Office of Missouri State Auditor

Nicole Galloway, CPA

Timeliness of Income Tax Refund Issuance

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CITIZENS SUMMARY

Findings in the audit of Timeliness of Income Tax Refund Issuance

Improvements Made in the Timeliness of Individual Income Tax Refunds	The state made improvements in the timely payment of individual income tax refunds during fiscal year 2018 compared to the previous 2 fiscal years. In addition to the total amount refunded being paid more timely during fiscal year 2018, improvements have also been made in decreasing the number of refunds being delayed.
Improved Cash Flow Allowed for More Timely Refunds	Improvements in the timeliness of income tax refunds resulted from improved cash flow to the General Revenue (GR) Fund in fiscal year 2018. According to monthly general revenue reports generated by the Office of Administration, the state collected significantly higher (32 percent) personal income tax revenue in January 2018 than in January 2017. While borrowings from the Budget Reserve Fund allowed the state to continue to meet its obligations and were replenished before 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. Due to the decrease in cash available since 2008, the state has had to use money borrowed from the Budget Reserve Fund for other operating obligations, making less reserve 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 Department of Revenue has established a priority system for paying individual income tax refunds.
Changes to State Withholding Tables	Changes made in 2018 to the state's individual income tax withholding tables to adjust for changes to the federal tax law and a reduction in state income tax rates have resulted in a significant reduction in revenues for individual income tax withholdings to the GR Fund during fiscal year 2019. The impact of these changes in cash flow on the timeliness of income tax refund issuance is uncertain. In addition, changes to the withholding table in January 2019 are expected to result in over withholding from a majority of taxpayers.

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

Timeliness of Income Tax Refund Issuance
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Honorable Michael L. Parson, Governor
and
Members of the General Assembly
and
Kenneth J. Zellers, Acting Director
Department of Revenue

We have audited certain operations of the Department of Revenue 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 years ended June 30, 2018 and 2017. 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 provisions related to the timeliness of income tax refund issuance.

3. Evaluate the economy and efficiency of certain management practices and procedures 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.

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 3 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) the need for improvement in management practices and procedures. 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

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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 2018, the department collected approximately $7.3 billion and $7.7 billion in individual income tax receipts, and paid related refunds of approximately $1.0 billion and $1.1 billion, respectively. During those fiscal years, the records also indicate the department collected approximately $435 million and $462 million in corporate tax receipts, and paid corporate income tax refunds totaling approximately $159 million and $161 million, respectively. DOR records indicate the state paid interest to taxpayers on approximately 79,000 individual income tax refunds totaling approximately $334,000 in fiscal year 2018. In contrast, the state paid interest on approximately 155,000 refunds totaling approximately $423,000 in fiscal year 2017. During those fiscal years, records also indicate the state paid interest on approximately 100 and 20 corporate income tax refunds totaling approximately $40,000 and $4,000, 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 amended 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 amended 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.

In response to a recommendation made in our prior audit report,[1] the General Assembly passed legislation to increase the interest rate the state has to pay on delayed refunds to the same level as the interest rate taxpayers must pay when making late tax payments. Effective August 28, 2018, Section 32.069, RSMo, was changed so that on and after July 1, 2019, the interest rate the state has to pay on delayed refunds will be determined by Section 32.065, RSMo, which sets the interest rate as the adjusted prime rate charged by banks, as determined by the Board of Governors of the Federal Reserve System. This statute also sets the interest rate paid by taxpayers. During calendar year 2018, this interest rate averaged 4 percent. Prior to July 1, 2019, the interest rate the state has to pay is determined by Section 32.068, RSMo, as previously discussed. During calendar year 2018, this interest rate averaged 1.1 percent.

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 continuous 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 by the time frames established in Section 32.069, RSMo. However, if a taxpayer does not 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).

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

[1] Report No. 2018-001, *Timeliness of Income Tax Refund Issuance*, issued January 2018.

- 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.[2]
- amended returns filed by taxpayers.[3]
- audited returns.[4]
- legal settlements.[5]
- protested returns.[6]

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,[7] 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.

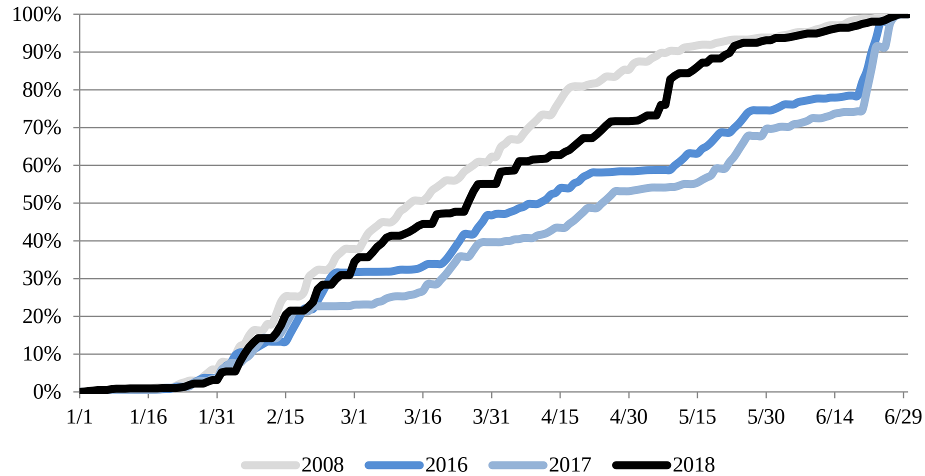
We obtained an understanding of the internal controls that are significant within the context of the audit objectives and assessed whether such controls have been properly designed and placed in operation. We obtained an understanding of legal provisions that are significant within the context of the 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.

[2] Apportioned tax credits are tax credits held until June each year to determine if taxpayers, in total, are claiming more than the 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.
[3] The DOR must receive a transcript from the Internal Revenue Service (IRS) to verify acceptance of a taxpayer's amended federal return, if applicable, which usually exceeds 45 days.
[4] Each year the DOR chooses returns to audit based on various factors.
[5] If a return is involved in a lawsuit, the refund is held until the lawsuit has been resolved.
[6] 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 department.
[7] The DOR redacted all personally identifiable taxpayer information from the records we received during the audit based on the department's 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.

1. Improvements Made in the Timeliness of Individual Income Tax Refunds

The state made improvements in the timely payment of individual income tax refunds during fiscal year 2018 compared to the previous 2 fiscal years. Based on state income tax refund data, in fiscal year 2018 the state paid 80 percent of total refunds by May 9. In contrast, for fiscal years 2016 and 2017 the state did not reach that payout level until June 20 and June 22, respectively. However, fiscal year 2018 still lags behind historical timeliness trends. For example, in fiscal year 2008 the state paid 80 percent of total refunds by April 17. Figure 1.1 shows the comparative timing of income tax refund payments for these years.

Figure 1.1: Percent of total refunds paid from January 1 to June 30, by fiscal year, for Fiscal Year 2008, 2016-2018



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

Decreases in delayed refunds

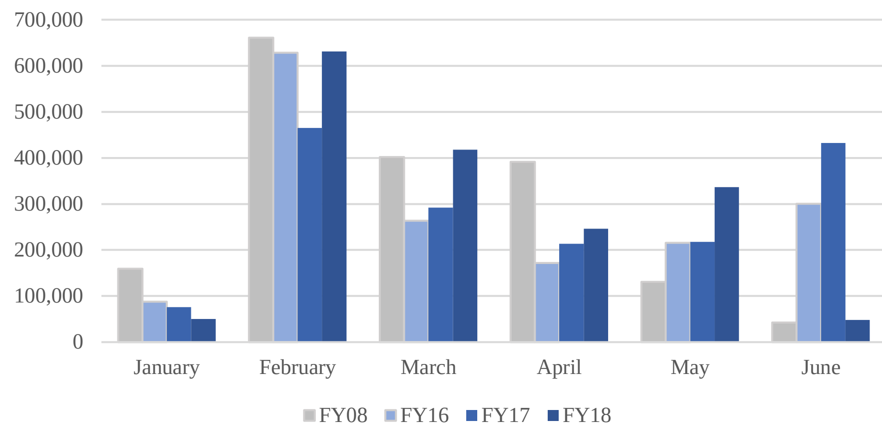
In addition to the total amount refunded being paid more timely during fiscal year 2018, improvements have also been made in decreasing the number of refunds being delayed. The number of June refunds paid in fiscal year 2017 was approximately 433,000 (24 percent of total refunds), but declined significantly in fiscal year 2018 to approximately 48,000 (3 percent of total refunds). For historical perspective, in fiscal year 2008 the number of June refunds was approximately 42,000 (2 percent of total refunds). Figure 1.2 shows the trends in number of refunds issued, by month, from January to June.

In fiscal year 2017, an estimated 672,000 of the approximate 1.8 million individual income tax refunds were paid more than 45 days[8] after being received (37 percent). In fiscal year 2018, an estimated 105,000 of the approximate 1.9 million individual income tax refunds were paid more than

[8] This number includes refunds with interest paid to taxpayers and refunds with interest under $1 not paid to taxpayers.

45 days[9] after being received (6 percent); an improvement of 567,000 returns. As a result of these improvements, the state has paid less in interest on late refunds. Interest paid on refunds decreased from approximately $423,000 paid on approximately 155,000 refunds in fiscal year 2017, to approximately $334,000 paid on approximately 79,000 refunds in fiscal year 2018.

Figure 1.2: Number of individual income tax refunds issued from January to June, 2008 and 2016-2018, 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 the timeliness of refund payments. While the number and amount of individual income tax refunds being paid later in the year increased from fiscal year 2016 to fiscal year 2017, significant improvements occurred in fiscal year 2018, with refunds being paid more timely. 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. Improved Cash Flow Allowed for More Timely Refunds

Improvements in the timeliness of income tax refunds resulted from improved cash flow to the General Revenue (GR) Fund in fiscal year 2018. Our prior audit report discussed the downward trend in the amount of cash reserves available in the GR Fund from 2008 through 2017. During 2018, the cash reserves improved slightly compared to 2017 but still remained low by historical standards.

Improved cash flow

According to monthly general revenue reports generated by the Office of Administration (OA), the state collected significantly higher (32 percent) personal income tax revenue in January 2018 than in January 2017. The January 2018 collections were also significantly higher (32 percent) than the amount collected in January 2019. This fluctuation resulted in increased cash

[9] This number includes refunds with interest paid to taxpayers and refunds with interest under $1 which was paid to taxpayers beginning March 2018.

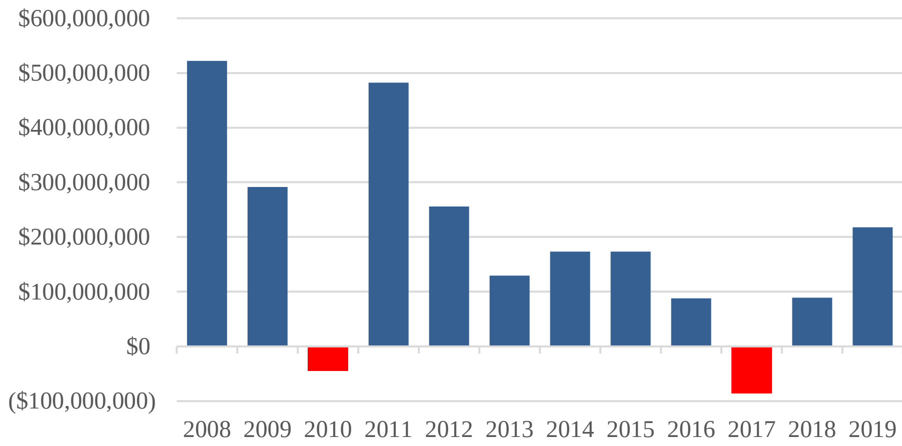
flow of approximately $223 million in January 2018, allowing the DOR to pay refunds more timely.

According to DOR records, throughout 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. In comparison, during June 2018, the most refunds processed and ready to be paid at any point during the month was approximately $6 million on June 28, 2018, with payment of the majority of these refunds occurring within the following week.

Historical cash flow issues continue

Figure 2.1 shows the state's GR Fund cash balance at January 1, less any loans from the Budget Reserve Fund. The balance at January 1, 2018, was $89 million, which is an increase of $175 million from the January 1, 2017 negative balance of $86 million. However, the January 2018 balance was still approximately $433 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 before 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. The state's GR Fund cash balance, less any loans from the Budget Reserve Fund, has continued to increase into fiscal year 2019. The balance at January 1, 2019, was $218 million, an increase of $129 million from the January 1, 2018, balance of $89 million.

Figure 2.1: 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 since 2008 as shown in Figure 2.1, the OA has had to use money borrowed from the Budget Reserve Fund for other operating obligations, making less reserve funding available for paying individual income tax refunds.

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 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 these 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,[10] 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 is not allowed to exceed 7.5 percent of net general revenue collections[11] for the previous fiscal year.[12]

Borrowing from the Budget Reserve Fund has increased since the 2008 recession through fiscal year 2017. However, during fiscal year 2018, $350 million was borrowed compared to $500 million borrowed during fiscal year 2017. For fiscal year 2019, $500 million has been borrowed from the Budget Reserve Fund through March. Figure 2.2 shows the amounts borrowed from budget reserve, by fiscal year.

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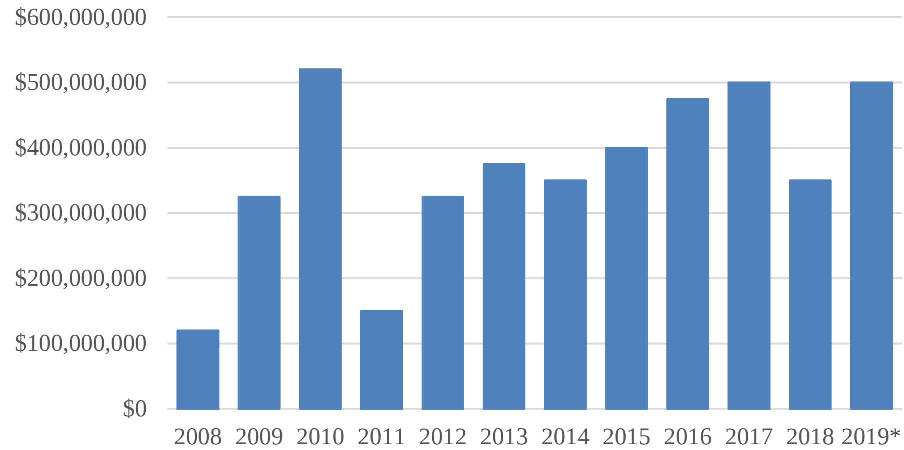
[10] For fiscal year 2018, the General Assembly appropriated $500 million for Budget Reserve Fund expenditures.

[11] 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.

[12] 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, 2018, was approximately $677 million (7.5 percent of the $9.02 billion net general revenue collections in fiscal year 2017). The actual fund balance was approximately $616 million.

Figure 2.2: Amounts borrowed from Budget Reserve Fund, 2008-2019, by fiscal year



* Fiscal year 2019 includes activity from July through March.

Source: Office of Administration records

The reasons for the fluctuations in fund balance of the GR Fund and causes of the cash flow shortage are beyond the scope of this report. However, previous audit reports[13] address various issues related to reductions to the state's tax base and reductions to tax revenues, and growth in spending in certain areas.

Conclusion

Improved availability of cash reserves in the GR Fund during fiscal year 2018 allowed the state to improve the timeliness of individual income tax refunds and reduce borrowing from the Budget Reserve Fund as compared to 2017. While cash flow improved for 2018, available cash levels still remain low by historical standards and have necessitated borrowing from the Budget Reserve Fund for operational purposes. The cash available to pay state obligations, including income tax refunds, is reliant upon the budget process. State policymakers must continue to address this issue to ensure all state obligations, including tax refunds, are being paid timely.

Recommendation

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

Auditee's Response

Due to this recommendation being legislative in nature, no management response can be obtained.

[13] 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.

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 same priority system in place in 2017 was still in use in 2018; however, DOR officials stated they made changes to the Priority 1 designation to help improve the timeliness of refunds.

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:

- Priority 1: Expedited Refunds - 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,[14] 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.

  Our prior audit report noted the DOR's practice had been to move large dollar refunds to Priority 1 in an effort to reduce the amount of interest the state would have to pay. However, according to department officials, during fiscal year 2018 this practice ended. During fiscal year 2017, approximately 16,700 refunds were issued as Priority 1; however, in fiscal year 2018, the department issued only 550 refunds as Priority 1.

- 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. In fiscal year 2018 and 2017, electronically-filed and 2D barcode returns accounted for approximately 95 percent and 94 percent,[15] respectively, 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.

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

[15] The fiscal year 2017 percentage has been restated from our prior audit report.

- 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 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 where 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 to not be fraudulent, the refunds are assigned a higher priority.

- Priority 9: 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 the amount 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 periods with cash flow restrictions, there is not enough money allocated each day to pay out all the 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. In November 2018, the DOR implemented a new tax system with the capability to pay select refunds within a priority; however, according to DOR officials, they will continue to use the same priority system to pay refunds and will continue, with management approval, to move select returns to the highest priority to expedite a refund.

Conclusion

With the DOR no longer moving large dollar refunds to Priority 1, this will result in smaller dollar refunds being paid more timely. However, the amount of interest due on large dollar refunds may increase if those refunds are delayed. In addition, as a result of changes to Section 32.069, RSMo, beginning July 1, 2019, the interest rate the state has to pay on delayed refunds will increase. Therefore, the longer the large dollar refunds are delayed, the more interest the state will be required to pay. While requiring refunds to be paid in the order they are processed and approved for payment will likely result in increased interest costs to the state, doing so would also result in more equitable treatment of all taxpayers owed an income tax refund.

Recommendation

The General Assembly evaluate the DOR's refund priority levels for appropriateness.

Auditee's Response

Due to this recommendation being legislative in nature, no management response can be obtained.

4. Changes to State Withholding Tables

Changes made in 2018 to the state's individual income tax withholding tables to adjust for changes to the federal tax law and a reduction in state income tax rates have resulted in a significant reduction in revenues for individual income tax withholdings to the GR Fund during fiscal year 2019 (through January). Not only will the GR Fund experience a reduction in total individual income tax revenue, but the timing of the revenue to the fund has also been altered with increases in tax remittances and reductions in withholdings. The impact of these changes in cash flow on the timeliness of income tax refund issuance is uncertain.

With the 2018 changes to the withholding tables, along with the federal tax law and state income tax rate changes, taxpayers are likely to receive smaller tax refunds or have larger amounts owed for tax year 2018 than in previous years. However, due to a lack of communication by the DOR, taxpayers have not been well informed about the potential impact of these changes. Also, some decisions made by the former Director of the Department of Revenue when developing the withholding tables have led to confusion and a lack of confidence regarding the accuracy of the withholding tables and the impact of the tables on future withholdings. In addition, the current withholding formula has not been updated in state regulations as required by state law.

Changing of 2018 withholding tables

The state's individual income tax withholding tables for tax year 2018 were initially delayed due to the changes to the federal tax law that occurred in December 2017. The DOR adjusted the state's withholding tables for changes in the federal tax law and the updated tables were published in March 2018. In October 2018, at the direction of the former Director, the DOR issued new withholding tables to help increase withholdings in response to concerns about reduced withholding levels during 2018. These changes have led to confusion and a lack of confidence regarding the accuracy of the withholding tables and the impact those withholding tables may have on taxpayers as they file their 2018 tax returns. In addition, when additional revisions were made to the withholding tables in January 2019, the DOR chose to exclude an adjustment to Missouri taxable income[16] that will impact a significant number of taxpayers, resulting in an over withholding for certain taxpayers with a federal income tax liability and Missouri adjusted gross income under $125,000. DOR officials stated the exclusion of this adjustment from the 2019 withholding calculation was made in an effort to simplify the calculation, and because including the adjustment did not significantly impact individual taxpayer withholdings. Based on our analysis of 2017 individual income tax return data from the DOR, an estimated 53 percent of the returns will be impacted by this adjustment, and will result in an estimated $62.9 million (1.2 percent[17]) increase in total withholdings for calendar year 2019. Since these changes were implemented in January 2019 they should offset some portion of the reduced withholdings from the first half of fiscal year 2019.

The director of the Department of Revenue, through the department, is responsible for providing guidance to taxpayers regarding withholdings, including updating the tax tables. Although the DOR is not required to publish regulations for most tax policy guidance, state law requires the withholding calculation be published in the Code of State Regulations (CSR). See page 17 for additional discussion. The director and the administration are responsible for providing this guidance and informing taxpayers of any changes.

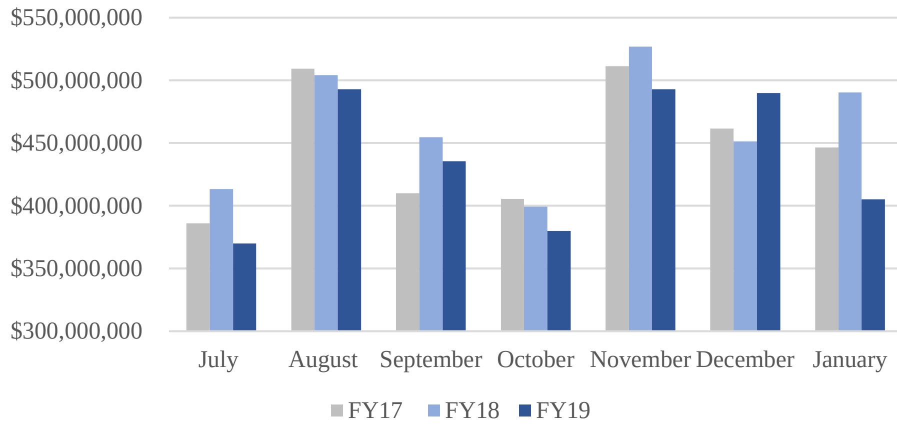
Impact on timeliness of income tax refunds

The impact of the changes to the withholding tables on the timeliness of income tax refunds is uncertain. Current consensus revenue estimates from the OA Division of Budget and Planning are projecting a reduction in state withholdings of approximately $275 million (4.8 percent) for fiscal year 2019 compared to fiscal year 2018. See Figure 4.1 for the comparison of actual income tax withholding revenues between July and January, for fiscal years 2017, 2018, and 2019.

[16] Section 143.171.2, RSMo, provides for a deduction equal to a percentage of a taxpayer's federal income tax liability on the Missouri individual income tax return. The maximum deduction percentage is 35 percent for individuals with Missouri adjusted gross income under $25,000. The deductible percentage declines as the Missouri adjusted gross income increases, and is fully phased out for individuals with Missouri adjusted gross income exceeding $125,000.

[17] This estimated percentage was calculated using the estimated total withholding revenue for fiscal year 2019 of $5.46 billion projected by the OA Division of Budget and Planning.

Figure 4.1: Individual income tax withholding amounts collected from July to January, for fiscal year 2017-2019



Source: Office of Administration records

However, the OA Division of Budget and Planning projects an increase in individual income tax remittances[18] that will help offset the significant reduction in withholding revenue. The combined decrease in withholdings and the increase in remittances is still estimated to result in a decrease in overall individual income tax revenue of approximately $109 million (1.4 percent) in fiscal year 2019 compared to fiscal year 2018 if the state meets its consensus revenue estimate. Because income tax withholdings occur on an even basis throughout the year, and remittances occur later in the fiscal year, the withholding table changes will have a negative impact on state cash flow.

According to OA Division of Budget and Planning estimates, the amount of individual income tax refunds the state will need to pay is projected to decrease $232 million (20.5 percent) in fiscal year 2019. The reduced amount of refunds to be paid will reduce necessary expenses, however, the changes in cash flow to the state still result in uncertainty about the state's ability to timely pay 2019 income tax refunds, and other obligations. Any level of revenue short of the current revenue estimates will likely necessitate additional borrowing from the Budget Reserve Fund or negatively impact the timeliness of income tax refunds in 2019.

Impact to taxpayers

Changes to the federal tax law, reduction in the state income tax rates, and changes to the state's withholding tables are expected to result in changes for many taxpayers in either smaller tax refunds or larger amounts owed for tax year 2018 compared to previous years. The DOR and the administration did not make sufficient efforts to inform individual taxpayers of the potential impact these changes may have on their 2018 tax returns. DOR officials stated they mailed flyers and sent emails to employers and contacted payroll

[18] Tax remittances, which are payments of taxes that are not withholdings and are not estimated quarterly payments, are expected to increase $134 million (15.4 percent) in fiscal year 2019.

agencies by telephone. However, notifications to individual taxpayers consisted only of social media posts that reached minimal taxpayers.

Timely notification to taxpayers of the potential impacts of the changes to the withholding tables would have allowed taxpayers to make adjustments to their withholding preferences prior to the end of the tax year and would have potentially alleviated concerns currently being faced by some taxpayers.

State regulation for withholdings not updated

The January 2019 withholding table calculation is not consistent with the state regulations, as required by state law. Section 143.191.3(1), RSMo, states, in part, "the method of determining the amount to be withheld shall be prescribed by regulations of the director of revenue." Currently, 12 CSR 10-2.015(20) states regarding the withholding formula: "The formula is mathematically stated as gross income minus standard deduction, minus personal and dependent exemptions, minus federal income tax withheld equals taxable income. Taxable income multiplied by the rate equals Missouri withholding." Based on our review of the January 2019 withholding table and related calculations, the current withholding tables and formula are inconsistent with the current regulation.

Amending the withholding formula regulation through the rulemaking process mandated by Chapter 536, RSMo, is necessary to inform the General Assembly of any changes in the rules through notice to the Joint Committee on Rules. This process also allows for notice and comment to the general public for input on the rules. In the event the rulemaking process could not be timely completed, the department has the ability to publish a temporary emergency rule as provided by Section 536.025, RSMo.

Conclusion

Changes to the state's withholding tables in 2018, along with a reduction in state income tax rates, have significantly decreased revenues from individual income tax withholdings during fiscal year 2019. In addition to negatively impacting taxpayers' 2018 tax return, the changes to the withholding tables are expected to have a negative impact on cash flow to the state, and could potentially have a negative impact on the timeliness of income tax refund issuance in 2019. In addition, the multiple changes to the withholding tables, and the lack of communication by the DOR to taxpayers regarding the potential impact of those changes, have led to confusion and a lack of confidence regarding the accuracy of the withholding tables.

Recommendation

The DOR continue to monitor the impact of the withholding table changes on the timeliness of income tax refunds, and take steps to inform taxpayers of the potential impact of changes made to the state's withholding tables and inform taxpayers of the steps necessary to make any changes to their withholding preferences going forward. The DOR should also update the state regulation to ensure consistency with any changes to the withholding tax calculation.

Auditee's Response

The DOR's written response is included in the Appendix.

MICHAEL L. PARSON
GOVERNOR

JOEL W. WALTERS
DIRECTOR OF REVENUE

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March 18, 2019

Robyn Vogt, CPA
Audit Manager
Missouri State Auditor's Office
HSTOB, Room 880
Jefferson City, MO 65101

Dear Ms. Vogt:

Below please find the Missouri Department of Revenue's response to the Missouri State Auditor's report on Timeliness of Tax Refund Issuance.

Changes to State Withholding Tables

Recommendation – The DOR continue to monitor the impact of the withholding table changes on the timeliness of income tax refunds, and take steps to inform taxpayers of the potential impact of changes made to the state's withholding tables and inform taxpayers of the steps necessary to make any changes to their withholding preferences going forward. The DOR should also update the state regulation to ensure consistency with any changes to the withholding tax calculation.

DOR Response –The DOR will continue to monitor the impact of the withholding table changes and will take steps to communicate with taxpayers. The DOR will begin work to update the state regulation.

If you have any questions, please contact Lynn Bexten at 751-7429, or Lynn.Bexten@dor.mo.gov.

Sincerely,

Joel Walters

Joel Walters

LB/

C: Maria Sanders
Mark Godfrey
Esta Zaring
Mike Davis
Joel Allison