

PERFORMANCE AUDIT  
OF THE  
HOMESTEAD PROPERTY TAX EXEMPTION PROGRAM

DEPARTMENT OF TREASURY

July 1998

27-245-97

## EXECUTIVE DIGEST

# HOMESTEAD PROPERTY TAX EXEMPTION PROGRAM

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### INTRODUCTION

This report, issued in July 1998, contains the results of our performance audit\* of the Homestead Property Tax Exemption Program, Department of Treasury.

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### AUDIT PURPOSE

This performance audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness\* and efficiency\*.

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### BACKGROUND

On March 15, 1994, voters approved ballot proposal A. Among its provisions, the proposal included a State education tax on all real property and a separate real property tax on nonhomestead property that did not qualify for an agricultural exemption. To be exempted from the nonhomestead property tax, a homeowner had to file for and receive a homestead property tax exemption\* .

The Homestead Property Tax Exemption Program is administered by the Department of Treasury. The homestead exemptions were received and processed by the Homestead Affidavit Unit, Individual Taxes Division, Bureau of Revenue. During the period June 1 through

\* See glossary on page 20 for definition.

November 1, 1997, the Unit was in transition and was transferred to the Local Property Services Division, Bureau of Local Government. As of January 31, 1998, the Unit had 6 permanent and 14 temporary employees. For fiscal year 1996-97, the Unit's operating costs approximated \$474,000.

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**AUDIT OBJECTIVES  
AND CONCLUSIONS**

**Audit Objective:** To assess the effectiveness and efficiency of the Department's administrative functions to ensure the completeness and accuracy of the homestead property tax exemption data base\*.

**Conclusion:** We concluded that the Department's administrative functions to ensure the completeness and accuracy of the homestead property tax exemption data base were generally effective and efficient. However, we noted reportable conditions\* related to the data base and social security numbers (Findings 1 and 2).

**Audit Objective:** To assess the effectiveness and efficiency of the Department in reviewing homestead property tax exemptions for appropriateness.

**Conclusion:** We concluded that the Department was generally effective and efficient in reviewing homestead property tax exemptions for appropriateness. However, we noted reportable conditions related to update forms\* , Internal Revenue Service information, and additional follow-up (Findings 3 through 5).

**Audit Objective:** To assess the effectiveness of the Department's monitoring and follow-up of the local units' processing of homestead property tax exemptions which

\* See glossary on page 20 for definition.

the Department had denied or rescinded and of the local units' collection of additional taxes.

**Conclusion:** We concluded that the Department's monitoring and follow-up of the local units' processing of homestead property tax exemptions which the Department had denied or rescinded and of the local units' collection of additional taxes were generally effective.

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**AUDIT SCOPE AND  
METHODOLOGY**

Our audit scope was to examine the program and other records of the Homestead Property Tax Exemption Program. 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.

Our methodology included examining records for the period January 1994 through January 1998. To accomplish our audit objectives, we reviewed procedures, analyzed reports, and evaluated the Department's conclusions regarding the appropriateness of property tax exemptions and controls related to the local units' processing of exemptions and their collection of additional taxes. Also, we performed selected tests of the data base, affidavit forms\* and update forms, and other records.

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**AGENCY RESPONSES**

Our audit report includes 5 findings and corresponding recommendations. The Department generally agreed with the recommendations. However, the Department stated that, in some cases, the cost to implement the recommendation would exceed the benefit or additional staff and system resources would be needed.

\* See glossary on page 20 for definition.

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Mr. Douglas B. Roberts  
State Treasurer  
Treasury Building  
Lansing, Michigan

Dear Mr. Roberts:

This is our report on the performance audit of the Homestead Property Tax Exemption Program, Department of Treasury.

This report contains our executive digest; description of agency; audit objectives, scope, and methodology and agency responses; background; 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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## Description of Agency

In August 1993, Act 145, P.A. 1993, was enacted. Act 145 eliminated local property taxes as a source of local and intermediate school district funding beginning in the 1994-95 school year. As a result, a new system to fund schools was needed and a comprehensive set of laws was passed in December 1993.

On March 15, 1994, voters approved ballot proposal A. Among its provisions, the proposal included a 6-mill State education tax on all real property and a separate real property tax on nonhomestead property that did not qualify for an agricultural exemption. The nonhomestead property tax was typically 18 mills. To be exempted from the nonhomestead property tax, a homeowner had to file for and receive a homestead property tax exemption.

The Homestead Property Tax Exemption Program is administered by the Department of Treasury. The homestead exemptions were received and processed by the Homestead Affidavit Unit, Individual Taxes Division, Bureau of Revenue. During the period June 1 through November 1, 1997, the Unit was in transition and was transferred to the Local Property Services Division, Bureau of Local Government. As of January 31, 1998, the Unit had 6 permanent and 14 temporary employees. For fiscal year 1996-97, the Unit's operating costs approximated \$474,000.

## Audit Objectives, Scope, and Methodology and Agency Responses

### Audit Objectives

Our performance audit of the Homestead Property Tax Exemption Program, Department of Treasury, had the following objectives:

1. To assess the effectiveness and efficiency of the Department's administrative functions to ensure the completeness and accuracy of the homestead property tax exemption data base.
2. To assess the effectiveness and efficiency of the Department in reviewing homestead property tax exemptions for appropriateness.
3. To assess the effectiveness of the Department's monitoring and follow-up of the local units' processing of homestead property tax exemptions which the Department had denied or rescinded and of the local units' collection of additional taxes.

### Audit Scope

Our audit scope was to examine the program and other records of the Homestead Property Tax Exemption Program. 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

To accomplish our audit objectives, we interviewed staff and reviewed policies and procedures. Our methodology included examining records for the period January 1994 through January 1998. Our audit work was performed between May 1997 and February 1998.

To accomplish our first objective, we analyzed reports and performed selected tests of the data base.

To accomplish our second objective, we tested selected affidavit forms and update forms and evaluated the Department's conclusions regarding the appropriateness of property tax exemptions.

To accomplish our third objective, we evaluated controls and tested records related to the local units' processing of exemptions and their collection of additional taxes.

### Agency Responses

Our audit report includes 5 findings and corresponding recommendations. The Department generally agreed with the recommendations. However, the Department stated that, in some cases, the cost to implement the recommendation would exceed the benefit or additional staff and system resources would be needed.

The agency preliminary response which 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.

## Background

To be exempted from the property tax on nonhomestead property, a homeowner has to file for and receive a homestead exemption. To obtain an exemption, the homeowner files a request for exemption with the local unit of government where the property is located. There are 1,525 local units of government in the State. The request could be on either an affidavit for homestead exemption form (affidavit form) or a homestead exemption update form (update form). The affidavit form was used to request the initial exemption on a piece of property when the program began. The affidavit form is also used when a new homestead is established. The update form is used when property is sold and allows the purchaser to request the exemption.

When a local unit receives the request for exemption, it processes the request, adjusts its records, and forwards the request to the Department of Treasury. When the Department receives the request, it enters the request (affidavit or update form) on its homestead property tax exemption data base. The request is granted and the property is considered exempt until the Department performs its various reviews.

To determine the appropriateness of the exemptions, the Department conducts tests to decide if the exemption should be accepted, denied, or pended for further review and additional information.

To receive the homestead exemption for the first year of the program, homeowners had to file affidavit and update forms with the local unit by May 1, 1994. Affidavit and update forms filed after May 1, 1994 were applicable for subsequent years. The Department entered approximately 2.5 million affidavit and update forms dated May 1, 1994 or earlier and approximately 0.5 million affidavit and update forms dated after May 1, 1994 into its homestead property tax exemption data base.

# COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

## EFFECTIVENESS AND EFFICIENCY OF ADMINISTRATIVE FUNCTIONS

### COMMENT

**Audit Objective:** To assess the effectiveness and efficiency of the Department of Treasury's administrative functions to ensure the completeness and accuracy of the homestead property tax exemption data base.

**Conclusion:** We concluded that the Department's administrative functions to ensure the completeness and accuracy of the homestead property tax exemption data base were generally effective and efficient. However, we noted reportable conditions related to the data base and social security numbers.

### FINDING

#### 1. Data Base

The Department did not have effective procedures to ensure that its homestead property tax exemption data base was complete.

The Department performs various reviews to determine the appropriateness of homestead property tax exemptions. A complete data base containing all exemptions is necessary so that all exemptions are subjected to these reviews.

The Department informed us that it had reasonable assurance that it had received all the affidavit and update forms due May 1, 1994 because it paid the local units of government to process and submit the forms by December 1, 1994. However, the Department did not have procedures to ensure that it had received all the update forms and those affidavit forms dated after May 1, 1994.

We determined that 109 local units of government had not submitted any update forms since the inception of the program. However, these local units had

submitted approximately 44,500 affidavit forms since the inception of the program in 1994. Of the 109 local units, 30 had submitted over 500 affidavit forms and 10 had submitted over 1,000 affidavit forms. It is reasonable to expect that some of these units with a large number of affidavit forms would have had some update forms to submit.

We selected a sample of 25 local units that had submitted update forms. We determined that they submitted 7,369 update forms and 55,228 affidavit forms since the inception of the program. The update forms to affidavit forms ratio was approximately 13%. Using this 13% ratio for the 109 local units that submitted approximately 44,500 affidavit forms but no update forms, we determined that there may be approximately 5,800 update forms that should have been submitted.

### **RECOMMENDATION**

We recommend that the Department develop effective procedures to ensure that its homestead property tax exemption data base is complete.

### **AGENCY PRELIMINARY RESPONSE**

The Department concurs that the absence of any update forms from a local unit of government is an indication that update forms may not have been submitted. However, when property subject to an existing homestead exemption is sold or transferred, the title companies have the option of either filing a rescission form for the existing exemption and a new affidavit to establish the buyer's homestead exemption or filing an update form to both rescind the seller's exemption and claim an exemption for the buyer. Many of the title companies prefer using the affidavit and rescission forms instead of the update forms. This is because they do not have to be concerned about disclosing the buyer's and seller's social security numbers to the other person.

The Department believes that it has received all of the update forms and affidavit forms and does not concur with the conclusion that 5,800 update forms are missing without first contacting the title companies for the local units in question. Given the potential benefit, the time required or the cost to implement additional procedures was not justified.

## **FINDING**

### **2. Social Security Numbers**

The Department's records contained incorrect social security numbers.

The Department performs various reviews that use social security numbers. Obtaining correct social security numbers is necessary so that all property tax exemptions are subjected to these reviews.

We determined, through a match with established social security number parameters, that the data base of approximately 3 million homestead property tax exemptions contained a total of approximately 36,400 (1%) affidavit forms and update forms that did not have correct social security numbers. Of these, approximately 25,100 were received without social security numbers and were assigned the same social security number for processing purposes.

The Department had determined that the denied homestead property tax exemptions averaged approximately \$650. Based on this average, we estimate that the approximately 36,400 affidavit and update forms represent approximately \$23.7 million of property tax exemptions that were not subject to review.

In our test of 50 of the approximately 25,100 affidavit and update forms with the same social security number, we noted 6 (12%) instances in which the homestead property tax exemption should be denied (i.e., the property was owned by a business, church, or credit union). Based on an average of \$650 per denied homestead property tax exemption, the 6 instances represent approximately \$3,900 of taxes that should have been assessed. Applying the 12% denial rate to the 25,100 affidavit and update forms indicates that approximately \$2 million of additional taxes should have been assessed.

Also, we noted 18 instances in which it was not possible to determine if the homestead property tax exemption should be denied based on available information. The 18 property owners had a total of 36 exemptions on file. These exemptions were accepted, and the taxpayer received the exemption. It is reasonable to expect that, with additional information, some of these exemptions should be denied. Using the \$650 amount, the 36 exemptions could represent approximately \$23,400 of taxes that should have been assessed.

## **RECOMMENDATION**

We recommend that the Department obtain correct social security number information for all homestead property tax exemptions.

## **AGENCY PRELIMINARY RESPONSE**

The Department concurs with the recommendation. However, the Department informed us that spending the time to correct the social security numbers on the 1% which are incorrect would not result in a significant increase in denied or rescinded exemptions. The small potential does not justify the time required to improve the accuracy of the social security numbers over 99%.

## **EFFECTIVENESS AND EFFICIENCY OF EXEMPTION REVIEW**

### **COMMENT**

**Audit Objective:** To assess the effectiveness and efficiency of the Department in reviewing homestead property tax exemptions for appropriateness.

**Conclusion:** We concluded that the Department was generally effective and efficient in reviewing homestead property tax exemptions for appropriateness. However, we noted reportable conditions related to update forms, Internal Revenue Service information, and additional follow-up.

### **FINDING**

#### **3. Update Forms**

The Department did not match update forms with its tax records to determine the appropriateness of the homestead property tax exemptions.

The matching of update forms with tax records helps to ensure that all exemptions are subject to review.

We determined that the homestead property tax exemption data base contained approximately 327,000 update forms, representing approximately \$212.6 million of property taxes, that were not subject to a match with individual tax records.

During our review of 50 update forms, we could not determine if the tax exemptions granted to 12 property owners were appropriate because more information was needed. The 12 property owners had 23 exemptions which could represent approximately \$14,950 of taxes that should have been assessed.

The Department reduced the effectiveness of its control process by not matching update forms with tax records.

### **RECOMMENDATION**

We recommend that the Department match the update forms with its tax records.

### **AGENCY PRELIMINARY RESPONSE**

The Department concurs with the recommendation. However, the Department stated that additional staff and system resources would be required to conduct the match and related follow-up. All available staff and resources are currently assigned to functions with a significantly greater rate of return.

### **FINDING**

#### **4. Internal Revenue Service Information**

The Department did not follow up some inconsistencies that were noted during a match of homestead property tax exemption data base information with Internal Revenue Service (IRS) tax information.

As part of the Department's control process, it matches selected information from its homestead property tax exemption data base with IRS tax records to detect inconsistencies related to a property owner's residency that required follow-up. Following up on each inconsistency is necessary to determine the appropriateness of an exemption.

The Department's match detected approximately 51,100 inconsistencies. The Department followed up approximately 12,400 of the inconsistencies; however, there were approximately 38,700 inconsistencies which were not followed up. We estimate that the 38,700 inconsistencies represent approximately \$25.2 million of property tax exemptions.

In our test of 25 of the approximately 38,700 inconsistencies which were not followed up, we determined that in 21 instances the IRS response was inconclusive in determining whether a homestead property tax exemption should be accepted or denied. In the other 4 instances, the IRS information indicated that the tax address was different than the homestead property tax exemption address and that the property with the exemption may not be a homestead. We also found 3 instances in which individuals had more than one exemption. These 7 instances had 11 homestead property tax exemptions which could represent approximately \$7,150 of taxes that should have been assessed. These property owners may not be eligible for homestead property tax exemptions.

The Department could improve the effectiveness of its control process by following up on all inconsistencies noted during the match of information with the IRS.

### **RECOMMENDATION**

We recommend that the Department follow up all the inconsistencies which were noted during the match of homestead property tax exemption data base information with IRS tax information.

### **AGENCY PRELIMINARY RESPONSE**

The Department concurs with the recommendation. However, the Department informed us that additional staff and system resources would be required to conduct the match and related follow-up. The available staff are being used in areas resulting in a greater percentage of denials and rescissions.

### **FINDING**

#### **5. Additional Follow-Up**

The Department did not perform a follow-up review on approximately 66% of the homestead property tax exemptions that its automated review process had identified for additional review.

The Department used an automated review process to detect potentially inappropriate homestead property tax exemptions that require additional review.

The additional review is necessary to determine the appropriateness of the exemption.

Of the approximately 3.0 million homestead property tax exemptions in the homestead property tax exemption data base, the automated review process detected approximately 370,000 that needed additional review. Of those 370,000 exemptions, approximately 243,000 are still awaiting review and a final determination of their appropriateness.

Using the date each affidavit or update form was signed, we aged the 243,000 homestead property tax exemptions. Approximately 210,000 (86%) were over one year old and approximately 108,000 (44%) were over three years old.

### **RECOMMENDATION**

We recommend that the Department perform follow-up reviews on homestead property tax exemptions that its automated review process identifies for additional review.

### **AGENCY PRELIMINARY RESPONSE**

The Department concurs that it has not completed examination of all of the affidavit or update forms in a pending status. However, this finding does not consider the affidavits and update forms included in problem batches that were all reviewed by the Department staff. The Department staff reviewed 100% of the affidavits included in problem (Type D) batches. By including the number of Type D affidavits in with the number of other affidavits reviewed, the percentage not reviewed would be reduced from 66% to 43%.

The remaining errors have significantly less potential than the affidavits from the problem batches or the other error conditions that were reviewed. Addressing the errors noted in the finding would require either additional staff or assigning existing staff to these errors instead of other assignments which have a greater percentage of denials or rescissions.

## EFFECTIVENESS OF MONITORING AND FOLLOW-UP

### COMMENT

**Audit Objective:** To assess the effectiveness of the Department's monitoring and follow-up of the local units' processing of homestead property tax exemptions which the Department had denied or rescinded and of the local units' collection of additional taxes.

**Conclusion:** We concluded that the Department's monitoring and follow-up of the local units' processing of homestead property tax exemptions which the Department had denied or rescinded and of the local units' collection of additional taxes were generally effective.

## Glossary of Acronyms and Terms

<b>affidavit form</b>	The affidavit for homestead exemption form used by the property owner to claim a homestead exemption.
<b>effectiveness</b>	Program success in achieving mission and goals.
<b>efficiency</b>	Achieving the most outputs and outcomes practical for the amount of resources applied or minimizing the amount of resources required to attain a certain level of outputs or outcomes.
<b>homestead property tax exemption</b>	A property tax exemption allowed because the property is a homestead. The property owner's exemption request is automatically granted unless denied by the Department of Treasury.
<b>homestead property tax exemption data base</b>	The Department of Treasury's data base showing all requests for homestead property tax exemptions. The request may be made on an affidavit form or an update form. The exemption may be accepted, denied, rescinded, or pended for further review. The data base contained approximately 3 million homestead property tax exemptions.
<b>IRS</b>	federal Internal Revenue Service.
<b>performance audit</b>	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 coming to the auditor's attention that, in his/her judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.

**update form**

The homestead exemption update form that is used when property is sold to allow the purchaser to claim a homestead exemption.