



# NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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Mike Foley  
State Auditor

Mike.Foley@nebraska.gov  
P.O. Box 98917  
State Capitol, Suite 2303  
Lincoln, Nebraska 68509  
402-471-2111, FAX 402-471-3301  
[www.auditors.nebraska.gov](http://www.auditors.nebraska.gov)

February 10, 2014

Kim Conroy, Tax Commissioner  
Nebraska Department of Revenue  
301 Centennial Mall South, 2<sup>nd</sup> Floor  
Lincoln, Nebraska 68509-5026

Dear Ms. Conroy:

We have audited the basic financial statements of the State of Nebraska (State) as of and for the year ended June 30, 2013, in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and have issued our report thereon dated December 30, 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 (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 management with an opportunity to review and to respond to the comments and recommendations contained herein. 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, 2013.

**1. Underpayment of Estimated Tax Penalty**

Title 316 NAC 20-002.01 states, in relevant part:

*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 . . . .*

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

Title 316 NAC 20-008.05 provides, in relevant part:

*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 that system checks be in place to ensure penalties reported to the Agency are calculated correctly, and tax penalties due are identified and assessed.

The Agency’s corporate tax system (CTX) lacked system checks to ensure corporations were correctly calculating penalties due or that corporations failing to 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 the accuracy of penalty forms submitted by corporations or to ensure that all corporate penalties owed were paid. 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. Two hundred accounts were reviewed for tax year 2008, and 28 were assessed an underpayment penalty for a total of \$246,691. At the time of this audit, the Agency was still in the process of reviewing corporate accounts for tax years 2009 and 2010.

Because all corporations were not subject to the Agency’s audit reviews, the number of non-complying corporations or possible unassessed penalty payments remained unknown. However, as of 2010, according to the Agency, approximately 20,500 corporations had filed tax returns in the State of Nebraska.

A similar finding was noted in the prior audit.

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

We recommend the Agency implement procedures or system verifications of corporate penalty forms to ensure that penalties are correctly identified and assessed.

*Agency's Response: The Department has a compensating control in place that addresses risks associated with corporate underpayment of estimated tax penalty. Although we feel that our current limited scope review identifies most material penalty situations, we are currently studying whether there are other methods that we could employ to make error determinations for this penalty.*

*The Department is also in the process of developing a modification to the corporate processing system, which will allow us to enter all Form 2220Ns that we receive and calculate them for mathematical correctness of the reported numbers. Further review will need to be performed by our Audit Section on those Form 2220Ns to determine the accuracy of the reported figures because of the complexities involved in the preparation of a correct Form 2220N.*

## **2. Tax Balances**

A good internal control plan requires that appropriate authorization be received prior to classifying accounts as inactive and, therefore, no longer subject to active pursuit for tax collection. Good internal controls also require that formal policies be adopted to document how inactive accounts are identified and subsequently managed.

The Agency does not currently have a formal policy in place for documenting the approved reclassification of tax balances from active to inactive status. In addition, not only does the Agency lack a formal policy describing the process of identifying which tax balances are determined to be inactive, but also no policy exists for governing the removal of records from the Agency's inactive file.

Annually, the Agency has identified certain tax balances and reclassified them from active to inactive. The reclassification was done only after the Agency performed all of its collection procedures. Once identified as inactive, the tax balances were moved to another database – where they could be maintained at a lower cost.

Per the Agency's separate database, inactive accounts had a debit balance (receivables) of \$21,698,956 and a credit balance (possible payables) of \$6,683,756, at June 30, 2013. Per the Agency, an example of a credit balance would be a corporation that made quarterly tax payments but never filed its final return. The inactive accounts dated back to 1967. These records were kept by the Agency in the event a taxpayer was required to make a payment due to liens placed against the taxpayer's property. According to the Agency, such balances are never written off or

forgiven. Per the Agency, the balances are compared to tax refund requests, so that any refund can be applied to the balance. The Agency is working on a formal policy; therefore, no new account balances were reclassified from active to inactive. During the fiscal year ended June 30, 2013, the Agency did record activity on previously identified inactive accounts.

A similar finding was noted in the prior audit.

There is an increased risk that tax balances due will be incorrectly classified as inactive when no formal policies exist for identifying, documenting the reclassification, and directing the subsequent management of inactive accounts.

We recommend the Agency implement formal policies for identifying and approving accounts for reclassification from active to inactive status. Such policies should include: 1) clearly defined collection procedures that must be performed and documented prior to reclassification; 2) the level of management approval, as well as the required documentation for such approval, needed for reclassification; and 3) both the specific procedures to be followed and documentation required for removing records from the inactive file.

*Agency's Response: The Department agrees with this recommendation. As indicated, the Department is developing formal policies associated with the classification of these tax balances. No new accounts will be reclassified from active to inactive until these policies have been completed and implemented*

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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 communication is intended solely for the information and use of management, the Governor and State Legislature, and others within the Agency and is not intended to be, and should not be, used by anyone other than these specified parties. However, this communication is a matter of public record, and its distribution is not limited.

SIGNED ORIGINAL ON FILE

Pat Reding, CPA, CFE  
Assistant Deputy Auditor