

# STATE OF CONNECTICUT



*AUDITORS' REPORT  
DEPARTMENT OF REVENUE SERVICES  
FOR THE FISCAL YEARS ENDED JUNE 30, 2013 AND 2014*

**AUDITORS OF PUBLIC ACCOUNTS**  
JOHN C. GERAGOSIAN ❖ ROBERT M. WARD

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# STATE OF CONNECTICUT



## AUDITORS OF PUBLIC ACCOUNTS

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September 22, 2016

### **AUDITORS' REPORT DEPARTMENT OF REVENUE SERVICES FOR THE FISCAL YEARS ENDED JUNE 30, 2013 AND 2014**

We have audited certain operations of the Department of Revenue Services (DRS) in fulfillment of our duties under Section 2-90 of the Connecticut General Statutes. The scope of our audit included, but was not necessarily limited to, the years ended June 30, 2013 and 2014.

The objectives of our audit were to:

1. Evaluate the department's internal controls over significant management and financial functions;
2. Evaluate the department's compliance with policies and procedures internal to the department or promulgated by other state agencies, as well as certain legal provisions.
3. Evaluate the economy and efficiency of certain management practices and operations, including certain financial transactions.

Our methodology included reviewing written policies and procedures, financial records, minutes of meetings, and other pertinent documents; interviewing various personnel of the department; and testing selected transactions. We obtained an understanding of internal controls that we deemed significant within the context of the audit objectives and assessed whether such controls have been properly designed and placed in operation. We tested certain of those controls to obtain evidence regarding the effectiveness of their design and operation. We also obtained an understanding of legal provisions that are significant within the context of the audit objectives, and we assessed the risk that illegal acts, including fraud, and violations of contracts, grant agreements, or other legal provisions could occur. Based on that risk assessment, we designed and performed procedures to provide reasonable assurance of detecting instances of noncompliance significant to those provisions.

We conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our 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 such a basis.

The accompanying *Résumé of Operations* is presented for informational purposes. This information was obtained from the department's management and was not subjected to the procedures applied in our audit of the department.

For the areas audited, we identified:

1. Deficiencies in internal controls;
2. Apparent noncompliance with legal provisions; and
3. Need for improvement in management practices and procedures that we deemed to be reportable.

The State Auditors' Findings and Recommendations in the accompanying report presents any findings arising from our audit of the Department of Revenue Services.

## COMMENTS

### FOREWORD

The Department of Revenue Services (DRS) operates primarily under the provisions of Title 12, Chapters 201, 202, and 207 through 229 of the General Statutes. The department is responsible for administering and ensuring compliance with applicable provisions of this title and certain other statutes related to the assessment and collection of taxes. Major functions of the department include collecting and processing tax revenues, developing tax regulations, and providing information and services to taxpayers.

Records pertaining to sales taxes collected by the Department of Motor Vehicles but credited to the Department of Revenue Services are examined as part of our audit of the Department of Motor Vehicles.

Section 12-1a of the General Statutes provides that the department is under the direction of a commissioner. Kevin B. Sullivan was appointed as commissioner effective January 10, 2011 and served in that capacity throughout the audited period.

## **Legislative Changes**

Notable legislative changes that took effect during the audited period are summarized by tax type and presented below:

- **Income Tax:**

Public Act 13-184, effective upon passage, reduced the Earned Income Tax Credit from 30 percent to 25 percent for taxable years commencing January 1, 2013 and increased the credit to 27.5 percent for taxable years commencing on or after January 1, 2014 and prior to January 1, 2015.

Public Act 13-232, effective upon passage, required DRS to perform a study and analysis of the personal income tax structure to consider the impact upon taxpayers.

Public Act 13-247, Section 330, effective July 1, 2013, required DRS to conduct a tax incidence study for personal income, sales, excise, corporation business and property taxes. DRS is to report back to the Finance, Revenue and Bonding Committee by December 31, 2014 and biennially thereafter.

Public Act 14-155, Sections 17 and 18, effective upon passage, subjected to the state income tax, the income nonresidents receive from nonqualified deferred compensation plans performing services in Connecticut including income subject to federal income taxes.

- **Sales and Use Tax**

Public Act 13-150, effective July 1, 2013, established a civil penalty for operating a business without a sales tax permit. The penalty is \$250 for the first day of operation without a permit and \$100 for each subsequent day of operating without the permit.

Public Act 13-151, effective upon passage, extended the length of time that boats stored during the winter are exempted from sales and use tax. It extends the sales tax exemption for storing noncommercial boats by two months, by starting the period sooner and ending later.

Public Act 13-184, Section 79, effective July 1, 2013, exempted most clothing and footwear costing less than \$50 from the 6.35 percent sales and use tax.

Public Act 13-184, Section 80, effective July 1, 2013, established a pilot program that allowed the department to require certain taxpayers who are delinquent on their sales and use taxes to electronically remit the taxes through an approved processor by the end of the second business day after each applicable sale.

Public Act 14-155, Section 14, effective October 1, 2014, moved up the deadline for remitting monthly sales taxes and filing sales tax returns from the last to the 20<sup>th</sup> day of

the month following the monthly return period and authorized the commissioner to require weekly sales tax returns from retailers that are delinquent in remitting the tax.

- **Corporation Business Tax**

Public Act 13-232, Section 8, effective July 1, 2013, extended from 15 to 25 years the maximum time during which taxpayers may carry forward the corporation business tax credit for donating land for educational uses. Section 9 of the act, effective July 1, 2013, stated that no tax credit shall be allowed with respect to any donation of land for educational use made on or after January 1, 2013.

Public Act 14-69, effective July 1, 2014 and applicable to income and taxable years starting on or after January 1, 2014, expanded the tax incentive for eligible manufacturers that establish a Manufacturing Reinvestment Account (MRA) and withdraw funds for a range of qualifying purposes. The act does so by exempting from corporation and personal income taxes 100 percent rather than 50 percent of any withdrawal from the MRA. In addition, the act reduced from 100 to 50, the number of manufacturers that can participate in the MRA program and increased from 50 to 100, the maximum number of employees a manufacturer may have to be eligible for the program.

Public Act 14-98, Section 44, effective July 1, 2014, increased from \$650 million to \$800 million the total amount of business tax credits available under the Urban and Industrial Site Reinvestment Program.

- **Cigarette and Tobacco Taxes:**

Public Act 13-184, Section 82, effective July 1, 2013, amended the sales tax to allow for the collection and remittance of the sales tax on cigarettes by the wholesaler or distributor.

- **Estate and Gift Taxes:**

Public Act 14-155, Section 11, effective July 1, 2014 changed how taxpayers must calculate the estate tax for those who die on or after January 1, 2015.

- **Gasoline Taxes:**

Public Act 13-232, Section 3, effective July 1, 2013, exempted from petroleum products gross earnings tax, the first sale of cosmetic grade mineral oil sold on or after July 1, 2013.

Public Act 14-155, Section 2, effective June 15, 2014, required DRS, in consultation with the Department of Energy and Environmental Protection, to issue annually information concerning the computation of the motor vehicle fuels tax on gaseous fuel.

- **Other Taxes:**

Public Act 13-112, effective October 1, 2013, increased from \$450 to \$1,000 the amount of legal fees or other compensation an attorney can receive before being subject to occupational tax.

Public Act 13-150, effective July 1, 2013, increased the threshold for review of penalty waivers by the commissioner from \$500 to \$1,000. The proposal allows the commissioner to waive any penalty of \$1,000 or less without review by the Penalty Waiver Committee. The act also prohibited the commissioner from issuing or renewing certain permits and licenses to anyone who owes taxes to the state.

Public Act 13-150, effective upon passage, authorized limited disclosure of tax return and return information in state personnel proceedings.

Public Act 13-184, Section 70, effective July 1, 2013, established a Tax Amnesty Program for the period of September 16, 2013 to November 15, 2013 and covers any periods ending on or before November 30, 2012.

Public Act 13-184, Section 72, effective upon passage, extended by two years the tax credit cap limitation for insurance tax credits until January 1, 2014. In addition, the act extended the electric generation tax for one additional calendar quarter from July 1, 2013 through October 1, 2013.

Public Act 13-184, Section 75, effective July 1, 2013, established a two-year moratorium on film production tax credits for motion pictures for fiscal years 2014 and 2015.

Public Act 13-184, Sections 77 and 78, effective July 1, 2013, eliminated provisions requiring DRS to deposit certain portions of sales and use and real estate conveyance tax revenue into the Municipal Revenue Sharing Account and instead required the revenue to go to the General Fund.

Public Act 13-232, Sections 1, 2, 5, and 6, effective July 1, 2013, changed the date when interest on an overpayment accrues for Public Service Companies, Estate, Petroleum Products, Gross Earnings and Gift taxes to the 91<sup>st</sup> day following the filing date of return or the amended return.

Public Act 13-232, Section 10, effective upon passage, amended the Film Infrastructure Credit to make the period in which an assignee may claim the credit consistent with the Film Production and Digital Animation Credits and applicable to income years commencing on or after January 1, 2013.

Public Act 13-232, Section 16, effective July 1, 2013, allowed an insurance company that filed a final return for a calendar year after making its first installment for the succeeding calendar year to claim an overpayment reported on the previous year's return as if it were paid or applied as of the due date of the first installment for the succeeding calendar year.

Public Act 14-2, effective upon passage, allowed for the exchange of accumulated Research and Development Tax Credits over a number of years for certain aerospace manufacturers for the undertaking of large-scale industrial reinvestment projects. Eligible taxpayers must meet certain employment and investment levels. The credit exchange is capped at a total \$400 million for the entirety of the agreement. The bill also caps the annual amount of credits exchanged to \$20 million over the first five years and \$33.3 million for the sixth and each subsequent year. The exchange amount, and whether or not the maximum cap exchange amount is realized, is based on whether the targets set forth in this bill are met by the manufacturer.

Public Act 14-51, Section 8, effective upon passage, required DRS to notify the Department of Consumer Protection by no later than June 15<sup>th</sup> of each year of any outstanding tax delinquencies owed to the state by any heating fuel dealer as defined in Connecticut General Statutes, section 16-23m.

Public Act 14-155, Section 4, effective January 1, 2015, required that all manufacturers whose cigarettes are sold in Connecticut to annually certify that they are participating in the Master Settlement Agreement or complying with the escrow requirements for nonparticipating manufacturers.

## **RÉSUMÉ OF OPERATIONS**

### **General Fund Revenues and Receipts**

General Fund tax revenues, license fees and all other revenues and non-revenue receipts totaled \$15,843,058,218 and \$15,930,810,872 for the fiscal years ended June 30, 2013 and 2014, respectively. Revenues other than taxes included payments for licenses to collect sales and use taxes and to sell cigarettes and tobacco products, service-of-process fees and costs related to tax warrants, expenditure refunds and federal funding.

General Fund tax refunds, budgeted as reductions of tax revenues, were \$1,149,151,150 and \$1,189,184,710 for the fiscal years ended June 30, 2013 and 2014, respectively.

A summary of tax revenues, net of refunds, for the fiscal years ended June 30, 2013 and 2014, with 2012 figures presented for comparative purposes, is presented below:

<b>(In Millions of Dollars)</b>	<b>2011-2012</b>	<b>2012-2013</b>	<b>2013-2014</b>
Personal Income	\$ 7,319	\$ 7,785	\$ 7,711
Sales and Use	3,685	3,830	4,166
Corporations	692	634	661
Public Service Companies	257	276	289
Inheritance Taxes	175	421	146
Insurance Companies	203	202	195
Alcohol/Cigarettes/Tobacco	476	460	437

Real Estate Conveyance Tax	102	107	170
Petroleum Companies	382	370	398
Admissions and Dues	34	37	40
Nursing Homes	144	151	149
Hospital Net Patient Revenue	262	348	317
All other Taxes	67	73	63
Total	<u><u>\$ 13,798</u></u>	<u><u>\$ 14,694</u></u>	<u><u>\$ 14,742</u></u>

The increases in revenues during the audited period were primarily due to personal income and sales and use tax revenues. Revenues from sales and use and personal income tax receipts accounted for approximately 79 and 80 percent of tax revenues, respectively, in the fiscal years ended June 30, 2013 and 2014.

### General Fund Expenditures

A summary of General Fund expenditures from department appropriations for the fiscal years ended June 30, 2012, 2013, and 2014, is presented below:

	<u>2011-2012</u>	<u>2012-2013</u>	<u>2013-2014</u>
Personal Services	\$ 56,979,111	\$ 53,590,380	\$ 55,603,677
Other Expenses	8,008,861	7,623,864	8,679,502
Total Budgeted Accounts	\$64,987,972	\$61,214,244	\$64,283,179
Restricted Appropriations	(21,975)	(26,077)	8,267
GAAP Appropriations	-	-	272,634
Totals	<u><u>\$ 64,965,997</u></u>	<u><u>\$ 61,188,167</u></u>	<u><u>\$ 64,564,080</u></u>

As presented above, operating expenditures increased over the audited period. Personal services increased as a result of the hiring of additional temporary help related to the tax amnesty program offered by the department in fiscal year 2013-2014. Other expenses increased due to advertising and mailing costs related to the tax amnesty program and the issuance of tax refund checks versus debit cards because of a security breach.

The number of filled positions changed during the audited period, as compared to the previous year. Below is a summary of positions as of June 30, 2012, 2013, and 2014:

	<u>June 30, 2012</u>	<u>June 30, 2013</u>	<u>June 30, 2014</u>
Full-Time	631	630	634
Part-Time	60	54	52
Temporary or Durational	1	2	2
Total	<u><u>692</u></u>	<u><u>686</u></u>	<u><u>688</u></u>

### **Special Transportation Fund**

In accordance with the provisions of Section 13b-61 of the General Statutes, motor fuel taxes and related fees collected by the department, pursuant to Chapters 221 and 222 of the General Statutes, were deposited into the Special Transportation Fund.

Special Transportation Fund receipts for the department totaled \$501,798,361 and \$507,915,770 for the fiscal years ended June 30, 2013 and 2014, respectively.

Special Transportation Fund tax refunds, budgeted as reductions of tax revenues, totaled \$6,094,615 and \$6,993,031 for the fiscal years ended June 30, 2013 and 2014, respectively.

A summary of Special Transportation tax revenues, net of refunds, for the audited period is presented below:

<b>(In Millions of Dollars)</b>	<b>2011-2012</b>	<b>2011-2013</b>	<b>2013-2014</b>
Motor Fuel Tax	\$ 360	\$ 356	\$ 351
Special Motor Fuel Tax	111	124	133
Motor Carrier Tax	15	16	17
Total	<b>\$ 486</b>	<b>\$ 496</b>	<b>\$ 501</b>

### **Audit Assessments**

Audits were conducted by examiners within the department's Audit Division to ensure taxpayer compliance, with regard to the filing of returns and the remitting of tax payments. Assessments were generated as a result of both office and field audit efforts. Based upon statistics provided by the Audit Division, assessments totaled \$303,195,499 and \$343,080,601, respectively, for the fiscal years ended June 30, 2013 and 2014. A summary of assessments by tax type for the audited period, as provided by the Audit Division, is presented below:

<b>(In Millions of Dollars)</b>	<b>2011-2012</b>	<b>2012-2013</b>	<b>2013-2014</b>
Corporation and Other	\$ 244	\$ 134	\$ 163
Sales and Use Taxes	102	89	93
Personal Income Tax	67	52	52
Excise Taxes	14	4	11
Public Service Taxes	42	12	24
All other Taxes	8	12	-
Total	<b>\$ 477</b>	<b>\$ 303</b>	<b>\$ 343</b>

### **Appellate Division**

The department's Appellate Division administers appeals from taxpayers disputing audit assessments. Following a taxpayer filing a written protest, a hearing is held. Based upon

information presented, appellate decisions are made concerning the validity of assessments. Further appeals are available to taxpayers by means of litigation.

Appellate Division activity reports, reflecting resolution activity for the fiscal years ended June 30, 2012, 2013, and 2014, are presented below. Revisions resulted from both court and Appellate Division decisions.

	<b>2011-2012</b>	<b>2012-2013</b>	<b>2013-2014</b>
Cases Resolved	1,351	1,347	1,448
Original Assessments	\$ 242,698,581	\$ 65,209,197	\$ 48,453,161
Revised Assessments	93,495,073	40,339,224	36,226,043
Assessment Reductions	\$ 149,203,508	24,869,973	\$ 12,227,118
Percentage Reduction	61%	38%	25%

### Accounts Receivable

The department's accounts receivable are derived from various sources, including audit assessments, delinquency assessments, penalty and interest charges, and returns filed without remittances or filed with an underpayment of tax liability. A summary of accounts receivable as of June 30, 2012, 2013, and 2014, is presented below:

	<b>June 30, 2012</b>	<b>June 30, 2013</b>	<b>June 30, 2014</b>
Taxes Receivable:	\$	\$	\$
Corporation Tax	45,564,395	28,530,186	26,570,909
Income Tax	260,287,414	206,332,106	207,368,426
Sales and Use Tax	217,122,683	229,136,613	189,721,107
Other Taxes	52,024,394	47,043,354	29,662,172
Total Taxes Receivable	<b>\$574,998,886</b>	<b>\$511,042,259</b>	<b>\$453,322,614</b>
Reductions:			
Credits	(126,500,586)	(146,279,074)	(129,936,411)
Appellate and Court Reductions	(67,402,020)	(49,615,204)	(26,907,290)
Estimated Uncollectible	(168,108,119)	(140,077,419)	(117,048,404)
Total Reductions	(362,010,725)	(335,971,697)	(273,892,105)
Net Taxes Receivable	<b>\$212,988,161</b>	<b>\$175,070,562</b>	<b>\$179,430,509</b>

The receivable balances reflect reductions for payments that were made on account by taxpayers to avoid the continued accrual of interest on assessments under protest and credits due taxpayers.

### Penalty Waivers

Provisions of certain statutes impose penalties for failure to satisfy taxes due within specified times. The Commissioner of Revenue Services is authorized to waive penalties, subject to the

provisions of Section 12-3a of the General Statutes, for cases in which the failure to pay the tax was due to reasonable cause and was not intentional or due to neglect. Section 12-3a requires approval of a Penalty Review Committee comprised of the commissioner of the Department of Revenue Services, the Secretary of the Office of Policy and Management and the State Comptroller for all penalty waivers over \$500 through June 30, 2013 and \$1,000 thereafter.

A summary of the penalty waiver activity for the fiscal years ended June 30, 2013 through 2014, as provided by the department, follows:

	<b>Requests</b>		<b>Denied</b>		<b>Approved Waivers</b>	
	<b>Cases</b>	<b>Penalties</b>	<b>Cases</b>	<b>Penalties</b>	<b>Cases</b>	<b>Penalties</b>
2011-2012	4,053	\$6,259,842	2,603	2,723,709	1,450	\$3,536,133
2012-2013	4,326	\$5,612,480	2,245	4,429,994	2,081	\$1,182,487
2013-2014	3,179	\$3,914,942	1,644	2,546,536	1,535	\$1,368,407

### **Audit and Compliance Bureau**

The Audit and Compliance Bureau is comprised of revenue agents who pursue collections through direct contact with taxpayers, field agents who issue tax warrants to delinquent taxpayers, hearing officers who provide an initial hearing process for delinquent taxpayers, and enforcement agents who investigate cases involving tax evasion. Records of the Audit and Compliance Bureau indicated revenues collected by the division were \$162,660,146 and \$145,863,226 during the 2013 and 2014 fiscal years, respectively.

The commissioner, upon the approval of an Abatement Review Committee, may abate any tax payable to the state that has been present on its suspense tax book for seven years and determined to be uncollectible. The Abatement Review Committee did not hold a meeting during the audited period.

In accordance with Section 12-3b of the General Statutes, it is the practice of the department to remove accounts considered to be uncollectible from its active accounts receivable file and transfer the amounts to the tax suspense book. The amounts transferred will eventually be considered, due to the statutorily required seven-year waiting period, for inclusion on abatement approval requests. Accounts totaling \$82,897,811 and \$120,590,874 were referred to this status during the 2012-2013 and 2013-2014 fiscal years, respectively.

## STATE AUDITORS' FINDINGS AND RECOMMENDATIONS

Our audit of the Department of Revenue Services identified the following areas that need improvement and warrant comment:

### **Statutory Reporting Requirements**

*Criteria:* Sound internal controls suggest that a centralized mechanism should be in place to monitor compliance with a department's various statutory and regulatory reporting requirements. Agencies should continuously evaluate their various reporting requirements and propose legislation when such requirements become obsolete or duplicative.

Section 12-7a subsection (b) of the General Statutes provides that the Commissioner of Revenue Services shall annually prepare a list of taxpayers who are delinquent in the payment of corporation business taxes. The list shall be arranged in sequential order by the taxpayer identification number assigned and shall be provided to the Secretary of the Office of Policy and Management (OPM) no later than July 15<sup>th</sup> annually.

*Condition:* The department did not comply with the reporting requirement of Section 12-7a subsection (b). Instead, the department provided an e-mail dated July 26, 2011, from OPM stating that it no longer desired to receive the report.

*Effect:* The department violated the statutory requirement of Section 12-7a subsection (b). Also, failure to include the required information may hinder effective decision-making by users of the report.

*Cause:* The department regarded the reporting requirement as obsolete. After OPM reviewed the report of corporation business taxpayers that had outstanding liability with DRS, OPM informed DRS that it no longer needed the report.

*Recommendation:* The Department of Revenue Services should address the perceived obsolescence of Section 12-7a subsection (b) of the General Statutes by seeking a legislative change to either repeal or otherwise amend the current language to reflect the current practice, or adhere to the statute. (See Recommendation 1.)

*Agency Response:* "Despite reduced agency resources, DRS regularly produces many similar reports to inform the Office of Policy and Management and the General Assembly. In this case, while not a material finding, DRS will

seek legislation to eliminate a report expressly no longer required by OPM.”

### **Maintenance and Disposition of Seized Property Cases**

*Background:* The Department of Revenue Services, Special Investigation Section (SIS), is primarily responsible for the investigation of civil and criminal violations of the Connecticut General Statutes pertaining to illegal importation of untaxed cigarettes, as well as other suspected violations of Connecticut tax statutes. In accordance with Section 12-330(g) of the General Statutes, the DRS commissioner is authorized to seize untaxed tobacco products as contraband.

Property seized under the above provisions may, after a hearing if one is requested, be offered for sale at auction or be disposed of in a manner deemed to be in the best interest of the state. Statutes of limitations exist, after which a hearing cannot be requested and the case should be closed. Proceeds from any sales of such items are to be deposited with the State Treasurer.

*Criteria:* The department’s SIS policy states that the property agent and/or SIS supervisor, and DRS Public Tax Service Unit (PSU) personnel should conduct a biannual audit of all property in the seized property evidence room, thereby ensuring compliance and accuracy. On a quarterly basis, the property agent will request an inventory list of all currently seized property, review it for accuracy, and in a timely fashion, follow accepted procedures regarding the disposal of any and all such seized property that is no longer required to be in the SIS inventory.

*Condition:* At the time of our review, we were informed that no quarterly reviews of seized property or biannual audits of all property in the evidence room were performed.

In addition, the physical inventory review performed by the DRS Internal Audit Division (IAD) on May 1, 2015, disclosed that in 107 cases, items listed as being present in the evidence room on the SIS inventory list were disposed of on August 14, 2014. The SIS did not update its inventory list for approximately eight months subsequent to disposal.

*Effect:* The accurate maintenance of seized property case records is crucial to better reflect case load data, and delays in updating the status of the cases makes statistics misleading.

*Cause:* We were informed that these conditions exist because of the transition of system changes from the SIS stand-alone system to the Integrated Tax Administrative System (ITAS) and other higher priority tasks.

*Recommendation:* The Department of Revenue Services should comply with its policies and procedures regarding the maintenance of seized property and update its inventory records in a timely manner after cases are closed. (See Recommendation 2.)

*Agency Response:* “This finding relates to the clerical task of updating the “evidence location” field for cases in the primary tracking system. This update does not materially affect the accurate maintenance of case records nor result in misleading case load data. During the audit review period, DRS was migrating the primary tracking system data from a stand-alone database into the Integrated Tax Administration System (ITAS). Only during the development, test and migration period were administrative updates not allowed in either system. Due to the agency’s dual-controlled evidence room, an accurate accounting of seized property cases located in the evidence room was maintained at all times. Migration to ITAS has been completed.”

*Auditors’ Concluding Comment:* Biannual audits and quarterly reviews were not performed by the agency’s SIS unit according to its own established procedures in order to ensure that seized properties were properly managed. Without implementing established procedures, internal controls are weakened.

### **Interest Payments on Returns Held for Audit**

*Criteria:* Established DRS procedures require that claims for tax refunds over a certain threshold be reviewed prior to issuance of the refund to help deter fraudulent returns. Statutory provisions generally require DRS to pay interest on refund requests held for more than 90 days. The requirement that interest be paid on these returns should ensure that they receive expedited handling to avoid or minimize interest payments.

*Condition:* Our review of 76 tax refund payments made during the 2012-2013 fiscal year, revealed the following:

- Interest totaling \$950,534 was paid on a tax refund amount of \$17,821,616. A taxpayer filed an amended return on December 28, 2011, but a review of the return did not commence until May 16, 2012. The tax refund was processed on November 14, 2012, when the review was completed.

- Interest totaling \$28,930 was paid on a tax refund amount of \$1,084,862. The taxpayer filed an amended return on September 5, 2012, but the tax refund was not processed until March 28, 2013, which contributed to the total interest payment.
- Interest totaling \$14,709 was paid on a tax refund amount of \$2,206,276. A taxpayer filed an electronic return on October 15, 2012. However, the tax refund was not processed until January 18, 2013.

*Effect:* The state incurred the expense of interest payments because returns were not processed in a timely manner.

*Cause:* With regards to the three examples presented above:

- The review process did not commence in a timely manner and there was a delay in the response from the taxpayer for additional information.
- We were informed that a certain step was missed in the Income Tax Audit Unit, which contributed to the total amount of the interest being paid.
- The processing of the tax refund was delayed because a tax return report is only generated on a quarterly basis.

In addition, the department stated that staffing shortages and other priorities contributed to returns not being processed in a timely manner.

*Recommendation:* The Department of Revenue Services should ensure that refund requests are processed in a timely manner to avoid the payment of interest. (See Recommendation 3.)

*Agency Response:* “During the related fiscal year ending, DRS issued refund claims totaling \$1.155 billion. The interest component of the total refunds issued was \$6.512 million or 0.56%. DRS always strive to minimize payment of refund interest. At times, however, delay is necessary to ensure appropriate review prior to the issuance of large refunds based on complex claims. This is especially true given reduced agency staffing levels. Such extended review is a preventative control that protects against issuing overstated or erroneous refunds. Though DRS agrees with this recommendation and will continue to expedite processing in order to minimize interest payments, the recommendation should be considered in the proper perspective.”

## **Manually Processed Tax Refunds**

*Background:* The Department of Revenue Services issues tax refunds due to the overpayment by taxpayers. One tenth of the total tax refunds are processed manually. The Operations Bureau processes about 14 percent of the manually processed tax refunds for the tax types that do not normally require refunds, due to corrections of mathematically incorrect returns, misapplied payments, duplicate payments, tax credits affected by new tax regulations, and other reasons. Tax refunds in the amount of \$1,000,000 or greater must be reviewed by appropriate personnel.

*Criteria:* Good business practice dictates that manually processed tax refunds, especially large refund amounts, should be reviewed by a supervisor or a manager before the tax refund checks are issued.

*Condition:* We were informed that, according to the department's policy, manual refunds over \$250,000 should be reviewed by a supervisor or a manager before a refund check is issued. However, these refund checks can still be issued without being reviewed and there are no controls in place to prevent the issuance of the checks.

*Effect:* A lack of effective review procedures may lead to the incorrect issuance of refund checks.

*Cause:* The department does not have effective controls in place to ensure that manual refunds are properly processed and reviewed before refund checks are issued.

*Recommendation:* The Department of Revenue Services should analyze manual refund data to determine the refund review threshold accordingly and implement effective controls to ensure issuance of correct manually processed tax refunds. (See Recommendation 4.)

*Agency Response:* "This recommendation is speculative and ignores effective controls that are in place. In addition, manual refunds processed by the Operations Bureau were 1.6% of total refunds processed. While not a material finding, DRS will more clearly direct that supervisory or managerial review is required for manual refunds exceeding an appropriate threshold. In addition, the agency will reduce or eliminate manual refunds through the planned IT modernization."

*Auditors' Concluding Comment:* It is DRS' responsibility to ensure that all controls are working effectively for the processing of tax refunds. Currently, manually processed refund checks over \$250,000 can be issued without review and

the system allows such refunds to be issued, which results in a significant internal control deficiency.

**Overtime**

*Criteria:* Section 5-245 of the General Statutes provides that employees receive overtime pay for a period in addition to the hours of the employee's regular workweek, when the additional work performed is authorized by the employee's appointing authority.

Good business practice dictates that formal written procedures be established for the approval of overtime.

*Condition:* We reviewed the records of 18 employees who charged overtime hours during the audited period. In eight cases, the department was unable to provide evidence to substantiate that the overtime worked was properly approved.

The department does not have written procedures in place for the approval of overtime.

*Effect:* A lack of proper documentation indicating the overtime was authorized lessens the assurance that such time was earned.

*Cause:* There are no established procedures for overtime authorization.

*Recommendation:* The Department of Revenue Services should establish procedures for the authorization of overtime to comply with Section 5-245 of the General Statutes. (See Recommendation 5.)

*Agency Response:* "DRS' Human Resource Unit staff confirmed with supervisors that pre-approval existed for each of the eight instances identified in this audit. DRS has procedures in place for approval of overtime. However, while not a material finding, DRS agrees with this recommendation and will assure that the procedures are available in writing to supervisors and managers."

*Auditors' Concluding*

*Comment:* During the audit, we requested documentation to show that pre-approval existed for each of the eight employees. DRS did not provide any.

**Alternative Work Schedule**

*Criteria:* The Administrative and Residual (P-5) Collective Bargaining Union Contract, Article 16A, Section Two states that employees should submit

their quarterly alternative work schedule (AWS) for the following quarter to their supervisors for approval.

*Condition:* We reviewed documentation for 15 employees who were on an AWS. Of the 15 employees, we found that, in eight cases, proper documentation was not on file to substantiate that the AWS requests were reviewed and approved by supervisors.

*Effect:* There is lack of assurance that the time charged by employees on the AWS represents approved time.

*Cause:* It appears that lack of administrative oversight might have contributed to this condition.

*Recommendation:* The Department of Revenue Services should ensure that alternative work schedules are reviewed and approved. (See Recommendation 6.)

*Agency Response:* “Given the pressures of reduced agency staffing, DRS is in the process of reevaluating the standards and procedures for AWS. While not a material finding, based on the eight cases cited in this audit, DRS has already reaffirmed existing procedures for supervisory and managerial AWS approvals.”

*Auditors’ Concluding*

*Comment:* During the prior audit, DRS stated that “the department will review our current practices to ensure compliance in the future.” As the condition shows, such compliance was lacking during the current review of AWS.

**Usage of Holiday Hours**

*Criteria:* Employee timesheets should be properly reviewed and approved by supervisors to ensure accuracy.

*Condition:* Our review of holiday time charged on non-holidays revealed that, in eight cases, employees charged holiday paid leave (HOL) on a day that is not defined as a holiday, according to their schedule.

*Effect:* There is lack of assurance that employee time and attendance records are accurate when holiday time is incorrectly charged.

*Cause:* It appears that lack of proper review of employee timesheets by supervisors contributed to this condition.

*Recommendation:* The Department of Revenue Services should ensure that supervisors properly review the employee timesheets prior to approval. (See Recommendation 7.)

*Agency Response:* “While this not a material finding, the agency agrees, but already requires supervisors to thoroughly review employee timesheets for approval. A reminder memorandum was issued by Human Resources to all DRS managers and supervisors on May 12, 2015. As a state-wide control, Core-CT should be updated to automatically reject “HOL” time entries made on days that are not defined as state ‘holidays’.”

### **Access to Core-CT for Terminated Employees**

*Criteria:* The Core-CT Security Liaison Guide states that each agency is responsible for assigning a Core-CT Security Liaison as the primary contact for the Statewide Core-CT Applications Security Administrator. The agency liaisons are responsible for requesting the deletion of access immediately upon notice of an employee’s termination, retirement, or transfer to another department or agency.

*Condition:* Our review of access to the Core-CT system for employees who no longer work for the department disclosed that the department did not immediately deactivate access to the system for five employees who were terminated. It took the department between three to 22 days to deactivate the employees’ access.

*Effect:* There is an increased risk of unauthorized access to the Core-CT system and possible manipulation of data.

*Cause:* The department does not have appropriate controls in place to ensure that employee access to Core-CT is deactivated immediately upon termination.

*Recommendation:* The Department of Revenue Services should establish controls to ensure that access to the Core-CT system is deactivated immediately upon termination of an employee. (See Recommendation 8.)

*Agency Response:* “DRS has effective controls over the deactivation process for typical terminations. The five employees identified in this audit were out of the office on unpaid leave for a period of time prior to their official termination. DRS will, however, take additional steps to deactivate access automatically upon termination.”

*Auditors' Concluding*

*Comment:* The employees were terminated and still had access to Core-CT. Therefore, the controls were not effective.

**Leave in Lieu of Accrual:**

*Criteria:* Agencies are allowed to use the Leave in Lieu of Accrual (LILA) time reporting code for the period between the first of the month, when employees earn accruals, and when employee accruals are posted to employee leave balances. LILA coding is intended to be temporary, and employee leave balances should be adjusted accordingly, as explained in the Core-CT Job Aid.

*Condition:* We noted four instances in which the LILA time reporting code was applied but not adjusted when earned accruals were posted, resulting in employee leave time not being charged for time taken.

*Effect:* Lack of monitoring of the use of the LILA time reporting code could result in employees using more leave time than they earned.

*Cause:* We were informed that the payroll office had new staff and the monitoring of the LILA time reporting code was overlooked.

*Recommendation:* The Department of Revenue Services should ensure that the LILA time reporting code is adjusted in accordance with Core-CT Job Aid procedures. (See Recommendation 9.)

*Agency Response:* "DRS agrees with this recommendation and has already taken measures to assure that employee leave time is properly claimed and charged."

**Petty Cash Fund**

*Criteria:* The State Accounting Manual requires that employees authorized to receive travel advances must sign a statement acknowledging the amount of cash advanced and submit an employee travel reimbursement form (CO-17XP) within five working days after returning from travel.

The State Accounting Manual states that when an expenditure has not been submitted to the State Comptroller for reimbursement, the check should be voided and attached to its stub. The manual also states that a reversal of the original entry should be made, increasing the balance of the fund.

*Condition:* Our review of 50 travel advances for the fiscal year ended June 30, 2013 and 2014, disclosed that a total of 13 reimbursement forms (CO-17XP) were submitted after five business days.

We also reviewed all voided checks from the petty cash fund account during the audited period and noted that four checks were not recorded in the petty cash fund account.

*Effect:* The department is not in compliance with the State Accounting Manual.

*Cause:* According to the department, employees did not submit the CO-XP forms in a timely manner. It is unknown why the voided checks were not recorded.

*Recommendation:* The Department of Revenue Services should comply with the State Accounting Manual petty cash fund requirements. (See Recommendation 10.)

*Agency Response:* “DRS made procedural changes to control and expedite the submission of travel advances before the APA’s FYE 2011/2012 2-90 report was issued in October 2014. However, the APA’s test period was not extended in order to review travel advances submitted under the revised agency procedures. The petty cash advance request form and actual petty cash advance check expressly informs employees of the five business day reporting requirement. The Business Office sends a reminder notice the day the form is due and notifies the employee’s Bureau Chief, Division Travel Coordinator and the employee if the deadline is not met. DRS clearly explained and documented to the APA staff that the four checks not recorded in the petty cash fund account were misprinted and erroneously deleted, not voided. Copies of the misprinted checks were included in the documentation provided to the APA.

*Auditors’ Concluding*

*Comment:* On March 26, 2015, DRS provided the travel advance procedures, which were not completed. On May 6, 2015, a draft finding was presented to DRS. The revised agency procedures were not established and implemented until November 23, 2015.

The evidence provided by DRS for the four checks mentioned above showed that the checks were voided.

**Recording of Actual Receipt Dates to Verify Timely Deposit**

*Criteria:* Section 4-32 of the General Statutes requires that state agencies deposit and account for monies received within 24 hours of receipt if the amount

received by an agency exceeds \$500. The department receives more than \$500 each day, but has received exemptions from the State Treasurer, allowing additional time to deposit and record certain tax payments.

*Condition:* In the current and prior audit, we found that the tax payments sent directly to the department are recorded on its books using the postmark date as the receipt date. However, it does not appear as though the postmark date could always accurately reflect that the deposits were made in a timely manner.

*Effect:* There is reduced assurance that these payments are being deposited timely in accordance with the statutory requirements and applicable extensions received from the State Treasurer.

*Cause:* The department believes that the cost and effort to record the actual receipt dates for these tax payments outweighs the benefit. In addition, the department has failed to establish, or otherwise apply, a consistent standard to determine the postmark date and, thus, the receipt date for the payments.

*Recommendation:* The Department of Revenue Services should establish a consistent standard for defining the postmark date to apply to the payments mailed directly to the department to ensure they are deposited in accordance with Section 4-32 of the General Statutes. (See Recommendation 11.)

*Agency Response:* “The agency’s ITAS information management does not allow DRS to enter a “received date” and a “postmark date”. DRS does have a consistent standard for defining the date recorded in ITAS that ensures the accuracy of the taxpayer’s account and applies that standard to payments or returns mailed directly to DRS. DRS does agree with this recommendation to the extent that there is room for improvement and intends to incorporate functionality in the agency’s planned systems upgrade.”

## **Processing of Suspended Transactions**

*Background:* Tax returns and payments entered into the department’s tax administration system are sometimes unable to be processed, thereby entering into a suspended status. There are many different reasons for transactions going into suspense, including a payment that does not match the coupon that is submitted, or a taxpayer name that does not match the social security number on file. Most suspended transactions are assigned a severity code based on the impact that it could have on a taxpayer’s account.

The resolution of suspended transactions is part of the routine procedures that should take place in any data processing environment, either on an ongoing basis or through the efforts of special projects designed to eliminate these transactions.

*Criteria:* Sound business practices dictate that suspended transactions should be resolved in a timely manner to prevent a delay in the processing of subsequent returns and to avoid repetitive errors.

*Condition:* We tested a sample of 20 transactions selected from a listing of approximately 5,600 high priority transactions, which were suspended for periods ranging from five months to over five years, and found that seven (35 percent) of the sampled transactions were not pursued or otherwise corrected in a timely manner. These transactions were suspended for periods ranging from twenty-one months to fifty-eight months.

*Effect:* Transactions that have been suspended and not resolved in a timely manner may prevent the department from readily identifying patterns that could be indicative of a potential problem and may result in the creation of a liability in the form of interest owed for late refunds.

*Cause:* The department's current practices fail to ensure the consistent and proactive follow-up on those high priority suspended transactions.

*Recommendation:* The Department of Revenue Services should strengthen its internal control procedures to ensure the timely resolution of suspended transactions, with emphasis on those transactions considered either high priority or identified as having a potential financial impact for the state. (See Recommendation 12.)

*Agency Response:* "Recent delays reflect the necessity to reassign limited staff from working suspended transactions to combating increased tax fraud. While this resulted in significant prevention of fraudulent tax refunds, other processing functions were impacted in terms of timeliness. In any event, DRS has already simplified and strengthened the internal control procedures to reduce unnecessary suspension of transactions and set clearer priorities for the resolution of suspended transactions."

*Auditors' Concluding Comment:* DRS appears to have simplified and strengthened the internal controls for processing suspended transaction post-audit testing. Our finding shows that the internal controls were not working effectively at the time of our audit.

## **Inventory and Property Control**

*Criteria:* Section 4-36 of the General Statutes requires each state agency to establish and maintain an inventory record as prescribed by the State Comptroller. The State Property Control Manual establishes the standards, which include tagging property and recording of inventory on Core-CT. The manual also requires that licensed software with a cost of \$1,000 or more must be capitalized and reported on the CO-59 form as licensed software. In addition, the manual indicates that the individual responsible for the day-to-day property management function should not conduct the physical inventory so as to maintain a segregation of duties.

The State Property Control Manual requires that each agency maintains a mandatory written listing of controllable property that has been approved by the agency head or designee. Such assets must be identified and controlled because of their sensitive, portable, and theft-prone nature. Controllable assets must be inventoried on a regular basis, possibly more frequently than capitalized assets because of the nature of the item. Also, controllable items are to be coded as minor equipment in Core-CT.

*Condition:* Our current audit review of the department's property control records revealed the following:

- From a sample of 35 inventory items randomly selected, we found that 15 items had the wrong location listed in Core-CT. Upon our inquiry, the department updated the location for all 15 items. These items were updated between three to 19 months late. In addition, two items did not have visible tags and one item was physically tagged but with a different number than what was listed in Core-CT.
- From a sample of 18 inventory items identified during random inspection of the department's premises, we found that three items had the incorrect location listed in Core-CT and one item was not tagged or listed in the department's inventory records.
- From a random sample of seven inventory items purchased during the audited period, we found that two items did not have a location recorded in Core-CT and another two items had the wrong location recorded in Core-CT.
- Licensed software totaling \$3,091,451 was erroneously reported on the CO-59 form for fiscal year 2014 as software owned by the state.

- The annual physical inventory is performed by the staff involved with maintaining property records.
- The department miscoded medical supplies valued at \$541 to the Minor Equipment Account in Core-CT for fiscal years 2013 and 2014.
- The department was unable to provide a list of controllable property for the audited period.
- The department's current controllable property list does not account for all the items that are portable and theft prone and does not have authorized approval as required.

*Effect:* The property inventory records were not accurate. The department has lessened assurance that its capital assets are properly maintained and safeguarded.

Controllable assets are not adequately controlled and thus at increased risk of loss.

*Cause:* It appears that a lack of strict adherence to the State Property Control Manual and weaknesses in managerial oversight contributed to the conditions.

Also, the department does not consider all theft-prone items as valuable and has set thresholds for some items based on value to include in its controllable property list. The department established this policy as a result of limited resources available to maintain inventories.

*Recommendation:* The Department of Revenue Services should improve internal controls over its property inventory in order to comply with the State Property Control Manual. (See Recommendation 13.)

*Agency Response:* "While no material findings result, DRS agrees with the need to fully comply with the state property management procedures. The following items should be noted: All of the over 1,700 tagged inventory items maintained by DRS were accounted for. DRS explained to the APA auditor that when a tag deteriorates or falls off, the system will not allow DRS to reissue a replacement tag. When this occurs, DRS uses the serial number of the item for identification purposes. All software was accounted for; the error was due to a misunderstanding of the manual procedures. Lastly, DRS and the APA auditor disagree on the interpretation of the State Property Control Manual's controllable property policy criteria. DRS asserts that shredders and scanners are not "theft prone" or "sensitive" items."

*Auditors' Concluding*

*Comment:* The finding is not questioning materiality, but the various deficiencies noted in the finding indicate the need for improvement in internal controls to adequately maintain inventories in accordance with the State Property Control Manual. The agency needs to reconsider what is sensitive and theft prone based on the risks.

**Administration of Internal Audit Unit**

*Background:* The DRS Internal Audit Unit consists of three employees – a director, a tax supervisor, and an accounts examiner. The unit is utilized in accordance with the department's mission of protecting taxpayer information by monitoring employee system access activities and the Data Loss Prevention (DLP) program. Additional functions performed by the unit include reviews based on requests from upper management, various compliance reviews for DRS employees, and acting as audit liaison for external auditors.

*Criteria:* Professional internal auditing standards are recommended guidelines that an internal audit organization can choose to adhere to for purposes of achieving quality and consistency in the performance of its work. These guidelines address the concepts of organizational independence, objectivity, proficiency, due professional care, continuing education, and the planning, performance, reporting and follow-up of engagements. In order to promote compliance with such standards, they should be in written form and formally adopted by the organization.

*Condition:* During the current and prior audit, we noted that the Internal Audit Unit has not adopted professional standards to guide in the performance of its duties. Additionally, the unit has not produced, in conjunction with management, a risk assessment to help justify the timing and frequency of the audits performed.

We also noted that some of the monitoring responsibilities handled by the Internal Audit Unit appear to be in violation of its independence.

*Effect:* The lack of adherence to established standards impedes the ability of the Internal Audit Unit to achieve the highest level of consistency and effectiveness. The failure of the unit to use documented risk assessments can impact the allocation of resources, preventing those resources from being used in a manner that results in the largest expected benefit.

*Cause:* The department indicated that the condition exists because of a lack of resources.

*Recommendation:* The Department of Revenue Services should consider adopting professional internal auditing standards to facilitate the operation of the Internal Audit Unit. (See Recommendation 14.)

*Agency Response:* “With all due respect, DRS strongly disagrees with the analysis resulting in this recommendation. The agency’s Internal Audit Unit, while small, adheres to established procedures, acts independently and effectively serves the agency with respect to risk prevention and correction. The Unit does so despite being inordinately engaged in the now perpetual process of supporting APA external audits.”

*Auditors’ Concluding Comment:*

During the prior audit, DRS stated that “The department agrees with this finding. The department will develop a plan of action to adopt professional standards for the internal audit activities.”

We were not provided with any established procedures indicated in the prior audit response. Furthermore, the APA does not require inordinate engagement from the DRS audit liaison. In fact, it is per DRS protocol that all the communication between the APA and DRS is directed through the audit liaison.

### **Noncompliance with Section 12-39aa Subsection (a) of the General Statutes**

*Criteria:* Section 12-39aa subsection (a) of the General Statutes provides that “if any return, claim, statement, or other document required to be filed with or any payment required to be made to DRS within a prescribed period on or before a prescribed date under authority of any provision of the general statutes is, after such period or such date, delivered by United States mail to DRS, the date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.”

*Condition:* During the current and prior audit, we found that the department has been following a practice of allowing a grace period in determining the timeliness of receipt of required tax returns or payments when received after the prescribed period or due date. For instance, with respect to required resident individual income tax return filings, we were informed that the department’s general practice has been to accept, as timely filed in compliance with Section 12-39aa subsection (a) of the General Statutes, any filing received within the grace period of three business days immediately following the prescribed period or due date, regardless of the postmark date.

*Effect:* The department is not in compliance with the provisions of Section 12-39aa subsection (a) of the General Statutes.

*Cause:* The department believes that the use of a grace period allows for the more effective and efficient use of its limited resources, and therefore enhances its staff's productivity during those periods immediately following a prescribed period or due date, when the demands on its resources are the greatest due to the large volume of filings. The department also indicated that the use of the grace period is a common business practice in most states it contacted.

*Recommendation:* The Department of Revenue Services should establish the procedures necessary to ensure that it is in compliance with Section 12-39aa subsection (a) of the General Statutes. (See Recommendation 15.)

*Agency Response:* "With all due respect, DRS continues to disagree with this recurring recommendation."

*Auditors' Concluding Comment:* During the prior audit, DRS stated that "the department agrees with this finding..." The practice of allowing a grace period in determining the timeliness of receipt of required tax returns or payments when received after the prescribed period or due date does not comply with the current statutory language.

### **Criminal Background Checks for Tax Amnesty Program**

*Criteria:* Section 12-35i (c) of the General Statutes requires that the tax amnesty program for unpaid taxes for periods ending November 30, 2012 should not be granted to any affected person who is a party to any criminal investigation or to any criminal litigation that is pending on July 1, 2013, in any court of the United States or this state.

*Condition:* We were informed that the department only verified the tax amnesty program applicants who are under investigation for a tax crime from its Integrated Taxation Administration System (ITAS), but did not verify the applicants for any other criminal investigations/litigations as required by statute.

*Effect:* Disqualified applicants with non-tax related criminal investigation/litigation may have been admitted to the amnesty program.

*Cause:* The department did not fully comply with Section 12-35i (c) of the General Statutes.

*Recommendation:* The Department of Revenue Services should ensure that tax amnesty recipients meet the eligibility requirements set forth in the General Statutes in order to be in compliance. (See Recommendation 16.)

*Agency Response:* “It should be noted that all previous tax amnesty programs only required DRS to ensure applicants did not have current Connecticut tax criminal cases. While the agency has no reason to believe that any tax amnesty was inappropriately approved, DRS acknowledges the error and agrees to comply with this recommendation with respect to any future tax amnesty subject to the provisions of Section 12-35i (c) of the General Statutes.”

## **GAAP Reporting**

*Background:* In conjunction with our audits of the state’s Comprehensive Annual Financial Reports (CAFR) for the fiscal year ended June 30, 2015, we reviewed the DRS Generally Accepted Accounting Principles (GAAP) Reporting Closing Packages submitted to the Office of the State Comptroller (OSC).

*Criteria:* The submission of complete and accurate GAAP information is instrumental in producing a fairly stated CAFR. Reports should be accurate and in compliance with the State Comptroller’s requirements as set forth in the State Accounting Manual and other related instructions.

The State Accounting Manual states that the modified accrual basis of accounting is applicable in the governmental fund type. Expenditures under the modified accrual basis of accounting should be recognized when the related fund liability is incurred.

*Condition:* Our review of DRS GAAP Reporting Package for Analysis of Tax Refund Paid for fiscal year 2015 disclosed:

- A voided refund check of \$3,519,713.85 was not reversed out in Core-CT. Instead, DRS issued \$846,213.81 in refunds against the amount for the fiscal year 2015 and rolled the balance of \$2,673,500.04 into the fiscal year 2016, which was used to pay other refunds in July, 2015. As a result, DRS overstated \$2,673,500.04 of tax refunds paid for the fiscal year 2015.
- A total of \$7,943.67 in tax refunds cannot be reconciled between Core-CT and DRS Integrated Tax Administration System (ITAS).

*Effect:* These conditions caused inaccurate information to be reported on the state’s CAFR.

*Cause:* We were informed that the process of the voided tax refunds has been in place since 1991. In this case, the tax refunds were accounted for in fiscal year 2015, but not paid until fiscal year 2016.

The cause for the unreconciled tax refunds is unknown.

*Recommendation:* The Department of Revenue Services should comply with the State Accounting Manual and ensure that tax refunds are recorded correctly to enhance the accuracy of GAAP reporting. (See Recommendation 17.)

*Agency Response:* “The voided check did not result in any state financial loss. DRS has never been advised by OSC that the accounting and reporting practice with respect to voided refund checks is erroneous. The agency will, however, seek OSC guidance in response to this recommendation.”

*Auditors’ Concluding Comment:* Tax refunds are considered as expenditures, as the State Accounting Manual clearly states, the expenditures under the modified accrual basis of accounting are recognized when the liability is incurred. In this case, DRS should have made proper entries for the voided tax-refund check in Core-CT to ensure tax refunds were reported correctly for the fiscal year.

### **Tax Return Processing Errors**

*Background:* In November 2012, the department discovered that two processing errors had occurred for a small segment of returns filed using the Modernized e-File (MeF) method of electronic filing of income tax returns.

The first error occurred because of a coding issue. Certain values were not transmitted to DRS, which affected returns that elected all or a portion of the overpayment to be applied towards an amount due for the interest on the underpayment of the estimated tax installments. Tax refunds of \$1,098,750 were overpaid to 2,603 taxpayer accounts. Another 149 taxpayer accounts had offsets or received credits for estimated payments totaling \$54,647. In addition, 92 taxpayers received bills that were understated by \$50,653.

The second error occurred as a result of a vendor software issue, which did not transfer certain values to DRS. This error did not have any financial impact on revenue and resulted in taxpayer overpayments being refunded rather than applied as an estimated payment to the next tax period as indicated by the taxpayer.

Upon discovering these issues, the department notified the affected taxpayers and reported the matter to appropriate authorities. The

department also made necessary coding changes that will prevent future occurrences.

*Criteria:* Sound internal controls suggest that a new system should be tested to verify that it is working properly before it is implemented.

Good business practices suggest that an accountability process should be in place to recover any lost revenue. Such a process would allow for the revenue to be properly tracked and documented.

*Condition:* During our review of the coding error that occurred in November 2012, we noted that two notifications were sent to taxpayers. The first was sent in December 2012 to initially notify them of an overpayment, and a follow-up notice was sent in October 2013 to remind them to return tax information and remittance.

We also noted that overpayments were only tracked for a certain period of time and no verification was performed to determine the amounts collected versus the amounts still outstanding.

An analysis performed by the department's Internal Audit Unit of the affected accounts shows the following approximate unrecovered amounts as of February 2016:

- \$362,459 out of the \$1,098,750 in refund revenue was not recovered
- \$41,473 out of the \$54,647 in offsets and credits were not recovered
- \$41,628 out of the \$50,653 in revenue from understated bills was not recovered

*Effect:* The uncollected revenue is for periods that fall outside the statute of limitations and cannot be recovered.

*Cause:* We were informed that the remittances received under the MeF method was tracked for a certain period of time, but the tracking stopped because of changes in personnel.

*Recommendation:* The Department of Revenue Services should ensure that a new system is properly tested before it is implemented to identify possible defects. The department should also make every effort to recover lost revenue in a timely manner and properly track and document its efforts. (See Recommendation 18.)

*Agency Response:* "In addition to the cause stated above, reduced agency resources contributed to this finding. DRS agrees with this recommendation and is

in the process of developing a business case to replace our multiple tax information management systems, which are not sufficiently integrated and are increasingly difficult to modify or test when new or revised applications are required to be integrated.”

## **Penalty Waivers**

### *Criteria:*

The department should have updated regulations to comply with Section 12-3a (c) of the General Statutes, especially when those regulations are used as guidance for the Penalty Review Committee.

Good business practices suggest that the decision made to approve or deny a tax penalty waiver is supported and properly documented. It should be in the best interest of the state and not subject to question by the taxpayer or the public in general. Also, the penalty waiver procedures should be properly documented.

Section 1-225 of the General Statutes requires public agencies to perform the following: (a) post meeting minutes to the public agency’s website not later than seven days after such meeting; (b) file not later than January 31<sup>st</sup> of each year with the Secretary of the State, a schedule of regular meetings for the ensuing year and to post such schedule on the public agency’s website; (c) file not less than 24 hours before a meeting, the agenda of such meeting with the Secretary of the State and to post such agenda on the public agency’s website; and (d) file not less than 24 hours before a special meeting, a notice of such special meeting with the Secretary of the State and to post the special meeting notice on the public agency’s website.

### *Condition:*

Our review revealed that the department is using an outdated regulation for its penalty waiver guidelines, and the new proposed regulation is not officially approved to be followed by the Penalty Review Committee.

During the audited period, the Penalty Review Committee did not file meeting schedules with the Office of the Secretary of the State. Also, the committee did not post meeting minutes in accordance with the statutes. There were four meeting minutes out of 20 that the department was unable to provide.

We were informed that the penalty waiver cases are tracked for aging and accountability, but there are no formal written procedures and no formal documentation kept for the review to support that this function is taking place.

During our review of 25 penalty waiver cases, we noted that the decisions for 11 cases had no documentation substantiating why DRS upper management changed the supported recommendation provided by the Legal Division attorneys.

*Effect:* It appears that not having proper updated guidelines in the form of regulations, as required by the statutes, caused issues in the handling of the penalty waivers.

The justification is unclear when there is no supporting documentation for changes in the decisions recommended by Legal Division attorneys.

*Cause:* It appears that the lack of administrative oversight contributed to the department not submitting the meeting minutes to the Office of the Secretary of the State and documenting procedures.

According to the department, some of the aforementioned conditions are unnecessary, as they are not required and they have a policy statement for taxpayer guidance.

*Recommendation:* The Department of Revenue Services should properly process and document penalty waiver requests in accordance with sections 12-3a and 1-225 of the General Statutes. (See Recommendation 19.)

*Agency Response:* “DRS agrees in part and respectfully disagrees in part with this recommendation. The agency’s existing regulation, supplemented by published guidance (including instructions with each application form) provide very clear standards for the penalty waiver review process. DRS has already taken corrective action with respect to the posting of meetings and minutes. Prior to completion of fieldwork for this audit, DRS had agreed and is implementing changes to document penalty waiver application aging. Finally, DRS agrees with the need to categorically document the reasons for modification of staff recommendations by the Commissioner or the Penalty Waiver Review Committee. The primary case tracking form is being revised to do so.”

## RECOMMENDATIONS

Our prior report on the fiscal years ended June 30, 2011 and 2012 contained a total of 14 recommendations. Of those recommendations, six have been implemented, resolved, or not repeated. The status of recommendations contained in the prior report is presented below.

### *Status of Prior Audit Recommendations:*

- *The Department of Revenue Services should implement regulations requiring periodic registration for the issuance of fisherman tax-exempt permits in accordance with Section 12-412 of the General Statutes. The current audit disclosed that the department implemented regulations regarding the issuance of fisherman tax-exempt permits. This recommendation is not being repeated.*
- *The Department of Revenue Services Human Resources Unit should implement standardized written performance and review procedures relative to its investigation process. Such procedures should include documentation to substantiate the human resources administrator's review of the case files prepared and agreement with the conclusions reached by staff. During the current audit, we noted that the department developed and implemented standardized written performance and review procedures concerning its investigation process. This recommendation is not being repeated.*
- *The Department of Revenue Services should ensure that annual performance evaluations are performed on all of its managerial employees. The current audit disclosed that the department performed evaluations on its managerial employees. This recommendation is not being repeated.*
- *The Department of Revenue Services should ensure that alternative work schedules are submitted and approved and to comply with the Administrative and Residual (P-5) Bargaining Union Contract. During the current audit, we noted that the department does not ensure that alternative work schedules are submitted and approved. This recommendation is being repeated. (See Recommendation 6.)*
- *The Department of Revenue Services should ensure that employees submit travel reimbursement forms in compliance with the requirements of the State Accounting Manual. The current audit disclosed that employees did not submit travel reimbursement forms in compliance with the State Accounting Manual. This recommendation is being repeated. (See Recommendation 10.)*
- *The Department of Revenue Services should establish a consistent standard for defining the postmark date to apply to the payments mailed directly to DRS to ensure they are deposited in accordance with Section 4-32 of the General Statutes. The current audit disclosed that the department still lacks a standard for defining the postmark date applied to payments. This recommendation is being repeated. (See Recommendation 11.)*

- *The Department of Revenue Services Audit Division should consistently follow its established policies and procedures regarding the necessary supervisory and managerial level reviews and approvals of its virtual audit files. During the current audit, we noted that reviews and approvals are properly performed. This recommendation is not being repeated.*
- *The Department of Revenue Services should strengthen its internal control procedures to ensure the timely resolution of suspended transactions, with emphasis on those transactions considered either high priority or identified as having a potential financial impact for the state. The current audit disclosed that suspended transactions are not addressed timely. This recommendation is being repeated. (See Recommendation 12.)*
- *The Department of Revenue Services should improve its internal controls by updating and maintaining formal, comprehensive written procedures related to the functions of its Collection and Enforcement Division and Audit Division. During the current audit, we noted that the department has updated procedures relating to its divisions. This recommendation is not being repeated.*
- *The Department of Revenue Services should consider adopting professional internal auditing standards to facilitate the operation of the Internal Audit Unit. The current audit disclosed that the department did not adopt professional internal auditing standards. This recommendation is being repeated. (See Recommendation 14.)*
- *The Department of Revenue Services should establish the procedures necessary to ensure that it is in compliance with Section 12-39aa subsection (a) of the General Statutes. During the current audit, we noted that the department did not establish procedures in order to comply with the statutes. This recommendation is being repeated. (See Recommendation 15.)*
- *The Department of Revenue Services should provide training to appropriate staff concerning the proper recording of equipment inventory. The current audit disclosed that the department needs to improve internal controls over its property inventory. This recommendation is being repeated to reflect current conditions. (See Recommendation 13.)*
- *The Department of Revenue Services should ensure that its disaster recovery plan is completely updated and finalized. We noted improvement in this area during the current audit. This recommendation is not being repeated.*
- *The Department of Revenue Services should ensure that the GAAP forms submitted to the State Comptroller are prepared accurately. We noted that tax refunds were not recorded correctly during the current audit. This recommendation is being repeated to reflect current conditions. (See Recommendation 17)*

*Current Audit Recommendations:*

- 1. The Department of Revenue Services should address the perceived obsolescence of Section 12-7a subsection (b) of the General Statutes by seeking a legislative change to either repeal or otherwise amend the current language to reflect the current practice, or adhere to the statute.**

Comment:

The department did not comply with the mandatory reporting requirements of Section 12-7a subsection (b).

- 2. The Department of Revenue Services should comply with its policies and procedures regarding the maintenance of seized property and update its inventory records in a timely manner after cases are closed.**

Comment:

We were informed that no quarterly review of seized property or biannual audit of all property in the evidence room was performed. In addition, the physical inventory review performed by the DRS Internal Audit Division (IAD) on May 1, 2015, disclosed that in 107 cases, items listed as being present in the evidence room on the SIS inventory list were disposed of on August 14, 2014. SIS did not update its inventory list for approximately eight months subsequent to disposal.

- 3. The Department of Revenue Services should ensure that refund requests are processed in a timely manner to avoid the payment of interest.**

Comment:

Our review of 76 tax-refund payments revealed that interest of \$950,534, \$28,930 and \$14,709 were paid on three separate tax returns.

- 4. The Department of Revenue Services should analyze manual refund data to determine the refund review threshold accordingly and implement effective controls to ensure issuance of correct manually processed tax refunds.**

Comment:

We were informed that, according to the department policy, manual refunds over \$250,000 should be reviewed by a supervisor or manager before a refund check is issued. However, a refund check can still be issued without being reviewed, and there are no controls in place to prevent the issuance of the checks.

- 5. The Department of Revenue Services should establish procedures for the authorization of overtime to comply with Section 5-245 of the General Statutes.**

Comment:

We reviewed the records of 18 employees who charged overtime hours during the audited period. In eight cases, the department was unable to provide evidence to substantiate that the overtime worked was properly approved.

- 6. The Department of Revenue Services should ensure that alternative work schedules are reviewed and approved.**

Comment:

We reviewed documentation for 15 employees who were on an AWS. Of the 15 employees, we found that, in eight cases, proper documentation was not on file to substantiate that the AWS requests were reviewed and approved by supervisors.

- 7. The Department of Revenue Services should ensure that supervisors properly review employee timesheets prior to approval.**

Comment:

Our review of holiday time charged on non-holidays revealed that, in eight cases, employees charged holiday paid leave on a day that is not defined as a holiday, according to their schedule.

- 8. The Department of Revenue Services should establish controls to ensure that access to the Core-CT system is deactivated immediately upon termination of an employee.**

Comment:

Our review of access to the Core-CT system for employees who no longer work for the department disclosed that the department did not immediately deactivate access to the system for five employees who were terminated. It took the department between three to 22 days to deactivate the employees' access.

- 9. The Department of Revenue Services should ensure that the LILA time reporting code is adjusted in accordance with Core-CT Job Aid procedures.**

Comment:

We noted four instances in which a temporary "leave in lieu of accrual" (LILA) time reporting code was applied but not adjusted when earned accruals were posted, resulting in employee leave time not being charged for time taken.

**10. The Department of Revenue Services should comply with the State Accounting Manual petty cash fund requirements.**

Comment:

Our review of 50 travel advances for the fiscal years ended June 30, 2013 and 2014 disclosed that a total of 13 reimbursement forms (CO-17XP) were submitted after five business days. We also reviewed all voided checks from the petty cash fund account in the audited period and noted that four checks were not recorded in the petty cash fund account.

**11. The Department of Revenue Services should establish a consistent standard for defining the postmark date to apply to the payments mailed directly to DRS to ensure they are deposited in accordance with Section 4-32 of the General Statutes.**

Comment:

Our review revealed that the use of the postmark date as the receipt date does not appear to always accurately reflect that deposits were made in a timely manner.

**12. The Department of Revenue Services should strengthen its internal control procedures to ensure the timely resolution of suspended transactions, with emphasis on those transactions considered either high priority or identified as having a potential financial impact for the state.**

Comment:

Our test sample of 20 transactions selected from a listing of approximately 5,600 high-priority transactions disclosed that seven (35%) of the tested transactions were not pursued or otherwise corrected in a timely manner. The transactions were suspended for periods ranging from twenty-one months to fifty-eight months.

**13. The Department of Revenue Services should improve internal controls over its property inventory to comply with the State Property Control Manual.**

Comment:

The current audit review of the department's property control records revealed control weaknesses.

**14. The Department of Revenue Services should consider adopting professional internal auditing standards to facilitate the operation of the Internal Audit Unit.**

Comment:

The Internal Audit Unit has not adopted professional standards as guidance in the performance of its duties. Additionally, the unit has not produced, in conjunction with

management, a risk assessment to help justify the timing and frequency of the audits performed.

- 15. The Department of Revenue Services should establish the procedures necessary to ensure that it is in compliance with Section 12-39aa subsection (a) of the General Statutes.**

Comment:

The Department of Revenue Services has been following a practice of allowing a grace period in determining the timeliness of receipts of required tax return filings or payments when received after the prescribed period or due date.

- 16. The Department of Revenue Services should ensure that tax amnesty recipients meet the requirements set forth in the General Statutes in order to be in compliance.**

Comment:

We were informed that the department only verified the tax amnesty program applicants who are under investigation for a tax crime from its Integrated Taxation Administration System (ITAS), and did not verify the applicants for any other criminal investigations/litigations as required by statute.

- 17. The Department of Revenue Services should comply with the State Accounting Manual and ensure that tax refunds are recorded correctly to enhance the accuracy of GAAP reporting.**

Comment:

Our review of the DRS GAAP Reporting Package for Analysis of Tax Refunds Paid for fiscal year 2015, disclosed that a voided refund check in the amount of \$3,519,714 was not reversed out in Core-CT, which led to tax refunds paid being overstated by \$2,673,500. Also, a total of \$7,943.67 in tax refunds cannot be reconciled between Core-CT and DRS Integrated Tax Administration System.

- 18. The Department of Revenue Services should ensure that a new system is properly tested before it is implemented to identify possible defects. The department should also make every effort to recover lost revenue and properly track and document its efforts.**

Comment:

During our review of a coding error that occurred in November 2012, we noted that the department did not properly track overpayments that were made to taxpayers.

**19. The Department of Revenue Services should properly process and document penalty waiver requests in accordance with sections 12-3a and 1-225 of the General Statutes.**

Comment:

Our review revealed that the department is using an outdated regulation for its penalty waiver guidelines. Also, the Penalty Review Committee did not file meeting schedules with the Office of the Secretary of the State or post meeting minutes in accordance with the statutes. In addition, we were informed that the penalty waiver cases are tracked for aging and accountability, but there are no formal written procedures and no formal documentation kept for the review. Our review of 25 penalty waiver cases revealed that decisions for 11 cases had no documentation substantiating why DRS upper management changed the supported recommendation provided by Legal Division attorneys.

**CONCLUSION**

We wish to express our appreciation for the cooperation and courtesies extended to our representatives by the officials and staff of the Department of Revenues Services during the course of our examination.



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Principal Auditor

Approved:



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