



New York State Office of the State Comptroller
Thomas P. DiNapoli

Division of State Government Accountability

Processing of Paper Tax Returns

Department of Taxation and Finance



Executive Summary

Purpose

To determine whether the deliverables of the contract with New York State Industries for the Disabled (NYSID)/SourceHOV were met and, if not, to assess actions the Department of Taxation and Finance (Department) has taken to correct the problems and ensure satisfactory contractor performance in the future. The audit covers the period January 1, 2012 through February 6, 2014.

Background

The Department is responsible for processing the State's approximately 10.9 million income tax returns. About 2 million (20 percent) of all personal income tax returns in the State are submitted as paper returns. In compliance with State Finance Law regarding preferred source vendors, in 2011 the Department contracted with NYSID, a workforce advocacy organization with preferred source status, to process the State's paper returns for tax processing years 2013 to 2015. According to State Finance Law, when a commodity or service desired by a State agency is available from a preferred source at a price that is no more than 15 percent above the prevailing market rate, the State agency must purchase that commodity or service from the preferred source.

NYSID partnered with a private firm - SourceHOV - to provide equipment and services needed to process the paper returns. Although NYSID is the prime contractor, its duties are largely administrative in nature. SourceHOV, as corporate partner, performs the technical work of tax returns processing. The Department is responsible for overseeing all services provided and for ensuring the timely, correct, and confidential processing of tax information. NYSID/SourceHOV's three-year contract is valued at about \$16 million. However, as of February 6, 2014, the Department had paid out only \$234,000, primarily to fund start-up costs.

Key Findings

- The Department failed to correctly assess the risks and potential impacts of a new vendor taking over the processing of paper returns, which ultimately led to significant quality issues and delays in tax returns processing in 2013.
- As a result, the Department incurred over \$6 million in overtime costs from April through December 2013 to mitigate issues with returns processing, in addition to other as yet unquantified costs for other diverted staff effort.
- Though there were significant breakdowns in many areas of the internal controls relating to the implementation of the contract, the Department took significant actions to correct problems and prepare for 2014.

Key Recommendations

- Determine the appropriate reimbursement due the vendor, as well as any cost reimbursement due the Department, and adjust compensation or seek damages as appropriate.
- Assess whether future processing of paper returns in-house or by a third-party vendor best meets the long-term practical and fiscal needs of the Department.

Other Related Audit/Report of Interest

[Department of Taxation and Finance: Sales Tax Audit Practices \(2010-S-33\)](#)

State of New York
Office of the State Comptroller

Division of State Government Accountability

April 9, 2014

Mr. Thomas H. Mattox
Commissioner
Department of Taxation and Finance
W. A. Harriman Campus
Building #9
Albany, NY 12227

Dear Commissioner Mattox:

The Office of the State Comptroller is committed to helping State agencies, public authorities and local government agencies manage government resources efficiently and effectively. By doing so, it provides accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of State agencies, public authorities and local government agencies, as well as their compliance with relevant statutes and their observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations. Audits can also identify strategies for reducing costs and strengthening controls that are intended to safeguard assets.

Following is a report of our audit entitled *Processing of Paper Tax Returns*. The audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law.

This audit's results and recommendations are resources for you to use in effectively managing your operations and in meeting the expectations of taxpayers. If you have any questions about this report, please feel free to contact us.

Respectfully submitted,

Office of the State Comptroller
Division of State Government Accountability

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This report is also available on our website at: www.osc.state.ny.us

Background

The Department of Taxation and Finance (Department) is responsible for processing the State's approximately 10.9 million income tax returns, which can be submitted either electronically or as paper returns. With the advent of electronic filing options, fewer taxpayers have been submitting paper returns, which currently account for about 2 million, or 20 percent, of all personal income tax returns in the State.

The Department contracts with an outside vendor to process the State's paper returns. Returns for a given tax year are processed in the following year (e.g., returns for the 2012 tax year are processed in 2013). Up until tax processing year 2013, Bank of America was the long-running provider of these services but ended its contract when the declining number of paper returns made it no longer fiscally worthwhile. In compliance with State Finance Law regarding preferred source vendors, the Department then contracted with NYSID, a workforce advocacy organization, to perform this service for tax processing years 2013, 2014, and 2015. According to State Finance Law, when a commodity or service desired by a State agency is available from a preferred source at a price that is no more than 15 percent above the prevailing market rate, the State agency must purchase that commodity or service from the preferred source.

NYSID has partnered with a private firm - SourceHOV - to provide equipment and services needed to process the paper returns. Although NYSID is the prime contractor, its duties are largely administrative in nature. They include negotiating the terms of the contract, vetting an adequate corporate partner to perform the scope of work required by the Department, and, as problems arise, coordinating efforts with the Department and the corporate partner to attempt to successfully execute the contract. SourceHOV, as corporate partner, performs the technical work of tax returns processing, including opening tax return envelopes; scanning returns to create electronic documents for data extraction and archive purposes; data entry; and developing, coding, and testing remittance, imaging, and returns processing systems to support these services. The Department is responsible for overseeing all services provided and for ensuring the timely, correct, and confidential processing of tax information.

The three-year contract amount is valued at about \$16 million, but compensation is predicated on the vendor meeting standards of performance regarding the deliverables. The contract allows for a range of options for adjusting compensation and/or seeking damages if performance standards are not met. As of February 6, 2014, Department had only paid NYSID \$234,000 against the contract, primarily for start-up costs.

Audit Findings and Recommendations

The contract with SourceHOV has many deliverables, some of which relate to timeliness and accuracy, while others relate to quality. We tested several that we determined to be most critical for the 2013 tax processing year, including accuracy of the return data submitted to the Department as well as timeliness of return processing by SourceHOV and quality of the data imaging of return information. We found the contractor significantly failed to meet the accuracy/completeness and timeliness requirements of the contract. We also discovered issues regarding quality of data imaging.

Many of these problems occurred in part because the Department did not correctly assess the risks or potential impacts of a new vendor taking over the processing of paper returns. As a result, it failed to develop contingency plans to support paper returns processing in the event of SourceHOV's non-performance. Department officials stated they did perform extensive background checks on the vendor, which included obtaining references from other State agencies that contracted with the vendor and from other states, going so far as to visit one other state to review the vendor's processing capabilities. Officials stated they also viewed webinars where SourceHOV demonstrated its software capabilities; however, Department staff did not go on site to view or test the software firsthand, which may have given a better indication of the firm's limitations.

We concluded that systemic problems in process preparation, testing, and oversight on behalf of both the contractor and the Department resulted in paper returns not being processed timely or accurately; return image integrity not being guaranteed; and the Department's need to divert substantial resources to mitigate 2013 tax processing problems. As a result, the Department incurred over \$6 million in overtime costs from April to December 2013 to remedy processing issues. Other as yet unquantified costs include interest charges on late refunds and non-overtime costs of additional staff hired or diverted to complete work the contractor failed to do.

We also found the Department has taken adequate steps to mitigate the problems that occurred in the 2013 tax processing year to provide assurance of future success. Additionally, if such problems do occur, the Department has developed an action plan to facilitate returns processing in 2014.

Paper Tax Returns Processing

In its contract for tax returns processing, the Department stipulates various performance standards for its deliverables, as well as a sliding scale of compensation and a wide range of other remedial options that can become effective in the event the contractor fails to deliver in accordance with Department requirements and procedures. We used statistical sampling techniques to examine contractor performance on three key deliverables related to accuracy, timeliness, and quality for a random sample of 100 paper returns selected from approximately 2 million processed by SourceHOV between January 1, 2013 and December 1, 2013. (As part of its response to the situation, we found the Department also conducted its own audit of these key performance

items.) The performance standards and contract terms related to the key deliverables we tested are as follows:

- **Accuracy/Completeness:** The Department requires a 99.5 percent accuracy/completeness rate, or an error rate of not more than one-half percent, for full compensation. If accuracy falls below 95 percent, compensation may be reduced by two times the error rate.
- **Timeliness:** SourceHOV is required to open a minimum of 25,000 tax return envelopes on the same business day as received and to complete full processing of each return within seven business days of receipt. Under the contract, the Department may assess liquidated damages of \$1,000 per day for failure to meet this requirement.
- **Quality of Data Imaging:** The contract requires the vendor to electronically transmit accurate, complete, and legible images of the original paper return documents to the Department. The Department may assess liquidated damages of \$500 per day for initial failure and \$250 for each day corrective action is late; repeated offenses of the same violation in the same audit period double liquidated damages.

Our sample results showed that a significant portion of the returns processed by SourceHOV were inaccurate, and almost none were timely. We determined, with 97.5 percent confidence, that SourceHOV introduced errors and inaccuracies in at least 22 percent (439,000) of the returns it processed. These errors occurred in key fields that affect the proper processing of returns, as well as the amount of tax owed or refund due, including the taxpayer's social security number, tax withholding amounts, and amounts recorded for wages, salaries, and tip income. The error rate in our sample is more than 40 times the level deemed acceptable by the performance standards (one-half percent) and could result in a 44 percent reduction in compensation under the terms of the contract.

Our sample testing also showed that at least 91 percent of the returns (1.8 million) were not processed timely. In fact, 80 of the 100 returns in our sample took more than a month to process rather than the seven days allowed by the standards. Department officials agreed that SourceHOV failed to meet the minimum standard of performance for timeliness from the very start of the contract. Based on partial information provided by the Department, it appears SourceHOV was only averaging about 8,800 electronic transmissions per day - about one-third of the volume specified in the contract.

SourceHOV digitally scans each paper return that it processes. These scanned images are saved and data from them is ultimately extracted and entered into the Department's systems. The quality of this digital imaging process is critically important since the original paper returns are eventually destroyed and the scanned images become the official record. As such, there really is no tolerable error rate, because the image needs to serve as the "document of record" and should be equal in quality to the original. Reviews of flagged returns by both the Department and the Office of the State Comptroller's Bureau of State Expenditures found significant problems in quality, including illegible or blank scanned documents, returns with pages scanned out of sequence, and scanned documents with pages missing.

While our testing showed a significant amount of imaging errors did occur, they were not as

prevalent as those we found with accuracy and timeliness. Six of the 100 returns we sampled had imaging errors. Applying this error rate to the total number of paper returns in our sample, we determined, with 95 percent confidence, an error rate ranging from 2 percent to 13 percent. Therefore, we are 95 percent confident that between roughly 44,000 and 250,000 returns had image errors. Not only can poor imaging quality result in accuracy and data entry errors in current returns, but the problems can also impact taxpayers in future years as changes in tax laws and policies are made. One example is the new Family Tax Credit payments currently slated for fall 2014, which officials indicate will be based at least in part on this information.

We determined that the failure to implement the terms of the contract could be attributed to several causes:

- The Department did not perform on-site testing of SourceHOV's processes or review its controls, quality assurance measures, or procedures. Though Department officials stated they expended about 10,000 hours measuring the results of sample data submitted through SourceHOV's system, they did not perform any on-site testing. They still relied heavily on the vendor to be able to meet the contract deliverables.
- In providing tax processing services to the State, SourceHOV had two different software systems available for use. The software SourceHOV chose, however, was not adequate for the task. Its visual presentation was difficult to follow, making accurate data entry a challenge. In addition, according to NYSID, the software could not handle high-volume usage.
- Neither the vendor nor the Department established an adequate on-site management structure to monitor operations and address problems as they arose. As problems with processing became apparent, officials stated there was limited time to correct the issues.

In March 2013, once the Department discovered significant problems with the 2012 return data from SourceHOV, officials initiated a series of mitigative actions. It exercised its rights under the contract to provide a cure period for SourceHOV to meet established deliverables; however, SourceHOV failed to meet the cure period. Also, the Department engaged a private consultant to assess the problems, and its report indicated a significant breakdown in management and in communication between the Department and SourceHOV. Further, the Department conducted an internal review of the errors in data imaging, timeliness, and accuracy, which showed significant shortfalls by SourceHOV in these areas. As the deficiencies became apparent, the Department had to operate in "crisis mode," requiring its own staff to process returns and attempt to rectify the problems with the returns processing and data entry processes. Officials stated this was largely because the limited time period for implementing a new vendor to take over paper personal income returns processing didn't allow time to remedy issues even as deficiencies occurred.

The Department incurred substantial costs to mitigate issues with the returns processing, including over \$6 million in overtime expenses for the period April through December 2013. Other as yet unquantified costs likely include those associated with any diverted staff resources, interest charges on late refund payments, and non-overtime payments to staff the Department hired to complete work the contractor failed to do. The Department has not yet made any payment to NYSID/SourceHOV for actual tax processing during 2013, but should take these extra costs into

consideration when determining appropriate compensation. The Department is in the process of collecting data on contractor performance and liquidated damages - and who owes what has yet to be fully determined. According to NYSID, at the Department's request, they have prepared invoices reflecting normal charges based on the contract agreement but have not actively pursued payment.

Though there were significant breakdowns in many areas of the internal controls relating to the implementation to the contract, we found the Department has taken significant actions, as noted in the following section of this report, to correct the mistakes that occurred in the 2013 processing year and to prepare for 2014.

Recommendation

1. Determine the appropriate reimbursement due the vendor as well as the total damages due the Department; adjust compensation or seek damages and/or other remediation as applicable.

Corrective Actions

Although there were weaknesses in how the Department managed and monitored the execution of the contract with SourceHOV, the Department has made significant changes to correct the prior problems, support contractor performance, and ensure a more successful processing year for 2014.

Most importantly, the Department has established an on-site management team consisting of approximately 17 full-time Department staff to work directly with SourceHOV. With this team in place, the Department has worked collaboratively with SourceHOV to test the new software and to improve optical character recognition processes as well as the physical flow of opening and sorting the returns received. As a result, the Department is now better able to continuously monitor the contractor's performance and react quickly to problems that may occur.

In addition, unlike the prior year, the Department has now conducted on-site testing of the contractor's software and systems to ensure that they will be successful for the 2014 processing year. We verified that these tests show the current version of SourceHOV's software is operating well, with no defects noted in returns processing.

Also, in an effort to reduce the volume of paper returns, the Department has established an option for free Internet-based electronic filing with no income restrictions. The IT-201 Full-Year Resident Income Tax form, IT-214: Real Property Tax Credit, and NYC-210: New York City School Tax Credit are all supported. Mailings have been sent to targeted individuals outlining the new Internet-based electronic filing option.

The Department also has increased its capability to process returns in-house, establishing a fully functioning paper returns processing center. There is a detailed action plan that addresses the potential of contractor non-performance, which includes strategies for the Department to take on this process in-house. However, a decision about the long-term future of the processing of paper returns is not finalized.

Recommendation

2. Determine if processing of paper returns in-house or by a third-party vendor best meets the long-term practical and fiscal needs of the Department.

Audit Scope and Methodology

The objectives of our audit were to determine whether the paper tax returns were, in fact, accurately and timely processed by NYSID/SourceHOV and to assess the Department's corrective actions to ensure satisfactory contractor performance in the future. The audit covers the period January 1, 2012 through February 6, 2014.

To accomplish our objectives, we interviewed Department, NYSID, and SourceHOV officials; examined the Department's contract with NYSID/SourceHOV and its paper returns processing records; visited SourceHOV processing centers; and reviewed the Department's policies and procedures. We familiarized ourselves with the internal controls related to paper returns processing and assessed their adequacy related to our testing, and analyzed Department data to assess the timeliness of paper returns processing. We selected a statistical random sample of 100 of 1,985,802 paper tax returns processed by SourceHOV for the period January 1, 2013 through December 1, 2013 to verify the accuracy, completeness, timeliness, and data imaging requirements of the contract were in compliance.

We conducted our performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the 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 a reasonable basis for our findings and conclusions based on our audit objective.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions, and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these functions do not affect our ability to conduct independent audits of program performance.

Authority

The audit was performed pursuant to the State Comptroller's authority under Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law.

Reporting Requirements

A draft copy of this report was provided to Department of Taxation and Finance officials for their review and comment. Their comments were considered in preparing this final report and are attached at the end.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Taxation and Finance shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and if the recommendations were not implemented, the reasons why.

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Vision

A team of accountability experts respected for providing information that decision makers value.

Mission

To improve government operations by conducting independent audits, reviews and evaluations of New York State and New York City taxpayer financed programs.

Agency Comments



STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
W.A. HARRIMAN CAMPUS
ALBANY, NY 12227

Edward Chaszczewski
Deputy Commissioner
Office of Processing and Taxpayer Services

March 11, 2014

John Buyce
Audit Director
Office of the State Comptroller
110 State Street - 11th Floor
Albany, New York 12236-0001

Re: 2013-S-64 Processing of Paper Tax Returns

Dear Mr. Buyce:

This is in response to your draft report concerning the Processing of Paper Tax Returns, Report 2013-S-64.

The draft report concludes that the Department of Taxation and Finance failed to appreciate the risks of having the New York Industries for the Disabled (NYSID), in conjunction with their partner SourceHOV, take over the processing of paper personal income tax returns. The Department agrees that it did not anticipate the possibility of the cascading vendor failures experienced in 2013 that led to significant processing delays for New York taxpayers, which in retrospect clearly was a risk with this new vendor. The Department deployed substantial in-house resources to correct the vendor's processing errors; although the audit concludes that there were unspecified breakdowns in internal controls, the Department is confident that the integrity of New York income tax collections was maintained.

As the draft report notes, the Department has taken significant steps to address the processing problems experienced in 2013. Most notably, the Department has leveraged the in-house capacity deployed in 2013 to process paper corporation franchise tax returns, enabling the Department to process a significant volume of paper personal income tax returns in-house. This new processing capability has allowed the Department to manage the vendor's return inventory on a daily basis, assuring that the delays experienced in 2013 will not be repeated.

The Department would like to thank the OSC auditors for their professionalism during the course of this audit.

Sincerely,

A handwritten signature in dark ink, appearing to read "Edward Chaszczewski".

Edward Chaszczewski
Deputy Commissioner

cc: James Brunt, Director of Internal Audit