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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

September 29, 1997

Mr. Michael H. Urbach
Commissioner
Department of Taxation and Finance
Building 9, State Campus
Albany, NY 12227

Re: Personal Income Tax Refunds
Report 97-D-18

Dear Mr. Urbach:

Pursuant to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution, Section 111 of the State Finance Law and Section 686 of the State Tax Law, the following summarizes our review of the accuracy of personal income tax refunds processed by the Department of Taxation and Finance (Department) during the tax processing year ended December 31, 1995 and the tax processing year ended December 31, 1996.

A. **Background**

Section 171 of the State Tax Law authorizes the Department to determine and collect personal income taxes. The Department uses a series of manual and computer processing procedures to determine tax liability and to verify prepayment of taxes made either through withholdings from wages or payment of estimated taxes. Beginning with the 1995 processing year, the Department contracted with Fleet Bank to capture tax return data into the processing system. Where a taxpayer has overpaid a tax liability, the Department authorizes a refund and submits it to the Office of the State Comptroller (OSC) for pre-audit and payment. During the periods January 1, 1995 through December 31, 1995 and January 1, 1996 through December 31, 1996, the Department authorized and submitted refunds for pre-audit and payment as shown on the next page.

	1/1/95-12/31/95	1/1/96-12/31/96
Number of Refunds Submitted	5,464,602	5,554,822
Value of Refunds Submitted	\$2,493,150,742	\$2,677,033,224
Average Refund Amount	\$456	\$482

OSC staff on-site at the Department continuously review the Department's personal income tax processing. The methodology utilizes a three-phase approach. In Phase One, OSC staff review the Department's tests of its computer processing system before the system is used to process returns. During Phase Two, samples of tax returns are reviewed to verify the ongoing integrity of the processing system. In Phase Three, customized computer programs are used to identify for audit those returns that meet predetermined criteria.

This report summarizes the results of our reviews for the tax processing year ended December 31, 1995 and the tax processing year ended December 31, 1996. Details concerning exceptions were reported to Department officials at the time the exceptions were identified, so that corrective action could be initiated promptly.

B. Results of Audit

We found 16,613 refunds which contained material errors that prevented the payment of the refunds as they were submitted. After these returns were reprocessed, we determined that our pre-audit prevented overpayments totaling \$3,278,795.

In addition, we questioned the accuracy of 487 other refunds. These refunds were paid, but the related tax returns were referred to the Department for review of potential tax problems. As of December 31, 1996, the Department had billed taxpayers a total of \$118,766 for 127 of the 487 questioned refunds. The Department has not yet acted upon the other 360 returns; however we estimate that an additional \$763,921 will be billed by the Department. We also learned that 49 refunds, which we had questioned during prior processing years, were reevaluated by the Department during our audit period, resulting in billings totaling \$184,519. (The results of our audit are summarized in the attached Exhibit A.)

1. System Errors

The computerized segment of the processing system is a series of automated steps designed to edit and validate tax returns data in volume. The computerized edits are based on the New York State Tax Law and the Rules and Regulations for implementing the Tax Law. Computerized processing enables each tax return to be processed identically. Therefore, when an error occurs in a computerized edit (system error), each return processed against that edit will be processed incorrectly. Prompt identification of any system error is a top priority for both the Tax Department and OSC personnel. All returns identified as being affected by a system error are subsequently rejected and reprocessed by the Tax Department.

During the twenty four month return processing period ended December 31, 1996, OSC personnel identified thirteen system errors resulting in the rejection and reprocessing of 8,730 refunds; \$127,741 in overpayments were prevented when these refunds were reprocessed. Examples of the more significant errors follows:

- In both 1995 and 1996, we found that programs designed to recompute the Earned Income Credit were not working properly. The processing system should compute the Earned Income Credit based on the higher of the Federal or New York State adjusted gross income. The programs were not performing the computation as intended. The programs also determine if a NYS tax return is on file before processing a stand alone Earned Income Credit form. We found the stand alone Earned Income Credit forms were not being matched to the returns data file and in some cases they were being matched to the previous year's file. As a result, we voided 1,813 Earned Income Credit returns, preventing the overpayment of \$24,426.
- In 1995, the Department's computer system for processing amended returns was incorrectly programmed to calculate interest on all amended returns regardless of filing date. We rejected 935 amended returns which received inappropriate interest, preventing the overpayment of \$2,196.
- In 1996, the processing system did not check to determine if 1993 and 1994 Real Property Tax Credit returns filed in 1996 were duplicates of credits paid in the 1994 or 1995 calendar years. The programs designed to perform this check were not operational at the start of the 1996 processing year. We rejected 5,907 potential duplicate refunds and requested the Department to correct its programs and reprocess the returns. Reprocessing of the 5,907 returns resulted in the Department stopping 1,100 refunds as duplicates of issued refunds, saving approximately \$99,800.

2. Processing Errors

We identified 7,883 refunds from our pre-audit and stratified audit samples which contained errors. Overpayments prevented on these refunds were about \$3,151,055. The errors we identified resulted because taxpayers completed returns incorrectly and this was not detected by the Department, Department personnel made adjustments to the returns that were not consistent with Department policy, or Fleet Bank incorrectly captured return data. The overall error rate for all audited returns was 5.4 percent in 1995 and 3.06 percent in 1996. These rates are higher than the error rates we had found during the previous processing period. This increase in the error rates is attributable to the addition of scanning to the processing cycle. Of the 7,883 errors, 4,785 errors resulted from the incorrect scanning of lines on the returns, which went undetected in the Fleet data capture system. In addition to the errors detected, the Department asked us to reject for reprocessing another 12,320 returns because of incorrect addresses and incorrect or misspelled names.

3. Faster Refund Payments

Beginning with the 1995 processing year, the interest free period for processing personal

and withholding tax refunds was reduced to 45 days. To meet this mandate Department officials needed to process about 1.5 million more refunds each year in the April to May period than they had in previous years. The Department was successful in moving up the processing of the refunds. The success is attributable to the new technology added by Fleet Bank, a commitment on the part of Department management and employees to reduce the processing time for returns, and improvements in the payment processing procedures.

4. System Test

On an annual basis, the Department performs various tests of its income tax processing system (i.e., submitting test tax returns with known error conditions, to ensure that the system processes tax returns correctly). We review the system test performed by the Department to determine the level of reliance we can put on the processing system. For our review of the 1996 and 1997 processing years, which we undertook in 1995 and 1996 respectively, we expanded our review of the Department's system test to include the system test performed by Fleet Bank on its data entry and data capture system. Except for a memo of minor issues presented to the Department concerning the Fleet Bank system test for the 1996 processing year, our review indicated the entire system test for both the Department and Fleet Bank was adequate for evaluating system performance.

Major contributors to this report were John Corbett, H. Michael Luft, Mary Lou Oberting, Joyce Korona, Shirley Abele, Carol Baker, Jennifer Carrara, Jill Conway, John Gaefka, Katie Gavigan, Richard Hart, Janet Harrison, Ed Leitgeb, John Murphy, Barbara Nelson, Eileen Ryan, Beth Wixted and Nancy Lisicki.

We would appreciate receiving any comments you may have concerning the issues raised in this report within 30 days indicating any actions planned or taken. We also wish to express our appreciation for the courtesies and cooperation extended to our auditors during their review.

Very truly yours,

Jerry Barber
Audit Director

cc: Patricia Woodworth

EXHIBIT A

DEPARTMENT OF TAXATION & FINANCE AUDIT OF PERSONAL INCOME TAX REFUNDS SUMMARY OF OVERPAYMENTS PREVENTED FOR THE 24-MONTH PERIOD ENDED DECEMBER 31, 1996				
	Overpayments Prevented			
	Confirmed		Estimated	
Status	Number	Amount	Number	Amount
Rejected	16,613	\$3,278,795		
Questioned	127	118,766	360	\$763,921
Total	<u>16,740</u>	<u>\$3,397,561</u>	<u>360</u>	<u>\$763,921</u>
Prior Period ⁽¹⁾	<u>49</u>	<u>\$184,519</u>	<u>0</u>	<u>\$0</u>

Note to Exhibit:

⁽¹⁾ This is the status of refunds questioned in prior periods, that had not been reevaluated by the Department as of December 31, 1994.