



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

PERFORMANCE AUDIT
OF THE
INDIVIDUAL INCOME TAX DIVISION
DEPARTMENT OF TREASURY

June 2014



Doug A. Ringler, C.P.A., C.I.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:
271-0230-14

Individual Income Tax Division

Department of Treasury

Released:
June 2014

Act 281, P.A. 1967, the Income Tax Act of 1967 (Sections 206.1 - 206.532 of the Michigan Compiled Laws) provides for a State tax on personal income. The Department of Treasury's Individual Income Tax (IIT) Division administers the Act for consistent and uniform compliance by persons subject to IIT. The IIT Division is responsible for collecting and processing IIT returns; correcting or disallowing questionable or erroneous IIT returns; initiating letters of inquiry and explanation to taxpayers; initiating assessments; and issuing refunds for IIT overpayments.

Audit Objective:

To assess the effectiveness and efficiency of the IIT Division's efforts to process IIT returns in a timely manner.

Audit Conclusion:

We concluded that the IIT Division's efforts to process IIT returns in a timely manner were effective and efficient. However, we noted one reportable condition (Finding 1).

Reportable Condition:

The IIT Division did not process all IIT returns requiring manual review in a timely manner (Finding 1).

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Audit Objective:

To assess the effectiveness of the IIT Division's efforts to ensure the accuracy of the IIT returns processed.

Audit Conclusion:

We concluded that the IIT Division's efforts to ensure the accuracy of the IIT returns processed were effective. Our audit report does not include any reportable conditions related to this audit objective.

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Agency Response:

Our audit report contains 1 finding and 1 corresponding recommendation. The Department of Treasury's preliminary response indicates that it agrees with the recommendation.

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DOUG A. RINGLER, C.P.A., C.I.A.
AUDITOR GENERAL

June 25, 2014

Mr. R. Kevin Clinton
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Clinton:

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

This report contains our report summary; a description of agency; our audit objectives, scope, and methodology and agency response and prior audit follow-up; our comments, finding, recommendation, and agency preliminary response; and a glossary of abbreviations and terms.

Our comments, finding, and recommendation are organized by audit objective. The agency preliminary response was taken from the agency's response at the end of our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with the audit recommendation and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

Sincerely,

A handwritten signature in black ink that reads "Doug Ringler".

Doug Ringler, C.P.A., C.I.A.
Auditor General

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Description of Agency

In 1967, the Michigan Legislature approved Act 281, P.A. 1967, the Income Tax Act of 1967 (Sections 206.1 - 206.532 of the *Michigan Compiled Laws*), which provides for a State tax on personal income. The Income Tax Act of 1967 was enacted for the purpose of meeting deficiencies in State funds. Individual income tax* (IIT) is calculated based on taxpayers' federal adjusted gross income* (AGI). For tax year 2013, IIT was levied at a rate of 4.25% of federal AGI with a \$3,950 exemption allowance per person.

The Department of Treasury's IIT Division administers the Income Tax Act of 1967 for consistent and uniform compliance by the persons subject to IIT. The IIT Division is responsible for collecting and processing 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. Also, the IIT Division computes and initiates assessments for deficiencies disclosed by the federal Internal Revenue Service.

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 2010 through 2013, taxpayers filed approximately 5 million IIT annual returns each year; 76% were electronically filed and 24% were paper filed. As of November 20, 2013, there were 74,593 IIT returns on the IIT Division's backlog*.

For fiscal year 2012-13, 77% of the IIT collected was credited to the State's General Fund and the remaining 23% was credited to the State's School Aid Fund. IIT accounted for 33% of all taxes collected by the Department of Treasury in fiscal year

* See glossary at end of report for definition.

2012-13. The IIT amounts collected from and refunded to taxpayers during fiscal year 2010-11 through fiscal year 2012-13 were as follows:

<u>Fiscal Year</u>	<u>Gross IIT Collections</u>	<u>IIT Refunds</u>
2010-11	\$ 9,864,822,909	\$2,138,745,997
2011-12	\$10,323,430,165	\$2,135,048,393
2012-13	\$10,690,501,041	\$1,699,037,732

The IIT Division had 118 employees as of October 1, 2013 and expended \$7.5 million in fiscal year 2012-13.

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

Audit Objectives

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

1. To assess the effectiveness* and efficiency* of the IIT Division's efforts to process IIT returns in a timely manner.
2. To assess the effectiveness of the IIT Division's efforts to ensure the accuracy of the IIT returns processed.

Audit Scope

Our audit scope was to examine the program and other records of the Individual Income Tax Division. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives. Our audit procedures, which included a preliminary survey, audit fieldwork, report preparation, analysis of agency response, and quality assurance, generally covered the period October 1, 2010 through March 31, 2014.

Audit Methodology

We conducted a preliminary survey of the IIT Division's operations to formulate a basis for defining the audit objectives and scope. Our preliminary survey included reviewing applicable laws, policies, and procedures and interviewing staff regarding their functions and responsibilities. Also, we observed staff performing selected processing functions and examined tax records and various reports reflecting the disposition of IIT returns processed, daily production, and the outcome of the IIT Division's quality assurance monitoring.

* See glossary at end of report for definition.

To accomplish our first objective, we analyzed the production reports for IIT returns received between October 1, 2010 through December 12, 2013. We compared and assessed the reasonableness of the processing time for the electronically filed IIT returns and paper filed IIT returns. Also, we obtained the backlog of unprocessed IIT returns as of November 20, 2013 and summarized it by calendar year received and type. We reviewed a randomly selected sample of 78 backlog IIT returns for reasonableness. We did not project the results of our testing into the remaining population.

In addition, we analyzed and compared the cost of processing electronically filed IIT returns, paper filed IIT returns, and IIT returns that required manual review. Further, we summarized the interest paid on IIT refunds not processed within the 45-day requirement. Also, we identified the IIT Division's efforts to minimize the cost and improve the timeliness of processing IIT returns.

To accomplish our second objective, we reviewed documentation of all manually overridden system edits for proper authorization and tested a judgmentally selected sample of system edits to determine whether the edit was in place and operating effectively throughout the audit period. Also, we tested a random sample of manually processed IIT returns to determine whether the changes made were appropriately documented and properly approved. We did not project the sample results into the remaining populations. In addition, we reviewed documentation of the IIT Division's biweekly reviews that monitor the accuracy of paper filed returns. Further, we reviewed the IIT Division's quarterly review of manually processed returns for fiscal year 2012-13.

When selecting activities or programs for audit, we use an approach based on assessment of risk and opportunity for improvement. Accordingly, we focus our audit efforts on activities or programs having the greatest probability for needing improvement as identified through a preliminary survey. Our limited audit resources are used, by design, to identify where and how improvements can be made. Consequently, we prepare our performance audit reports on an exception basis.

Agency Response and Prior Audit Follow-Up

Our audit report contains 1 finding and 1 corresponding recommendation. The Department of Treasury's preliminary response indicates that it agrees with the recommendation.

The agency preliminary response that follows the recommendation in our report was taken from the agency's written comments and oral discussion at the end of our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and the State of Michigan Financial Management Guide (Part VII, Chapter 4, Section 100) require the Department of Treasury to develop a plan to comply with the audit recommendation and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

We released our prior performance audit of Individual Income Tax Return Processing, Department of Treasury (271-0230-05), in January 2007. The IIT Division complied with 8 of the 11 prior audit recommendations. We rewrote 1 prior audit recommendation for inclusion in Finding 1 of this audit report, and we determined that 2 prior audit recommendations were no longer applicable.

COMMENTS, FINDING, RECOMMENDATION,
AND AGENCY PRELIMINARY RESPONSE

EFFECTIVENESS AND EFFICIENCY OF EFFORTS TO PROCESS IIT RETURNS IN A TIMELY MANNER

COMMENT

Audit Objective: To assess the effectiveness and efficiency of the Individual Income Tax (IIT) Division's efforts to process IIT returns in a timely manner.

Audit Conclusion: We concluded that the IIT Division's efforts to process IIT returns in a timely manner were effective and efficient.

Our audit conclusion was based on our audit efforts as described in the audit scope and audit methodology sections and the resulting reportable condition* noted in the comments, finding, recommendation, and agency preliminary response section.

We noted one reportable condition. In our professional judgment, this matter is less severe than a material condition* but represents an opportunity for improvement in the IIT Division's processing of IIT returns. The reportable condition related to interest paid on IIT refunds (Finding 1).

In reaching our conclusion, we reviewed the timeliness of processing IIT returns and analyzed the IIT Division's backlog. We considered that the IIT Division processed approximately 5 million IIT returns annually, generally processed electronically filed returns within 6 days and paper returns within 20 days, and had a backlog of 74,593 returns at November 20, 2013. We also considered that taxpayers electronically filed 76% of the IIT returns, decreasing the percent of error and need for manual intervention from 16% to 7%. In addition, we considered that the cost of processing electronically filed returns was negligible, the cost of processing paper filed returns was \$2.30 per return, and the cost of processing a return that required manual review was \$13 per return. Further, we considered that the IIT Division paid an average of \$2.6 million per calendar year in interest on refunds not processed within the 45-day requirement. Also, we considered the significant risk of fraud, the timeliness in which taxpayers respond to inquiries of the IIT Division, and the IIT Division's policies and procedures for processing IIT returns that require manual review. We believe that the results of our audit efforts provide a reasonable basis for our audit conclusion for this audit objective.

* See glossary at end of report for definition.

FINDING

1. Interest Paid on IIT Refunds

The IIT Division did not process all IIT returns requiring manual review in a timely manner. As a result, the Department of Treasury paid \$7.7 million of interest on IIT refunds between January 1, 2011 and December 31, 2013.

Section 205.30(3) of the *Michigan Compiled Laws* imposes a 1% interest penalty on IIT refunds that are not paid or credited within the latter of 45 days after the claim is filed or 45 days after the statutory due date of the tax return.

The IIT Division's computerized audit program* analyzes approximately 5 million Michigan IIT returns annually for completeness, mathematical accuracy, and compliance with predefined processing rules. The IIT Division's management indicated that IIT Division staff, on a priority basis, manually review IIT returns that do not pass the computerized analysis. However, as of November 20, 2013, the IIT Division had a backlog of 74,593 IIT returns:

Calendar Year Received	Number of IIT Returns With Potential			Total Number of Unprocessed IIT Returns
	Assessments	Refunds (2)	Credit	
Unknown (1)	509	1,225	2	1,736
2006	2			2
2007	18	2		20
2008	322	146	2	470
2009	258	334	11	603
2010	542	1,066	32	1,640
2011	1,364	1,677	43	3,084
2012	8,390	3,498	175	12,063
2013	23,467	30,007	1,501	54,975
Total	34,872	37,955	1,766	74,593

(1) Although the database did not indicate the calendar year that the IIT Division received these IIT returns, our review of a sample of 8 of these IIT returns indicated that 6 were received in calendar year 2013 and 2 were received in calendar year 2011.

(2) The State is at risk of incurring interest payments on these backlogged IIT returns.

* See glossary at end of report for definition.

The IIT Division's management indicated that IIT returns may be included in the backlog for various reasons, including awaiting taxpayer response, IIT Division workload priorities, inexperienced staff as a result of the fiscal year 2010-11 retirements, and litigation.

Also, for calendar years 2011 through 2013, the Department of Treasury paid an average of \$2.6 million per calendar year in interest on manually reviewed IIT returns that resulted in refunds as follows:

Calendar Year	Total Number of IIT Returns Manually Reviewed*	Interest Paid on Current Period IIT Returns	Interest Paid on Prior Year IIT Returns	Total Interest Paid
2011	325,004	\$ 330,693	\$1,966,024	\$2,296,717
2012	367,944	291,985	2,036,689	2,328,674
2013	361,309	418,623	2,691,406	3,110,029
Total	1,054,257	\$1,041,301	\$6,694,119	\$7,735,420

* The IIT Division could not identify the total number of manually reviewed IIT returns that resulted in interest payments; however, IIT returns that result in an assessment or a credit do not incur interest payments.

The IIT Division's management indicated that approximately \$500,000 of interest was paid in fiscal year 2012-13 as a result of a Supreme Court decision.

We reported a similar issue in our prior audit of the IIT return processing. The Department of Treasury agreed with our recommendation and indicated that it implemented system enhancements and procedures that would reduce interest costs and significantly reduce its backlog of returns. The Department decreased the backlog from the prior audit by approximately 14,400 returns, or 16%; however, the Department paid an average of \$1.8 million more in interest costs, per calendar year, on manually reviewed IIT returns than during the prior audit.

RECOMMENDATION

We recommend that the IIT Division process all IIT returns requiring manual review in a timely manner.

AGENCY PRELIMINARY RESPONSE

The Department of Treasury agrees with the recommendation and indicated that it will continue to identify opportunities that will allow it to process refund returns requiring manual review as timely as possible to mitigate the payment of interest. The Department also indicated that it has recently received legislative funding to implement software that will improve its ability to timely process returns subject to interest.

The Department noted that, even with its limited resources, it processed over 5 million IIT returns annually, of which 99% were processed timely with no interest payments required. The Department also noted that 84% of returns filed each year were received during a four-month window, January through April. In addition, the Department noted that property tax credits and home heating credits do not accrue interest; however, they are given processing priority for the benefit of the taxpayer. Further, the Department noted that some interest payments are unavoidable because of litigation. For example, a 1994 court decision determined that the accrual of interest does not stop even though the Department is waiting for additional information because the taxpayer did not file a complete return. Also, in 2013, the Department paid \$466,000 in interest because it was required to delay processing of certain returns until two court decisions were finalized.

EFFECTIVENESS OF EFFORTS TO ENSURE THE ACCURACY OF IIT RETURNS PROCESSED

Audit Objective: To assess the effectiveness of the IIT Division's efforts to ensure the accuracy of the IIT returns processed.

Audit Conclusion: We concluded that the IIT Division's efforts to ensure the accuracy of the IIT returns processed were effective.

Our audit conclusion was based on our audit efforts as described in the audit scope and audit methodology sections. Our audit report does not include any reportable conditions related to this audit objective. We believe that the results of our audit efforts provide a reasonable basis for our audit conclusion for this audit objective.

GLOSSARY

Glossary of Abbreviations 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.
assessment	A billing issued for taxes, penalties, and interest due. The Department of Treasury's Office of Collections is responsible for maintaining the accounts receivable records for assessments and collecting the balances due.
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 the IIT Division to identify tax returns that require further examination and potential adjustments by a processing clerk.
effectiveness	Success in achieving mission and goals.
efficiency	Achieving the most outputs and the most outcomes practical with the minimum amount of resources.
individual income tax (IIT)	A State tax on personal income.
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.

material condition

A matter that, in the auditor's judgment, is more severe than a reportable condition and 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 audit that provides findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.

reportable condition

A matter that, in the auditor's judgment, is less severe than a material condition and falls within any of the following categories: an opportunity for improvement within the context of the audit objectives; a deficiency in internal control that is significant within the context of the audit objectives; all instances of fraud; illegal acts unless they are inconsequential within the context of the audit objectives; significant violations of provisions of contracts or grant agreements; and significant abuse that has occurred or is likely to have occurred.

