

Office of the Auditor General
Performance Audit Report

**Corporate Income Tax and
Michigan Business Tax**
Department of Treasury

September 2016

State of Michigan Auditor General
Doug A. Ringler, CPA, CIA

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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Office of the Auditor General

Report Summary

Performance Audit

*Corporate Income Tax (CIT) and Michigan
Business Tax (MBT)
Department of Treasury*

Report Number:
271-0240-15

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September 2016

The Business Tax Division (BTD), within the Tax Processing Bureau, is responsible for processing CIT and MBT returns and payments as well as responding to taxpayer inquiries received through correspondence, telephone calls, and Web-based contacts. In fiscal years 2014 and 2015, the combined CIT and MBT tax revenue totaled \$420 million and \$892 million, respectively.

Audit Objective			Conclusion
Objective #1: To assess the effectiveness of the CIT and MBT processing controls in identifying exceptions in submitted returns.			Moderately effective
Findings Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
The Department of Treasury did not timely remove access rights to the SAP system for separated or transferred employees. System access still existed for 79% of the BTD users who separated or transferred during the audit period (Finding #1).		X	Agrees
BTD did not ensure that 76% of taxpayers receiving accelerated payments for the Historic Preservation Credit and the Brownfield Redevelopment Credit submitted annual MBT returns (Finding #2).		X	Agrees
BTD should improve procedures to verify that taxpayers claiming funds which were paid on their behalf (flow-through withholding payments) resulted in proper reporting and collection of required tax revenue. We could not verify these payments for 24% of the sampled CIT returns (Finding #3).		X	Agrees
BTD should establish procedures to periodically perform an independent review of annual CIT and MBT returns that fall below the agency's established minimum approval thresholds to ensure the propriety and validity of processed returns (Finding #4).		X	Agrees

Findings Related to This Audit Objective (Continued)	Material Condition	Reportable Condition	Agency Preliminary Response
The Department of Treasury did not consistently conduct remote monitoring of telephone calls to ensure that taxpayers receive the best possible service from customer service representatives. Quality assurance personnel met only 53% of their goal to remotely monitor incoming calls (<u>Finding #5</u>).		X	Agrees
BTD did not have a process to notify taxpayers when submitted CIT or MBT returns were deactivated and not processed. Taxpayer notifications were not sent for 14% of the sampled deactivated returns (<u>Finding #6</u>).		X	Agrees

Audit Objective			Conclusion
Objective #2: To assess the efficiency of the Tax Processing Bureau's processing of CIT and MBT returns.			Efficient
Findings Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
BTD should obtain a listing of taxpayers that have an agreement with a State agency for a certificated credit that will or may become available in a future period to assist in the timely processing of MBT returns (<u>Finding #7</u>).		X	Agrees

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

Office of the Auditor General
201 N. Washington Square, Sixth Floor
Lansing, Michigan 48913

Doug A. Ringler, CPA, CIA
Auditor General

Laura J. Hirst, CPA
Deputy Auditor General



OAG

Office of the Auditor General

201 N. Washington Square, Sixth Floor • Lansing, Michigan 48913 • Phone: (517) 334-8050 • www.audgen.michigan.gov

Doug A. Ringler, CPA, CIA
Auditor General

September 21, 2016

Mr. Nick A. Khouri
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Khouri:

I am pleased to provide this performance audit report on Corporate Income Tax and Michigan Business Tax, Department of Treasury.

We organize our findings and observations by audit objective. Your agency provided preliminary responses to the recommendations at the end of our fieldwork. The *Michigan Compiled Laws* and administrative procedures require an audited agency to develop a plan to comply with the recommendations and submit it within 60 days of the date above 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,

Doug Ringler
Auditor General

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AUDIT OBJECTIVES, CONCLUSIONS, FINDINGS, AND OBSERVATIONS

IDENTIFYING EXCEPTIONS IN SUBMITTED RETURNS

BACKGROUND

The Business Tax Division (BTD), located organizationally in the Tax Processing Bureau within the Department of Treasury, administers Michigan's Corporate Income Tax (CIT) and its Michigan Business Tax (MBT). BTD's responsibilities include processing CIT and MBT returns and any associated inquiries related to the returns.

From January 1, 2012 through March 31, 2015, BTD received approximately 103,000 CIT returns and 196,000 MBT returns (see Exhibit #1).

In addition to processing the tax returns received, BTD is responsible for addressing taxpayer correspondence relating to CIT and MBT returns. BTD receives approximately 2,700 telephone calls (see Exhibit #2) and 860 pieces of mail correspondence a month from taxpayers (see Exhibit #3).

AUDIT OBJECTIVE

To assess the effectiveness* of the CIT and MBT processing controls in identifying exceptions in submitted returns.

CONCLUSION

Moderately effective.

FACTORS IMPACTING CONCLUSION

- BTD utilized a computerized audit program to identify errors within all CIT and MBT returns. Our testing of BTD's computerized audit program noted that it operated as designed.
- BTD established a framework for CIT and MBT return processing.
- BTD supervisors reviewed CIT and MBT returns that exceeded predetermined levels to ensure proper processing.
- BTD supervisors reviewed tax return adjustment letters that deviated from standard BTD language.
- BTD supervisors reviewed BTD correspondence sent to taxpayers as a result of inquiries from taxpayers.
- Reportable conditions* related to the need for:
 - Timely removal of system access rights (Finding #1).

* See glossary at end of report for definition.

- Process to ensure that taxpayers with accelerated payments file MBT returns (Finding #2).
- Verification of flow-through withholding payments (Finding #3).
- Periodic review of processed tax returns under the minimum approval thresholds (Finding #4).
- Consistent monitoring of incoming taxpayer telephone calls (Finding #5).
- Taxpayer notification of deactivated CIT and MBT returns (Finding #6).

FINDING #1

Timely removal of system access rights needed.

The Department of Treasury did not timely remove access rights to the SAP system for separated or transferred employees. This increased the risk of unauthorized modification or disclosure of return data.

Department of Treasury electronic documentation policy ET-03164 requires the deletion of user access for all accounts no later than day-end of the user's last day or no later than the next business day when a user's job duties change. When a user terminates employment or the user's job duties change, BTD is responsible for notifying the Office of Privacy and Security, which will then disable the user's SAP system access.

79% of employees retained access to confidential data after separation or transfer.

However, we noted that 15 (79%) of the 19 separated or transferred BTD users who had access to CIT or MBT return data from January 1, 2012 through March 31, 2015 did not have their user access disabled on a timely basis. As a result, these 15 users had access to confidential taxpayer data for up to 423 days after their separation or transfer date:

<u>Days to Disable Access</u>	<u>Separations</u>	<u>Transfers</u>
Less than 1 day	0	4
1 to 5 days	3	1
6 to 10 days	5	0
11 to 50 days	2	1
51 to 180 days	0	0
181 to 365 days	0	2
366 to 423 days	0	1

When users transfer positions, the risk of unauthorized modification or disclosure of return data increases because the users could potentially retain their building access and obtain additional system user access. No instances of unauthorized access came to our attention.

RECOMMENDATION

We recommend that the Department of Treasury timely remove access rights to the SAP system for separated or transferred employees.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

BTB agrees and will work to consistently and timely remove SAP access from its employees that have departed. An email notification process has already been established to provide notice regarding departed employees to both the Support Services Division and the Office of Privacy and Security who work together to accomplish the actual system removal.

FINDING #2

Process needed to ensure that taxpayers with accelerated payments file MBT returns.

MBT returns were not submitted by 76% of the taxpayers receiving accelerated payments.

BTD did not ensure that taxpayers receiving accelerated payments for select credits submitted annual MBT returns and thereby paid the appropriate taxes.

Sections 208.1435 and 208.1437 of the *Michigan Compiled Laws* allow for the Historic Preservation Credit and the Brownfield Redevelopment Credit. When claiming these credits, taxpayers have two options:

- Claim 100% of the credit to apply to current and future MBT tax liability. These nonrefundable credits can only be utilized when the taxpayer has a tax liability.
- Receive an accelerated payment for 90% of the authorized amount of the credit. The Special Historic Preservation Credits are limited to 86%. A taxpayer receiving the credit, if they meet the filing requirements, must file a MBT tax return for the tax year the credit is claimed.

As of March 13, 2015, 79 taxpayers claimed \$109.4 million in accelerated payments for the Historic Preservation Credit and the Brownfield Redevelopment Credit for tax years 2012 and 2013. Our review disclosed that 60 (76%) of the 79 taxpayers, who received \$54 million in accelerated payments, did not submit annual MBT returns for the tax year in which the taxpayers claimed the payments.

RECOMMENDATION

We recommend that BTD ensure that taxpayers receiving accelerated payments for select credits submit annual MBT returns and thereby pay the appropriate taxes.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

BTD agrees. After discussion with the Tax Policy Division, BTD has developed a process to follow. BTD has implemented the process and sent letters to all taxpayers that received a credit for tax years 2012 and 2013. The letter requests they either file a return or send an explanation why they are not required to file. The letter gives them 30 days to respond. Pursuant to this policy, BTD will: accept, through their written attestation, they are not required to file, receive a return, or compute an assessment for failure to respond to our letter. For those not responding, BTD has sent delinquency notices for tax year 2014.

FINDING #3

Additional procedures needed to verify flow-through withholding payments.

Reported flow-through withholding payments could not be verified for 24% of the sampled returns.

BTD should improve procedures to verify that taxpayers claiming funds which were paid on their behalf (flow-through withholding payments) resulted in proper reporting and collection of required tax revenue.

Flow-through entities pay withholdings to the Department of Treasury on behalf of the entities' members. The entities' members then claim those withholdings on the members' annual CIT returns to offset their total tax due.

BTD analyzes CIT returns for completeness, mathematical accuracy, and compliance with predefined processing rules. BTD staff then follow up any variances noted.

From March 14, 2013 through April 10, 2015, BTD received 746 CIT returns for tax periods 2012 and 2013 claiming \$31.9 million in flow-through withholding payments. We reviewed 25 randomly selected CIT returns claiming flow-through withholding payments and identified exceptions in 6 (24%) of the returns.

RECOMMENDATION

We recommend that BTD improve procedures to verify that taxpayers claiming flow-through withholding payments result in proper reporting and collection of required tax revenue.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

BTD generally agrees with this recommendation but reiterates the historical reasons that prevented a systematic approach to solving the issue. The tracking of underlying accounts/payments was extremely complicated from a systems implementation standpoint and with limited implementation time and resources, a business decision was made to verify these withholding payments through Tax Compliance Bureau post audit efforts. Additionally, the Department supplied the legislature with a draft bill that would eliminate FTW altogether and as an update, PA 158 of 2016 was signed into law on 6/9/16. This act eliminates the requirement that flow through entities withhold income tax on members' distributive share of income.

FINDING #4

Periodic review procedures needed for processed tax returns under the minimum approval thresholds.

37% of returns requiring additional follow-up were not subject to an independent review and approval.

BTD should establish procedures to periodically perform an independent review of annual CIT and MBT returns that fall below the agency's established minimum approval thresholds to ensure the propriety and validity of processed returns.

Effective management controls are critical to help prevent and detect, on a timely basis, the processing of erroneous and unauthorized tax returns.

BTD uses a transaction approval process within the SAP system to provide security over the creation and processing of CIT and MBT returns. BTD relies on audit trails and approvals to ensure the validity of processed returns. However, returns processed manually by BTD staff, below certain thresholds, were not subject to any additional review.

Our examination of the return approval process from January 1, 2012 through April 10, 2015 noted that BTD processed approximately 94,000 CIT returns and 176,000 MBT returns, below certain thresholds, that the SAP system identified as having errors or other items requiring additional follow-up. Of these returns, 33,887 (36%) CIT returns and 67,423 (38%) MBT returns did not have an independent review and approval.

From August 2014 through May 2015, 2 of the 4 BTD supervisors completed targeted reviews of CIT and MBT returns and taxpayer correspondence processed by a limited number of staff to determine the accuracy of the returns processed under the approval threshold. Although the targeted reviews identified errors in the returns processed, the sampling methodology used by the supervisors was not random and would prevent an accurate determination of an overall error rate from these reviews.

To obtain an accurate error rate that is representative of all CIT and MBT returns processed by BTD staff, the independent review should include all BTD staff who process CIT and MBT returns. The returns should be selected using a statistical approach to include all returns that fall below the agency's established minimum approval thresholds.

RECOMMENDATION

We recommend that BTD establish procedures to periodically perform an independent review of annual CIT and MBT returns that fall below the agency's established minimum approval thresholds to ensure the propriety and validity of processed returns.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

BTD agrees and continues to work with the QA group to create and implement an objective QA process for all returns including those that normally do not queue for approval. BTD has also implemented a process for front-line supervisors to query each

employee's work on a monthly basis and randomly sample several returns that normally would not queue for approval. The samples are reviewed for accuracy and recorded on a spreadsheet for future use.

FINDING #5

Taxpayer telephone calls should be consistently monitored to help ensure quality of service.

The Department of Treasury did not consistently conduct remote monitoring of telephone calls to ensure that taxpayers receive the best possible service from customer service representatives (CSRs).

The Tax Processing Bureau's quality assurance policy requires quality assurance personnel to monitor a sample of telephone calls to evaluate the quality of the interaction between the caller and the CSR.

Beginning in June 2013, the policy required a minimum of 1 CSR evaluation per month and up to a maximum of 8 evaluations per month if a CSR's average score was below 75% in the prior month. Prior to June 2013, the policy required a minimum of 2 CSR evaluations per month and up to a maximum of 8 evaluations per month. To improve identified performance issues, the CSR supervisor provides coaching to the CSR and, if necessary, makes corrections to the taxpayer's account or tax return. As of March 31, 2015, BTD had 18 CSRs responsible for handling taxpayer telephone calls.

Quality assurance personnel remotely monitored only 53% of the required telephone calls.

From January 1, 2012 through March 31, 2015, BTD received approximately 104,000 telephone calls from CIT or MBT taxpayers. Our review disclosed that during that time, quality assurance personnel completed only 275 (53%) of the 517 required telephone call evaluations for 8 randomly sampled CSRs. We noted that the sampled CSRs had between 7% and 94% of their required telephone call evaluations completed.

The Department of Treasury informed us that the required call evaluations were not completed because of the reassignment of quality assurance personnel to other projects and temporary position vacancies.

RECOMMENDATION

We recommend that the Department of Treasury consistently conduct remote monitoring of telephone calls to ensure that taxpayers receive the best possible service from CSRs.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

BTB agrees and the Support Services Division will work to consistently apply its quality control measures to telephone calls conducted within BTB. Some inconsistencies occurred during the release of SAP system enhancements associated with registration as certain QA staff were pulled from their normal duties to assist with system implementation, trouble shooting, and remedies.

FINDING #6

Process needed to ensure taxpayer notification of deactivated returns.

Taxpayer notification letters were not sent for 14% of the sampled deactivated CIT or MBT returns.

BTD did not have a process to notify taxpayers when submitted CIT or MBT returns were deactivated and not processed. Lack of notification results in delays in the filing and processing of proper CIT or MBT returns and does not educate taxpayers to help reduce the amount of future unnecessary filings.

BTD will deactivate a submitted return if the taxpayer is not required to file a return, files the wrong or an incomplete return, or files a duplicate return. Processing guidelines require BTD to provide taxpayers with a notification letter when BTD deactivates a submitted tax return.

Our examination of CIT and MBT returns processed from January 1, 2012 through March 31, 2015 noted that BTD deactivated approximately 5,000 CIT returns and 11,000 MBT returns. We reviewed BTD documentation for 45 randomly selected deactivated CIT and 45 randomly selected deactivated MBT returns and noted that BTD did not notify 13 (14%) taxpayers.

When calculation assistants deactivate tax returns, BTD relies on the calculation assistants to manually generate taxpayer notification letters. A process was not in place to alert BTD supervisors when calculation assistants deactivated tax returns. Without involving the supervisors, BTD cannot ensure that it made taxpayers aware of the status change of their submitted returns.

RECOMMENDATION

We recommend that BTD implement a process to notify taxpayers when submitted CIT or MBT returns are deactivated and not processed.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

Although BTD generally agrees that it did not always ensure notification was sent to taxpayers informing them of a voided or deactivated return, this notification is not statutorily required and BTD will review its policy and determine whether it is appropriate to continue under a balancing of customer service and resource consideration for other, mandatory functions. If it is determined that the notification should continue, BTD will implement a procedure to ensure staff consistency as recommended. The vast majority of the returns in question are voided because there is never a filing obligation to begin with. This reality was reflected in the audited sample where 98% of the returns reviewed simply had no filing obligation at all. When there is no filing obligation, there necessarily can be no further delay in the collection of tax revenue or refunds associated with subsequent, proper returns.

PROCESSING CIT AND MBT RETURNS

BACKGROUND

Businesses meeting the CIT or MBT filing thresholds are required to annually file a return. BTD utilizes a computerized audit program to analyze the returns for completeness, mathematical accuracy, and compliance with predefined processing rules. BTD staff then manually review returns that do not pass the computerized analysis; make any required changes; process the returns; and, if required, notify the taxpayers of any changes made to their returns.

As of March 31, 2015, BTD had a backlog of approximately 17,100 CIT and MBT returns (see Exhibit #1). During the audit period, BTD reduced processing time to an average of 22 days for a CIT return and an average of 32 days for an MBT return. Section 205.30 of the *Michigan Compiled Laws* (the Revenue Act) requires the payment of interest on returns with a refund due 45 days after the return is filed.

In addition to processing the returns received, BTD is responsible for addressing taxpayer correspondence relating to CIT and MBT. Correspondence typically relates to follow-up on a notice of assessment, a notice of adjustment, or a taxpayer request for a refund. As of September 30, 2015, BTD had a correspondence backlog of 682 items and, for the quarter ended September 30, 2015, BTD was averaging 46 days to process customer correspondence (see Exhibit #3).

AUDIT OBJECTIVE

To assess the efficiency* of the Tax Processing Bureau's processing of CIT and MBT returns.

CONCLUSION

Efficient.

FACTORS IMPACTING CONCLUSION

- BTD timely processed CIT and MBT returns received.
- Reduction of the CIT and MBT return processing backlog (see Exhibit #1).
- Reduction of the backlog of taxpayer correspondence (see Exhibit #3).
- Reportable condition related to obtaining a listing of taxpayers that have an agreement with a State agency for a certificated credit that will or may become available in a future period.

* See glossary at end of report for definition.

FINDING #7

Credit documentation needed to timely process MBT returns.

An average of 400 days was needed to process MBT returns with no claimed credits, compared with 73 days for all MBT returns.

BTD should obtain a listing of taxpayers that have an agreement with a State agency for a certificated credit that will or may become available in a future period. This would assist in more timely processing of MBT returns.

The Corporate Income Tax Act replaced the Michigan Business Tax Act for most taxpayers effective January 1, 2012. Section 208.1107(1) of the *Michigan Compiled Laws* states that for tax years ending after 2011, the only taxpayers eligible to file an MBT return are those that qualify for a certificated credit or that have an agreement with a State agency for a certificated credit that will or may become available in a future period.

During our audit period, BTD implemented a process requiring calculation assistants to review all MBT returns for tax years ending after 2011. Also, for all MBT returns received that do not claim a certificated credit, BTD required calculation assistants to send a notice requesting the taxpayer to file an amended tax return claiming the certificated credit or to provide documentation confirming that a certificated credit will or may become available to the taxpayer in a future period.

From January 1, 2012 through April 10, 2015, we identified 8,751 MBT returns submitted for tax year 2012 or 2013 in which taxpayers did not claim a certificated credit. We determined that it took an average of 400 days to process these returns, compared with the 73-day average it took for all MBT returns processed during the same time period.

With a process to obtain certificated credit documentation from State agencies awarding the credits, BTD could reduce the need to contact taxpayers and thereby significantly reduce MBT processing time.

RECOMMENDATION

We recommend that BTD obtain a listing of taxpayers that have an agreement with a State agency for a certificated credit that will or may become available in a future period to assist in the timely processing of MBT returns.

AGENCY PRELIMINARY RESPONSE

Treasury provided us with the following response:

BTD agrees and has established an arrangement with the MEDC to obtain a list of all certificated credits that have been issued. The MEDC has agreed to send quarterly updates of all new credits that have been approved.

SUPPLEMENTAL INFORMATION

CORPORATE INCOME TAX AND MICHIGAN BUSINESS TAX

Department of Treasury

Schedule of CIT and MBT Returns Received and Processed From January 1, 2012 Through March 31, 2015

	<u>Prior to 2012</u>	<u>2012</u>				<u>2013</u>			
		<u>January - March</u>	<u>April - June</u>	<u>July - September</u>	<u>October - December</u>	<u>January - March</u>	<u>April - June</u>	<u>July - September</u>	<u>October - December</u>
Number of CIT Returns:									
Received	N/A	N/A	N/A	N/A	N/A	9,614	12,689	12,140	9,527
Processed	N/A	N/A	N/A	N/A	N/A	6,677	9,987	9,289	8,790
In process	N/A	N/A	N/A	N/A	N/A	2,937	5,639	8,490	9,227

	<u>As of January 1, 2012</u>	<u>2012</u>				<u>2013</u>			
		<u>January - March</u>	<u>April - June</u>	<u>July - September</u>	<u>October - December</u>	<u>January - March</u>	<u>April - June</u>	<u>July - September</u>	<u>October - December</u>
Number of MBT Returns:									
Received	-	46,580	47,105	32,219	18,094	12,348	8,567	5,897	5,682
Processed	-	51,655	51,501	38,338	23,045	19,264	14,543	11,821	10,472
In process	76,977	71,902	67,506	61,387	56,436	49,520	43,544	37,620	32,830

N/A = Not applicable.

Source: Prepared by the Office of the Auditor General based on unaudited data obtained from the Department of Treasury.

UNAUDITED
Exhibit #1

2014				2015	Total	Quarterly Average
January - March	April - June	July - September	October - December	January - March		
14,253	7,976	12,984	9,435	14,433	103,051	11,450
12,285	8,690	13,814	10,092	18,471	98,095	10,899
11,195	10,481	9,651	8,994	4,956		

2014				2015	Total	Quarterly Average
January - March	April - June	July - September	October - December	January - March		
4,905	4,568	3,787	3,299	2,922	195,973	15,075
9,435	9,964	7,312	7,510	5,989	260,849	20,065
28,300	22,904	19,379	15,168	12,101		

CORPORATE INCOME TAX AND MICHIGAN BUSINESS TAX

Department of Treasury

Schedule of Telephone Call Statistics for CIT and MBT
From January 1, 2012 Through March 31, 2015

	2012				2013			
	January - March	April - June	July - September	October - December	January - March	April - June	July - September	October - December
Number of telephone calls received	9,147	11,721	9,714	9,954	9,299	7,248	5,851	6,993
Average wait time	0:02:38	0:02:53	0:03:06	0:04:02	0:04:33	0:03:09	0:02:10	0:01:41
Abandoned telephone calls	510	471	474	553	573	302	205	135
Abandoned telephone call rate	5.6%	4.0%	4.9%	5.6%	6.2%	4.2%	3.5%	1.9%

Source: Prepared by the Office of the Auditor General based on unaudited data obtained from the Department of Treasury.

UNAUDITED
Exhibit #2

2014				2015	
January - March	April - June	July - September	October - December	January - March	Total
7,375	7,440	6,081	6,200	7,066	104,089
0:01:14	0:01:54	0:01:21	0:01:48	0:01:49	0:02:29
116	117	93	117	122	3,788
1.6%	1.6%	1.5%	1.9%	1.7%	3.6%

CORPORATE INCOME TAX AND MICHIGAN BUSINESS TAX
Department of Treasury

Schedule of CIT and MBT Mail Correspondence Received and Processed
From April 1, 2013 Through September 30, 2015

	2013			2014			
	April - June	July - September	October - December	January - March	April - June	July - September	October - December
Mail Correspondence:							
Received	3,926	3,626	2,568	2,378	2,846	2,128	1,869
Processed	4,240	4,715	2,844	3,591	4,513	5,280	3,692
In process	12,800	11,711	11,435	10,222	8,555	5,403	3,580
Average number of days to process	303	237	273	524	391	329	254

Source: Prepared by the Office of the Auditor General based on unaudited data obtained from the Department of Treasury.

UNAUDITED
Exhibit #3

2015				
<u>January - March</u>	<u>April - June</u>	<u>July - September</u>	<u>Total</u>	<u>Monthly Average</u>
2,076	2,321	2,116	25,854	862
3,530	3,256	2,625	38,286	1,276
2,126	1,191	682		
189	93	46		

CORPORATE INCOME TAX AND MICHIGAN BUSINESS TAX

Department of Treasury

Schedule of Claimed MBT Certificated Credits by Tax Year
From January 1, 2012 Through March 31, 2015

Tax Credit	Awarding Agency	Tax		
		2008	2009	2010
Nonrefundable Certificated Credits (1):				
NASCAR Speedway Credit	Treasury	\$	\$ 319,763	\$ 473,718
Renaissance Zone Credit	MEDC			
Historic Preservation Credit	MSHDA	373,257	952,582	3,182,995
MEGA Federal Contract Credit	MEDC			87,296
Brownfield Redevelopment Credit	MEDC	14,453,803	16,736,040	48,715,732
MEGA Plug-In Traction Battery Manufacturing Credit	MEDC			
MEGA Poly-Silicon Energy Cost Credit and Miscellaneous MEGA Battery Credits	MEDC			
Total nonrefundable certificated credits		<u>\$ 14,827,060</u>	<u>\$ 18,008,385</u>	<u>\$ 52,459,741</u>
Refundable Certificated Credits (2):				
MEGA Employment Tax Credit	MEDC	\$ 22,036,590	\$ 52,974,983	\$ 83,708,401
Hybrid Technology Research and Development Credit	MEDC		249,104	
Farmland Preservation Credit	MDARD		42,118	44,147
MEGA Federal Contract Credit	MEDC			
Film Production Credit	Michigan Film Office	7,729,431	166,567	6,205,959
MEGA Plug-In Traction Battery Manufacturing Credit	MEDC			
MEGA Poly-Silicon Energy Cost Credit and Miscellaneous MEGA Battery Credits	MEDC			
Brownfield Redevelopment Credit (3)	MEDC			
Historic Preservation Credit (3)	MSHDA			
Total refundable certificated credits		<u>\$ 29,766,021</u>	<u>\$ 53,432,772</u>	<u>\$ 89,958,507</u>

(1) Nonrefundable certificated credits are tax credits that are limited by the amount of a payer's tax liability.

(2) Refundable certificated credits are tax credits that can be received even if they exceed the payer's tax liability.

(3) Brownfield Redevelopment Credits and Historic Preservation Credits can be refunded if accelerated. The amount of credit is reduced when accelerated.

Source: Prepared by the Office of the Auditor General based on unaudited data obtained from the Department of Treasury.

UNAUDITED
Exhibit #4

Year				
2011	2012	2013	2014	Total
\$ 403,085	\$ 402,353	\$	\$	\$ 1,598,920
	21,376,214	21,632,130	1,967,494	44,975,838
4,642,535	116,866			9,268,235
595,439				682,735
51,391,167	10,919,111	5,542,593		147,758,446
3,790,524	15,512,866			19,303,390
	37,532	1,549,505		1,587,037
<u>\$ 60,822,750</u>	<u>\$ 48,364,942</u>	<u>\$ 28,724,229</u>	<u>\$ 1,967,494</u>	<u>\$ 225,174,601</u>
\$ 157,036,802	\$ 254,632,371	\$ 92,020,523	\$	\$ 662,409,670
200,755				449,859
118,225	1,273,807	1,347,914	469,947	3,296,158
130,241				130,241
52,273,966	578,607			66,954,530
30,439,476	27,487,134			57,926,610
	132,466,921	138,950,494		271,417,415
	43,646,913	42,840,759	19,097,078	105,584,750
	20,625,191	2,284,398	8,922,819	31,832,408
<u>\$ 240,199,465</u>	<u>\$ 480,710,944</u>	<u>\$ 277,444,088</u>	<u>\$ 28,489,844</u>	<u>\$ 1,200,001,641</u>

CORPORATE INCOME TAX AND MICHIGAN BUSINESS TAX

Department of Treasury

Schedule of Estimated Outstanding MBT Certificated Credits by Tax Year

As of February 9, 2015

(In Millions)

Certificated Credit	Tax								
	2013	2014	2015	2016	2017	2018	2019	2020	2021
MEGA Employment Tax Credit	\$ 399.7	\$ 430.1	\$ 448.4	\$ 457.5	\$ 471.6	\$ 483.5	\$ 497.9	\$ 511.7	\$ 515.7
MEGA Battery Credit	229.3	191.5	110.5	75.0	25.0				
MEGA Poly-Silicon Energy Cost Credit	15.9	28.8	31.4	34.0	36.9	39.6	37.4	40.5	31.9
Other MEGA Credits	71.3	73.0	73.7	60.9	55.5	45.6	36.5	27.0	20.6
Brownfield Redevelopment Credit	25.0	25.0	28.4	35.8	17.8	11.5	8.7	5.0	3.0
Film Production Credit	39.8	3.1	14.0	13.4					
Other *	25.4	27.0	22.0	21.0	20.0	19.0	18.0	17.0	16.0
Total certificated credits	<u>\$ 806.4</u>	<u>\$ 778.5</u>	<u>\$ 728.4</u>	<u>\$ 697.6</u>	<u>\$ 626.8</u>	<u>\$ 599.2</u>	<u>\$ 598.5</u>	<u>\$ 601.2</u>	<u>\$ 587.2</u>

* Includes Anchor Company Credit, Farmland Preservation Credit, Historic Preservation Credit, and Renaissance Zone Credit.

Source: Office of Revenue and Tax Analysis, Department of Treasury.

Year										Total
2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	
\$ 522.1	\$ 537.0	\$ 552.9	\$ 559.8	\$ 570.7	\$ 582.0	\$ 593.8	\$ 606.0	\$ 128.8	\$ 132.7	\$ 9,001.9
										631.3
17.6	8.8									322.8
11.3	9.7	8.1	5.5	1.8	1.3	1.4	0.6	0.6		504.4
										160.2
										70.3
10.0	5.0									200.4
<u>\$ 561.0</u>	<u>\$ 560.5</u>	<u>\$ 561.0</u>	<u>\$ 565.3</u>	<u>\$ 572.5</u>	<u>\$ 583.3</u>	<u>\$ 595.2</u>	<u>\$ 606.6</u>	<u>\$ 129.4</u>	<u>\$ 132.7</u>	<u>\$ 10,891.3</u>

DESCRIPTION

Public Act 122 of 1941, as amended (the Revenue Act), provides the Department of Treasury with the authority to collect taxes and identify tax deficiencies for assessment.

MBT became effective January 1, 2008 and replaced the single business tax. MBT assesses a tax on every business with business activity in Michigan and apportioned gross receipts over \$350,000. The base of the tax starts with federal taxable income or a comparable measure of income for partnerships and S corporations, which would then be subject to various adjustments, including apportionment, to identify business activity in Michigan. The tax rate equals 4.95%. Insurance companies and financial institutions file separate returns and pay taxes on a different basis than other MBT return filers. Insurance companies pay at the rate of 1.25% of gross direct premiums written on property or risk located in Michigan. Financial institutions pay a tax of 0.235% on the value of their net capital stock.

CIT replaced MBT, effective January 1, 2012. Unlike MBT, which levies a tax on all businesses regardless of how they are organized, CIT imposes a 6% corporate income tax on C corporations and taxpayers taxed as corporations federally that have business activity in Michigan and apportioned gross receipts over \$350,000. Sole proprietorships and pass-through entities, such as partnerships, S corporations, and limited liability companies taxed as a partnership or an S corporation, are not required to pay taxes or file returns under CIT. Insurance companies and financial institutions file separate CIT returns and pay a tax on a different basis than other CIT return filers. Insurance companies pay at the rate of 1.25% of gross direct premiums written on property or risk located in Michigan or a retaliatory tax, whichever is higher. Financial institutions pay tax at the rate of 0.29% of net capital stock.

Taxpayers with certificated credits may elect to continue filing an MBT return until the taxpayer exhausts all certificated credits. The taxpayer must choose to continue filing under MBT with the first filing of the return for tax year 2012. From January 1, 2012 through March 31, 2015, BTD received MBT returns claiming approximately \$1.4 billion in certificated credits (see Exhibit #4), with an estimated \$10.9 billion in certificated credits to be claimed in tax years 2013 through 2031 (see Exhibit #5).

In fiscal years 2014 and 2015, the combined CIT and MBT tax revenue totaled \$420 million and \$892 million, respectively.

BTD had approximately 50 employees administering CIT and MBT during our audit period.

AUDIT SCOPE, METHODOLOGY, AND OTHER INFORMATION

AUDIT SCOPE

To examine the records and processes related to the Department of Treasury's administration of CIT and MBT. 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 findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

PERIOD

Our audit procedures, which included a preliminary survey, audit fieldwork, report preparation, analysis of agency responses, and quality assurance, generally covered the period January 1, 2012 through April 10, 2015.

METHODOLOGY

We conducted a preliminary survey of BTD to formulate a basis for establishing our audit objectives and methodology. To obtain an understanding of BTD's processes, activities, and internal control*, we:

- Interviewed BTD management and staff.
- Observed and reviewed BTD's processes and procedures related to the processing of CIT and MBT returns.
- Obtained an understanding of applicable sections of the *Michigan Compiled Laws* and BTD's policies and procedures.
- Reviewed BTD's statistical reports.
- Examined a sample of CIT and MBT returns and verified the proper processing of the tax returns.
- Analyzed CIT and MBT return and correspondence data.

OBJECTIVE #1

To assess the effectiveness of the CIT and MBT processing controls in identifying exceptions in submitted returns.

To accomplish this objective, we:

- Judgmentally selected 20 potentially high-risk lines on the various CIT return forms and tested a random sample of CIT returns to ensure that BTD's

* See glossary at end of report for definition.

computerized audit program was operating as designed to identify errors within the tax return.

- Judgmentally selected 22 potentially high-risk lines on the various MBT return forms and tested a random sample of MBT returns to ensure that BTD's computerized audit program was operating as designed to identify errors within the tax return.
- Reviewed BTD's computerized audit program to evaluate the effect of disabled CIT and MBT edit checks in ensuring the accuracy of processed returns.
- Tested a random sample of 25 of 321 CIT returns and a random sample of 25 of 543 MBT returns in which members of a unitary business group* also filed a separate return for the same tax period to ensure that BTD properly processed the returns.
- Tested a random sample of 25 of 746 CIT returns claiming flow-through withholding payments to ensure BTD verified that the flow-through entities paid the withholdings to the Department of Treasury.
- Tested a random sample of 25 of 1,848 returns in which taxpayers filed both a CIT and an MBT return for the same tax period to ensure that BTD properly processed the returns.
- Tested a random sample of 60 of 295 MBT returns claiming a certificated credit to ensure that BTD received the required credit certificates, including confirmation of the certificated credit with the awarding State agency.
- Reviewed MBT return data for taxpayers receiving accelerated payments to determine if the taxpayers appropriately filed tax returns.
- Tested a random sample of 45 of 5,079 CIT deactivated returns and a random sample of 45 of 11,341 MBT deactivated returns to ensure that BTD appropriately sent notification letters to taxpayers.
- Tested a random sample of 46 of 32,630 inbound CIT and MBT taxpayer correspondence received to ensure that BTD properly processed the correspondence.
- Tested a random sample of 8 of the 18 CSRs to ensure the completeness BTD's remote monitoring of CSR telephone calls.

* See glossary at end of report for definition.

- Tested a random sample of 25 of 4,262 CIT returns with differences in the taxpayer-claimed estimated payment and BTD-determined estimated payment to ensure that BTD properly applied taxpayer payments.
- Tested a random sample of 36 of 2,292 CIT processed returns and 34 of 7,571 MBT processed returns requiring BTD management approval to ensure proper approval.
- Analyzed CIT and MBT return data to identify processed returns below BTD's approval threshold.

OBJECTIVE #2

To assess the efficiency of the Tax Processing Bureau's processing of CIT and MBT returns.

To accomplish this objective, we:

- Tested a random sample of 100 of 101,871 CIT returns and a random sample of 100 of 177,508 MBT returns to determine BTD's timeliness in processing returns.
- Analyzed CIT and MBT return data to determine, on a quarterly basis, the number of returns received, processed, and backlogged.
- Analyzed CIT and MBT correspondence data to determine BTD's timeliness in processing taxpayer correspondence.
- Tested a random sample of 45 of 1,725 CIT and MBT returns on hold as of March 20, 2015 to ensure that the hold placement was appropriate.
- Analyzed CIT and MBT return data to ensure the appropriate assignment of unprocessed tax returns to BTD calculation assistants.
- Reviewed outstanding SAP system changes to determine the impact on BTD's processing of CIT and MBT returns.

CONCLUSIONS

We base our conclusions on our audit efforts and the resulting material conditions* and reportable conditions.

When selecting activities or programs for audit, we direct our efforts based on risk and opportunities to improve State government operations. Consequently, we prepare our performance audit reports on an exception basis.

* See glossary at end of report for definition.

**AGENCY
RESPONSES**

Our audit report contains 7 findings and 7 corresponding recommendations. The Department of Treasury's preliminary response indicates that BTM agrees with all of the recommendations.

The agency preliminary response that follows each 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 an audited agency to develop a plan to comply with the recommendations 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.

**SUPPLEMENTAL
INFORMATION**

Our audit report includes supplemental information presented as Exhibits #1 through #5. Our audit was not directed toward expressing a conclusion on this information.

GLOSSARY OF ABBREVIATIONS AND TERMS

BTD	Business Tax Division.
CIT	Corporate Income Tax.
CSR	customer service representative.
effectiveness	Success in achieving mission and goals.
efficiency	Achieving the most outputs and the most outcomes practical with the minimum amount of resources.
internal control	The plan, policies, methods, and procedures adopted by management to meet its mission, goals, and objectives. Internal control includes the processes for planning, organizing, directing, and controlling program operations. It also includes the systems for measuring, reporting, and monitoring program performance. Internal control serves as a defense in safeguarding assets and in preventing and detecting errors; fraud; violations of laws, regulations, and provisions of contracts and grant agreements; or abuse.
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.
MBT	Michigan Business Tax.
MDARD	Michigan Department of Agriculture and Rural Development.
MEDC	Michigan Economic Development Authority.
MEGA	Michigan Economic Growth Authority.
MSHDA	Michigan State Housing Development Authority.
NASCAR	National Association of Stock Car Auto Racing.

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.
unitary business group (UBG)	A group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, one of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the UBG or has business activities or operations that are integrated with, are dependent upon, or contribute to each other.

