

# STATE OF CONNECTICUT

**PERFORMANCE AUDIT  
DEPARTMENT OF REVENUE SERVICES**

**APRIL 5, 2006**

**AUDITORS OF PUBLIC ACCOUNTS  
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## TABLE OF CONTENTS

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<b>EXECUTIVE SUMMARY .....</b>	<b><i>i-iv</i></b>
<b>BACKGROUND .....</b>	<b>1</b>
<b>Accounts Receivable .....</b>	<b>2</b>
<b>Appellate Case Reductions.....</b>	<b>2</b>
<b>Tax Amnesty Program .....</b>	<b>3</b>
<b>AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY .....</b>	<b>5</b>
<b>NOTEWORTHY ACCOMPLISHMENTS.....</b>	<b>7</b>
<b>AREAS REQUIRING FURTHER REVIEW .....</b>	<b>8</b>
<b>RESULTS OF REVIEW .....</b>	<b>9</b>
<b>Accounts Receivable .....</b>	<b>9</b>
<b>Item No. 1 - Refund for Inaccurate Income Tax Return.....</b>	<b>9</b>
<b>Item No. 2 - Hold Status Placed on Accounts not Being Released Promptly .....</b>	<b>11</b>
<b>Item No. 3 - Erroneous Refund.....</b>	<b>13</b>
<b>Appellate Case Reductions.....</b>	<b>14</b>
<b>Item No. 4 - Interest Acquisition Accounts.....</b>	<b>14</b>
<b>Tax Amnesty Program .....</b>	<b>15</b>
<b>Item No. 5 - Taxpayers Identifiable Prior to Tax Amnesty .....</b>	<b>15</b>
<b>RECOMMENDATIONS.....</b>	<b>18</b>
<b>CONCLUSION .....</b>	<b>20</b>

## EXECUTIVE SUMMARY

In accordance with the provisions of Section 2-90 of the Connecticut General Statutes and with *Government Auditing Standards* issued by the Comptroller General of the United States, we have conducted a performance audit of the accounts receivable, appellate case reductions for audit tax assessments, and the Tax Amnesty Program, at the Department of Revenue Services. The audit covered internal control, compliance, economy and efficiency, and effectiveness and results issues, all of which are types of performance audits.

The conditions noted during the audit, along with our recommendations, are summarized below. Our findings and the Agency's responses are discussed in detail in the "Results of Review" section of this report.

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### Accounts Receivable

#### **Refund for Inaccurate Income Tax Return**

Proper review of income tax returns provides reasonable assurance to management about the validity of transactions and the operating effectiveness of internal controls. The effectiveness of established controls increases the efficiency of employees during transaction processing.

The Department processed and refunded \$3,800 to a taxpayer who filed a tax return that showed no income from sources within the State, and \$3,850 in income tax paid to the State.

The Department granted tax credits to taxpayers who had income from sources within the State and from another state, without obtaining the documentation needed to verify the payment made by the taxpayers to the other state. The credits granted to these taxpayers reduced their tax liability to the State of Connecticut and created a refund to the taxpayers. The amount refunded to the taxpayers may become lost revenue to the State if they become uncollectible and are abated.

The Department allowed excess tax credits to joint income tax filers for income tax paid to another state. The taxpayers had income from sources within the State of Connecticut as well as from another state. The excess credits provided to the taxpayers resulted in a full refund of the amount of income tax paid to the State of Connecticut for income derived from sources within the State.

**The Department should verify the accuracy of information provided by taxpayers on their tax returns prior to refunding them the amount they claimed on the tax return as payment in excess of the amount of tax due to the State, to minimize refund overpayments. (See Item 1.)**

**Accounts on Hold Status**

The establishment and enforcement of procedures to periodically review accounts that were placed on hold status would enhance the resolution of the issues between the taxpayer and the State. It would also result in the timely release of the hold status on the accounts so that the taxpayers can be billed promptly.

The Department places accounts on hold status to research and resolve issues between a taxpayer and the State. Placing an account on hold status stops all billing and collection processes until the hold is removed. However, the account continues to accrue monthly interest while it is on hold. Ten accounts totaling \$9,875,381 in principal, penalty, and interest were placed on hold status while the issues were being resolved. The hold status on three of these accounts should have been released and the taxpayers billed. However, the hold was not released and the three accounts continued to accrue interest. The statute of limitation established by Section 12-415(f) of the General Statutes, for billing and collecting outstanding taxes due, expired while one of the three accounts was still on hold. The Department made a recommendation to write-off the account due to the expiration of the statute of limitation.

**The Department should establish and implement effective procedures to periodically review all accounts that were placed on hold status to determine if the issue has been resolved and then allow the taxpayers to be billed, if necessary, before the statute of limitation expires. (See Item 2.)**

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**Erroneous Refund**

Proper validation of the name and taxpayer identification number on income tax returns, by the tax system, prior to issuing a refund to taxpayers enhances internal control over cash disbursements. The validation process provides assurance to management that cash disbursements are correct and that established procedures are operating as intended. Effective controls help to minimize errors that may occur during transaction processing.

The Department issued two checks, one check in error, to two taxpayers who filed a joint income tax return. The taxpayers entered an incorrect taxpayer identification number for the spouse on their joint income tax return. The tax system identified the spouse as the primary taxpayer due to this error and issued a refund for \$600 to the spouse.

**The Department should strengthen validation parameters in the tax system with regard to taxpayer identification information. (See Item 3.)**

**Appellate Case Reductions**

**Interest  
Acquisition  
Accounts**

The timely settlement of appeals by the taxpayers enhances the effectiveness of the Department's efforts to increase public awareness of the State tax laws to obtain voluntary compliance from the taxpayers. Also, the timely settlement of appeal cases enhances the operating effectiveness of the Department's audit of the taxpayers. It eliminates the need for the Department to invoke the provisions of Section 12-226a of the Connecticut General Statutes during subsequent audits of the taxpayers, for issues previously appealed by a taxpayer and resolved with the State. The Department invokes the provisions of Section 12-226a if it appears that a taxpayer's business transactions were improperly or inaccurately reflected, or when it appears that business arrangements have little or no business purpose.

Fourteen interest acquisition cases totaling \$59,699,416 have been in the appellate inventory of cases between 570 days to 2,218 days and are accruing interest on a monthly basis. The Department's average time to settle appellate cases is 418 days. Some of the cases were assessments for multiple years' tax liabilities. The taxpayers appealed the cases due to adjustments by the Department, in accordance with the provisions of Section 12-226a of the Connecticut General Statutes, for interest expenses related to business acquisitions, which were deducted by the taxpayers when reporting their income subject to State tax. Due to the length of time the cases have been on appeal, the accrued monthly interest on some of the accounts has exceeded the tax amount due from the taxpayers. In one case, the total accrued interest is \$5,283,000 greater than the total tax assessment due from the taxpayer.

**The Department should evaluate the status of the interest acquisition accounts and resolve the cases so that the accounts would not continue to accrue interest. The Department should also resolve these cases to enhance the effectiveness of the audit of taxpayers to determine the correctness of the tax returns they file. (See Item 4.)**

**Tax Amnesty Program**

**Taxpayers  
Identifiable  
Prior to Tax  
Amnesty**

Section 12-735(b) of the Connecticut General Statutes states that if any person has not made a return within three months after the due date for filing the return, the Commissioner may make such a return at any time thereafter, according to the best information obtainable and according to the form prescribed.

The Department could have identified and billed some of the taxpayers who participated in the 2002 Tax Amnesty program, for the amount of outstanding tax liability due, prior to the tax amnesty program. Some of

these taxpayers had outstanding tax liabilities that are six years old or older and had participated in the 1995 Tax Amnesty program. Under the 2002 Tax Amnesty program, taxpayers who had outstanding tax liabilities and had been identified and billed were eligible for a full penalty waiver and 25 percent interest reduction, if they pay their outstanding tax liabilities in full during the tax amnesty period. If the Department had identified and billed these taxpayers and collected the outstanding tax liabilities due from them, prior to the 2002 Tax Amnesty program, the penalty and interest on their account would have been additional revenues to the State.

**The Department should verify the payment status of all taxpayers, make an estimate, and bill the taxpayers for all years for which the taxpayers failed to make a return. (See Item 5.)**

## **BACKGROUND**

The Department of Revenue Services (DRS) is responsible for administering the tax laws of the State of Connecticut and collecting State tax revenues. The Department is also responsible for ensuring that all tax returns are filed and taxes are paid, as required by the Connecticut General Statutes. Through its voluntary compliance program, it provides incentives to encourage businesses and individuals who are not in compliance with Connecticut tax laws to voluntarily register or bring their accounts into compliance. The Department collects taxes and enforces the State tax statutes and regulations for those who do not voluntarily comply. It collects tax revenues for the State from about 41 tax types. The biggest sources of State tax revenues are the personal income tax, corporation business tax, and sales and use tax.

The divisions within the Department that are mainly responsible for collecting State tax revenues are the Appellate Division, the Audit Division, and the Collection and Enforcement Division. Through its Audit and Collection and Enforcement Divisions, the Department conducts inspections to determine whether taxpayers are properly registered and are operating legally with the necessary permits. The inspections also help the Department to increase public awareness of tax laws and to obtain compliance. Through its Audit Division, the Department reviews tax returns to ensure their correctness. Through its Appellate Division, the Department receives and reviews all taxpayer appeals.

The Department uses innovative technologies such as CTWebFile, TeleFile, and e-File for income tax filings, and Connecticut Fast File for business tax filings, to reduce the cost of processing tax returns. Further attempts to reduce the cost of processing tax returns include the use of Electronic Funds Transfer (EFT) to collect tax revenues and to deposit refund claims directly into eligible taxpayers' bank accounts. To further enhance the effectiveness of its collection efforts, the Department is a member of the Multistate Tax Commission's (MTC) National Nexus Program, which operates a voluntary disclosure program that allows taxpayers to resolve potential tax liabilities simultaneously with multiple states.

The Department utilizes its Master Business Data Base (MBDB) system, the Income Tax Return Processing (ITRP) system, Integrated Tax Administration System (ITAS) and a Computerized Automated Collection System (CACS) in the collection of delinquent tax returns and deficient taxes. The MBDB system is the Department's primary computer system for processing and storing business taxpayers' information and the ITRP system is the primary computer system for processing and storing individual income tax return information. The information in these systems is used in conjunction with the CACS and ITAS files for identifying and determining the account status of taxpayers. The CACS is a case management system used by management to prioritize the collection caseload.

The Department is currently converting information in the MBDB, ITRP and CACS tax systems to the Integrated Tax Administration System (ITAS). The ITAS will combine computer hardware and software to consolidate tax data from the Department's current multiple computer systems. This will give staff greater access to information needed to respond to taxpayer inquiries. Major functions of the system include taxpayer registration, returns and payment processing, taxpayer accounting, case management, revenue accounting, and correspondence.

The ITAS project will be implemented in five phases. Upon completion of all phases, ITAS functions will operate under a single integrated database for all taxes.

**Accounts Receivable**

The Department of Revenue Services' accounts receivable balances arise from underpaid, unreported and underreported taxes and assessments issued by the Department. Generally, taxpayers are required to file their tax returns and pay their taxes annually. Under the provisions of the Connecticut General Statutes, the Commissioner of Revenue Services may examine the tax returns to determine their correctness. This examination is conducted primarily by the Department's Audit Division, which is also primarily responsible for generating assessments for the State. The Collection and Enforcement Division is responsible for collecting all overdue taxes and enforcing the State tax statutes and regulations for those who fail to voluntarily comply.

The accounts receivable balance includes accounts under appeal, accounts on hold, underpaid liabilities and accounts in litigation with the Department. The accounts receivable balances also include accounts that do not meet the criteria for write-offs because there is a likelihood of collecting those accounts in the future, and accounts in the suspense tax book. The suspense tax book is an inventory of accumulated accounts which the Department has deemed to be temporarily uncollectible. Cases are added to the suspense tax book each month and must remain there for a period of seven years before being submitted for abatement.

The Department maintains its accounts receivable record in the ITAS, MBDB and ITRP databases. The accounts receivable record is the current status of the taxpayers' account balances. The balances are made up of tax, penalty and interest charges. Payments made on the receivable balances are posted to the systems to reduce the outstanding balance. Payments made by the taxpayers are applied first to the penalty, then the interest, and then the tax.

The Department reported the following accounts receivable balances and allowance for uncollectible accounts during the fiscal year ended June 30, 2003.

<b><u>Tax Type</u></b>	<b><u>Tax Amount Receivable</u></b>	<b><u>Total Estimated Uncollectible</u></b>
Corporation Business Tax	\$ 66,546,792	\$ 2,790,329
Sales and Use Tax	\$ 74,380,811	\$ 5,968,275
Income Tax	\$140,155,143	\$ 3,354,709
Motor Fuels	\$ 1,619,317	\$ 157,168
Other Taxes	\$ 32,756,837	\$20,230,111
<b>Totals</b>	<b><u>\$315,458,900</u></b>	<b><u>\$32,500,592</u></b>

**Appellate Case Reductions**

The Appellate Division receives and reviews all taxpayer appeals. The division's tax appellate officers and specialists conduct informal hearings, render determinations, and negotiate settlements of tax controversies. Most of the tax controversies arise from audit tax assessments

by the Audit Division. Most differences are settled during the audit process. However, if a taxpayer still disagrees with the audit findings, the taxpayer can request a formal hearing with the Department's Appellate Division. The Appellate Division works with the taxpayer to resolve any outstanding issues in order to settle the dispute.

Through August 2, 2004, the Appellate Division had an inventory of 943 outstanding cases totaling \$240,212,356, in the following breakdown:

<b><u>Tax Type</u></b>	<b><u>Total # of Cases</u></b>	<b><u>Total Amount in Dispute</u></b>
Corporation Business Tax	206	\$138,095,761
Sales, Use, and ADC Tax	237	\$ 69,929,427
Income Tax	324	\$ 20,704,359
Miscellaneous Tax	<u>176</u>	<u>\$ 11,482,809</u>
<b>Total</b>	<b><u>943</u></b>	<b><u>\$240,212,356</u></b>

Most of the appellate cases result from adjustments by the Department. The Department may invoke Section 12-226a of the Connecticut General Statutes to prevent taxpayers from artificially shifting income and profits from the State to another jurisdiction, through interest and royalty expense deduction for payments by a parent company to its wholly owned affiliate. Shifting income or profits to another entity that the taxpayer controls, or with which it has an agreement or arrangement, may allow the controlling taxpayer to eliminate or reduce its State tax if the controlled party is not taxable in the State, or if the controlling party can reduce its percentage of income apportioned to the State.

Under applicable sections of the Connecticut General Statutes, any person aggrieved because of any order, decision, determination or disallowance of the Department may, within one month after service upon the taxpayer of notice of such decision, determination or disallowance, make an appeal to the Superior Court. The Appellate Division provides litigation support to the Litigation Division on cases appealed by the taxpayers to the Superior Court. When a case is under litigation, the account is placed on litigation hold status, which stops contact with the taxpayer in regards to paying the bill. However, interest continues to accrue on the tax liability while the case is on litigation hold.

### **Tax Amnesty Program**

Under the provisions of Section 12-35g of the Connecticut General Statutes, the Department of Revenue Services conducted a tax amnesty program from September 1, 2002, through November 30, 2002. The objective of the tax amnesty program was to provide taxpayers that have delinquent taxes an opportunity to pay their taxes in full and avoid criminal or civil prosecution. The tax amnesty applied to any taxable period ending on or before March 31, 2002. The program allowed both business and non-business taxpayers to apply for amnesty in connection with unpaid, unreported or underreported tax liabilities and to pay their taxes without the application of a penalty. Taxpayers who filed for tax amnesty and were approved, received a full waiver of the entire penalty, plus a 25 percent reduction in interest, if they paid their outstanding tax in full by the end of the tax amnesty period.

Under procedures established in accordance with the provisions of Section 12-35g of the Connecticut General Statutes, the Department authorized and arranged for installment payments for some taxpayers who demonstrated financial hardship. Taxpayers who were approved for an installment payment plan received a full waiver for the entire penalty but with no interest reduction, if they had already been identified and billed. Also, interest accrued at the statutory rate of one percent per month on the unpaid balance of their tax liability. However, if the taxpayers paid their outstanding tax liability in full by the end of the tax amnesty program, they received the full penalty waiver and interest reduction. Taxpayers who had not been identified and billed were eligible for the full penalty waiver and 25 percent interest reduction, even if they did not pay their outstanding tax liability in full by the end of the tax amnesty program. For these taxpayers, interest accrued on the unpaid balance of their tax liability at the rate of three-quarters of one percent per month, until the end of the tax amnesty period. Failure to honor the installment payment agreement resulted in revocation of the amnesty, resulting in the canceled penalty and reduced interest being added back to the outstanding balance. In addition, interest accrued at one percent per month on the unpaid portion of their tax liability at the expiration of the tax amnesty period. The Department also conducted a tax amnesty program from September 1, 1995, to November 30, 1995. The 1995 tax amnesty program applied to any taxable periods ending on or before March 31, 1995.

The Department of Revenue Services collected \$109,729,127 and \$40,924,908, respectively, during the 2002 and 1995 tax amnesty periods. Of these amounts, \$75,253,434 or 68 percent and \$28,842,300 or 70 percent, respectively, were receipts from taxpayers who had already been identified and billed for their outstanding tax liability. Many of the taxpayers who participated and received the benefits of the 2002 Tax Amnesty Program were also beneficiaries of the 1995 Tax Amnesty Program.

## **AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY**

The Auditors of Public Accounts, in accordance with Section 2-90 of the Connecticut General Statutes, are responsible for examining the performance of State entities to determine their effectiveness in achieving legislative purposes.

We conducted this performance audit of accounts receivable, appellate case reductions, and the Tax Amnesty program in accordance with auditing standards generally accepted in the United States of America and the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The audit covered internal control, compliance, economy and efficiency, and effectiveness and results issues, all of which are types of performance audits.

The objectives of our review of the Department's accounts receivables were to determine the following:

- ❖ Whether the Department has established and implemented effective procedures to ensure collection of the receivables.
- ❖ The reliability, validity, or relevance of financial information reported as accounts receivable.
- ❖ Whether the Department has established and implemented effective procedures to reduce the occurrence of accounts receivable.

The objectives of our review of the appellate case reductions were to determine the following:

- ❖ The relative ability of alternative approaches to yield better program performance or eliminate factors that inhibit program effectiveness.
- ❖ The reason for the continued increase in the appellate case reductions and efforts by the Department to increase State tax revenues by reducing the number of cases that are appealed by the taxpayers and reduced on appeal.

The objectives of our review of the tax amnesty program were to determine the following:

- ❖ The effectiveness of the program in collecting past tax liabilities of taxpayers who participated in the program.
- ❖ Whether the Department updated its database to ensure that tax amnesty participants filed for tax amnesty for all years for which they had outstanding tax liabilities, as well as stayed current in their tax filings.
- ❖ The extent to which legislative goals and objectives were achieved and whether the program produced the intended results or produced effects that were not intended by the legislature.

We reviewed accounts receivables from taxes, and appellate case reductions at fiscal year ended June 30, 2003. We also reviewed the tax amnesty program for the period of September 1 through November 30, 2002, and September 1 through November 30, 1995.

All of our audit work was performed at the Department of Revenue Services. We reviewed accounting data provided by the Department, relative to information obtained from pertinent

sections of the Connecticut General Statutes, the Department's website, Auditors of Public Accounts prior audit reports, and such other information that was helpful in completing the audit. We also interviewed DRS managers and employees. Finally, we relied to a great extent on computer processed transactions in selecting our samples for the transactions tested.

## **NOTEWORTHY ACCOMPLISHMENTS**

The Department of Revenue Services has made significant progress in accomplishing its goal to achieve the highest level of voluntary compliance, to collect State tax revenues in the most cost effective manner, and to improve its programs and processes so that taxpayers may have confidence in the integrity, efficiency and effectiveness of the State tax system.

Efforts by the Department to reduce the number of appellate cases from corporation business taxpayers' appeals to the Department for interest expense add-back led to legislative changes. Section 78(b) of Public Act 03-6 (June Special Session), effective from passage and applicable to income years commencing on or after January 1, 2003, required corporation business taxpayers to add back certain "...deductible interest expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members".

In our review of the appellate case reductions, we noted that many of the appellate cases occurred due to the Department invoking the provisions of Section 12-226a of the Connecticut General Statutes. Generally, the Department invokes the provisions of Section 12-226a if it appears that the activity, income, business or capital of the taxpayer was improperly or inaccurately reflected because the taxpayer's transactions with a related party were not conducted at arm's length. Also, the Department invokes the provisions of Section 12-226a when it appears that business arrangements have little or no business purpose or when it appears that transfers were made by a parent company to its affiliate member for tax avoidance purposes. Corporation business tax is computed based on the percentage of a corporation's Connecticut source income. Deduction of interest expense reduces the amount of taxable income to the State.

During appeal hearings, most of the issues by the taxpayers center mainly on the lack of a statutory prohibition against corporation business taxpayers' deduction of interest expense paid by a parent company to its wholly-owned affiliate. During this time, the taxpayers provide further evidence to support any transfers and payments to its affiliates and to justify any interest expense deductions. The Department evaluates the evidence presented by the taxpayers. This evaluation may result in reduction of the assessment in order to settle the case. Also, the aftermath of recent adverse court case decisions by Connecticut and other states' courts, has caused the cancellation of or large reductions in the original amount assessed.

The Department currently has an inventory of 206 total corporation business tax appellate cases amounting to \$138,095,761, under appeal. Of this number, 83 appeals totaling \$103,157,359 or 74 percent, resulted due to the Department invoking the provisions of Section 12-226a of the Connecticut General Statutes. While most of these cases relate to interest expense add-back by the Department, which occurred prior to the passage of Public Act 03-6 (June Special Session), the Department anticipates that the number of appeals for interest expense add-back will significantly decrease, because of corporation business taxpayers' voluntary response to the provisions contained in Section 78(b) of Public Act 03-6 (June Special Session). The Department also anticipates that this decrease will result in a significant increase in the amount of corporation business tax revenue generated for the State.

## **AREAS REQUIRING FURTHER REVIEW**

As noted in Item Number 1, the Department granted credits to taxpayers for income tax paid to other states without obtaining proper documentation from the taxpayers. The Department is migrating to Webfile, Electronic Filing, and Telephone filing systems for income tax processing purposes. These filing systems do not allow taxpayers to attach the necessary documentations to support credits claimed. Currently, the Department uses a back-end process to verify documentary evidence of tax payment to other states, for taxpayers who claimed credit for taxes paid to other states, before granting the credit to the taxpayers. Sometimes, this back-end verification process results in accounts receivable to the State because such verifications are made after a refund had been issued to the taxpayer. Proper mechanisms built into the new filing systems to electronically verify these credits up-front will be more effective. This procedure will reduce tax liabilities to the State arising from refunds to taxpayers who claimed credits on their tax return for payments made to other states. The Department should establish and implement procedures to ensure that credits claimed on returns that are filed electronically are verified before allowing the credits and issuing refunds to the taxpayers.

Also, as noted in Item Numbers 1 and 3, the Department allowed excess tax credits to joint income tax filers for income tax paid to another state, and issued an income tax refund to a taxpayer who was not a primary taxpayer on a joint income tax return. The Department's tax system could have prevented these errors, which resulted in overpayments to taxpayers, had sufficient verification been made to determine the accuracy of the returns. The Department should review safeguards that are currently in place to ensure that returns that do not meet criteria established for processing income tax returns are processed only after sufficient verification has been made to determine the accuracy of the returns.

## RESULTS OF REVIEW

### Accounts Receivable

#### Item 1 – Refund for Inaccurate Income Tax Return

*Criteria:* Proper review of income tax returns filed by taxpayers, including all required forms and attachments, prior to issuing income tax refunds, enhances internal control over the disbursement of tax refunds. Such review enhances the effectiveness of transaction processing procedures and provides assurance to management that disbursements to taxpayers are appropriate.

*Condition:* Our review of 25 accounts receivable transactions arising from income tax refunds showed that in one instance the Department processed and refunded \$3,800 to a taxpayer who filed an income tax return and reported no income from sources within the State. The Form W-2 earning statement attached by the taxpayer showed that the taxpayer did have \$87,000 in income from the State and paid \$3,850 in State income tax. The Department processed the return as filed by the taxpayer, and refunded \$3,800 of the total amount paid by the taxpayer.

The Department issued income tax refund checks to four taxpayers, out of 25 we reviewed, who have an outstanding tax liability. These taxpayers claimed a credit for income tax paid to other states. However, the taxpayers did not provide the necessary documentation required to show evidence of payment to other states and to verify the accuracy of the amount they claimed.

We also noted one instance where the Department provided excess credit in the amount of \$4,680 to joint income tax filers who had income from the State of Connecticut and from another state. The proportion of the credit granted to these taxpayers in relation to their total tax liability exceeded the proportion of their taxable income in relation to their Connecticut adjusted gross income.

*Effect:* The \$3,800 refunded to a taxpayer resulted in an overpayment. The income tax refunds issued to taxpayers who claimed credit for payments made to other states, without providing the required documentation, resulted in an outstanding tax liability from the taxpayers. Also, the excess credit resulted in a full refund to the taxpayers, of the tax paid for income from sources within the State, and created an overpayment to them. Receivable balances resulting from these overpayments might become lost revenue to the State if they become uncollectible and are abated.

*Cause:* The Department processes income tax returns as filed and issues refunds, if claimed, to the taxpayer. The tax returns are then reviewed, after a refund has been issued, to determine the accuracy of the information provided on them. The Department then pursues any overpayment made to the taxpayers as a result of the refund.

*Recommendation:* The Department should verify the accuracy of information provided by taxpayers on their tax returns prior to refunding them the amount they claimed on the tax return as payment in excess of the amount of tax due to the State, to minimize refund overpayments. (*See Recommendation I.*)

*Agency Response:* “The Department disagrees with this recommendation. The “Cause” is incorrect and misleading. The Department key punches returns as they are filed by the taxpayer. Returns will then automatically go through a series of “system edits” designed to identify inaccuracies as they are being processed. If a return is not affected by any of the edits the return is processed and posted to the system. The Department processed the returns based on how the return was filed by the taxpayer and the requirements of the Connecticut General Statutes.

Section 12-704(a)(2) of the Connecticut General Statutes limits the credit allowed on the Tax Return to the rate at which the State would have taxed the income earned from another jurisdiction. The return in question did not allow a credit in excess of the tax due.

The Form W-2 is only a mechanism for reporting wages, withholding and other tax payroll information for an employee. It is not the determining factor of where income is sourced. A taxpayer’s income is sourced to the appropriate state through the filing of a tax return. The original return from the taxpayer was correct as filed and met the criteria for processing that return. The taxpayer realized their error and filed a corrected return. Examining the Form W-2 along with the return as it was originally filed would still have resulted in this refund being sent out. Had the taxpayer not amended their return, only a “back-end” validation process would have identified the error, as it does with credit for income tax paid to other states.

The Department’s responsibility to the taxpayers of Connecticut is to process returns in the most efficient manner possible. The Agency is moving forward in the electronic filing of returns and return information. This move necessitates a change in return processing, putting into place additional “front-end validations” and relying on “back-end” processes to validate the return”.

*Auditor's Concluding Comment:*

The “Cause” was not intended to suggest that the Department has no “system edits” in place to identify inaccuracies as returns are processed. The Department’s “system edits” did not identify the inaccuracy in these returns so, the returns were processed as filed and the taxpayers were allowed the excess tax credit and the refund, which created the overpayments. The Department has not collected the overpayments from all of these taxpayers.

**Item 2 – Hold Status Placed on Accounts not Being Released Promptly**

*Background:*

The Department places accounts on hold status to resolve issues between a taxpayer and the State. Once an account is placed on hold status, the taxpayer cannot be contacted for payment of the amount due and a bill cannot be sent to the taxpayer for the particular account for which the hold was placed, until the issue is resolved. However, the account continues to accrue interest while it is on hold. Once the issue is resolved, the account is released from the hold status. The taxpayer can then be contacted and the account pursued for collection.

*Criteria:*

According to Section 12-415(f) of the Connecticut General Statutes, every notice of a deficiency assessment shall be mailed within three years after the last day of the month following the period for which the amount is proposed to be assessed or within three years after the return is filed, whichever is later.

Effective procedures to periodically review accounts placed on hold status would enable relevant issues pertaining to those accounts to be resolved as soon as possible. It would also enable the hold status to be released so that the taxpayers could be billed.

*Condition:*

We noted the following conditions for three of the ten accounts placed on hold status, which we reviewed.

1. One account totaling \$82,000, was placed on hold in October 2003, in order to allow the Department to make a revision on the initial audit bill. Agency personnel completed the revision and requested release of the hold in January 2004. However, the hold was not released for the account to be billed, until we notified the Department in July 2004.
2. One account totaling \$2,400, was placed on hold on October 17, 2000, to correct a return billing. However, the hold on the account was not released after the correction until July 2004. The principal

balance of \$1,600 on the account continued to accrue interest during this period of time.

3. One account totaling \$1,550, was placed on hold on October 27, 2000, because a correction was needed to add penalty charges. The penalty was added, but the hold was never released. When we brought this to the attention of the Department in July 2004, the Department made a recommendation to write-off the account because the statute of limitation had expired.

*Effect:* The State lost revenue totaling \$1,550 because an account that was resolved was not released from hold status for billing before the statute of limitation expired. Other accounts inappropriately left on hold status are also at risk of becoming lost revenue to the State. When resolved accounts are not released for billing and collection, those accounts create an additional tax liability for taxpayers.

*Cause:* There was a delay in releasing the hold status on some accounts due to the implementation of the Integrated Tax Administration System (ITAS). Also, the Department was not aware that the hold status placed on the accounts was not released.

*Recommendation:* The Department should establish and implement effective procedures to periodically review all accounts that were placed on hold status to determine if the issue has been resolved and then allow the taxpayers to be billed, if necessary, before the statute of limitation expires. (*See Recommendation 2*).

*Agency Response:* “The Department agrees with the auditor’s findings. The “hold and release” process has been changed. Prior to the implementation of the Integrated Tax Administration System (ITAS) a manual release of the accounts on hold was required. The ITAS system will now automatically populate the release date with the system date plus 30 days when a “hold” is placed on a liability. When the release date passes, the hold is automatically released and a billing notice is generated to the taxpayer. The ITAS system has in place certain controls over the “hold” accounts and will automatically perform error-checking steps before an account is allowed to be put on hold. Releases will be made on holds unless intentional manual steps are taken to prevent it. Due to this system enhancement, it has been recommended that an ITAS billing hold report be generated by unit and distributed and reviewed to alert the division of any potential oversights. The Department will identify taxpayers that meet this criteria and will take any necessary action.”

**Item 3 – Erroneous Refund**

*Criteria:* Proper validation of the name and taxpayer identification number on income tax returns, by the tax system, prior to issuing a refund to taxpayers enhances internal control over cash disbursements. The validation process provides assurance to management that cash disbursements are correct and that established procedures are operating as intended. Effective controls help to minimize errors that may occur during transaction processing.

*Condition:* We noted one instance in our review of 25 accounts receivable transactions, where the Department issued two refund checks to two taxpayers who filed a joint income tax return. One of the checks was a refund issued in error to the spouse on the joint tax return.

*Effect:* The State made an erroneous payment totaling \$600 to the taxpayers. The payment may become lost revenue to the State if it proves uncollectible.

*Cause:* Weaknesses in the tax system’s validation of taxpayer identification information contributed to this condition.

*Recommendation:* The Department should strengthen validation parameters in the tax system with regard to taxpayer identification information. (*See Recommendation 3.*)

*Agency Response:* “The Department is aware that this programming issue exists in the current system. This system is in the process of being replaced with an Integrated Tax Administration System (ITAS) which will not allow this type of issue to occur in the future. The account in question was corrected and billed, the system then correctly generated the refund to the proper taxpayer. The \$600 in question has subsequently been collected along with additional penalty and interest.

As stated previously the Department is aware of the issue with the current system, which according to the Information Services Division (ISD), is a restriction with the software. As it was explained to the Auditor this issue only comes about in a unique circumstance involving two separate systems. With the limited ISD resources available to the Department and the significant amount of time required to correct this problem, we will address this issue in Phase 2 of the Integrated Tax Administration System implementation.”

**Appellate Case Reductions**

**Item 4 – Interest Acquisition Accounts**

*Background:* When a taxpayer appeals an audit assessment, the account is placed on appellate hold. The appellate hold status stops any contact with the taxpayer in regards to collecting the bill. It also stops the MBDB system from sending a monthly bill to the taxpayer for the subject assessment. However, interest continues to accrue on the tax liability while the case is on appeal. Taxpayers can minimize the accrual of interest by making a deposit in the nature of a cash bond or by paying the tax liability, under protest, in full or in partial, pending the final resolution of the appellate case.

*Criteria:* The Department’s efforts and programs designed to increase public awareness of the State tax laws and to obtain voluntary compliance from the taxpayers would be enhanced by settling appeals by the taxpayers in a timely manner. Settling the appeals in a timely manner will also enhance the effectiveness of the Department’s future audits of the taxpayers. It will ensure that audit assessments will not be made on the same issues previously appealed by a taxpayer and resolved with the State.

*Condition:* Fourteen interest acquisition cases totaling \$59,699,416 have been in the appellate inventory of cases between 570 days to 2,218 days. Some of these cases were audit assessments by the Department on corporation business taxpayers for multiple years’ tax liabilities. The cases were appealed by the taxpayers, and are on the appellate hold status, due to adjustments by the Department for interest acquisition expenses deducted by the taxpayers in reporting their income subject to State tax. Due to the length of time that these cases have been on appellate hold, the accrued monthly interest on some of the accounts has exceeded the taxpayers’ original tax liability. In one case, the total accrued interest is \$5,283,000 greater than the total amount of tax assessment due from the taxpayer. By statute, the Department must review tax returns within three years to determine their correctness. Due to this statutory requirement, the Department makes an assessment on the taxpayers for the same issues that taxpayers have appealed, but not settled with the State.

*Effect:* Corporation business taxpayers can appeal adjustments made by the Department when earlier appeals on the same issue have not been resolved. The adjustments become part of the accounts receivable balance. The accounts continue to accrue interest,

thereby increasing the taxpayer's liability. These adjustments could be overstating the accounts receivable from these taxpayers if the taxpayers' appeals are sustained.

*Cause:* The Department is currently reviewing the interest acquisition accounts under appeal to determine whether to settle or to litigate those cases. Also, the three year statute of limitation required for the Department to determine the correctness of returns filed by taxpayers compels the Department to audit and make an assessment on taxpayers on the issues appealed, but not yet resolved.

*Recommendation:* The Department should evaluate the status of the interest acquisition accounts and resolve the cases so that the accounts do not continue to accrue interest. The Department should also resolve these cases to enhance the effectiveness of the audit of the taxpayers to determine the correctness of the tax returns they file. *(See Recommendation 4.)*

*Agency Response:* "The Department agrees with this recommendation. The Office of Planning and Organizational Development (OPOD), an internal division within the Department of Revenue Services, has recently reviewed the Appellate process and the reason for the increase in cases that are appealed. OPOD has recommended changes that are in the process of being implemented. The recommendation that is mentioned relates to a policy decision which was unduly complex. At issue was whether a taxpayer is entitled to deduct interest expense attributable to a debt it assumed in a reverse triangular merger. The Appellate Division has recently received approval from the General Counsel to resolve these fourteen acquisition cases. The case in question has been resolved as well as two others of lesser dollar amounts. The taxpayers of the remaining cases have been contacted and conferences have been scheduled."

## **Tax Amnesty Program**

### **Item 5 – Taxpayers Identifiable Prior to Tax Amnesty**

*Criteria:* Section 12-735(b) of the Connecticut General Statutes states that if any person has not made a return within three months after the due date for filing the return, the Commissioner may make such a return at any time thereafter, according to the best information obtainable and according to the form prescribed.

*Condition:* Our review of 65 taxpayers who participated in the 2002 Tax Amnesty program found that the Department could have already identified and billed six of the taxpayers owing a total of \$33,522

in outstanding tax liability. Some of these tax liabilities are six years or older. Also, we noted that these same six taxpayers participated in the 1995 Tax Amnesty program.

*Effect:* The Department provided a 25 percent interest reduction amounting to \$2,395 to taxpayers who had previously filed for tax amnesty and are already in the State tax system. The State could have collected this amount, plus an additional penalty waiver amounting to \$1,646 from these taxpayers, had they been identified and billed prior to the tax amnesty program.

*Cause:* The Department did not identify and verify the payment status of these taxpayers who were participants in a previous tax amnesty program to ensure that they continued to file and pay their taxes or to bill them if they did not pay.

*Recommendation:* The Department should verify the payment status of all taxpayers, make an estimate, and bill the taxpayers for all years for which the taxpayers failed to make a return. (*See Recommendation 5.*)

*Agency Response:* “The Department disagrees with this recommendation. When available, the Department does in fact bill taxpayers on what is referred to as Best Information Available (BIA). This can include Federal Tax Return information and any other information available to the Department. In reviewing the "Backup for Summary of Audit Findings" that was provided, we found that none of these taxpayers met the specific criteria used in billing taxpayers for other tax years prior to the 2002 Amnesty Program. The six cases referred to by the Auditor in the report would have been identified and billed at a later date. In each of the cases, there was no federal return filed, it was below the threshold, it was a zero tax due return, it was a late filed return or it was a “drop-filer”. The Department has recently developed a compliance program to address the issue of "drop-filers". The late-filed returns would have been billed through our "Prior Year Non-Filer Program" possibly bringing in more penalty and interest charges than Amnesty collected. There was no clear-cut information available to our Audit Division to bill these taxpayers prior to the start of the 2002 Amnesty program.

Our Audit Division has a Non-Filer Program that reviews Federal Income Tax returns and wage information for taxpayers. Taxpayers are billed for years that they have not filed if it was determined that a Connecticut Income Tax liability existed and it meets predetermined audit criteria. Approximately seventeen months after the Department receives the Federal

information, letters are sent to taxpayers indicating no Connecticut Income Tax return has been filed. The letters for the 2000 tax year were mailed out at the time of the 2002 Amnesty Program, which allowed these taxpayers to benefit from the program. The reason for the delay was the time lag involved in receiving the information from the Internal Revenue Service.”

*Auditor’s Concluding Comment:*

We acknowledge the Department’s disagreement with this audit recommendation, however, we stand by our finding.

## RECOMMENDATIONS

- 1. The Department should verify the accuracy of information provided by taxpayers on their tax returns prior to refunding them the amount they claimed on the tax return as payment in excess of the amount of tax due to the State, to minimize refund overpayments.**

Comments:

The Department refunded taxpayers who incorrectly claimed excess credit for income taxes paid to another state and other taxpayers who did not attach required documentation to their tax return, without properly verifying the returns to ensure that the amount of refunds the taxpayers claimed were correct. The refund resulted in overpayments to the taxpayers. The Department has not collected the overpayments from these taxpayers.

- 2. The Department should establish and implement effective procedures to periodically review all accounts that were placed on hold status to determine if the issue has been resolved and then allow the taxpayers to be billed, if necessary, before the statute of limitation expires.**

Comment:

The Department placed several accounts on hold status to resolve issues with the taxpayer. Although the issue was resolved on all the accounts, the hold was not released. The statute of limitation for billing one of these taxpayers expired while the accounts were still on hold status. The taxpayer was not billed and the Department made a recommendation to write-off the account because the statute of limitation had expired.

- 3. The Department should strengthen validation parameters in the tax system with regard to taxpayer identification information.**

Comment:

The Department issued a refund, in error, to the spouse on a joint income tax return because the tax system did not properly validate the taxpayer identification information provided by the spouse on the joint return. The lack of proper validation of the information resulted in an overpayment to the spouse.

- 4. The Department should evaluate the status of the interest acquisition accounts and resolve the cases so that the accounts would not continue to accrue interest. The Department should also resolve these cases to enhance the effectiveness of the audit of the taxpayers to determine the correctness of the tax returns they file.**

Comment:

Some cases classified as interest acquisition accounts have been in the appellate inventory of cases between 570 and 2,218 days. On average, the Department resolves appellate cases in about 418 days. These cases continue to accrue monthly interest, which increases the balance of tax liability due from the taxpayers.

- 5. The Department should verify the payment status of all taxpayers, make an estimate, and bill the taxpayers for all years for which the taxpayers failed to make a return.**

Comment:

The Department could have identified and billed many of the taxpayers who received the full benefit of the tax amnesty program at the expense of the State by making an estimate of the amount of tax they owe and billing them for that amount prior to another tax amnesty program. Taxpayers who had been identified and billed by the Department did not receive the same benefits of the tax amnesty program as those who have not been identified and billed.

## CONCLUSION

In conclusion, we wish to express our appreciation for the cooperation and courtesies extended to our representative by the officials and staff of the Department of Revenue Services.

Moses C. Ude  
Associate Auditor

Approved:

Kevin P. Johnston  
Auditor of Public Accounts

Robert G. Jaekle  
Auditor of Public Accounts