent review of their changes. Allowing employees who are verifying data to make changes without the subsequent verification of the appropriateness of their changes increases the risk that inappropriate refunds could be issued.
- c. RPD had not provided for an audit trail* or an audit log* that would identify changes made to the returns during the data entry process. In addition, RPD was unable to provide us with a record of the 2-D bar-coded IIT returns to which changes were made during the data entry process. The inability to

* See glossary at end of report for definition.

identify returns with changes made during data entry or verification increases the possibility that inappropriate changes would not be detected during return processing operations.

With regard to items b. and c., RPD informed us that it had not included these controls in the design of the 2-D Return System.

RECOMMENDATION

We recommend that RPD revise its data entry process to minimize the ability of its staff to make inappropriate changes to Michigan IIT paper returns encoded with a 2-D bar code.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation and indicated that it will implement revised procedures related to data entry of 2-D bar-coded returns by December 31, 2006.

GLOSSARY

Glossary of Acronyms and Terms

adjusted gross income (AGI)	The amount used in the calculation of an individual's income tax liability, i.e., gross income after certain adjustments are made but before standardized and itemized deductions and personal exemptions are made.
adjusted prime rate	The average predominant interest rate quoted by not less than three commercial banks to large businesses, as determined by the Department of Treasury. The adjusted prime rate is based on the average prime rate charged by not less than three commercial banks during the six-month period ending on March 31 and the six-month period ending on September 30.
assessment	A billing issued for taxes, penalties, and interest due. The Department of Treasury's Collection Division is responsible for maintaining the accounts receivable records for assessments and collecting the balances due.
audit log	An audit trail of computer system activity (e.g., files accessed, jobs processed, and commands entered into a computer console).
audit trail	A chronological record of activities that is sufficient to enable the reconstruction, review, and examination of the sequence of environments and activities surrounding or leading to each event in the path of a transaction from its inception to output of final results.
backlog	An accumulation of unfinished work. In this report, "backlog" refers to unprocessed IIT returns.
computerized audit program	An automated examination of tax return information according to a series of predefined algorithms and error conditions. The program is used by RPD to identify tax

returns that require further examination and potential adjustments by a processing clerk.

delinquent taxpayer A taxpayer who did not file an annual return and/or remit the appropriate IIT as required by the Income Tax Act.

effectiveness Program success in achieving mission and goals.

e-file The electronic submission of a tax return via the Internet using a personal computer.

IIT individual income tax.

Individual Income Tax (IIT) System The information system used to process an individual's tax return and payment or refund of IIT.

letter of inquiry A letter issued by the Department of Treasury which states the Department's opinion that a taxpayer needs to furnish additional tax-related information of taxes owed to the State and the reason for that opinion. The letter also explains the procedure by which the taxpayer may initiate communication with the Department to resolve any dispute. If the issue is not resolved within 30 days from the time the letter is sent, the Department can issue a notice of intent to assess followed by a notice of final assessment.

management control The plan of organization, methods, and procedures adopted by management to provide reasonable assurance that goals are met; resources are used in compliance with laws and regulations; valid and reliable data is obtained and reported; and resources are safeguarded against waste, loss, and misuse.

material condition A reportable condition that could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment

of an interested person concerning the effectiveness and efficiency of the program.

performance audit

An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.

reportable condition

A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.

RPD

Return Processing Division.

telefile

The transmission of tax return information using an automated telephone system.

two-dimensional (2-D)
bar code

A high density bar code composed of a stack of rows with small black rectangles arranged in columns that represent a corresponding number, letter, or symbol. Optical scanners convert the bar code into usable information for data entry.

username

The unique set of characters identifying a user of a shared computer program, system, or network that allows access when coupled with a password.

validity

The extent to which an amount reported by a taxpayer is factual and accurate.

