Office of Missouri State Auditor

Nicole Galloway, CPA

Timeliness of Income Tax Refund Issuance

Report No. 2018-001

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Missouri State Auditor

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CITIZENS SUMMARY

Findings in the audit of the Timeliness of Income Tax Refund Issuance

Background	The Department of Revenue (DOR) is required to pay interest to individual taxpayers if refunds are not paid within 45 days of filing a return. The DOR must pay interest to corporate taxpayers if refund are not paid within 120 days. Interest paid to individuals totaled $306,077 in fiscal year 2016 on 82,983 refunds, and $423,366 in fiscal year 2017 on 154,985 refunds. During those fiscal years, the records also indicate the state paid interest on corporate income tax refunds totaling approximately $4,000 and $28,000, respectively.
Individual Income Tax Refunds Not Paid Timely	The state has paid individual income tax refunds in an increasingly untimely manner, with significant delays in fiscal years 2015, 2016, and 2017. Based on state income tax refund data, in fiscal year 2008 the state had paid out 80 percent of total refunds by April 17. In contrast, for the 3 fiscal years ended June 30, 2015, 2016, and 2017, the state did not reach that payout level until May 20, June 20, and June 22, respectively. In fiscal year 2016, an estimated 485,000 of the approximate 1.8 million individual income tax refunds were paid more than 45 days after being received (27 percent). Data was not available as of fieldwork completion, but the number of refunds paid past 45 days for fiscal year 2017 is expected to be higher than 2016.
Reduced Cash Flow Limits the State's Ability to Make Timely Payments	The state does not have sufficient cash available in the General Revenue (GR) Fund to ensure individual income tax refunds are paid timely. The amount of cash reserves available in the GR Fund has significantly decreased over the past 10 years. As a result, borrowing from the Budget Reserve Fund has increased since the 2008 recession. The state has had to use the money borrowed from the Budget Reserve Fund for other operating obligations, making less funding available for paying individual income tax refunds.
Refunds Are Not Paid in the Order Processed	State law does not specify that income tax refunds must be paid in the order in which they are received or processed. As a result, the DOR has established a priority system for paying individual income tax refunds. The DOR's practice has been to issue larger refund amounts first in an effort to reduce the interest that must be paid by the state. The result is longer delays for taxpayers receiving smaller dollar refunds.
Current State Laws Are Unfair to Taxpayers	Current state laws regarding interest on income tax refunds are unfair to taxpayers. During calendar year 2017, the state paid interest to taxpayers at an average rate of .7 percent for late payment, while taxpayers paid an average rate of 4 percent for late payment, and also had to pay penalties to the state for failure to pay and failure to file. In addition, state law does not clearly require the state to pay interest on untimely refunds to taxpayers until the accrued interest owed exceeds $1. As a result, taxpayers were not paid an estimated $116,000 in interest accrued on their income tax refunds during fiscal year 2016.
Interest Erroneously Not Paid to Taxpayer	When state law was changed in 2015 to reduce the timeframe for paying interest from 90 to 45 days, DOR personnel did not update the department's computerized tax system timely to reflect the law change, resulting in an estimated $29,000 in interest owed but not actually paid to taxpayers.
Inconsistent Regulation on Refund Interest	The DOR's regulation on refund interest is not consistent with state law and has not been revised since 1986.

Due to the limited objectives of this audit, no overall rating has been provided.

Timeliness of Income Tax Refund Issuance
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NICOLE GALLOWAY, CPA
Missouri State Auditor

Honorable Eric R. Greitens, Governor
and
Members of the General Assembly
and
Joel W. Walters, Director
Department of Revenue
and
Sarah H. Steelman, Commissioner
Office of Administration
Jefferson City, Missouri

We have audited certain operations of the Department of Revenue and the Office of Administration related to the timeliness of income tax refund issuance in fulfillment of our duties under Chapter 29, RSMo. The scope of the audit included, but was not necessarily limited to, the year ended June 30, 2016. The objectives of our audit were to:

1. Evaluate the internal controls over significant management and financial functions related to the timeliness of income tax refund issuance.

2. Evaluate compliance with certain legal requirements related to the timeliness of income tax refund issuance.

3. Evaluate the economy and efficiency of certain management practices and operations related to the timeliness of income tax refund issuance.

Except as discussed in the following paragraph, we conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a basis, except as explained in the Scope and Methodology section of this report related to Office of Administration management's refusal to provide certain written representations.

Government Auditing Standards require us to obtain and report the views of responsible officials of the audited entity concerning the findings, conclusions, and recommendations included in the audit report. Due to the nature of this report, and due to the majority of the findings being legislative in nature, we were unable to obtain views of responsible officials for the findings, conclusions, and recommendations outlined in findings 1 through 4 of the Management Advisory Report. The views of responsible Department of Revenue officials were obtained and included where appropriate.

For the areas audited, we identified (1) no significant deficiencies in internal controls, (2) noncompliance with legal provisions, and (3) deficiencies in management practices and operations. The accompanying Management Advisory Report presents our findings arising from our audit of the timeliness of income tax refund issuance.

Nicole R. Galloway, CPA
State Auditor

The following auditors participated in the preparation of this report:

Director of Audits:	Robert E. Showers, CPA, CGAP
Audit Manager:	Susan J. Beeler, CPA, CIA
In-Charge Auditor:	Joshua Shope, M.Acct., CPA
Audit Staff:	Shelbi M. Becker

Timeliness of Income Tax Refund Issuance
Introduction

Background

The Department of Revenue (DOR) was created by Article IV, Section 12, Missouri Constitution as the central collection agency for state revenues. The DOR Taxation Division administers and collects personal and business taxes, including individual and corporate income taxes, and initiates refunds for overpayments. DOR records indicate during the fiscal years ended June 30, 2017 and 2016, the department collected approximately $7.3 billion and $7.2 billion in individual income tax receipts, and paid related refunds of approximately $1 billion and $998 million, respectively. During those fiscal years, the records also indicate the department collected approximately $435 million and $486 million in corporate tax receipts, and paid corporate income tax refunds totaling approximately $159 million and $182 million, respectively. DOR records indicate the state paid interest to taxpayers for individual income tax refunds totaling approximately $423,000 in fiscal year 2017 and approximately $306,000 in fiscal year 2016. During those fiscal years, the records also indicate the state paid interest on corporate income tax refunds totaling approximately $4,000 and $28,000, respectively.

Statutes establishing interest requirements

Prior to 2002, Section 143.811.4, RSMo, required the state to pay interest to taxpayers if the state did not pay income tax refunds within 4 months after the last day prescribed for filing a tax return or within 4 months after the return was filed, whichever was later. As required by Section 32.065, RSMo, the interest rate was the adjusted prime rate charged by banks, as determined by the Board of Governors of the Federal Reserve System. During the 2002 legislative session, the General Assembly passed legislation establishing Sections 32.068 and 32.069, RSMo, which, among other things, changed interest provisions to reduce interest rates the state had to pay. According to DOR officials, 2001 was the first year the state had difficulty issuing income tax refunds timely due to cash flow problems. Section 32.068, RSMo, established the interest rate for refunds to be equal to the previous 12-month annualized average rate of return on all funds invested by the State Treasurer, rounded to the nearest 1/10 of 1 percent. Section 32.069, RSMo, specified the date interest would begin accruing by requiring interest to be paid on any refund or overpayment if it was not refunded within 120 days from the latest of the following dates (1) the last day prescribed for filing a tax return or refund claim, without regard to any extension of time granted; (2) the date the return, payment, or claim was filed; or (3) the date the taxpayer filed for a credit or refund and provided accurate and complete documentation to support such claim.

Section 32.069, RSMo, was revised by the General Assembly in 2010 to decrease the number of days the state had to pay refunds before interest would be owed on an individual income tax refund from 120 to 90 days. The corporate income tax interest provision remained at 120 days.

Effective August 28, 2015, Section 32.069, RSMo, was again revised by the General Assembly to decrease the number of days the state has to pay refunds before interest would be owed on an individual income tax refund from 90 to

45 days and established the date the return is filed as the date from which interest would begin accruing if the refund was not paid within the 45 days. The corporate income tax interest provision remained at 120 days.

Payment process

When processing and making refund payments, the DOR is contacted regularly by the Office of Administration (OA) during February through June about the dollar amount allocated to the department to make refund payments that day or week. These allocations are based on the OA's continual monitoring of the cash flow of the General Revenue (GR) Fund, as explained in Management Advisory Report (MAR) finding number 2.

The DOR assigns each individual income tax refund a priority category, which allows department personnel to put an emphasis on certain types of refunds. Corporate income tax refunds are processed in the order they are received.

Reasons for delays

Most refunds will accrue interest if they are not paid out by the time frames established in Section 32.069, RSMo. However, if a taxpayer neglects to include all relevant information and documentation when filing a return or a notice of adjustment suggesting a financial change to the return is sent to the taxpayer by the DOR, interest will normally begin accruing at a later date (e.g., the date the taxpayer provides all relevant documents to the DOR).

DOR officials stated the main reasons for delays in issuing refunds include the following:

- lack of cash allocated to the DOR by the OA for issuing refunds from the GR Fund.
- submission errors by taxpayers requiring DOR personnel to manually review the returns.
- apportioned tax credits.[1]
- amended returns filed by taxpayers.[2]
- audited returns.[3]
- legal settlements.[4]
- protested returns.[5]

[1] Apportioned tax credits are tax credits held until June each year to determine if taxpayers, in total, are claiming more than maximum limit allowed by statute. If the limit has been exceeded, the DOR must apportion the tax credit between all returns claiming the tax credit.
[2] The DOR must receive a transcript from the Internal Revenue Service (IRS) to verify acceptance of the taxpayer's amended federal return, if applicable, which usually exceeds 45 days.
[3] Each year the DOR chooses returns to audit based on various factors.
[4] If a return is involved in a lawsuit, the refund is held until the lawsuit has been resolved.
[5] If the taxpayer's refund is denied by the DOR or the DOR determines the taxpayer owes additional taxes, the taxpayer may file an official protest with the DOR.

Scope and Methodology

To gain an understanding of the timeliness of income tax refund issuance, we reviewed written policies and procedures, redacted income tax records,[6] and other pertinent documents; interviewed various personnel of the DOR, the OA, and the State Treasurer's Office; and tested select income tax returns to ensure interest was paid to taxpayers when required, and the correct interest rate was properly applied.

We obtained an understanding of the internal controls that are significant within the context of the audit objectives and assessed whether such controls have been properly designed and placed in operation. We obtained an understanding of legal provisions that are significant within the context of the audit objectives, and we assessed the risk that illegal acts, including fraud, and violations of applicable contract, grant agreement, or other legal provisions could occur. Based on that risk assessment, we designed and performed procedures to provide reasonable assurance of detecting instances of noncompliance significant to those provisions.

During our audit, officials from the DOR and OA impeded audit staff from completing work timely. DOR and OA personnel delayed responses to audit questions and were unwilling to meet to discuss audit issues timely. Some documentation from the DOR was delayed to such an extent that the State Auditor had to issue a subpoena[7] to the DOR to obtain the documentation. In addition, certain documentation had to be requested multiple times by the auditors to ensure we obtained sufficient, appropriate audit evidence. This lack of timely access to documentation and personnel delayed completion of the audit.

In addition, officials from the OA refused to provide certain written representations to our office as requested. While such management representations are not specifically required by Government Auditing Standards for performance audits, it is standard practice of the State Auditor's Office to require such representations be provided to help ensure adequate audit evidence has been obtained. Historically, state agencies have not refused to provide such assurances.

[6] The DOR redacted all personally identifiable taxpayer information from the records we received during the audit based on its interpretation of the Missouri Supreme Court decision in the case of *Director of Revenue v. State Auditor* 511 S.W.2d 779 (Mo. 1974). The redactions by the DOR did not prevent us from obtaining sufficient evidence to meet our audit objectives.

[7] After much delay from the DOR, on April 18, 2017, the DOR sent a letter to the State Auditor questioning the Auditor's authority to perform the audit and denying access to certain requested records. Based on that letter, the State Auditor issued a subpoena to obtain the requested records. See Appendixes A and B for a copy of the letter and the subsequent subpoena. The requested records were provided to us by the DOR after the subpoena was issued.

We asked OA management to provide, among other things, the following written representations:

- "We have not knowingly withheld from you any records that in our judgment would be relevant to your audit."
- "We are responsible for the department's compliance with provisions of laws, regulations, contracts, and grant agreements applicable to it; and we have identified, and disclosed to you, all such provisions that we believe have a significant effect on the timeliness of tax refunds issuance."

OA management refused to provide these written representations and instead provided the following representations, which significantly altered the meaning of these representations:

- "We have not knowingly withheld from you any records you requested that in our judgment would be relevant to your review."
- "We are responsible only for the department's compliance with provisions of laws and regulations relating to the timing of tax refunds applicable to the department; and we have responded to any questions regarding the same that you identified."

In effect, OA officials declined to provide assurance they (1) had not withheld relevant information from the audit staff and (2) had disclosed all provisions of laws, regulations, contracts, and grant agreements that the agency believed would have a significant effect on the audit.

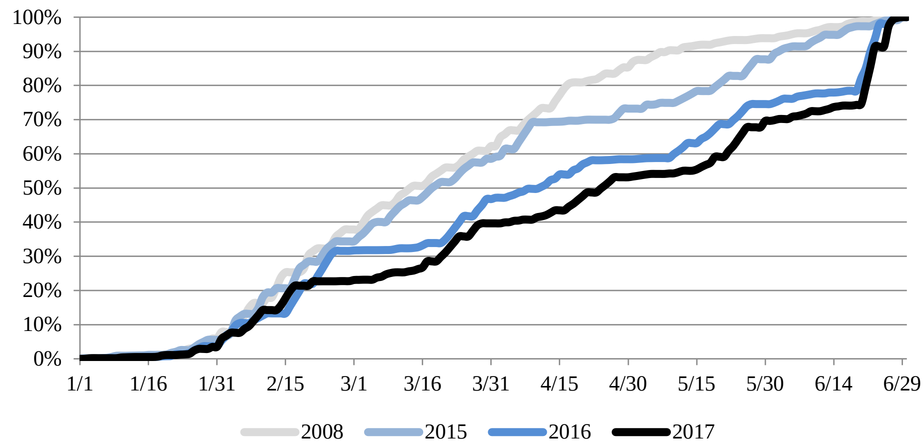
We met with certain OA officials on November 8, 2017, to discuss these changes. At that meeting, they affirmed the refusal to provide the requested written representations.

Refusal to provide such written representations is concerning and may indicate information relevant to our audit was knowingly withheld from us by OA management in an attempt to conceal inappropriate activities and/or noncompliance with state laws, regulations, contracts, or grant agreements.

1. Individual Income Tax Refunds Not Paid Timely

The state has paid individual income tax refunds in an increasingly untimely manner, with significant delays in fiscal years 2015, 2016, and 2017. Based on state income tax refund data, in fiscal year 2008 the state had paid out 80 percent of total refunds by April 17. In contrast, for the 3 fiscal years ended June 30, 2015, 2016, and 2017, the state did not reach that payout level until May 20, June 20, and June 22, respectively. See Figure 1.1 for a depiction of the comparative timing of income tax refund payments.

Figure 1.1: Percent of total refunds paid from January 1 to June 30, by fiscal year, for Fiscal Year 2008, 2015-2017



Source: Data from the state's computerized accounting system (SAM II)

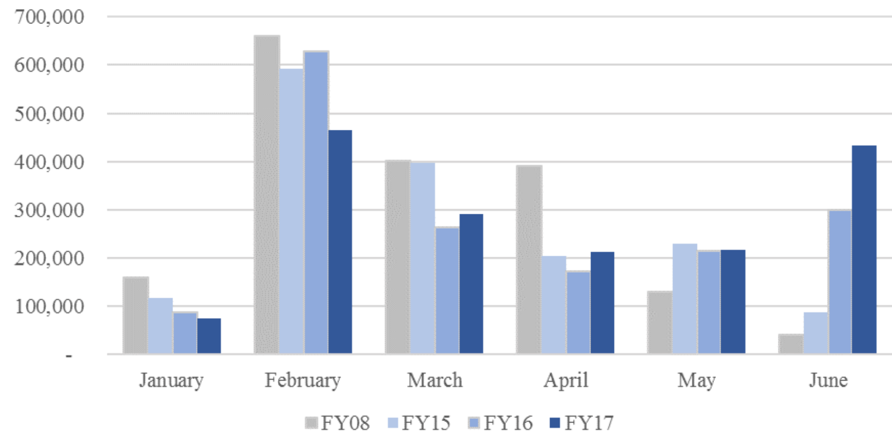
In addition to the dollar value of refunds being paid increasingly later in the year, the number of refunds being delayed has also increased significantly. The number of refunds paid in the month of June has increased from approximately 42,000 (2 percent of total refunds) in fiscal year 2008, to an average of approximately 367,000 (22 percent of total refunds) in the 2 fiscal years ended June 30, 2017. Figure 1.2 shows the trends in number of refunds issued, by month from January to June.

Refunds increasingly delayed

In fiscal year 2016, an estimated 485,000 of the approximate 1.8 million individual income tax refunds were paid more than 45 days[8] after being received (27 percent). At the time of our data request, the fiscal year 2017 data was not complete; however, based on other data trends throughout this report, the number of individual income tax refunds that exceeded 45 days for fiscal year 2017 is likely higher than in 2016. As a result of paying income tax refunds increasingly later in the year, the state has paid approximately $729,000 in interest to individual taxpayers over the past 2 fiscal years. Interest paid totaled $306,077 in fiscal year 2016 on 82,983 refunds, and $423,366 in fiscal year 2017 on 154,985 refunds.

[8] This number includes refunds with interest paid to taxpayers and refunds with interest under $1 not paid to taxpayers (see MAR finding number 4.2 for an explanation of why interest under $1 is not paid).

Figure 1.2: Number of individual income tax refunds issued from January to June, 2008 and 2015-2017, by fiscal year



Source: DOR records

Conclusion

State laws reducing the timeframe the DOR has to pay refunds before interest accrues were presumably intended to improve timely payment of such refunds; however, these laws have not worked as intended. In the 2 years since state law was changed to reduce the allowable timeframe the DOR had to make refund payments from 90 days to 45 days before paying interest, both the number of returns accruing interest and the amount of interest paid by the state has increased. The increasing number and amounts of individual income tax refunds being paid later in the year, and incurring increasing interest penalties, is a significant issue to the taxpayers of the state. This report discusses the significant causes of the identified trends, as well as other issues related to the timeliness of income tax refund issuance and the impact on taxpayers.

2. Reduced Cash Flow Limits the State's Ability to Make Timely Payments

The state does not have sufficient cash available in the General Revenue (GR) Fund to ensure individual income tax refunds are paid timely. As a result, the state has experienced an increase in the number of refunds being paid late and an increase in the amount of interest paid to taxpayers. General revenue cash reserves have been depleted since the 2008 recession, requiring the OA to increasingly borrow budget reserve funds for operational obligations. Therefore, budget reserve money is not available during individual income tax season to help pay refunds timely.

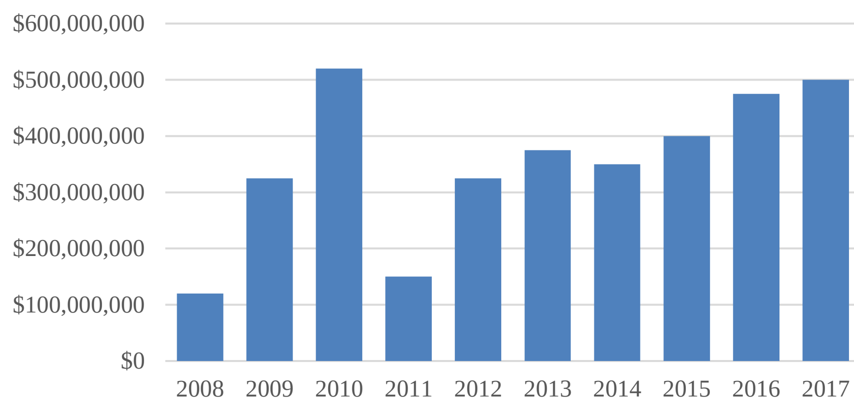
Cash management and the use of the Budget Reserve Fund

The OA is responsible for monitoring revenues and expenditures in the GR fund. Based on estimates of revenues, historical spending data, and appropriations for expenditures, each day the OA projects the amount of monies available for spending for the day, month, and fiscal year. To ensure the state has enough available cash to make any planned or unplanned payments, the OA looks at long-term obligations to make strategic decisions about the use of available GR cash. If the GR fund is not projected to have sufficient cash to cover all known and potential expenditures anticipated in the coming days and months, the OA must allocate the cash available among the different expenditure types, including tax refunds, bond obligations, public education payments, public assistance payments, and state payroll, among other obligations.

To ensure adequate cash is on hand to pay the above obligations, the OA is allowed to borrow from the Budget Reserve Fund on a short term basis when necessary. Under the Missouri Constitution, Article IV, Section 27(a), the Commissioner of Administration is allowed to transfer monies each year, as set by appropriations,[9] from the Budget Reserve Fund to the GR Fund, if necessary, to meet the cash requirements of the state, and must repay these transfers before May 16 of the same fiscal year. The Budget Reserve Fund shall not exceed 7.5 percent of net general revenue collections[10] for the previous fiscal year.[11]

Borrowing from the Budget Reserve Fund has increased since the 2008 recession. Figure 2.1 shows the amounts borrowed from budget reserve, by fiscal year.

Figure 2.1: Amounts borrowed from Budget Reserve Fund, 2008-2017, by fiscal year



Source: Office of Administration records

Cash reserves have been depleted

The amount of cash reserves available in the GR Fund has significantly decreased over the past 10 years. Figure 2.2 shows the state's GR Fund cash balance at January 1, less any loans from the Budget Reserve Fund. The balance at January 1, 2017, was negative $86 million, and was the first

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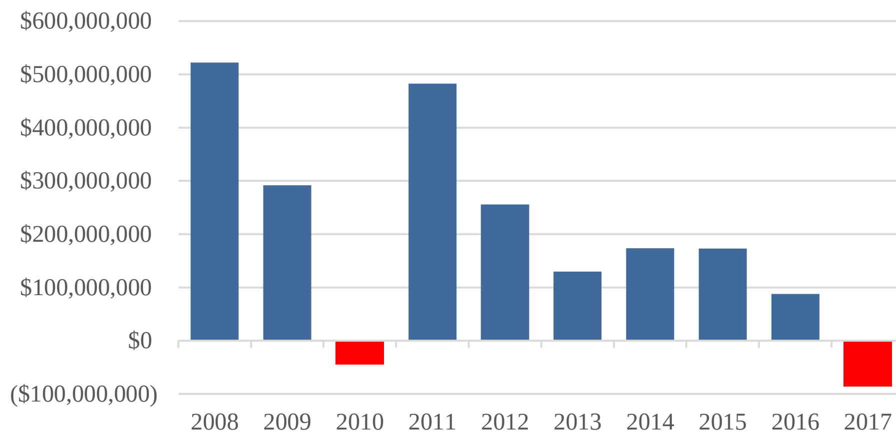
[9] For fiscal year 2017, the General Assembly appropriated $500 million for Budget Reserve Fund expenditures.

[10] Net general revenue collections are all revenues deposited into the GR Fund less refunds and revenues designated by law for a specific distribution or transfer to another state fund.

[11] At the end of any fiscal year any Budget Reserve Fund balance exceeding 7.5 percent of the general revenue collections must be transferred to the GR Fund as required by the Missouri Constitution, unless the legislature directly appropriates a higher amount in the Budget Reserve Fund (except the balance in the fund at year-end cannot exceed 10 percent of general revenue collections). Such appropriation was not made; therefore, the maximum amount the Budget Reserve Fund could have been at June 30, 2017, was approximately $659 million (7.5 percent of the $8.79 billion net general revenue collections in fiscal year 2016). The actual fund balance was approximately $591 million.

negative balance since January 2010, following the 2008 recession. The January 2017 balance was also approximately $608 million less than the pre-recession January 2008 balance. While borrowings from the Budget Reserve Fund allowed the state to continue to meet its obligations and were replenished by May 16 every year, as required by the Missouri Constitution, this trend indicates the state has not replenished its overall cash reserves following the 2008 recession.

Figure 2.2: General Revenue Fund cash balance, net of budget reserve borrowing, at January 1, by year



Source: Office of Administration records

Due to the decrease in cash available depicted in Figure 2.2, the OA has had to use money borrowed from the Budget Reserve Fund for other operating obligations, making less funding available for paying individual income tax refunds.

The reasons for the reduced fund balance of the GR fund and causes of the cash flow shortage are beyond the scope of this report. However, previous audit reports[12] address various issues related to reductions to the state's tax base and reductions to tax revenues, and growth in spending in certain areas.

Delays in issuing refunds not due to DOR inefficiencies

According to DOR records, during April 2017 and through the majority of June 2017, the DOR had tax refunds totaling over $200 million processed and ready to be paid, but could not proceed with payment due to the lack of cash available in the GR Fund. Near the end of June 2017, after other state obligations had been paid, the state had sufficient cash available in the GR Fund to pay approximately $50 million in tax refunds each business day from June 21, 2017, to June 26, 2017, effectively paying out all processed refunds.

[12] Report No. 2017-113, *Cost of Tax Incentives and Exemptions*, issued in October 2017, Report No. 2017-051, *Tax Credit Programs*, issued in June 2017, Report No. 2017-018, *Statewide Single Audit*, issued in March 2017, Report No. 2017-098, State Legal Expense Fund, issue September 2017, and Report No. 2017-099, Legal Expense Fund Letter, issued September 2017.

Conclusion

Even with an increased reliance on budget reserve borrowing, the timeliness of income tax refund issuance has worsened in recent years. The state is experiencing significant cash flow shortages. As a result, the number of taxpayers receiving their income tax refunds untimely, and the amount of interest paid on those refunds continues to increase. The cash available to pay state obligations, including income tax refunds, is reliant upon the budget process. State policymakers must address this issue to ensure all state obligations, including tax refunds, are being paid timely.

Audit limitation based on OA's refusal to provide certain written representations

OA management refused to provide certain written representations that would provide assurance we received all information from the OA relevant to our audit, and that management disclosed all legal provisions that would have a significant effect on the audit. Such representations provide additional assurance that the audit evidence obtained is sufficient and appropriate. Without such representations from management it is unclear if the OA knowingly withheld information that could have had an impact on our audit conclusions and recommendation for this finding. See the Scope and Methodology section of this report (page 6) for additional information on the representations the OA refused to provide.

Recommendation

The General Assembly take action to improve the cash reserves available in the GR Fund.

3. Refunds Are Not Paid in the Order Processed

State law does not specify that income tax refunds must be paid in the order in which they are received or processed. As a result, the DOR has established a priority system for paying individual income tax refunds. The DOR's practice has been to issue larger refund amounts first in an effort to reduce the interest that must be paid by the state.

The DOR's tax system groups individual income tax refunds by return type and assigns each a priority category in the DOR's tax system. Refunds are typically paid based on the following priorities:

- <u>Priority 1: Expedited Refunds</u> - These are refunds the DOR has moved to this priority from a lower priority to expedite payment. Based on DOR's interpretation of case law,[13] department officials did not grant us access to personally identifiable taxpayer information; therefore, we could not determine which taxpayers had their refunds moved to Priority 1 to expedite payment. However, DOR officials stated the primary reason refunds are moved here is to avoid paying interest.

[13] Missouri Supreme Court decision in the case of *Director of Revenue v. State Auditor* 511 S.W.2d 779 (Mo. 1974).

- Priority 2: Debt Offset Refunds - These are refunds for debt owed by taxpayers to the DOR, Internal Revenue Service, other Missouri state agencies, and other states with reciprocal offset agreements.

- Priority 3: Property Tax Credit Refunds - Individuals over age 65 and individuals who are disabled, if they are under certain income thresholds, can receive a property tax credit on their state income tax returns.

- Priority 4: Electronically-filed and 2D Barcode Returns with Refunds - The 2D barcode returns are paper returns printed from an electronic tax return file. They contain barcodes that can be scanned into the DOR computerized system and do not have to be manually processed by the DOR. In fiscal year 2017, electronically-filed and 2D barcode returns account for approximately 92 percent of all the individual income tax returns filed.

- Priority 5: Current Year Paper Returns with Refunds - These returns must be manually processed by the DOR.

- Priority 6: Miscellaneous Refunds - Miscellaneous refunds include refunds from prior year returns, amended returns, and current returns that require adjustments to be made in the tax system by the DOR personnel. These refunds must be manually reviewed and then moved to a higher priority.

- Priority 7: Temporary Hold to Check for First-time Filers - These are returns in which the taxpayer has requested the refund be direct deposited. These refunds are held here for one day to determine if the taxpayer is a first-time filer. If the taxpayer is a first-time filer, the system changes the refund from direct deposit to a paper check. This process was put into place by the DOR at the beginning of the 2016 filing season to help prevent refund fraud. If the taxpayer is not a first-time filer, the return is automatically moved back to the priority in which it normally would have been placed.

- Priority 8: Fraud Refunds Not Issued - These are refunds that have been flagged as possible fraud based on various information received or not received from the taxpayer. They are held until DOR personnel can manually review the refunds. If they are determined not to be fraudulent, the refunds are assigned a higher priority.

- Priority 9: Refunds Over $40,000 or Amnesty Accounts - These refunds must be manually reviewed and then moved to a higher priority. Amnesty accounts are for taxpayers with delinquent tax balances that will have the interest and penalties waived if the delinquent taxes are paid by an established date determined by the DOR.

Refunds are paid in the order they are received within each priority. Each day refunds are typically paid starting with the highest priority category and continuing until all monies allocated by the OA for tax refunds have been expended that day (see MAR finding number 2 for more information about how the OA determines how much money to allocate each day). During cash flow restrictions, there is not enough money allocated each day to pay out all the priority categories. Therefore, on any given day, DOR officials may choose to pay all refunds in a lower priority category before a higher priority category to help limit the amount of interest due on refunds in the lower priority categories.

The tax system prevents DOR personnel from paying only select refunds within a priority; therefore, with management approval, select returns can be moved to the highest priority to expedite a refund. According to DOR officials, the practice has been to move large dollar refunds to Priority 1 in an effort to reduce the interest that must be paid by the state. As a result, smaller refund amounts are held increasingly longer by the DOR because interest on these refunds is less likely to exceed the $1 threshold for which interest will be paid (see MAR finding number 4.2 for further explanation of the $1 interest threshold).

Conclusion

Because no requirement exists to pay refunds in the order processed, the DOR has made the fiscal decision to pay larger dollar refunds before smaller dollar refunds in an effort to reduce interest costs. The result is longer delays for taxpayers receiving smaller dollar refunds. Requiring refunds to be paid in the order they are processed and approved for payment could result in increased interest costs to the state, but would improve the timeliness of refunds for individuals with smaller tax refunds and would result in more equitable treatment of all taxpayers owed an income tax refund.

Recommendation

The General Assembly evaluate and consider requiring individual income tax refunds be paid in the order they are approved for payment.

4. Current State Laws Are Unfair to Taxpayers

Current state laws regarding interest on income tax refunds are unfair to taxpayers. Taxpayers must pay a significantly higher interest rate when making late tax payments than the state is required to pay on delayed refunds, and taxpayers are not compensated for waiting for refunds unless interest exceeds $1.

4.1 Interest rate due to taxpayers is minimal

The current interest rate paid by the state for late income tax refunds, as defined by state law, is minimal and does not adequately compensate taxpayers for the use of their money. Taxpayer penalties and interest rates on tax payments due to the state are much more significant and provide appropriate motivation to taxpayers to make payments timely.

Sections 32.068 and 32.069.2, RSMo, require the state to pay taxpayers interest on any individual tax refunds not paid within 45 days of filing the related return at an interest rate equal to the twelve-month annualized average rate of return on all funds invested by the State Treasurer. During calendar year 2017, the interest rate averaged .7 percent.

In contrast, Section 32.065, RSMo, sets the interest rate paid by taxpayers for late payment of taxes as the adjusted prime rate charged by banks determined by the Board of Governors of the Federal Reserve System. During calendar year 2017, the interest rate averaged 4 percent. In addition to having to pay a 4 percent interest rate, taxpayers must also pay penalties for failure to file or failure to pay their income taxes. According to Section 143.741, RSMo, a penalty is imposed at a rate of 5 percent each month, not to exceed 25 percent of the unpaid balance, for taxpayers who fail to file by the due date. In addition, taxpayers are imposed a penalty at the rate of 5 percent of the unpaid balance for failure to pay, pursuant to Section 143.751, RSMo.

Table 4.1 shows the interest that would have to be paid by the state for a $250 or $1,000 refund based on various refund payment dates compared to the interest and penalties an individual taxpayer would owe if the taxpayer owed those amounts and paid taxes the same number of days late (interest rates as of June 30, 2017).

Table 4.1: Interest paid by the state on a $250 and $1,000 refund, by the number of days late, and comparison of interest and penalties paid by taxpayers on amounts due to the state

Amount	Days Late	Interest Paid By the State (1)	Interest and Penalties Paid by the Taxpayer
$ 250	46	$ 0.00	$ 13.76
250	100	0.00	15.24
250	200	0.00	17.98
250	365	1.75	22.50
1,000	46	0.00	55.04
1,000	100	1.92	60.96
1,000	200	3.84	71.92
1,000	365	7.00	90.00

(1) The $0.00 amounts in this column represent interest amounts under $1. The DOR does not pay interest to taxpayers until the interest amount exceeds $1 (see MAR finding number 4.2 for further details).

Conclusion

The current rate of interest paid by the state on late income tax refunds does not provide adequate compensation to taxpayers for the use of their money. In addition, taxpayers are treated in an inequitable manner by being required to pay an interest rate that is significantly greater than the interest rate paid by the state. Taxpayers are also required to pay additional penalties for late filing and/or late payment, while the state does not have to pay any penalties for issuing refunds untimely.

4.2 Interest not paid until it exceeds $1

State law[14] does not clearly require the state to pay interest on untimely refunds to taxpayers until the accrued interest owed exceeds $1. Based on our review of DOR refund data, there were 402,000 individual income tax refunds paid during fiscal year 2016 that were more than 45 days late and received no interest. As a result, taxpayers were not paid an estimated $116,000 in interest accrued on their income tax refunds during fiscal year 2016. At the time of our data request, the fiscal year 2017 data was not complete. However, based on other data trends throughout this report, interest accrued under $1 in 2017 is likely higher than in 2016.

Based on the average .6 percent interest rate paid during fiscal year 2016, we determined a refund would have to be at least $1,316 for it to accrue $1 of interest on the forty-sixth day after filing. Table 4.2 show the length of time, in days, it would take for various refund amounts to accrue $1 of interest in fiscal year 2016.

Table 4.2: Length of time to accrue $1 of interest, by refund amount

Refund Amount	Number of Days until $1 of Interest Accrues
$ 1,000	61
500	122
100	606
50	1,211

Based on the data in Table 4.2, it is fiscally advantageous to the state for the DOR to prioritize larger refund amounts to avoid paying interest because smaller refunds are unlikely to accrue interest that exceeds $1. For fiscal year 2016, approximately 71 percent of all refunds issued by the DOR were less than $500. As a result, approximately 1.2 million of the approximately 1.8 million refunds paid by the DOR in fiscal year 2016 could have been held by the DOR for nearly 4 months (122 days) after the filing date before accruing $1 in interest.

Conclusion

Due to state law not clearly requiring interest to be paid until it exceeds $1, many taxpayers with individual income tax refunds past 45 days do not receive interest and are forced to wait for their refund without any compensation from the state.

Recommendations

4.1 The General Assembly evaluate state law regarding the interest individual taxpayers receive for late paid tax refunds and consider making changes to ensure the state and taxpayers are treated in a more equitable manner.

[14] The DOR interprets Section 143.811.1 RSMo, to mean no interest for untimely refund payments shall be allowed or paid on tax refunds unless it exceeds $1. See MAR finding number 6 for more explanation of the department's interpretation of this section.

4.2 The General Assembly evaluate whether state law should be clarified to require interest be paid on tax refunds if the interest amount is less than $1.

5. Interest Erroneously Not Paid to Taxpayers

When state law was changed in 2015 to reduce the timeframe for paying interest from 90 to 45 days, DOR personnel did not update the department's computerized tax system timely to reflect the law change, resulting in an estimated $29,000 in interest owed but not actually paid to taxpayers.

Section 32.069.2, RSMo, effective August 28, 2015, decreased the number of days for which interest was required be paid on an individual income tax refund from 90 days to 45 days. However, due to various factors, the DOR did not update its computerized tax system for this change until January 4, 2016. Therefore, any refunds paid by the DOR from August 28, 2015, through January 4, 2016, were only paid interest if they exceeded 90 days when they should have been paid interest after 45 days. During that time an estimated 1,200 refunds (totaling $29,000) each had at least $1 of accrued interest that was not paid. DOR personnel stated they were aware of this issue, but had not considered refunding the taxpayers the interest owed to them after the system was updated.

Recommendation

The DOR review refunds paid from August 28, 2015, through January 4, 2016, and pay affected taxpayers any interest they are owed.

Auditee's Response

As of 2017, the DOR is under new leadership and is looking closely at a number of areas of improvement, this being among them. The DOR understands this recommendation and will evaluate providing the refunds as recommended.

6. Inconsistent Regulation on Refund Interest

The DOR's regulation on refund interest is not consistent with state law and has not been revised since 1986.

State regulation 12 CSR 10-2.070, which requires interest to be paid on refunds not paid to taxpayers within 120 days, was established by the DOR in 1976 and was not revised when the authorizing statute was amended. The regulation requires refunds to be issued in accordance with Section 143.811, RSMo, and interest to be paid in accordance with Section 32.065, RSMo. Since the enactment of this regulation, state laws requiring interest to be paid on refunds have incurred three significant revisions, while the regulation has remained unchanged.

Effective in 2002, Section 32.065, RSMo, no longer controls income tax refund interest. Section 32.068 and 32.069, RSMo, were enacted in 2002 requiring refunds to have interest paid using the annual rate of interest as calculated by the State Treasurer and corporate and individual tax refunds to be issued within 120 days of the following dates (1) the last day prescribed for filing a tax return or refund claim, without regard to any extension of time granted; (2) the date the return, payment, or claim is filed; or (3) the date the taxpayer filed for a credit or refund and provided accurate and complete documentation to support such claim. In addition, revisions were made to Section 32.069, RSMo, in 2010 and 2015 reducing the amount of days for individual income tax refunds to be owed interest from 120 to 90 to 45 days. The 2015 revision also changed the date individual income tax refund interest began to accrue to the date the return was filed.

The DOR does not pay interest on individual tax refunds if the interest amount is less than $1, based on its interpretation of Section 143.811.1, RSMo. Section 143.811.1, RSMo, only references the interest rate determined by Section 32.065, RSMo, without any reference to Sections 32.068 or 32.069, RSMo, which are the current interest provisions for individual income tax refunds.

The DOR's interpretation of this statute section has not been promulgated in a rule. According to Section 536.010, RSMo, a "rule" is defined as each agency's statement of general applicability that implements, interprets, or prescribes a law or policy or it describes the organization, procedures, or practice requirements of any agency. The DOR's interpretation is generally applicable as it affects a large number of taxpayers' ability to receive interest from the state. Under this law, the DOR is required to promulgate its interpretation as a rule. DOR's current regulation on refund interest is not consistent with state law.

Recommendation

The DOR revise its regulation of interest on refunds, to reflect current state law and its interpretation of the law.

Auditee's Response

The DOR understands this recommendation and will begin the process to revise the regulation.

Timeliness of Income Tax Refund Issuance
Letter from the Department of Revenue to the State Auditor Denying Access to Certain Records

ERIC R. GREITENS
GOVERNOR

JOEL W. WALTERS
ACTING DIRECTOR OF REVENUE

MISSOURI DEPARTMENT OF REVENUE
POST OFFICE BOX 311
JEFFERSON CITY, MISSOURI 65105-0311
PHONE: (573) 751-4450
FAX: (573) 751-7150
WEBSITE: www.dor.mo.gov
E-MAIL: dormail@dor.mo.gov

April 18, 2017

Paul Harper, General Counsel
Missouri State Auditor's Office
301 West High St.
Jefferson City, MO 65101

Dear Mr. Harper:

It is my understanding that the State Auditor's Office ("SAO") would like to know whether documents exist within the Department of Revenue ("Department") that we would consider responsive to the ten requests for information we have received associated with the audit referenced the SAO's letter dated March 2, 2017 and addressed to former Acting Director Wood Miller.

On March 6, 2017 the Department received the following requests for information (in bold):

1. The total amount of interest paid for Corporate and Individual Income tax refunds for FY2012, FY2013, FY2014, FY2015, and FY2016.

Pursuant to the Department's April 17, 2017 letter to the SAO, the Department is compiling the information and will produce the information by April 21, 2017.

2. How many refunds were untimely which led to interest being paid for Individual and Corporate Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016?

Pursuant to the Department's April 17, 2017 letter to the SAO, the Department is compiling the number of refunds in which the Department paid interest for FY2012, FY2013, FY2014, FY2015, and FY2016, and the Department will produce that information by April 21, 2017.

1

3. The total number of refunds issued for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.

Pursuant to the Department's April 17, 2017 letter to the SAO, the Department is compiling the information and will produce the information by April 21, 2017.

4. The total number of returns processed (whether the taxes were refunded, paid, or are still owed) for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016?

Pursuant to the Department's April 17, 2017 letter to the SAO, the Department is compiling the information and will produce the information by April 21, 2017.

5. The general reasons for why Corporate and Individual Income tax refunds are not being issued timely?

Subject to the concerns raised in the Department's April 17, 2017 letter, information regarding the general reasons impacting the timing of corporate and income tax refunds will be provided by April 21, 2017.

6. Any documentation of controls or procedures for the handling of Corporate and Individual income tax refunds for revenue.

This request seeks information for the purpose of an unconstitutional performance audit. The Department does not believe that the Auditor's Office is constitutionally empowered to conduct a performance audit and requests that the SAO state whether it is conducting a performance audit. The Department further requests that if the SAO believes the Auditor is authorized by law to review this information, the SAO inform the Department of the basis of the Auditor's authority.

7. A short memo listing the steps taken by the Department from when the refund is received, reviewed, and then refund returned to the taxpayer, and an estimated timeframe for the Department uses to issue the refund (if known).

This request seeks information for the purpose of an unconstitutional performance audit. The Department does not believe that the Auditor's Office is constitutionally empowered to conduct a performance audit and requests that the SAO state whether it is conducting a performance audit. The Department further requests that if the SAO believes the Auditor is authorized by law to review this information, the SAO inform the Department of the basis of the Auditor's authority. Subject to and without waiving the foregoing objection, an estimated timeframe for the Department to issue the refund does not currently exist.

On March 20, 2017, the Department received the following requests for information:

1. Does the DOR have a real-time report(s) that shows the number of individual income tax refunds that are over 45 days and a running total of interest owed?

The Department is able to generate reports showing the number of individual income tax refunds that are over 45 days and a running total of interest owed.

2. Does the DOR have a real-time report(s) that shows the number of corporate tax refunds that over 120 days and a running total of interest owed?

The Department is able to generate reports showing the number of corporate tax refunds that are over 45 days and a running total of interest owed.

3. If so, can we obtain a copy of the report(s) on a regular basis (receive it on the same day every week) until our audit has concluded?

This request seeks information for the purpose of an unconstitutional performance audit. The Department does not believe that the Auditor's Office is constitutionally empowered to conduct a performance audit and requests that the SAO state whether it is conducting a performance audit. The Department further requests that if the SAO believes the Auditor is authorized by law to review this information, the SAO inform the Department of the basis of the Auditor's authority.

As stated in my letter to you from April 17, 2017, despite having joined the Department of Revenue very recently, I am committed to working with the SAO in the best interests of the people of Missouri. While maintaining the constitutional and privacy concerns I raised in my April 17, 2017 letter, I will provide the foregoing documentation by Friday, April 21, 2017.

Sincerely,

Joel Walters

Joel Walters
Acting Director of Revenue

Timeliness of Income Tax Refund Issuance
State Auditor Subpoena of Department of Revenue Records

OFFICE OF MISSOURI STATE AUDITOR

SUBPOENA

To: Custodian of Records and
Corporate Designee
Missouri Department of Revenue
301 West High St., Room 670
Jefferson City, MO 65101

YOU ARE COMMANDED AND REQUIRED to appear personally before the State Auditor or her representative, Paul Harper, General Counsel, at the Harry S Truman State Office Building, 301 West High Street, Room 880, Jefferson City, MO 65102, at 9:00 a.m. on April 28, 2017, for purposes of providing testimony and producing for examination, copying, and interrogation the following records and documents listed on Exhibit A attached to this Subpoena.

ISSUED this 19th day of April 2017, pursuant to Section 29.235.4(1), RSMo.

(STATE AUDITOR'S SEAL)

Nicole Galloway
Missouri State Auditor

I, Joshua Shope, served the foregoing subpoena by service on ____________ this 19th day of April 2017.

EXHIBIT A

You are to preserve for production and inspection, and then appear as instructed on the attached subpoena and produce for inspection and examination, the following items in your possession or under your control as previously requested by the State Auditor's Office (As documented in the letters contained in Exhibits B and C):*

1. Any and all documentation or reports related to the total amount of interest paid for Corporate and Individual Income tax refunds for FY2012, FY2013, FY2014, FY2015, and FY2016.
2. Any and all documentation or reports related to the number of refunds that were untimely which led to interest being paid for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.
3. Any and all documentation or reports related to the total number of refunds issued for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.
4. Any and all documentation or reports related to the total number of returns processed (whether the taxes were refunded, paid, or are still owed) for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.|
5. Any documentation of controls or procedures for the handling of Corporate and Individual income tax refunds for Revenue.
6. Any reports or other documentation that that shows the number of individual tax refunds that are currently over 45 days and the total of interest owed.
7. Any reports or other documentation that that shows the number of corporate tax refunds that are currently over 120 days and the total of interest owed.

You must also bring sufficient witnesses to testify on the record regarding the following:

1. The general reasons for why Corporate and Individual Income tax refunds are not being issued timely.
2. The steps taken by the Department from when the refund is received, reviewed, and then refund returned to taxpayer, and an estimated timeframe for the Department to issue the refund.
3. On any matter related to the above referenced documents.

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* This request for records includes all materials that exist in paper ("hard copy") or electronic form (including but not limited to records and data maintained on computers, tablets, smart phones, external electronic storage drives, thumbnail drives, remote servers or back up tapes). All information requested in the items above are subject to inspection, review and copying by the state auditor. Section 29.235.4(1), RSMo. **To the extent that the documents contain personally identifiable tax information, such information should be redacted.**

Exhibit A Page 1 of 1

EXHIBIT
B

NICOLE GALLOWAY, CPA
Missouri State Auditor

March 30, 2017

Wood Miller, Acting Director
Missouri Department of Revenue
301 West High St.. Room 670
Jefferson City, MO 65101

Dear Acting Director Miller:

As you know, this office is currently auditing the Department of Revenue regarding the issuance of tax refunds. Our auditors requested the following information on March 6, 2017:

1. The total amount of interest paid for Corporate and Individual Income tax refunds for FY2012, FY2013, FY2014, FY2015, and FY2016.

2. How many refunds were untimely which led to interest being paid for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.

3. The total number of refunds issued for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.

4. The total number of returns processed (whether the taxes were refunded, paid, or are still owed) for Corporate and Individual Income tax for FY2012, FY2013, FY2014, FY2015, and FY2016.

5. The general reasons for why Corporate and Individual Income tax refunds are not being issued timely?

6. Any documentation of controls or procedures for the handling of Corporate and Individual income tax refunds for Revenue.

7. A short memo listing the steps taken by the Department from when the refund is received, reviewed, and then refund returned to taxpayer, and an estimated timeframe for the Department uses to issue the refund (if known).

Additionally, on March 20, 2017, our auditors requested the following additional information:

1. Does the DOR have a real-time report(s) that shows the number of individual tax refunds that are over 45 days and a running total of interest owed?

2. Does the DOR have a real-time report(s) that shows the number of corporate tax refunds that are over 120 days and a running total of interest owed?

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3. If so, can we obtain a copy of the report(s) on a regular basis (receive it on the same day every week) until our audit has concluded?

Our auditors followed up with our audit contact, Lynn Bexten, on a few occasions in March to request an estimate of when we would receive responses to our requests. Ms. Bexten was unable to provide any information about the timeline for responses. You and I spoke on March 28, 2017, and you stated that the Department is currently working on the requests but could not specify a timeframe for when responses would be provided. To date, no information requested has been provided by the Department.

Section 29.235.1, RSMo, requires this office to conduct its audits in accordance with standards established by the Comptroller General of the United States (commonly known as the "Yellow Book"). The Yellow Book requires that auditors obtain sufficient and appropriate evidence to support all of its findings and conclusions. Furthermore, under Section 29.235, RSMo, the auditor is authorized to examine all books, accounts, records, reports, and vouchers of any entity subject to audit. Section 29.235, RSMo, further authorizes the State Auditor's office to issue subpoenas as needed to conduct an audit under Chapter 29.

The auditors have requested these documents so that they may perform the audit of the Department. Any further delay will increase the time it takes to complete this audit. I would ask that by April 10, 2017, you provide responses to the requested information. If some of the information cannot reasonably be provided by that date, I ask that you contact me so that we can discuss a mutually agreeable date for that information's release.

If you have any questions, you may contact me by email at Paul.Harper@auditor.mo.gov or by telephone at (573) 751-4213.

Sincerely,

Paul Harper

Paul Harper
General Counsel

EXHIBIT
C

NICOLE GALLOWAY, CPA
Missouri State Auditor

April 10, 2017

Joel Walters, Acting Director
Missouri Department of Revenue
301 West High St., Room 670
Jefferson City, MO 65101

Dear Acting Director Walters:

I am responding to your letter dated April 7, 2017, in which you requested more time to provide the requested information concerning the issuance of tax refunds audit.

As outlined in my letter dated March 30, 2017, to Acting Director Miller, this office began requesting information on March 6, 2017. The March 6th request was merely an inquiry regarding historical information related to corporate and individual income tax refunds. Additionally, on March 20, 2017, this office made a second request for further information, requesting whether the Department had any real time tax refund reports and, if so, a timeframe on their availability.

Auditors from this office followed up with Lynn Bexton throughout the month of March to request an estimate of when this office would receive the information. Because no estimate was forthcoming, I called Acting Director Miller on March 28, 2017, to obtain the status of our request. Acting Director Miller informed me during that conversation that the Department was working on the documentation but that he could not provide an estimate of when the Department would have the information ready for the Auditor's Office.

As you know, I sent the March 30th letter to Acting Director Miller outlining the conversations and requesting that the Department send the requested information by April 10, 2017. Additionally I asked Acting Director Miller to contact me if some of the information cannot be obtained by that date to discuss a mutually agreeable date for the remainder of the information.

As of this date, more than a month after the original request, this office has received no information and no estimate of when the Department of Revenue would provide the documentation, even on the simple questions of whether the Department produces real time reports. We would ask that you provide all requested documents no later than next Monday, April 17, 2017, so that the audit is not delayed any further.

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Please be aware that the State Auditor and her authorized representatives under law have access to the records of state departments. I would hope that this matter can be resolved without further incident. Please be aware that additional delays may require this office to use other legal means to obtain the documents necessary to complete our review.

If you have any questions, you may contact me by email at Paul.Harper@auditor.mo.gov or by telephone at (573) 751-4213.

Sincerely,

Paul Harper

Paul Harper
General Counsel

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