



NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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January 29, 2013

Douglas Ewald, Tax Commissioner
Nebraska Department of Revenue
301 Centennial Mall South, 2nd Floor
Lincoln, Nebraska 68509-5026

Dear Mr. Ewald:

We have audited the basic financial statements of the State of Nebraska (the State) as of and for the year ended June 30, 2012, in accordance with auditing standards generally accepted in the United States of America, and have issued our report thereon dated January 16, 2013. In planning and performing our audit, we considered the State's internal control over financial reporting (internal control) as a basis for designing audit procedures for the purpose of expressing our opinions on the basic financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

In connection with our audit described above, we noted certain internal control or compliance matters related to the activities of the Nebraska Department of Revenue (the Agency) or other operational matters that are presented below for your consideration. These comments and recommendations, which have been discussed with the appropriate members of the Agency's management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of prior year comments and recommendations. To the extent the situations that prompted the recommendations in the prior year still exist, they have been incorporated in the comments presented for the current year. All other prior year comments and recommendations (if applicable) have been satisfactorily resolved.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified.

Draft copies of this letter were furnished to the Agency to provide them an opportunity to review the letter and to respond to the comments and recommendations included in this letter. All formal responses received have been incorporated into this letter. Responses have been objectively evaluated and recognized, as appropriate, in the letter. Responses that indicate corrective action has been taken were not verified at this time, but will be verified in the next audit.

The following are our comments and recommendations for the year ended June 30, 2012.

1. Underpayment of Estimated Tax Penalty

Title 316 NAC 20-002.01 states,

“Every corporation or business which is taxed as a corporation under the Internal Revenue Code shall make payments of Nebraska corporation estimated income tax if the Nebraska tax liability for the taxable year can reasonably be expected to be \$400 or more after deducting the total estimated allowable credits...”

Title 316 NAC 20-008.01 states, “A penalty is due on any underpayment of estimated tax.”

Title 316 NAC 20-008.05 states, “If there has been an underpayment of estimated tax as of any installment date, a Corporation Underpayment of Estimated Tax, Form 2220N, must be completed and attached to the Nebraska Corporation Income Tax Return, Form 1120N...”

A good internal control plan requires system checks be in place to ensure penalties reported to the Agency are calculated correctly and tax penalties due are identified and assessed.

During testing we noted the Agency’s Corporate Tax System (CTX) did not have system checks to ensure corporations were correctly calculating penalties due or that corporations that did not assess and pay penalties were in compliance with the Agency’s rules and regulations.

Furthermore, the Agency did not have procedures in place to manually review all penalty forms submitted by corporations for accuracy or to ensure corporations who should have paid penalties did so. Instead, the Agency’s audit staff performed reviews of corporate tax returns identified as high risk for owing but not paying a penalty. According to the Agency, for the tax years 2006 and 2007, 318 accounts were reviewed and 90 were assessed an underpayment penalty for a total of \$521,856. For tax year 2008, 200 accounts were reviewed and 28 were assessed an underpayment penalty for a total of \$246,691. The Agency was still in the process of reviewing tax year 2009. It is unknown the number of corporations or possible penalty payments that were not assessed as not all corporations were subject to the Agency’s audit reviews. However, as of 2010, according to the Agency, there were approximately 20,500 corporations that filed in the State of Nebraska.

During our testing of corporate tax returns, we noted two of six corporations did not properly calculate the penalty, which were not corrected by the Agency because they did not have procedures to review the penalty forms submitted by the corporations. The dollar errors noted were not significant (\$93 overpayment and a \$2 underpayment).

When system checks are not in place and procedures are not performed to ensure penalties are properly paid, in compliance with State regulations, it is likely penalties are being underpaid by corporations either intentionally or by error.

We recommend the Agency implement changes so the system reviews corporate tax returns to ensure penalties are correctly identified and assessed.

Agency's Response: Our Department has a compensating control in place which we feel adequately addresses risks associated with corporate underpayment of estimated tax penalty. However, we will continue to monitor this issue from an internal control and tax administrative perspective and will consider implementing stronger controls to this system based upon a continuing evaluation of the risks involved and the availability of resources.

2. Tax Balances

A good internal control plan requires the appropriate authorization be received prior to classifying accounts as inactive and thus no longer actively pursuing collection for the tax. Good internal controls also require a formal policy be adopted to document how inactive accounts will be identified.

The Agency does not have a formal policy to document the approval of reclassifying tax balances from active to inactive. In addition, the Agency does not have a formal policy to describe the process of identifying which tax balances are determined to be inactive, nor does the Agency have policies on removing records from their inactive file. Annually, the Agency identifies certain tax balances and reclassifies them from active to inactive. This reclassification is done only after the Agency has performed all its collection procedures. Once the balances have been identified as inactive, they are moved to another database where they can be maintained at a lower cost.

Per the Agency's separate database, inactive accounts have a debit balance (receivables) of \$21,426,578 and a credit balance (possible payables) of \$6,871,630. Per the Agency, an example of a credit balance would be a corporation who made quarterly tax payments but never filed their final return. The inactive accounts date back to 1967. These records are kept by the Agency in the event a taxpayer is required to make a payment due to liens placed against the taxpayer's property. According to the Agency, these balances are never written off or forgiven. Per the Agency, these balances are compared to tax refund requests so that any refund can be applied to the balance.

There is an increased risk balances will be incorrectly classified as inactive when there is no formal policy on the identification of inactive accounts or how the reclassification approval will be documented.

We recommend the Agency implement a formal policy documenting the reclassification process and the approval to classify accounts as inactive. This policy should include: clearly defined collection procedures which have been performed and can be supported, as well as the level of management approval that will approve the balances to be purged, and how the approval will be documented. In addition, to ensure integrity and completeness of the inactive file, the above policy should also include procedures to be followed and documentation required to remove records from their inactive file.

Agency's Response: The Department agrees with this recommendation and will develop and implement a formal policy and the associated procedures for classifying, approving and documenting inactive balance accounts.

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Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Agency and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to the Agency.

This report is intended solely for the information and use of the Agency, the Governor and State Legislature, others within the Agency, Federal awarding agencies, pass-through entities, and management of the State of Nebraska and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

SIGNED ORIGINAL ON FILE

Pat Reding, CPA, CFE
Assistant Deputy Auditor