

City of Detroit

OFFICE OF THE AUDITOR GENERAL



**Performance Audit of the Finance
Department – Income Tax Division**

April 2009 – September 2014




City of Detroit
OFFICE OF THE AUDITOR GENERAL
2 WOODWARD AVENUE, SUITE 216
Detroit, Michigan 48226
PHONE: (313) 224-4558
FAX: (313) 224-4091
www.detroitmi.gov

Mark W. Lockridge
AUDITOR GENERAL

MEMORANDUM

DATE: November 10, 2015

TO: Honorable City Council
Honorable Mayor Mike Duggan

FROM: Mark W. Lockridge, CPA 
Auditor General

RE: Performance Audit of the Finance Department – Income Tax Division

CC: John Hill, Chief Financial Officer
John Naglick, Chief Deputy CFO/Finance Director

Attached for your review is our report on the audit of the Finance Department – Income Tax Division. This report contains our audit purpose, scope, objectives, methodology, and conclusions; background; our audit findings and recommendations; and the responses from the Finance Department and the Budget Department.

Responsibility for the installation and maintenance of a system of internal control that minimizes errors and provides reasonable safeguards rests entirely with Income Tax Division and the Finance Department. Responsibility for monitoring the implementation of recommendations is set forth in Section 7.5-105 of the City Charter which states in part:

Recommendations that are not put into effect by the department shall be reviewed by the Finance Director who shall advise the Auditor General and the City Council of the action being taken with respect to the recommendations.

We would like to thank the employees of the Income Tax Division for their cooperation and assistance extended to us during this audit.

Copies of all of the Office of the Auditor General reports can be found on our website at www.detroitmi.gov/How-Do-I-Find-Detroit-Archives/Auditor-General-Audits-Archives

**Performance Audit of the Finance Department –
Income Tax Division**

April 2009 – September 2014

Contents

	<u>Page</u>
AUDIT PURPOSE, SCOPE, OBJECTIVES, METHODOLOGY AND CONCLUSIONS	1
BACKGROUND	3
STATUS OF PRIOR AUDIT FINDINGS	5
AUDIT FINDINGS AND RECOMMENDATIONS	
1. The Income Tax Division Fails to Adequately Manage Collections	6
2. Income Tax Refunds Are Not Processed on a Timely Basis	8
3. The Income Tax Refund Process Lacks Adequate Internal Controls	9
4. Failure to Assess Interest on Taxpayers Who Do Not Comply with the Estimated Tax Requirements	11
5. Employer Tax Withheld Is Not Matched to Employee Tax Withheld Claimed	12
6. Inadequate Utility Users Tax Processing Procedures	13
7. The Income Tax Division Does Not Adequately Safeguard Confidential Information	15
8. There Is No Active Income Tax Board of Review	16
9. Capital Asset Policies and Procedures Are Not Followed	17
10. Non-Compliance with Year-end Closing Procedures	18

FINDINGS RELATED TO OTHER DEPARTMENTS

19

- 1. The Finance Department Record Safeguarding Procedures Are Not Adequate**

AGENCY RESPONSES

Finance Department

ATTACHMENT A

AUDIT PURPOSE, SCOPE, OBJECTIVES, METHODOLOGY AND CONCLUSIONS

AUDIT PURPOSE

The audit of the Finance Department – Income Tax Division was performed in accordance with the Office of the Auditor General’s (OAG) Charter mandate to make audits the financial transactions, performance and operations of City agencies based on an annual risk-based audit plan prepared by the Auditor General, or as otherwise directed by City Council.

AUDIT SCOPE

The scope of this audit was an independent review and assessment of the income tax process as administered by the Income Tax Division of the Finance Department for the period April 2009 through September 2014.

Our audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States, except for the completion of an external peer review of the Office of the Auditor General within the last three years.

AUDIT OBJECTIVES

The overall audit objectives were:

- To assess the internal controls related to financial transactions;
- To determine compliance with Finance Directives, policies, plans, procedures, laws, and regulations;
- To conduct a follow-up review of the audit findings and issues of non-compliance from the prior audit report; and
- To assess the effectiveness and efficiency of Income Tax Division operations.

AUDIT METHODOLOGY

To accomplish our audit objectives, our audit work included:

- A review of prior audit reports;
- A review of pertinent ordinances, Finance Directives, policies and procedures;
- Interviews with Income Tax Division personnel and other personnel involved in the tax process;
- Documentation of the various tax processes;
- Observation and testing of income tax processes and procedures that we considered adequate to accomplish our objectives; and
- Other audit procedures necessary to accomplish our objectives.

CONCLUSIONS

As a result of our audit we have concluded that:

- There are internal control weaknesses over annual returns, Utility Users Tax, the Tax Administrative System, and the refund and collection process.
- The Income Tax Division is not fully compliant with Finance Directives, policies, plans, procedures, laws, and regulations.
- Core operations contain significant deficiencies that negatively affect effectiveness and efficiency.
- Seven of the previously cited prior audit findings have not been resolved. Three were partially resolved.

BACKGROUND

The Income Tax Division is responsible for administering the City's income tax and the utility users tax. Services provided by this division include tax return preparation, taxpayer assistance, and collection of income and utility users taxes, income tax payment plans, and enforcement of the income and utility users tax ordinances.

The City derives its income taxing power from the Michigan Public Act 284 of 1964, as amended and adopted by the City under Ordinance 900-F. Act 284, P.A., 1964 provided that the City could levy a 3% income tax on income earned by resident individuals, 2% income tax on corporate income earned within the City, and a 1.5% income tax on nonresident individual's income earned within the City. The act also provides for the collection of estimated and withheld income taxes.

Act 500, P.A., 1998 reduced the City's income tax rates by one-tenth of a percentage point per year for residents and one-twentieth of a percentage point for non-residents over a ten-year period, until rates are 2.0% and 1.0% respectively. Act 500, P.A., suspension of the tax rate reductions can occur if any three of the following economic and financial criteria are met:

- Funds are withdrawn from the City's budget stabilization fund for two or more consecutive City fiscal years or there is a balance of zero in the City's budget stabilization fund.
- The City's income tax revenue growth rate is 95% or less.
- The local tax base growth rate is 80% or less of the statewide tax base growth rate.
- The City's unemployment rate is 10% or higher according to the most recent statistics available from the Michigan Jobs Commission.

In fiscal year 2012, the City of Detroit tax rate reductions fell to 2.4% for residents, 1.2% for non-residents and 2.0% for corporations.

Beginning January 1, 2016, the State of Michigan Department of Treasury will process the City's individual income tax returns for the tax year beginning January 1, 2015. If the State of Michigan Treasury receives returns for tax years that end before 2015, the returns will be sent to the City for processing by the City.

Beginning January 1, 2017, the State of Michigan Department of Treasury will process the City's corporate income tax returns, unincorporated information returns, composite income tax returns and fiduciary income tax returns for tax years beginning on or after January 1, 2016. If the State of Michigan Treasury receives returns for tax years that end before 2016, the returns will be sent to the City for processing by the City.

According to the Human Resources Department, currently the Income Tax Manager position is vacant.

Ms. Tanya Stoudemire served as the Income Tax Manager from March 2012 to May 2015.

Ms. Charlene Carter-Sims served as the General Manager from November 2003 to March 2012.

The following table shows the Budgeted Appropriations of the Income Tax Division, and Municipal Income Tax Revenue for the City of Detroit, for fiscal years ended 2012 through 2014:

	<u>Fiscal Years Ended June 30</u>		
	<u>2012</u>	<u>2013</u>	<u>2014</u>
Appropriations	\$ 4,225,087	\$ 4,181,366	\$ 5,297,234
Revenues	\$ 250,000,000	\$ 228,000,000	\$ 239,700,000
Number of Staff	40	36	42

STATUS OF PRIOR AUDIT FINDINGS

The Auditor reviewed three prior audit reports of the Finance Department – Income Tax Division issued by the Office of the Auditor General. The audit reports are: an Internal Control Audit for the period April 2004 through February 2006, a Performance Audit for the three years ended June 30, 1995 and a Performance Audit for the period of April 2007 through March 2009. These reports included the findings listed below. The date following the finding indicates the date of the audit report in which the finding was first reported.

1. Failure to Assess Taxpayers Who Fail to Comply with the Estimated Tax Provisions of the Income Tax Ordinance (June 1992)
This finding has not been resolved. See finding 5 on page 13.
2. Need to Process City Income Tax Refund on a Timely Basis (June 1992)
This finding has not been resolved. See finding 3 on page 10.
3. Need to Substantiate Reported Withholding Amounts (June 1988)
This finding has not been resolved. See finding 6 on page 14.
4. Additional Corporate Auditors Needed to Maximize Income Tax Revenue. (June 1992)
This finding has not been resolved. See finding 2 on page 8.
5. Need for Section-wide Comprehensive Formal Procedures Manual (June 1984)
This finding has been partially resolved. See findings 3, 4, and 7 on pages 10, 11, and 15, respectively.
6. Need for Comprehensive Formal Procedures and Allocation of Staff to Monitor Compliance with the City's Utility Users Tax Ordinance (June 1988)
This finding has not been resolved. See finding 7 on page 15.
7. Need to Match Income from Partnership Returns to the Partner's Individual Income Tax Return (June 1992)
This finding has been resolved.
8. Need to Conduct Periodic Reconciliations of the City's Accounting System to the City's Computerized Income Tax System (June 1984)
This finding has not been resolved. See finding 7 on page 15.
9. Need Improved Utilization of the City's Income Tax System Through the Use of Analytical Applications (June 1984)
This finding has been partially resolved. See finding 1 on page 6.
10. Lack of a Current and Comprehensive ITS Reports/Production Manual (June 1984)
This finding has been partially resolved. See findings 3, 4, and 7 on pages 10, 11, and 15, respectively.

AUDIT FINDINGS AND RECOMMENDATIONS

1. The Income Tax Division Fails to Adequately Collect Tax Revenue

The Income Tax Division fails to adequately manage and actively collect income taxes on the earnings of construction project workers, athletes, and entertainers who work and/or perform in the City of Detroit. Each year the City of Detroit hosts various construction projects, athletic games, and entertainers. Unlike other cities that levy income taxes which include Cincinnati, OH, New York City, NY, and Philadelphia, PA, the city is not actively collecting taxes on the various construction project workers, athletic team members, and entertainers.

We estimate that during the 2013-2014 and 2014-2015 seasons, the City of Detroit has lost an average of \$1.7 million in income tax revenue each year that could have been collected from professional athletes participating in baseball, football, and hockey games that were played in Detroit. This does not include the lost income tax revenue from construction project employees and entertainers.

An effective internal control system requires that all procedures be in place and implemented that ensure that there is adequate control over the assessments, billings and collection of revenues.

Section 18-10-12 (c) (1) of the Detroit Municipal Code requires individuals, unincorporated entities and corporations to file a declaration of estimated tax and to make estimated tax payments if city income tax is not withheld from their taxable income. Estimated taxes do not have to be declared or paid if the estimated tax liability is \$100 or less for individuals and unincorporated entities or less than \$250 for corporations. Sections 18-10-17 (a) (3) and (4) provides for interest to be assessed on the deficiency amount at the rate of one percentage point above the adjusted prime rate per annum from the time the payment was due until paid.

Failure to effectively collect revenue reduces the amount of revenue available to the City to pay for operations. Public knowledge of the lack of collection efforts undermines the City's ability to collect monies owed.

According to Income Tax Division management, Field Investigators have been assigned and are responsible for actively contacting companies or representatives of construction project workers, athletes, and entertainers so that income taxes can be paid on their earned income.

Recommendations

We recommend that the Income Tax Division:

- Assess, bill, and tax construction project workers, athletes, and entertainers who work and/or perform in the city.
- Assign Income Tax Division personnel to obtain the various schedules of athletic teams and entertainment venues at the beginning of each season or prior to performances.

- Monitor and review building permits for planned construction projects.
- Contact athletic teams and entertainment venues directly.
- Contact general contractors to obtain the names of subcontractors.
- Attend Pre-construction meetings to obtain required individual income tax information.

2. Income Tax Refunds Are Not Processed on a Timely Basis

A review of the Income Tax Process determined that the City continues to pay significant interest on refunds. Interest paid after the mandated forty-five day period was \$494,797 for the audit period which was April 1, 2009 to September 30, 2014.

Michigan Compiled Laws (MCL) require municipalities to include interest on refunds that have not been paid after the filing of the tax return. Interest is accrued at a rate of one percentage point above the adjusted prime rate per annum as established in MCL sections 205.23 and 205.30.

Although the Division has made strides to improve the processing time of refunds and interest payments have decreased by \$200,000 since the last audit period, the payment of interest over \$400,000 on refunds is significant and an unnecessary expense.

By processing income tax returns in a timely manner, the Income Tax Division could save the City over \$400,000 in interest payments which would contribute funds to the city.

Currently interest payments that are owed on income tax refunds are additional unnecessary debt to the City. This debt can be eliminated by processing income tax returns in a timely manner.

According to Income Tax Division management, some returns are not processed within the 45 day period because of limited staff.

Recommendation

We recommend that the Income Tax Division:

- Implement procedures and secure the necessary resources to enable the Division to process refunds within the forty-five day period as specified.
- Eliminate interest payments
- Assess interest and penalties on taxpayers who own the city

3. The Income Tax Refund Process Lacks Adequate Internal Controls

During our review of the internal controls over the Income Tax Division's refund process, the auditor could not verify that the following internal control deficiencies have been corrected:

- No documented criteria are used for performing audits of estate and trust returns.
- There is no supervisory review of the work performed by the one person responsible for auditing, reviewing, and posting data changes in the Income Tax accounting software for these returns.
- There is no supervisory review of income tax investigators' refund audit process for individual tax returns.
- No legal action was pursued against three individuals that submitted fraudulent tax returns in an attempt to claim refunds totaling \$33,000.

Good internal controls require:

- Policies and operating procedures should be in writing and communicated to employees. Such documentation provides day to day guidance and facilitates training.
- Duties to be segregated among different people to reduce the risk of errors or misappropriation. No one person should have control over all aspects of financial transactions. An individual should not have responsibility for more than one of the three transaction components: authorization, custody, and recordkeeping.
- Internal control systems should be monitored. Monitoring is a process that assesses the quality of the system's performance over time. Ongoing monitoring occurs in the ordinary course of business and includes regular management and supervisory activities and other actions personnel take in performing their duties.
- Sec. 18-10-17 (a)(12) of the municipal code provides that if any part of the deficiency or an excessive claim for credit is due to a fraudulent intent to evade the tax imposed under this article, or to obtain a refund for a fraudulent claim, a penalty of one hundred (100) percent of the deficiency, plus interest as provided in subsection (b)(1)--(4) of this section, shall be added. The penalty becomes due and payable after a final assessment is issued as provided for in subsection (c)(2) of this section.

Failure to maintain good internal controls over refunds can lead to a loss in revenues and less efficient use of resources. Failure to properly segregate duties pertaining to refunds, including the ability to authorize, access, and modify data stored in the Income Tax accounting software, could lead to misappropriation or fraud. Lack of written procedures for processing tax returns weakens internal controls over returned refund checks.

Failure to pursue legal action against the individuals that submitted fraudulent tax returns sets a bad example for other taxpayers and may lead to an increase in fraudulent tax returns in the future.

Income Tax Division management indicated that:

- The Income Tax Division does not have enough staff to adequately segregate duties and to perform supervisory reviews of the audits of corporate, partnership, estate, trust, and individual returns.
- Staff shortage and lack of legal expertise are the primary reasons ITD did not pursue legal action against the individuals that submitted the fraudulent tax returns.

Recommendations

We recommend that the Income Tax Division:

- Strengthen internal controls over the refund process including adequate supervisory reviews.
- Establish supervisory review of corporate, partnership, estate, trust and individual refund returns.
- Establish written procedures for handling returned refund checks.
- Refer fraudulent returns to the Law Department for legal action.

4. Failure to Assess Interest on Taxpayers Who Do Not Comply with the Estimated Tax Requirements

The income tax ordinance sets out the requirement for the payment of estimated city income taxes. The Income Tax Division's practice of not assessing and collecting penalty interest on taxpayers who fail to pay the required estimated tax by the required dates does not comply with the ordinance. The failure to assess interest on delinquent estimated income tax payments has been cited in prior audit reports going back to June 1992.

Section 18-10-12 (c) (1) of the Detroit Municipal Code requires individuals, unincorporated entities and corporations to file a declaration of estimated tax and to make estimated tax payments if city income tax is not withheld from their taxable income. Estimated taxes do not have to be declared or paid if the estimated tax liability is \$100 or less for individuals and unincorporated entities or less than \$250 for corporations. Sections 18-10-17 (a) (3) and (4) provides for interest to be assessed on the deficiency amount at the rate of one percentage point above the adjusted prime rate per annum from the time the payment was due until paid.

The failure to collect interest penalties on delinquent income tax payments results in a loss of revenue for the City. It encourages taxpayers to ignore the estimated payment requirements because there are no consequences, and it defers revenues that should have been received by the required due dates.

According to the Income Tax Manager, although the Tax Administrative System (TAS) was not implemented with the capability of assessing interest penalties on taxpayers who fail to pay estimated taxes by the required due dates, the new Income Tax Division accounting system does have the capability to assess interest penalties on taxpayers who fail to pay estimated taxes by the required due dates.

Recommendations

We recommend that the Income Tax Division:

- Determine the annual loss of interest revenue to the City.
- Begin assessing and collecting interest penalties on delinquent estimated income tax payments as soon as possible.
- Consider the feasibility of computing interest penalties on delinquent estimated income tax payments using an electronic spreadsheet.

5. Employer Tax Withheld Is Not Matched to Employee Tax Withheld Claimed

Employers are required to fill out a withholding registration form (D-SS4) for City resident employees and non-resident employees that worked in the City. Employers having withholding taxes greater than \$100 are required to file a withholding registration form every month. Taxpayers can deduct the total withholding tax reported on their W-2s local tax section from the total income tax payable to the City.

The Income Tax Division does not reconcile withholding taxes received from employers for payroll deductions to the respective withholding claimed by their employees on the withholding statements (W-2) submitted and their individual tax returns.

Best practices require that prevention techniques are a deterrent of financial risk and fraud attempts. Good accounting procedures require the verification of the accuracy of the tax revenue the City received from employer tax withholdings to the amount claimed by their employees.

When employer tax withholdings received are not matched to the respective employee withholdings claimed, there is no assurance that the withholdings claimed are valid. Employees could have increased the withholdings they claimed by falsifying their W-2 statements. Moreover, the employers may not remit withholding tax even though the employee W-2 is accurate. This would result in a loss of revenue that would remain undetected.

Income Tax Division management stated that the Income Tax Division did not have enough people to do the matching manually, but the new software does have the capability of an automated matching program.

Recommendation

We recommend that the Income Tax Division include a proposal to update the Income Tax software in its capital budget to perform the tasks of matching employer tax withholdings to the total of employee withholdings claimed.

6. Inadequate Utility Users Tax Processing Procedures

According to Section 141.1152 of the City Utility Users Tax Act, “the city may levy, assess, and collect from those users in that city a utility users’ tax.” It is the responsibility of the Finance Income Tax Division to ensure that all taxes that are owed to the city are paid in a timely manner. These include utility user taxes that should be paid by companies such as AT&T, Comcast, DTE, and Detroit Thermal LLC.

Our review of the Income Tax Division’s utility users’ tax process revealed the following deficiencies:

- There are no standard procedures in place to identify utility users tax non-filers.
- The Income Tax Division does not have the capability to assess utility user taxes.
- The Income Tax Division does not take action against utility companies that are not filing annual returns.

Section 18-11-9 of the Municipal Code (Uniform Utility Users Tax) provides:

If the administrator determines that a user has failed to apply the full amount of the tax due under this article, he may, or if he determines that a public utility or resale customer has failed to remit the amount of tax money received from users, and due the city, he shall issue a proposed assessment showing the amount due and unpaid, together with interest and penalties that may have accrued thereon. The proposed assessment shall be served upon the user, public utility or resale customer in person, or by mailing by registered or certified mail to his last known address. Proof of mailing the proposed assessment is prima facie evidence of a receipt thereof by the addressee.

Section 18-11-4 provides, “An annual return for each year shall be filed by the public utility and resale customer on or before the end of the fourth month following the end of the tax year.”

The Detroit Utility Users Tax Annual Return, Form D-U1A, serves as annual account reconciliation for the calendar year. Every account must file an annual reconciliation on Form D-U1A.

The Instructions for Form D-U1 Detroit Utility Users Tax Monthly Return provides, “A return must be filed for each month of the calendar year...Public utilities and resale customers should report the amount of tax billed utility users during the month shown on the return.”

Good accounting practices require accounting records be adjusted periodically, usually monthly, to reflect corrected transaction activity and account balances.

Possible effects of the deficiencies in the utility users tax process are:

- By not billing non-filers in a timely manner, the City is not receiving the maximum available tax revenue.
- Without filing an annual return, an underpayment for utility users tax may go undetected, which results in the City not receiving the maximum tax revenue.
- The Income Tax accounting software serves as a subsidiary ledger to the Detroit Resource Management System (DRMS). The utility users tax assessment totals per the Income Tax accounting software should represent accounts receivables for utility users tax. If no account receivables for utility users tax actually exist, the two systems are not properly reconciled.

Representatives of the Income Tax Division provided the following explanations:

- The Division is not identifying and billing non-filers due to lack of staff.
- In the past, the Income Tax Division sent out letters to utilities requesting them to file annual returns but no responses were received from the companies. No other action has been taken due to lack of staff.
- Some of the accounts in the Income Tax accounting software are old accounts that need to be reconciled or deleted, but the Income Tax Division does not have the staff to perform the account reconciliations.

Recommendations

We recommend that the Income Tax Division:

- Levy, assess, and bill utility companies that owe taxes to the city.
- Establish standard procedures to identify non-filers of utility users' tax.
- Notify the utility companies that are not filing annual returns, and follow up to obtain the necessary annual utility users tax returns.
- Contact the utility companies that are not filing monthly utility users' tax returns, and instruct them to file monthly returns along with their payments.
- Assign personnel to reconcile utility users' tax assessment totals in the Income Tax accounting software to DRMS.

7. The Income Tax Division Does Not Adequately Safeguard Confidential Information

The Income Tax Division's current storage practices do not adequately safeguard confidential data and physical storage facilities. Income tax data are easily accessible and not adequately safeguarded. They are filed in plain cardboard boxes with lift off tops and stored in the Basement Storage area. Individual return information is accessible to persons not authorized to access this information.

According to Michigan Department of Treasury Safeguard Requirements of Confidential Data:

- Access to tax returns and tax return information will be allowed only to those authorized employees... who need the information to perform their official duties.
- Any records created from tax returns and tax return information will be stored in an area that is physically safe from access by unauthorized persons during duty hours, as well as off-duty hours, or when not in use.
- All personnel who will have access to the tax returns, and to any records created by the tax return information, will be advised of the confidential nature of the information, the safeguards required to protect the information and the civil and criminal sanctions for noncompliance contained in MCL 205.28(1)(f) and (2).
- All confidential information, which includes, but is not limited to, data stored electronically and any related output and paper documents, will be secured from unauthorized access and with access limited to designated personnel only.

Failure to keep taxpayers information confidential, such as social security numbers and addresses, could lead to identity theft.

According to Income Tax Division management, the storage container found in the basement which contains the confidential information that belong to tax payers does not belong to the Income Tax Division. It belongs to the Finance Treasury Division.

Recommendation

We recommend that the Income Tax Division institute procedures and practices to adequately safeguard confidential information.

8. There Is No Active Income Tax Board of Review

Based on our review the last Income Tax Board of Review meeting was held in the late 1980s or early 1990s. Currently, there are no appointed Income Tax Review Board members. Therefore, taxpayers have no means to appeal a final tax assessment without appealing directly to the State. City Ordinance created the Income Tax Board of Review to give taxpayers an unbiased means to appeal final tax assessments of the Income Tax Division before having to appeal to the State Commissioner of Revenue.

City of Detroit Ordinance No. 900-F Sec. 91 provides, "The governing body of the city shall appoint an income tax board of review consisting of 3 residents of the city who are not city officials or employees." The governing body as described in Sec. 18-10-18 of the municipal code is City Council. Sec. 92 provides, "A taxpayer or employer may file a written notice of appeal with the secretary of the Income Tax Board of Review within 30 days after receipt of a final assessment, denial in whole or part of a claim for refund, or special ruling of the administrator. Upon receipt of the notice of appeal, the board of review shall notify the administrator, who shall forward within 15 days to the board a certified transcript of all actions and findings taken by him relating to the matter under appeal." Sec. 18-10-22 of the municipal code provides that "A taxpayer or employer aggrieved by a final assessment, denial, decision, or order of the Income Tax Board of Review, other than a decision under subsection (1) of this section, may appeal the assessment, denial, decision, or order to the tax tribunal not more than thirty-five (35) days after the final assessment, denial, decision, or order is issued."

Without an active Income Tax Board of Review, taxpayers wishing to appeal a final tax assessment do not receive the third-party due process as intended, and required by City Ordinance. The failure to ensure an active Income Tax Board of Review denies taxpayers their right to due process under the law.

As of July 2015, one of the three members was appointed to the Income Tax Board of Review. The appointed member term expires in June 2016. No other appointments have been made to the Income Tax Board of Review.

Recommendation

We recommend that the Income Tax Division contact the Law Department, the Mayor's Office, and the City Council to request that they take the necessary action to select and appoint an Income Tax Board of Review.

9. Capital Asset Policies and Procedures Are Not Followed

During the testing of internal controls for the Income Tax Division's capital assets, the following weaknesses were identified:

- No physical inventory has been performed since 2007.
- Newly purchased and tagged inventory was not listed on the Income Tax Division's Asset Inventory Report.
- Inventory items removed from the Income Tax Division are still on the Asset Inventory Report.

Capital Asset Finance Directive 95 requires that City Departments shall perform an inventory update of their capital assets at least annually before the end of each fiscal year and reconcile to the Oracle capital asset inventory report.

Failure to perform an annual physical inventory increases the risk of inaccurate capital asset records, misappropriation and fraud. Not reconciling the physical assets with items in the Oracle Capital Asset System weakens the integrity of the Income Tax Division capital asset internal controls.

Income Tax Division management stated that the lack of staff and knowledge as the reasons why a physical inventory of assets has not been performed and newly purchased assets have not been entered into DRMS.

Recommendations

We recommend that the Income Tax Division perform physical inventories annually and reconcile results to the Oracle Capital Asset System.

10. Non-Compliance with Year-end Closing Procedures

The Income Tax Division failed to submit year-end closing exhibits to the Finance Department Accounts Division by the scheduled due dates.

The following conditions existed:

- For year ending June 2013, out of 21 required year-end forms, 21 or 100% were not on file or submitted to the Finance Department.
- For the year ending June 2014, out of 22 required year-end forms, 22 or 100% of the forms were not on file or submitted to the Finance Department.

According to Finance Administration policies and procedures, it is critical that each agency adhere to the due dates outlined in the Fiscal Year End Closing Instructions and it is the Agency's responsibility to submit all required information accurately, completely, and timely.

In addition, each agency still must submit required forms even if the forms are not applicable to the city agency. The form preparer must enter N/A on the form, sign it, and have the form signed by an approved signor.

Non-compliance with the Year-End Closing Procedures could delay the Finance Department from compiling accurate year-end information for the City of Detroit Comprehensive Annual Financial Report (CAFR). Also, not submitting timely documents prevents the external auditors from completing the financial audit on time in order to meet the State mandated due date.

Income Tax Division management stated that the Income Tax Division was more concerned about journal entry accruals rather than year end forms.

Recommendation

We recommend that Income Tax Division should:

- Complete all required year-end forms and exhibits.
- Enter N/A on forms that are not applicable to the Income Tax Division.
- Ensure that all required forms are signed by approved signors.
- Submit all required year-end forms and exhibits to the Finance Department Accounts Division by the scheduled due dates.

FINDINGS RELATED TO OTHER DEPARTMENTS

1. Finance Department Record Safeguarding Procedures Are Not Adequate

During the review of the adequacy of controls over Finance Income Tax Division filing and record retention, it was determined that copies and supporting documents of Finance Department transaction records are not properly secure and/or safeguarded in the basement storage area.

Copies of confidential documents that belong to city residents and non-residents are stored in public areas that can be accessed by anyone who goes into the Basement Storage Area. The information includes personal items such as copies of personal identification and social security numbers. In one instance, a copy of a death certificate was found.

According to the State of Michigan Records Management Services Division guidelines, all documentation retained for the efficient operation of the City must comply with record retention guidelines, which include a safe and secure location. Particular attention must be given to records subject to legal retention requirements. Confidential information must be safeguarded against inappropriate access and use.

Access to any and all copies of confidential information entrusted to the City of Detroit Finance Department increases the possibility that improper or fraudulent transactions can be made and remain undetected. Critical records may be lost, removed, or destroyed. Confidential information may not remain confidential and certain information such as copies of personal identifications, social security numbers, and death certificates may permit unauthorized access to resident and non-resident personal data.

The auditor determined that a lack of management oversight lead to resident and non-resident tax payer personal and confidential information being exposed in the basement storage area. Although management has been informed in the past about problems with storing personal and confidential information, they did not correct the problem.

Recommendations

We recommend that:

- The Finance Department assumes responsibility for the basement storage area and properly secures confidential files.
- The Finance Department develops a long-range plan to scan documents and store them in a retrievable electronic format.

ATTACHMENT A



CITY OF DETROIT
FINANCE DEPARTMENT
INCOME TAX/RETURNS PROCESSING

COLEMAN A. YOUNG
MUNICIPAL CENTER
2 WOODWARD AVENUE, SUITE 1220
DETROIT, MICHIGAN 48226
PHONE 313-224-1715
FAX 313-224-1741
WWW.DETROITMI.GOV

November 5, 2015

Mark W. Lockridge, Auditor General
Office of the Auditor General
2 Woodward Avenue
Coleman A. Young Municipal center, Room 216
Detroit, MI 48226

RE: Response to Performance Audit of the Finance Department –
Income Tax Division

Dear Mr. Lockridge:

The following presents the Office of Treasury- Income Tax Division's response to the indicated findings and related recommendations in the audit, prepared by the Office of the Auditor General, of what is formerly known as the Finance Department- Income Tax Division for the period of April 2009 – September 2014.

Introduction

The City of Detroit former Finance Department- Income Tax Division has been severely understaffed for many years while also operating with seriously outdated systems. There has been a dramatic reduction in resources since the department's peak employment. Budget reductions during the Kilpatrick Administration resulted in many layoffs, a highly unusual situation in a revenue generating division anywhere. Since the announcement that the State Treasury Department will begin processing income tax returns in 2016, numerous employees have resigned under the presumption their positions would be eliminated. Recently we have augmented staff with both full and part time contractors, however we acknowledge that current staffing levels are inadequate.

Mark W. Lockridge, Auditor General
November 5, 2015
Page 2

As you are aware, the Office of the Chief Financial Officer ("Office of the CFO"), which includes the former Finance Department - Income Tax Division, is currently undergoing a major restructuring. The design of the restructured Office of the CFO was based on comparative and best-in-class municipalities and cities, nationally recognized in performing similar functions and work streams. The restructuring includes: reorganization of management structure, job titles, job duties, work flow processes, and with respect to the income tax, improvements to the tax software program. New staff positions with market-based salaries have been posted on the City's website since June 2015; thousands of applications have been submitted for positions throughout the Office of the CFO. Interviews are underway currently and we anticipate the Income Tax Division will have its new structure and the majority of its employees in place in January 2016.

In the interim, the former Finance Department- Income Tax Division has begun to address the issues noted in your report. We are making steady progress. In 2013, the City purchased a new tax software program, used by all other cities in Michigan that impose an income tax and by numerous cities in Ohio. The City's Department of Innovation and Technology ("DoIT"), the Office of Treasury- Income Tax Division, and the tax software vendor are working tirelessly to ensure a smooth transfer of historical records from the old system to the new system, while at the same time working with the State Treasury Department to ensure data compatibility between our two systems. The Division has hired an outside consulting firm to create a comprehensive training program to ensure proper use of the tax software program and maximize productivity.

Finding No. 1. The Income Tax Division Fails to Adequately Manage Collections

Department's Response:

The Income Tax Division acknowledges that historically it has neither managed adequately nor collected actively income taxes on the earnings of construction project workers, athletes, and entertainers who work and/or perform in the City of Detroit. We recently hired three auditors (contract employees) who have already initiated the Auditor General's recommendations. In addition, we are working closely with the Office of Contracting and Procurement; Human Rights Division; the Buildings, Safety, Environmental and Engineering Division; and the Jobs and Economy Team to share

information and coordinate efforts to identify all potential taxpayers. The reorganized Income Tax Division includes plans for staff dedicated to this segment of taxpayers.

Finding No. 2. Income Tax Refunds Are Not Processed on a Timely Basis

Department's Response:

We have hired numerous temporary personnel to process refunds more timely. Regardless, the Income Tax Division acknowledges that it has paid an unacceptable amount of interest on refunds. This is primarily due to the fact that the Division is severely understaffed, but it is also the result of challenges with the implementation of a new tax software program in 2014 and 2015. With the State Treasury takeover of the processing of income tax refunds and the availability of e-filing, we anticipate a substantially more efficient and timely process for paying refunds.

With regard to the Auditor General's recommendation to assess interest and penalties on taxpayers who owe the City, the Division emphasizes that we *are* assessing interest and penalty, which is automatically calculated by our tax software. In addition, more than \$600,000 in refunds have been disallowed for tax year 2014 in instances where the taxpayer had a prior year liability, interest and penalty.

Finding No. 3. The Income Tax Refund Process Lacks Adequate Internal Controls

Department's Response:

The Income Tax Division acknowledges the deficiencies in Finding 3. We agree with all of the recommendations. Note that the State Treasury will handle refund returns beginning with tax year 2015 for individuals and tax year 2016 for corporate, partnership, estate and trust returns. Our reorganized Division will have supervisory review of personnel handling refund returns for tax years that the State Treasury does not process. The Office of the CFO has also created an Administrative Issuance System that will, for example, establish internal policies and procedures through CFO Directives. We are also currently meeting internally and with the Law Department to establish processes for referring fraudulent returns and delinquent taxes for legal action.

Finding No. 4. Failure to Assess Interest on Taxpayers Who Do Not Comply with the Estimated Tax Requirements

Department's Response:

The Income Tax Division acknowledges it has not done an adequate job of assessing and collecting penalty and interest on taxpayers who fail to pay the required estimated tax by the required date. The Division intends to utilize the capabilities of the new tax software program to assess interest and penalty on non-individual estimated tax requirements for tax year 2015; the State Treasury will perform this function as it assumes processing of income tax returns.

Finding No. 5. Employer Tax Withheld Is Not Matched to Employee Tax Withheld Claimed

Department's Response:

The Income Tax Division acknowledges it has not adequately reconciled withholding taxes received from employers for payroll deductions to the respective withholding claimed by employees on the withholding statements (W-2) submitted and their individual tax returns. The Division is currently customizing the new tax software program to track withholding and monitor compliance of both employers and employees. Further, we are working with the Office of Contracting and Procurement, Human Rights Division and the Jobs and Economy Team to ensure that companies working on development projects in the City of Detroit are properly withholding, reporting, and remitting taxes.

Finding No. 6. Inadequate Utility Users Tax Processing Procedures

Department's Response:

The Income Tax Division agrees with this finding. In coordination with DoIT, the Office of the CFO will be implementing a new, cloud-based financial management system. A component of this implementation will involve data clean-up efforts in DRMS and other subsidiary ledgers, like the tax software system. The Office of the CFO expects these workstreams will result in reconciliation between the tax software system and DRMS, enabling clean data to be converted to the new financial management system. The Division plans to revisit the recommendations in the Auditor General

Mark W. Lockridge, Auditor General
November 5, 2015
Page 5

Report once the Office of the CFO's reorganization is complete and as other tax restructuring initiatives progress.

Finding No. 7. The Income Tax Division Does Not Adequately Safeguard Confidential Information

Department's Response:

The Income Tax Division does not agree with this finding. The storage practices to which the Auditor General refers no longer exist. The City underwent an Internal Revenue Service Security Safeguard Audit in August 2015. The City's facilities were deemed satisfactory. The City retained its eligibility to receive federal taxpayer information.

Finding No. 8. There Is No Active Income Tax Board of Review

Department's Response:

The Income Tax Division does not agree with this finding. The Detroit City Council has recently approved three Board of Review members and the Law Department has prepared an orientation packet for the members, including a proposed set of policies and procedures. The Division will ensure all taxpayers have proper due process. Note that the Board of Review will handle taxpayer appeals even after the State Treasury assumes income tax return processing.

Finding No. 9. Capital Asset Policies and Procedures Are Not Followed

Department's Response:

The Income Tax Division acknowledges that capital asset policies and procedures have not been followed due to lack of staff. As stated in Finding No. 6, the anticipated new financial management system will include data clean-up efforts in the Oracle DRMS Fixed Assets module to prepare for data conversion to the new financial management system. Additionally, the Office of the Controller recently engaged an outside consulting firm to conduct a comprehensive Capital Asset Physical Inventory and

appraisal that will ensure proper data conversion. As stated in Finding No. 3, the Office of the CFO will be issuing new CFO Directives to ensure policies and procedures are revised and/or updated in line with best practices.

Finding No. 10. Non-Compliance With Year-end Closing Procedures

Department's Response:

The Income Tax Division acknowledges it failed to comply with Year-end Closing Procedures and we agree with the Auditor General's recommendations. Additionally, the Office of the Controller will be creating new Year-end Closing Procedures aligned with the new financial management systems. Procedures will be issued as a CFO Directive.

FINDINGS RELATED TO OTHER DEPARTMENTS

Finding No. 1. Finance Department Record Safeguarding Procedures Are Not Adequate.

Department's Response:

The Income Tax Division does not agree with this finding. We do not store tax documents in the basement of the Coleman A. Young Municipal Center. Further, the Division has requested the lease or purchase of two high speed scanners for the purpose of eliminating storage of all paper documents currently on the 12th floor. We will use temporary staff, if necessary, to expedite the digitalization of stored paper documents. We will also execute proper document retention and destruction protocols.

Sincerely,



Carol O'Cleireacain

Interim Tax Administrator and Deputy Mayor for
Economic Policy, Planning and Strategy

CO'C/DNP