

**GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE CHIEF FINANCIAL OFFICER**

**PROACTIVE INTEGRITY SURVEY ON
OUT OF STATUTE REFUNDS
AT THE
OFFICE OF TAX AND REVENUE (OTR)**

OFFICE OF INTEGRITY AND OVERSIGHT



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GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Chief Financial Officer



Office of Integrity and Oversight

MEMORANDUM

TO: Stephen M. Cordi, Deputy Chief Financial Officer
Office of Tax and Revenue

FROM: William J. DiVello, Executive Director
Office of Integrity and Oversight

DATE: August 6, 2012

SUBJECT: Proactive Integrity Survey on the Out of Statute Refunds at the
Office of Tax and Revenue (OTR) (**Report No. 11-02-25-OTR**)

Attached is our report summarizing the results of the Proactive Integrity Survey on the Out of Statute Refunds at the Office of Tax and Revenue's (OTR). The proactive integrity survey is designed to identify management issues and internal control deficiencies that may require immediate management corrective actions or further audit or investigation. The overall objective of this survey was to determine whether OTR complied with applicable laws and regulations on "out of statute refunds."

The Office of Integrity and Oversight (OIO) directed four corrective actions needed to OTR management to address findings cited in the report. We received a written response from OTR on July 12, 2012. OTR concurred with the corrective actions needed and provided the planned actions; however, two of the four responses did not have targeted completion dates. We request OTR to provide targeted completion dates for recommendations 3 and 4 no later than August 16, 2012.

We appreciate the assistance and cooperation that you and your staff provided to OIO during this survey. Should you have any questions or need additional information, please call me at (202)442-6445 or your staff may contact Mohamad Yusuff, Director, Internal Audit at (202)442-8240.

Attachment

cc: Natwar M. Gandhi, Chief Financial Officer, Government of the District of Columbia
Angell Jacobs, Chief of Staff, OCFO
Kathy Crader, Chief Risk Officer, OCFO

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ABSTRACT

The Office of Integrity and Oversight (OIO) conducted a proactive integrity survey (the survey) on the Office of Tax and Revenue's (OTR) compliance with the DC Code applicable laws and regulations on out of statute refunds. This survey focused on Individual and Corporate Franchise tax refunds.

The survey identified management issues that require corrective action and/or review on the design of internal controls surrounding out of statute refunds. These issues include:

- a) the ability to override system controls to authorize out of statute refunds;
- b) out of statute refunds credits were not written off in ITS;
- c) the ability to adjust returns beyond a reasonable timeframe; and
- d) refunds were made to taxpayers who requested "credit carry forward."

This report includes four corrective action recommendations to OTR management to correct the noted management issues. We received a written response from OTR on July 12, 2012. OTR concurred with the corrective actions needed and provided planned actions that we consider to be sufficient and reasonable. However, we request a target completion date for corrective actions three and four. A copy of OTR's response is included as Exhibit A.

PURPOSE

The proactive integrity survey (the survey) is designed to identify management issues and internal control deficiencies that may require immediate management corrective actions or further audit or investigation.

The objective of this survey was to determine whether OTR complied with applicable laws and regulations on out of statute refunds. Specifically, DC Code 47-4304 states that "a credit or refund of an overpayment of a tax imposed by this title shall not be allowed unless the taxpayer files a claim within the later of 3 years from the due date of the return or 3 years from the date that the tax was paid."

SCOPE AND METHODOLOGY

The survey focused on the Individual and Corporate Franchise tax refunds. We performed the following survey procedures:

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1. Queried the Data Warehouse to obtain a list of paid individual and business tax refunds for the period of October 1, 2010 through June 7, 2011.
2. Identified the population of potential out of statute refunds by calculating (in EXCEL) the following equation:

If the field of Due Date + Three Years was greater than or equal to the Refunds Date processed by OTR – Date Due of Original Return, then the cell was flagged as a potential out of statute refund.

This comparison yielded a potential out of statute population of 1,612 records.

3. From the above mentioned population, we extracted a random sample of 60 returns using ACL sampling application with 95 percent confidence, 5 percent error rate, and zero rate of expected deviation.
4. Reviewed the selected sample returns by examining the ITS Taxpayer electronic documentation (production data) during the fact finding field period (the second week of June to the fourth week of June 2011) – including available electronic documentation on mailing address, financial accounts, ITS notes on suppression, and notices.
5. Reviewed the selected samples in ITS for the following attributes: (i) the tax entity receiving the refunds, the tax type of the refunds and for which tax year; (ii) the date of final refund request/payment; (iii) determine whether the refunds are made within the statutory period of refund, or out of the statutory period of DC Code 47-4304 which stated that “a credit or refund of an overpayment of a tax imposed by this title shall not be allowed unless the taxpayer files a claim within the later of 3 years from the due date of the return or 3 years from the date that the tax was paid.”

MANAGEMENT ISSUES

Out of Statute Refunds appeared to be Approved by Overriding the ITS Controls

We found OTR employees have the ability to override this systemic control through adjustments such as changing the date the return was received (INDATE ADJ) to effect the

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statute limitation date or transferring an out of statute credit from an older period to an in statute (current) period and refunding the credit.

In an example provided to our office in June 2011, we did in fact note that a refund was stopped as the amended return that was received after the statute expired. However, in April 2012, we reviewed the example in ITS and found that subsequent to our initial review, an employee performed an “in-date adjustment” to revise the date the return was received to make the refund within statutory timelines in statute. The refund was processed and sent to the taxpayer with interest.

In another instance, we noted a taxpayer’s credit was moved from an “out-of-statute period” and transferred to a “current period” and was duly refunded. This refund was approved by overriding the ITS control.

As specified in DC Code 47-4304, once a refund has past statutory deadlines, it should not be available to a taxpayer. However, it appears that the credit is not systemically written-off, or that all out of statute refund scenarios were not considered in the design of the system of controls in ITS. As a result, the controls around authorization of out of statute refunds can be overridden by related OTR personnel.

There is No Red Flag to identify ITS Adjustments that Were Not Made Within a Reasonable Timeframe

In January 2011, it was discovered that an OTR employee committed refund fraud by making adjustments in ITS to increase the amounts of taxpayers’ individual income tax withholdings (to amounts exceeding the declared earned income long after the earning tax year) and subsequently approving refunds out of the unauthorized withholding adjustments. One of the items in our sample pertained to the fraud identified in January 2011.

OTR should seriously consider modifying the ITS adjustment business rules to limit an employee’s ability to make an adjustment without supervisory approval to the individual income tax withholding line after a specified timeframe, subsequent to the earning tax year; moreover, the amount of withholding total should not be greater than the declared earned income amount. Human errors and fraud could occur within ITS when there is no red flags established in the ITS Adjustment module for those adjustments that are made long after the earning tax year.

Out of Statute Refunds Credits Were Not Written Off in ITS

It was noted that out of statute refunds remain as outstanding credits in ITS taxpayer accounts and were not written off as required by the DC Code. The availability of credits

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on taxpayer accounts increases the risk that a credit will be moved to another account or improperly refunded.

As specified in DC Code 47-4304, out of statute refund should not be available to a taxpayer; therefore, out of statute refund credits in ITS taxpayer accounts should be identified and written off to avoid human errors or unauthorized refunds. Human errors and fraud could occur within ITS when out of statute refunds remain as outstanding credits in ITS taxpayer accounts.

Refunds Were Made to Tax Payers Who Requested Tax Credit Carry Forward

During our survey, we noted that refunds were made to taxpayers, who requested tax credit carry forward, and we did not find any written documentation in ITS evidencing that the taxpayers requested refunds subsequently. Refunding of a carry forward can effect later tax periods as taxpayers claim the credit on subsequent tax returns.

As specified by DC Code 47-4304, “a credit or refund of an overpayment of a tax imposed by this title shall not be allowed unless the taxpayer **files a claim** within the later of 3 years from the due date of the return or 3 years from the date that the tax was paid.”

CORRECTIVE ACTIONS NEEDED

The Deputy Chief Financial Office, OTR, should:

1. Review and, as appropriate, update the design of out of statute refund controls to ensure that the policies, procedures and the related information system takes into account all types of out of statute refunds.
2. Assure that the ITS adjustment module business rules limit the ability to make adjustments to individual income tax withholding to a reasonable timeframe after the earning tax year and the amount of withholding total is not greater than the declared earned income amount.
3. Take specific actions to assure that out of statute refund credits in ITS taxpayer accounts are identified and written off to avoid human errors or unauthorized refunds.
4. Review and update as needed the policies and procedures on refunding money to taxpayers who request a tax credit carry forward to ensure refunds are handled properly.

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MANAGEMENT RESPONSES AND OIO COMMENTS

Management Response (Corrective Action Needed No. 1)

OTR concurred with the correction action needed and stated that they will review the design of the out of statute controls to ensure that the policies, procedures and related information system follow the out of statute code section.

OIO Comment

OTR planned actions are sufficient.

Management Response (Corrective Action Needed No. 2)

OTR concurred with the corrective action needed; however, they are unable to limit the ITS adjustment module to limit the adjustment to individual income tax withholding to a reasonable timeframe or the amount to no greater than the income. OTR will continue to rely on the change report reviews and the refund reviews to stop unauthorized changes in the current environment. Additionally, there is an automated review item that looks at withholding in excess of 10 percent also catches fraudulent W-2 submissions.

OIO Comment

Although OTR does not plan to revise the adjustment module, we consider the alternative action of reviewing the change reports and the automated review item to be responsive and reasonable.

Management Response (Corrective Action Needed No. 3)

OTR concurred with the corrective action needed and stated that out of statute credits are in the system because of system issues. The automated credit write-off program is not functioning properly and has been turned off for redevelopment. The revised credit write-off process is in testing and will be in production as soon as it has been approved.

OIO Comment

OTR planned action is sufficient; however, an implementation date for the revised credit write-off process was not provided. OIO requests a targeted completion date for the implementation of the revised credit write-off process.

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Management Response (Corrective Action Needed No. 4)

OTR concurred with the corrective action needed and stated they will review all policies and procedures on refunding money to taxpayers who requests tax credit carry forwards. They will also ask all administrations to review the policies with their employees during annual training sessions.

OIO Comment

OTR planned actions are sufficient; however, targeted completion dates for the review and revision of procedures and the implementation of the annual employee training was not provided. OIO requests a targeted completion dates for these actions.

EXHIBIT A: OFFICE OF TAX AND REVENUE'S RESPONSE

GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE CHIEF FINANCIAL OFFICER
OFFICE OF TAX AND REVENUE



Stephen M. Cordi
Deputy Chief Financial Officer

MEMORANDUM

TO: William J. DiVello, Executive Director
Office of Integrity and Oversight

FROM: Stephen M. Cordi, Deputy Chief Financial Officer
Office of Tax and Revenue

DATE: July 12, 2012

SUBJECT: Draft Report on Proactive Integrity Survey on the Out of Statute Refunds
at the Office of Tax and Revenue (OTR) (Report No. 11-02-25-OTR)

OTR has reviewed the report and the recommendations and has the following responses to the corrective actions stated as follows:

1. Review and as appropriate update the design of out of statute refund controls to ensure that the policies, procedures and the related information system taking into account all types of out of statute refunds.

Response: We agree.

We are reviewing the design of the out of statute controls to ensure that the policies, procedures and the related information system follow the out of statute code section. We will make any corrections to the policies and procedures by September 30, 2012.

2. Assure that ITS adjustment module business rules should be limited in its ability for making adjustment to individual income tax withholding to a reasonable timeframe after the earning tax year and the amount of withholding total should not be greater than the declared income amount.

Response: We agree.

Currently we are unable to limit the ITS adjustment module to limit the adjustment to individual income tax withholding to a reasonable timeframe. Limiting the amount to no greater than income is also a problem and we currently rely on the change report reviews and the refund reviews to stop unauthorized changes in the current environment. The automated review item that looks at withholding in excess of 10% of wages also catches fraudulent W-2 submissions.

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July 12, 2012

3. Take specific actions to assure that out of statute refund credits in ITS taxpayer accounts are identified and written off to avoid human errors or unauthorized refunds.

Response: We agree.

Out of statute credits are currently residing in the system because of system issues. The automatic credit write off program is not functioning properly and has been turned off for redevelopment. The revised credit write off process is currently in testing and will be in production as soon as it has been approved.

4. Review and update as needed the policies and procedures on refunding money to taxpayers who requested tax credit carry forward to ensure controls in place for refunds are done in the proper manner.

Response: We agree.

We will review all policies and procedures on refunding money to taxpayers who request tax credit carry forwards to ensure the policies and controls are in place so refunds are done properly. We will ask all administrations to review the policies with their employees during annual training sessions.

Should you need additional information, please contact Glen Groff, Director of Operations, at 442-6499.