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**Homestead Tax Deduction Program Deficiencies
May Have Caused the District to Lose
As Much As \$44.7 Million
During Fiscal Years 1998 Through 2000**

November 19, 2001

EXECUTIVE SUMMARY

PURPOSE

Pursuant to Public Law 93-198, Section 455, the District of Columbia Auditor reviewed the operations of the Homestead Tax Deduction Program managed by the Office of the Chief Financial Officer's Office of Tax and Revenue.

CONCLUSION

The District of Columbia may have lost approximately \$44.7 million in real property tax revenue during the review period, excluding penalties of approximately \$8 million or more, because the Office of Tax and Revenue (OTR) did not properly and aggressively manage the Homestead Tax Deduction Program (the Program) during the period covered by this audit. Penalties were not factored into the Auditor's lost revenue estimate because OTR may opt to waive a presently undetermined amount of such penalties that were the result of OTR's internal management deficiencies.

The Homestead Tax Deduction Program was established to provide homestead and senior citizen property tax reductions to qualified residential real property owners. The desired results or benefits for which this Program was established were not sufficiently achieved during the three-year period covered by this audit. It is the Auditor's opinion that this was due in significant part to a lack of effective managerial oversight and direction, in addition to ineffective manual and automated processes used by OTR for granting, revoking, monitoring and calculating these tax reductions. The processes were not fully automated and lacked adequate internal controls to ensure that the tax reductions were properly granted for eligible properties and promptly terminated for ineligible properties.

Although OTR made substantial improvements in the administration of the Homestead Tax Deduction Program prior to, and during the three-year period under audit, the Auditor found that the methodology used by OTR still lacked adequate, effective internal controls to ensure full compliance with the law. Homestead and senior citizen tax reduction applications were not in OTR's records for a significant number of property owners that received these reductions, and data on some tax reduction applications in OTR's records were not adequately screened and validated before tax reductions were granted. In other words, eligibility was often not determined before owner's received tax reductions. Additionally, because of onerous, inefficient manual and automated processes, annual compliance audits of each property, or even a

significant percentage of properties in the Homestead Tax Deduction Program, were not conducted in accordance with OTR's Homestead Audit Unit's strategic plan. Consequently, owners received tax reductions on ineligible properties that might have been detected if all or a significant number of properties had undergone periodic reviews. Further, complete rules and regulations were not published to ensure that the public was fully informed about the legal requirements for participating in the Program. As a result, many owners may not have known that they were required to notify OTR when a property became ineligible for the homestead and senior citizen tax reductions.

The conditions discussed above are indicia of OTR's mismanagement of the Homestead Tax Deduction Program during the period covered by this audit. Consequently, property owners may have received homestead and senior citizen tax reductions even though the owners may not have occupied the property. Some owners appeared to have received the deduction on multiple properties at the same time. Additionally, other owners appeared to have received tax reductions that were brought forward from prior property owners. Further, corporations and businesses, ineligible for the Program, appear to have received the homestead tax reduction on residential properties. Program mismanagement, and general failure to adhere to the requirements of the law regarding homestead and senior citizen tax reductions, placed the District at great risk of failing to collect millions of dollars in residential real property taxes.

The Office of the Chief Financial Officer (OCFO) concurred with the Auditor's conclusion that the Homestead Tax Deduction Program needs improvement, agreed with the "spirit" of the Auditor's recommendations, and conceded that as much as \$19 million in potential revenue is still materially affected by inadequate administration of the program. The OCFO also conceded that the material difference between the Auditor's and OCFO's estimated revenue losses arises primarily from the fact that the Auditor included losses from properties participating in the program without an application and the OCFO did not include those properties.

FINDINGS

1. The Office of Tax and Revenue did not always ensure that owners were qualified to receive homestead and senior citizen tax reductions before granting tax reductions.
2. OTR did not accurately calculate tax reductions when property ownership changed.
3. Improvements are needed in the number and quality of property eligibility audits conducted.
4. Written standard policies, procedures and rules governing the Homestead Tax Deduction Program were not finalized.
5. Fiscal Year 2001 legislation may permit continuing tax reductions on ineligible properties beyond fiscal year 2001.

RECOMMENDATIONS

1. The Homestead Application Database should be modified to perform additional edits before homestead and senior citizen tax reductions are granted.
2. All OTR computer systems used in the eligibility determination process should utilize common identification numbers, such as social security numbers and tax identification numbers, assigned to real property owners and co-owners for effective automated data matching.
3. OTR should develop a mechanism to automate data matching, with assistance from the District's Chief Technology Officer, from the Homestead Application Database to computer systems in other District agencies using social security numbers and federal tax identification numbers.
4. OTR should develop guidelines, with assistance from the District's Chief Technology Officer, to standardize the format for entering names and addresses into all computer systems available for use in the process of determining eligibility for the homestead tax deduction and senior citizen tax relief.

5. OTR should ensure that tax reductions are granted only after an application has been filed and eligibility has been definitively determined.
6. OTR should program the property tax billing system to automatically terminate tax reductions on properties when ownership changes, thereby forcing new owners to file an application to receive property tax reductions.
7. OTR should program the tax billing system to prorate tax reductions on a monthly basis when applications are received in accordance with the law.
8. OTR must enhance the Homestead Audit Unit's resources and automate the data matching steps of the audit process to reduce the time required to perform each audit.
9. The Manager of the Homestead Audit Unit must maintain a list of audit properties and the results and statistics on property compliance audits conducted annually.
10. OTR officials should develop performance measures for the Homestead Audit Unit relative to homestead and senior citizen property tax reduction audits for inclusion in OTR's annual performance plan.
11. The Deputy Chief Financial Officer for OTR must immediately finalize all policies and procedures relative to the Homestead Tax Deduction Program. Further, regulations must be promulgated in the District of Columbia Municipal Regulations setting forth all the requirements for participating in the Program.
12. The Deputy Chief Financial Officer for OTR should immediately develop the staff and technical resources necessary to ensure that every Class 1 Property is periodically audited, and ineligible properties are promptly removed from the Homestead Tax Deduction Program.
13. OTR must collect all real property taxes, penalties and interest resulting from property owners improperly receiving homestead and senior citizen tax reductions in violation of District law.

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PURPOSE

Pursuant to Public Law 93-198, Section 455, the District of Columbia Auditor reviewed the operations of the Homestead Tax Deduction Program managed by the Office of the Chief Financial Officer's Office of Tax and Revenue.

OBJECTIVE, SCOPE, AND METHODOLOGY

The overall objective of the audit was to determine the effectiveness of the Office of Tax and Revenue (OTR) in granting homestead and senior citizen property tax reductions to single-family residential property owners. To accomplish this objective, we sought to determine whether:

1. OTR adhered to District laws and regulations related to homestead and senior citizen real property tax reductions;
2. internal controls were adequate to detect and remove from the Program, in a timely manner, properties ineligible for property tax reductions; and
3. OTR granted tax reductions to ineligible property owners.

The audit included an examination of the operations of OTR that related to managing the Homestead Tax Deduction Program (the Program) for fiscal years 1998 through 2000.

The Auditor focused on the propriety of property tax reductions granted to owners for two types of residential property: 1) owner occupied homes, and 2) senior citizen owner occupied homes. These properties represent over 95% of the properties in the Program. (See Appendix I for other property types in the Program.) In conducting the audit, the Auditor reviewed D.C. Law 2-45, as amended, entitled the "Residential Property Relief Act of 1977," D.C. Code, Sections 47-849 through 47-856; D.C. Law 6-153, as amended, entitled the "Real Property Tax Rates for Tax Year 1987 Act of 1986," D.C. Code, Section 47-863; D.C. Law 14-4, the "Homestead and Senior Citizen Real Property Tax Amendment Act of 2001," D.C. Code, Sections 47-850(h) and 47-863(h); and other relevant laws, regulations, policies and procedures.

The Auditor also examined documents and records obtained from OTR and interviewed officials responsible for managing the Program. We obtained data files containing information regarding properties that received tax reductions as of September 30th for each fiscal year reviewed. We used the fiscal year 2000 data file to select a sample of 971 properties for a detailed review, and determined which of the properties also received the tax reductions in fiscal years 1998 and 1999 (See Appendix II for Sample Selection Methodology). Where necessary, officials of other offices of the Government of the District of Columbia were interviewed to facilitate a thorough examination of the Program.

BACKGROUND

D.C. Code, Section 47-850(c), initially authorized the formerly titled Department of Finance and Revenue to accept applications for the Homestead Tax Deduction Program. However, upon subsequent reorganization of the Department of Finance and Revenue, responsibility for the Program was transferred to the Office of Tax and Revenue (OTR) within the Office of the Chief Financial Officer of the District of Columbia. OTR is now responsible for administering all real property tax laws of the District of Columbia.

All real property in the District of Columbia, unless expressly exempted, is subject to real property taxation. The tax amount is assessed annually on the estimated market value of the property, and is based on a unique tax rate for each of the five classes of real property used by the District of Columbia. Of the five classes, Class 1 Property has the lowest real property tax rate, \$0.96 per \$100 of the assessed value. Pursuant to D.C. Code, Section 47-813(e), property owners must file a properly completed application to have property classified as Class 1 Property and to obtain the Class 1 Property tax rate (See Appendix III for application form). Only Class 1 Properties may be eligible for homestead and senior citizen tax reductions.

According to D.C. Code, Section 47-813(c-3), to be classified as Class 1 Property during the audit period, the property must have been improved residential real property, unless otherwise exempt, that was owner-occupied, contained not more than five dwelling units or was a single dwelling unit owned as a condominium, and was used exclusively for non-transient residential dwelling purposes. Improved residential real property owned by a cooperative housing association may be classified as Class 1 Property if shareholders occupy the majority of the dwelling units. D.C. Code, Section 47-813(c-3), further defines the requirements for

classification as Class 1 Property during the audit period as follows: 1) the dwelling unit must be any room or group of rooms forming a single unit that is used by a person for living, sleeping, and the preparation and eating of meals for a period of more than five consecutive days during any one stay; and 2) the person must own the dwelling unit.

Unimproved property, which abuts Class 1 Property and has common ownership, may be classified as Class 1 Property. Also, unimproved real property which is separated from Class 1 Property by a public alley less than 30 feet wide and has common ownership may also be classified as Class 1 Property when specific conditions required by law are met.

According to D.C. Code, Section 47-813(c-3), to be classified as Class 2 Property during the audit period, the property must be improved and occupied residential real property, unless otherwise exempt. The property must be occupied, but not by the owner, contain not more than 5 dwelling units or is a single dwelling unit owned as a condominium, and is used exclusively for non-transient residential dwelling purposes. Improved residential real property owned by a cooperative housing association shall also be classified as Class 2 Property so long as the shareholders or members of the cooperative housing association occupy less than 50% of the dwelling units. Additionally, improved and occupied multifamily residential real property, which contains more than five dwelling units and is used exclusively for non-transient purposes, must also be classified as Class 2 Property.

Unimproved property, which abuts Class 2 Property and has common ownership, may be classified as Class 2 Property. Also, unimproved real property which is separated from Class 2 Property by a public alley less than 30 feet wide and has common ownership may be classified as Class 2 Property when specific conditions required by law are met. (See Appendix IV for other property classes and tax rates.)

The Homestead Tax Deduction Program was established to provide property tax relief for owners of Class 1 Property. The Program provides a homestead tax deduction and senior citizen tax relief to qualified owners who receive the Class 1 Property tax rate.

D.C. Law 2-45, entitled "Residential Property Relief Act of 1977," established the homestead tax deduction. The law provided for a deduction from the estimated market value of residential real property for the purpose of computing the real property tax. Pursuant to D.C. Code, Section 47-850, \$30,000 is deducted from the estimated market value of Class 1 Property prior to calculating the tax on the property. An owner's annual tax bill is significantly reduced

when property is eligible for the \$30,000 deduction because the property owner receives two benefits: 1) \$30,000 of the property value is not taxed, and 2) the property is taxed at the lowest tax rate available on residential property, the Class 1 Property tax rate. An example of the reduction in an owner's annual tax bill due to the homestead tax deduction is included in the tax calculated on a sample property in Table I. In the example, the Class 1 property tax rate is used to calculate the tax on an eligible property, and the Class 2 property tax rate is used to calculate the tax on an ineligible property. Usually, property that is not eligible for the homestead tax deduction is also ineligible for the Class 1 Property tax rate; if the property is ineligible for treatment as a Class 1 property, the property is taxed at a higher property tax rate.

Additionally, D.C. Law 6-153, entitled "Real Property Tax Rates for Tax Year 1987 Act of 1986," established senior citizen property tax relief. The law provided for a reduced residential real property tax liability for qualified property owners age 65 or older. Pursuant to D.C. Code, Section 47-863(b), the property tax liability is reduced by 50% for senior citizens who qualify for the homestead tax deduction and meet other qualifying criteria. In other words, after receiving the homestead tax deduction described in the previous paragraph, the annual real property tax bill is further reduced by 50% for qualified senior citizens. An example of the tax reduction due to senior citizen tax relief is also shown in the tax calculated on the sample property in Table I. If the property is not eligible for the homestead tax deduction and the Class 1 Property tax rate, the property is also ineligible for senior citizen tax relief.

Table I
Sample Property Tax Calculation
Tax on Eligible Property Compared to Tax on Ineligible Property

Description	Tax on Eligible Property (Class 1)	Tax on Ineligible Property (Class 2)	Difference
Property Value	\$190,000.00	\$190,000.00	
Homestead Deduction	30,000.00	.00	
Property Value after Homestead Deduction	160,000.00	190,000.00	
Property Tax Rate	0.96*	1.34*	
Property Tax after Homestead Deduction	\$ 1,536.00	\$ 2,546.00	\$1,010.00
Senior Citizen Tax Relief	50%	00%	
Property Tax after Senior Citizen Tax Relief	\$ 768.00	\$ 2,546.00	\$1,778.00
* Tax rate per \$100 of property value: Class 1 Property rate - \$0.96 Class 2 Property rate - \$1.34			

Source Office of the D C Auditor

The Program affects a significant number of residential property owners, as demonstrated in Table II by the large number of properties included in the Program during fiscal years 1998 through 2000. An average of 89,000 properties were classified by OTR as owner-occupied or senior citizen owner-occupied homes.

Table II
Properties Receiving Tax Reductions in the
Homestead Tax Deduction Program

Fiscal Year	Total Properties Receiving Tax Reductions
1998	93,417
1999	96,131
2000	94,308

Source OTR

Requirements for Granting Property Tax Reductions

In order to obtain homestead and senior citizen tax reductions, owners of eligible property must file an application in accordance with D.C. Code, Sections 47-850(c), 47-850(e) and 47-863(g). (See Appendix III for application form.) The application describes the criteria that a property must meet before obtaining the tax reductions, and contains the owner's affidavit that the criteria have been met. The affidavit affirms that the following criteria have been met in order to receive the homestead tax deduction:

1. the owner lives in the property;
2. the owner is subject to D.C. income taxation during the period the property receives the homestead tax deduction; and
3. the owner agrees to notify OTR of ownership or residency changes.

Additionally, the application affidavit must affirm that the following additional requirements have been met in order to receive senior citizen tax relief:

1. the owner is age 65 or older;
2. the senior citizen occupant owns 50% or more of the property; and
3. the adjusted gross income of everyone living in the home is less than \$100,000 for the prior calendar year.

Pursuant to D.C. Code, Sections 47-850(e) and 47-863(g), an approved application qualifies the property, and the owner receives tax reductions beginning the first full month following the date on which the properly completed application was filed.¹ Tax reductions remain effective through the end of the current five-year filing period, which is September 30, 2001, provided the property remains eligible to receive tax reductions.

To obtain tax reductions beyond September 30, 2001, D.C. Code, Sections 47-850(e) and 47-863(g), previously required each property owner to file a new application; however, D.C. Law 14-4, entitled the "Homestead and Senior Citizen Real Property Tax Amendment Act of 2001," eliminated the re-application requirement. The law, which became effective June 13, 2001, allows tax reductions to continue indefinitely beyond September 30, 2001, unless the property ceases to qualify.

Pursuant to D.C. Code, Sections 47-850(e) and 47-863(g), owners are required to notify OTR in a timely manner when properties become ineligible for homestead and senior citizen tax reductions. Tax reductions are terminated the first full month following the date the property became ineligible. If the owner fails to notify OTR of ineligibility, tax reductions are terminated for the entire tax year; the property may be taxed at a rate greater than the Class 1 property rate, and a 10% tax penalty is added to the tax due for each tax year that the property was ineligible. Additionally, 9 DCMR 338 provides that failure to notify OTR of senior citizen ineligibility will subject the owner to interest at the rate of 1% per month, or portion of a month, from the date prescribed for the payment of the tax to the date the deficiency is paid. Other fines and penalties may also apply for failure to notify OTR that the property has become ineligible.

¹ After filing an application, OTR's policy is to grant tax reductions retroactively to the first full month following the date the application was filed. If an application was filed before the owner moved into the property, the policy is to grant reductions retroactively to the first full month after the date the owner moved into the property instead of the month following the date the application was filed.

Enforcement of Tax Reduction Requirements is More Difficult for Certain Properties

As stated above, D.C. Code, Sections 47-850(c), 47-850(e) and 47-863(g) authorize tax reductions, upon proper application and approval, for residences which are occupied by the owner of the property, and where the owner is subject to District income taxation during the period for which the tax reduction is sought. OTR officials informed the Auditor that members of Congress, Congressional staff, and employees of international organizations such as the World Bank and International Monetary Fund may also receive homestead tax reductions. According to OTR officials, due to the political sensitivity of the positions held by these individuals, it is extremely difficult for OTR to obtain sufficient information necessary to enforce the laws governing the Homestead Tax Deduction Program for properties owned by these individuals. Consequently, many of these individuals may be the unintended beneficiaries of homestead and senior citizen tax reductions in violation of District law.

Results of Prior Audits of Properties in the Program

During Fiscal Year 1996, the District of Columbia Financial Responsibility and Management Assistance Authority, on behalf of the Government of the District of Columbia, executed a contract with Municipal Tax Bureau, Inc. (MTB). MTB was to audit and collect real property taxes from property owners claiming and receiving homestead tax deductions in violation of District law. During the contract period of August 1996 through February 1998, MTB performed services on specific properties where owners received homestead tax deductions in tax years 1997 and earlier.

Documents prepared by OTR were provided to the Auditor that summarized the results of audits performed by MTB. OTR officials stated that they do not have written audit reports from MTB. The documents provided by OTR indicated that over 16,700 properties were audited, and approximately \$65 million in deductions, penalties and interest were identified as potentially due the District from owners who received the homestead tax deductions in violation of District law. OTR determined that only approximately \$22 million of the \$65 million was collectable. The remaining \$43 million was never recorded as a receivable by OTR and technically could not be written off; however, the practical effect was that the District abandoned any effort to collect this money despite the absence of a statute of limitation applicable to the District's collection efforts. Over \$13 million has been collected, and \$9 million remained uncollected as of March 1, 2001. Collection of the outstanding balance is an ongoing effort by OTR.

OTR maintains a database of information regarding the properties audited by MTB, and periodically monitors the status of some of the properties in the database. However, the Auditor found that some properties previously audited by MTB have not been effectively monitored by OTR. For example, the Auditor's findings in this report include 35 of the 16,700 properties already identified by MTB as potentially ineligible. Fifteen of the 35 properties still appeared to be receiving homestead tax deductions in fiscal years 1998, 1999 and 2000 despite questionable property eligibility. Another 12 properties are included in the findings for fiscal year 2000 alone, and 8 properties for fiscal year 2001.

Improvements Made by OTR

The Auditor was informed and observed that prior to, and during the three-year period under audit, OTR made substantial improvements in the administration of the Homestead Tax Deduction Program. These improvements began in 1996 and could result in a complete rebuilding of the District's real property tax administration system by the end of fiscal year 2002.

According to OTR, real property tax processing was manually managed prior to 1998, records were poorly maintained, and documentation was not retrievable. The real property tax billing system had been developed in the 1960's, when on-line data entry was non-existent, and data systems were not linked. In 1996, the Real Property Tax Administration was reorganized to stabilize operations and develop a comprehensive plan to revitalize real property initiatives. Improved management of the Homestead Tax Deduction Program was included in this plan.

As discussed earlier in this report, in 1996 MTB was contracted to begin audits of properties where owners received homestead tax reductions. MTB's audit identified 16,700 properties that may have been ineligible for the reductions prior to fiscal year 1998, and resulted in the collection of \$13 million of taxes, penalties and interest from owners of ineligible properties.

Additionally, in 1997, OTR removed the Class 1 Property tax rate from approximately 25,000 properties, and revoked homestead and/or senior citizen tax reductions. This action was based on the owners' failure to file applications by September 1, 1996, which was the filing date required by the law at that time. The owners' overwhelming opposition to OTR's actions resulted in the District reinstating the Class 1 Property tax rate and the homestead and senior citizen tax reductions, although applications still were not filed. (See Appendix V)

According to OTR officials, the MTB audits and the 1997 problem described in the preceding paragraphs highlighted the urgent need for automation and systems improvements to effectively manage the Homestead Tax Deduction Program. A Homestead Audit Unit was established in 1997 to assist MTB with the property audits and to continue performing audits after the MTB audit contract ended. Several automated systems were developed in 1998 to provide short-term improvements to real property tax management, which included development of a Homestead Application Database to track the status of tax reduction applications.

A new real property tax administration computer system, RPT 2000, was also implemented in fiscal year 2000, which included homestead and senior citizen tax reduction indicators. This system replaced the prior real property tax billing system. This new system provides, for the first time, the ability for online review of the Recorder of Deeds' land records to manually verify ownership information on tax reduction applications. It also allows OTR to manually match property owners' social security numbers from the applications with the income tax filing database to help verify that owners occupy properties and that owners filed District income tax returns, in compliance with the law.

RPT 2000, the primary computer system, and approximately 20 auxiliary systems are used for real property tax administration. RPT 2000 maintains assessment values, ownership and sales information, tax amount, tax exemption/reduction information, and tax payment and adjustment information. RPT 2000 data is extracted and loaded in auxiliary systems to provide the basic demographic property information. Data is also loaded into RPT 2000 from auxiliary systems to reflect updates and changes originating from stand-alone systems or from other District agencies. The tax reduction proration system is an example of a stand-alone system implemented in fiscal year 2001 to prorate tax reductions in compliance with the law. The majority of these transfers of data between systems are not real time or online, but are done manually using Microsoft Excel spreadsheets. The interfaces between the systems are not automated.

The most recent upgrade to the program's management occurred as a process enhancement in May 2001. Since that time, tax reduction applications must accompany transfer documents when property sales and transfers occur, or else tax reductions are manually removed from the property. OTR officials claim that tax reductions were removed or changed for approximately 1,200 properties since May 2001 as a result of this enhancement.

Finally, OTR officials indicated that OTR plans to implement a single Integrated Tax System during fiscal year 2002 to centralize data warehousing and to automate interaction and validation of data that is entered into any subsystem. Some of the planned benefits of the Integrated Tax System are to:

1. consolidate all valuation systems, spreadsheets, and databases used today into one central system that enforces data integrity;
2. provide a single integrated system and database to maintain all tax types related to a property including real property tax, BID tax, public space rental tax, special assessments, etc.;
3. eliminate processing delays and redundant data entry by automating the transfer and updating of information between systems;
4. provide the opportunity to monitor compliance activities between real property taxes, business taxes, and individual income taxes by providing links between a property owner, an individual income taxpayer, and a business taxpayer; and
5. eliminate processing of paper for homestead applications, income and expense forms, and other real property forms and applications.

FINDINGS

THE DISTRICT MAY HAVE LOST APPROXIMATELY \$39.5 MILLION DUE TO OTR's FAILURE TO PROPERLY MANAGE THE HOMESTEAD TAX DEDUCTION PROGRAM

The Auditor found that the process used by OTR for granting homestead and senior citizen tax reductions lacked adequate internal controls to ensure that the tax reductions were properly granted and timely terminated for ineligible properties. D.C. Code, Sections 47-850(c), 47-850(e) and 47-863(g), require owners to properly complete and file an application to obtain the tax reductions. Additionally, D.C. Code, Section 47-850(c), requires that the property be occupied by the owner who is subject to District income taxation. The process for granting tax reductions is not fully automated and does not include adequate controls to ensure full compliance with the law. Consequently, many owners appear to have wrongfully received the reductions, and the District lost at least \$39.5 million in tax revenue, excluding penalties, over the three fiscal years covered by this review. Table III presents the estimated amounts of revenue lost each year, excluding penalties.

While the estimated lost revenue does not include penalties of approximately \$8 million or more, the law mandates that a 10% penalty be added to the tax due for each year that a property was ineligible. The Auditor excluded penalties from the estimated loss because OTR's ineffective management of the Homestead Tax Deduction Program is partially responsible for ineligible properties receiving tax reductions. OTR officials indicated that it is unlikely that OTR would collect penalties that were caused by internal program mismanagement, for example: 1) OTR's failed attempt to have everyone reapply for tax reductions in 1997, and 2) OTR's subsequent failure to adequately validate information transferred between tax administration systems.

Table III
Homestead Tax Deduction Program
Revenue Lost in Fiscal Years 1998, 1999 and 2000
(\$ in hundreds of thousand's)

Year	Revenue Lost Due to Homestead Tax Deduction	Revenue Lost Due to Senior Citizen Tax Relief	Total
1998	\$ 7.2	\$ 3.0	\$10.2
1999	8.4	4.0	12.4
2000	<u>11.2</u>	<u>5.7</u>	<u>16.9</u>
Total	\$26.8	\$12.7	\$39.5

Source: Office of the D.C. Auditor

Approximately \$26.8 Million in District Revenue Lost on Properties Ineligible for Homestead Tax Deduction

The Auditor estimates that owners of at least 27,600 properties may have wrongfully received homestead tax deductions during fiscal year 2000. The Auditor examined records for a sample of 971 properties out of 89,000 properties selected from the fiscal year 2000 data file. It appears that the owners of approximately 31% of the sample properties may have incorrectly received homestead deductions for the entire year since these properties did not have ownership changes during the year. For example, owners receiving homestead deductions for occupying property may not have actually lived in the property. Owners received the deduction on properties that: 1) appeared to be vacant, 2) had billing addresses that were outside the District, or 3) had addresses that differed from the property address. Also, owners appeared to have received the deduction on more than one property at a time. For instance, an owner who received the homestead tax deduction for property located on 6th St., S.E., also received the homestead tax deduction and senior citizen tax relief for property located on 7th St., S.W. Additionally, corporations and businesses, ineligible for the Program, received the deduction on residential properties. A gas supply corporation with a mailing address in Buffalo, New York received the homestead deduction for residential property located on 22nd St., N.W. A business with a mailing address in Fairfax, Virginia received the homestead tax deduction for residential property located on Warren St., N.W. In other instances, owners received the deduction on properties although it

appeared that no application had been filed or the application filed was not properly completed. Projecting the 31% ineligibility percentage within our sample of 971 properties to the 89,000 properties that received deductions in fiscal year 2000, it appears that at least 27,600 properties may have improperly received homestead tax deductions.

Owners who wrongfully received the homestead tax deduction also wrongfully received the benefit of the Class 1 Property tax rate, the lowest property tax rate available in the District. The qualifying criteria for the Class 1 Property tax rate include some of the same criteria for homestead tax deduction eligibility. The Auditor found that properties potentially ineligible for the homestead tax deduction in our sample were also potentially ineligible for the Class 1 Property tax rate because: 1) it appeared that the owners did not occupy the properties, 2) the property owners were corporations or businesses instead of a person, or 3) the owners did not file an application to obtain the Class 1 Property tax rate. Properties ineligible for the Class 1 Property rate, at a minimum, should have been taxed at the Class 2 Property tax rate. Taxation at higher rates may also be applicable if OTR determines that a particular property qualifies for a rate greater than the Class 2 Property rate.

Based on the above sample results, the Auditor estimates that the District lost a minimum of \$11.2 million in property tax revenue, excluding penalties, in fiscal year 2000 due to homestead deductions on ineligible properties. By deducting \$30,000 from the assessed value of the properties before calculating taxes and before determining the appropriate property class tax rate, OTR lost a minimum of \$402 in tax revenue on each of the 27,600 potentially ineligible properties. OTR should not have excluded \$30,000 from taxation and should have at least taxed the property at the Class 2 Property tax rate. Table IV illustrates the amount of taxes that OTR would have received, but may have lost, on \$30,000 if an ineligible property had been taxed at the Class 2 Property tax rate.

Table IV
Property Taxes Lost
on each Ineligible Property in Fiscal Year 2000

Description	Amount
Amount not Taxed	\$30,000.00
Class 2 Property Tax Rate	\$1.34*
Tax Amount Lost	\$402.00
* Tax per \$100 of property value	

Source Office of the D C Auditor

The Auditor also estimates that the District lost a total of approximately \$15.6 million in tax revenue, excluding penalties, during fiscal years 1998 and 1999 because owners received homestead deductions on ineligible properties. Fifty-three percent of the properties found ineligible in our fiscal year 2000 sample also received deductions in fiscal year 1998, and 63% of the fiscal year 2000 ineligible properties received the deductions in fiscal year 1999. These properties were ineligible for the homestead deduction and the Class 1 Property tax rate in both fiscal years. The Auditor estimates that the District lost at least \$7.2 million and \$8.4 million in tax revenue, excluding penalties, for fiscal years 1998 and 1999, respectively.

Disqualifying Data on the Application was not Detected by Computer Edits

According to OTR officials, the process for determining eligibility for homestead and senior citizen tax reductions is a combination of automated and manual steps. The process begins with OTR receiving and keypunching applications into the Homestead Application Database, a computer program that performs limited edits of the application data. For example, the system verifies that the property is residential property by matching applicable data from the application to data in the real property tax system. Additionally, the Homestead Application Database determines whether multiple applications were filed for a single property, and whether all applicable questions on the application are answered. Owners receive the reductions if applications pass the Homestead Application Database edits.

In the test of 971 properties, the Auditor found that owners wrongfully received the reductions because the system edits did not reject applications with questionable data. For example, the Homestead Application Database did not reject applications from owners with a corporation or business name, owners with mail addresses different from tax property addresses, and owners applying for tax reductions on more than one property. Additionally, the system did not detect that the social security number "0" was invalid or that the owner did not sign the application affidavit.

Manual Process of Verifying Application Data and Property Eligibility is Very Inefficient

Additional steps are necessary to process applications rejected by system edits. Rejected applications are forwarded to the Homestead Audit Unit within OTR for manual verification of application data and a determination of property eligibility. Based on discussions with the Homestead Audit Unit staff, the manual process includes, but is not limited to: 1) obtaining documents from the owner that prove residency and clarify discrepancies in the application, 2) matching the property owner's name, mailing address, and other data to data in automated and manual property tax records maintained by OTR, 3) matching the owner's name and mailing address to income tax returns in the OTR income tax return system, and 4) researching other appropriate records as needed.

The Auditor performed the second and third procedures described above on the sample of 971 properties and found the procedures to be effective but very tedious and time consuming. The Auditor manually compared the data between systems to perform the second and third procedures in the process, and found that the lengthy process prevents a timely verification of application data and a determination of property eligibility. In many instances, the owner's name, mailing address, and tax property address were in different formats in each computer system; therefore, matching data with the use of computer technology was impossible because of this simple defect.

OTR Granted Reductions Before Establishing Eligibility

During the test of 971 properties, the Auditor found that owners of 83 properties received tax reductions, however, applications were not found for the owners of these properties in the Homestead Application Database. According to OTR officials, missing applications may be due to: 1) the application not being received, 2) the tax reduction may have been granted based on the owner presenting a receipt to indicate that the application was filed but misplaced by OTR, 3) the application was rejected by the Homestead Application Database and is in the processing pipeline, 4) the tax reduction was granted based on a verbal request or letter written by the owner, and 5) the tax reduction may have been brought forward from a previous filing period which predated the Homestead Application Database. All explanations indicate that owners received tax reductions before or without a full eligibility determination by OTR, therefore possibly contributing to the District's tax revenue loss.

Approximately \$12.7 Million Lost Due to Senior Citizen Tax Relief on Ineligible Properties

The District may have lost an additional \$12.7 million of property tax revenue, excluding penalties, due to senior citizen tax relief on ineligible properties during fiscal years 1998, 1999 and 2000. D.C. Code, Section 47-863(b), provides a 50% decrease in residential real property tax liability for Class 1 Property owners that are age 65 or older. Additionally, senior citizens are required to file an application to obtain senior citizen tax relief. The Auditor found that some properties were not eligible for senior citizen tax relief because they were not Class 1 Properties. The Auditor also found no evidence that the owners had actually applied for property tax reductions.

Twenty percent of the properties ineligible for the homestead deduction in our fiscal year 2000 sample of 971 properties were also ineligible for senior citizen tax relief. Based on the results of the sample, it appears that owners of at least 5,600 properties potentially ineligible for homestead deductions also incorrectly received senior citizen property tax relief during fiscal year 2000.

The Auditor estimates that the District lost approximately \$5.7 million in tax revenue, excluding penalties, during fiscal year 2000 due to senior citizen tax relief on ineligible properties. The Auditor calculated this estimate using an average property value of \$148,000.

The Auditor determined the average value of properties that received senior citizen tax relief in fiscal year 2000 from the fiscal year 2000 data file. Table V presents the calculation of taxes on the average property value using the Class 1 Property rate and tax reductions, compared to taxes on the average property value assessed at the Class 2 rate if tax reductions had not been applied. The difference between the two calculations is the average amount of tax revenue lost on an ineligible property. In the sample in Table V, the difference of \$1,416.80 consists of \$402, the amount of taxes levied against \$30,000 of the property's fair market value at the Class 2 Property rate, and \$1,014.80, the amount of taxes that would have been due if no senior citizen property tax relief applied. At a tax loss of \$1,014.80 on each ineligible property, the District lost approximately \$5.7 million in property tax revenue, excluding penalties, in fiscal year 2000 alone due to improper senior citizen property tax relief.

Table V
Comparison of Taxes on Class 1 Property
To Taxes on Class 2 Property
Fiscal Year 2000

Description	Class 1 Property	Class 2 Property	Property Tax Difference
Property Value	\$148,000.00	\$148,000.00	
Homestead Deduction	30,000.00	.00	
Property Value after Homestead Deduction	118,000.00	148,000.00	
Property Tax Rate	0.96*	1.34*	
Property Tax after Homestead Deduction	\$ 1,132.80	\$ 1,983.20	
Senior Citizen Tax Relief	50%	00%	
Property Tax after Senior Citizen Relief	\$ 566.40	\$ 1,983.20	\$1,416.80
*Tax rate per \$100 of property value			

Source Office of the D C Auditor

The Auditor also estimates that the District lost a total of approximately \$7 million in taxes, excluding penalties in fiscal years 1998 and 1999 because owners received senior citizen tax relief on ineligible properties. We estimate that the District lost approximately \$3 million, excluding penalties, in fiscal year 1998, and \$4 million in tax revenue, excluding penalties, in fiscal year 1999. Forty-one percent of the properties found ineligible for senior citizen tax relief in our fiscal year 2000 sample also received the reduction in fiscal year 1998, and 54% of

properties in the fiscal year 2000 sample received senior citizen property tax relief in fiscal year 1999. The properties were ineligible in both fiscal years because the properties did not qualify as Class 1 property, and the Auditor found no evidence that the owners had actually applied for property tax reductions.

RECOMMENDATIONS

1. The Homestead Application Database should be modified to perform additional edits before homestead and senior citizen tax reductions are granted. All OTR computer systems used in the eligibility determination process by the Homestead Audit Unit should be linked to the Homestead Application Database for effective and timely automated application data matching and verification. For example, the computer systems maintained for recording deeds, assessing property taxes, and processing income tax returns should be linked to the Homestead Application Database. The interfaces between the systems should be automated.
2. All OTR computer systems used in the process should utilize common identification numbers assigned to real property owners and co-owners for effective automated data matching. This identification number could be the social security number for individuals or federal tax identification numbers for partnerships, corporations and businesses. The common identification number would automate matching of owners between computer systems to determine proof of ownership and compliance with other legal requirements before granting tax reductions. The federal tax identification number would immediately flag the property owner as a partnership, corporation or business that may not be entitled to receive homestead and senior citizen tax reductions.
3. OTR should develop a mechanism to automate data matching, with assistance from the District's Chief Technology Officer, from the Homestead Application Database to computer systems in other District agencies using, for example, social security numbers and federal tax identification numbers. Matching the owner to: 1) the driver's license and vehicle registration systems at the Department of Motor Vehicles, 2) the voter registration system at the Board of Elections, and 3) the billing system at the Water and Sewer Authority could additionally confirm the

owner's residence. Matching the owner to records maintained in the vital statistics system at the Department of Health could verify the age and mortality of the owner receiving or applying for tax reductions. Matching the owner to records maintained by the Department of Consumer and Regulatory Affairs could identify vacant properties that are not eligible for tax reductions.

4. OTR should develop guidelines, with assistance from the District's Chief Technology Officer, to standardize the format for entering names, and addresses and other information into all computer systems available for use in the process of determining eligibility for the homestead tax deduction and senior citizen tax relief. A standard format would facilitate comparison of the owner's mail address to the tax property address to determine whether the owner resides in the property.
5. OTR should ensure that tax reductions are granted only after an application has been filed and eligibility has been definitively determined.

APPROXIMATELY \$5.2 MILLION IN DISTRICT REVENUE LOST DUE TO OTR's FAILURE TO ACCURATELY CALCULATE TAX REDUCTIONS WHEN PROPERTY OWNERSHIP CHANGED

Based upon an analysis of properties included in the Auditor's sample, OTR did not properly calculate tax reductions when property ownership changed. The law requires that homestead and senior citizen tax reductions be terminated the first month after ownership changes, and tax reductions must be prorated on a monthly basis after the new owner files an application. The Auditor determined that OTR's property tax billing system included tax reductions when calculating the property tax for properties with new owners, and automatically transferred to new owners tax reductions granted to previous owners. In other words, when taxes were calculated, homestead and senior citizen tax reductions were granted to new owners before a determination of eligibility was made. This deficiency possibly cost the District approximately \$5.2 million in tax revenue, excluding penalties, in fiscal years 1998, 1999 and 2000.

D.C. Code, Sections 47-850(e) and 47-863(g), require property owners to notify OTR in a timely manner when properties become ineligible for homestead and senior citizen tax reductions, and the benefits must be terminated the first month after ineligibility. For instance, a property becomes ineligible when it is no longer occupied by the owner or when the owner transfers the property ownership. Additionally, the law requires that new owners apply for the tax reductions. Eligible property owners receive tax reductions beginning the first month following the date on which a properly completed application has been filed. The law requires monthly proration of tax reductions.

As previously stated, new owners automatically received homestead and senior citizen tax reductions prior to a determination of property eligibility when property tax assessments were calculated. The examination of records for the sample of 971 properties selected from the fiscal year 2000 data file exposed improper tax calculations on 132 properties that changed ownership during the fiscal year. In nine instances, the benefit became effective in October 1999 for properties where new owners had subsequently filed applications. For example, if an owner purchased and moved into a property in December 1999, and filed an application in January 2000, OTR made the tax reduction retroactive to October 1999, before the date of property ownership and the application filing. In this example, the tax reduction's effective date should have been February 2000 instead of October 1999. Additionally, October 1999 was the effective date for new owners in 43 cases where the Auditor found no evidence that an application had been filed, and in 80 cases where the reductions granted to prior owners appeared to have been carried forward to new owners.

According to OTR officials, the real property tax billing system did not prorate tax reductions when property taxes were calculated in fiscal years 1998 and 1999, and the new real property tax billing system implemented in March 2000 also does not prorate tax reductions when property taxes are calculated. A subsidiary system, which was not functioning properly at the time of this audit, is designed to prorate tax reductions before the new property tax billing system calculates real property taxes. Our examination of records also revealed that the new property tax billing system does not automatically terminate tax reductions for properties when ownership changes. Instead, the tax billing system is programmed to calculate taxes only for the full year on each property, including homestead and senior citizen tax reductions, regardless of when the property changed ownership. Fifty percent of the full year property taxes due the District are billed to the owner of record in March and September of each year. Therefore, the tax bill gives tax reductions to new owners prior to a determination of property eligibility.

The Auditor conservatively estimates that the District lost at least \$2.4 million in property tax revenue, excluding penalties, because tax reductions were not properly calculated when property ownership changed during fiscal year 2000. Given the percentage of properties with ownership changes in our sample, we believe that tax reductions were improperly calculated on at least 6,000 properties that changed ownership during fiscal year 2000.

The Auditor also estimates that the District lost approximately \$2.8 million in tax revenue, excluding penalties, during fiscal years 1998 and 1999 because tax reductions were improperly calculated for properties that changed ownership during those years. Eight percent of the properties in our fiscal year 2000 sample had ownership changes in fiscal year 1998, and 13% of the properties had ownership changes in fiscal year 1999. The Auditor found no evidence that the new owners filed applications to obtain tax reductions. Moreover, the new owners were not automatically entitled to receive tax reductions on these properties. The Auditor estimates that tax reductions were improperly calculated on approximately 2,500 properties that had ownership changes in fiscal year 1998, and 3,800 properties in fiscal year 1999 because the new owners did not qualify to receive tax reductions.

RECOMMENDATIONS

1. OTR should program the property tax billing system to automatically terminate tax reductions on properties when ownership changes, thereby forcing new owners to file an application to receive property tax reductions.
2. OTR should program the tax billing system to prorate tax reductions on a monthly basis when applications are received in accordance with the law.

IMPROVEMENTS ARE NEEDED IN THE NUMBER AND QUALITY OF PROPERTY ELIGIBILITY AUDITS CONDUCTED

The Office of Tax and Revenue's Homestead Audit Unit did not annually conduct audits of all Class 1 Property to determine compliance with legal requirements. The mission of the Homestead Audit Unit is "to create an effective and efficient utilization of resources for data matching, analysis, constant compliance review of homestead and senior citizen eligibility requirements that support good tax administration for the agency." One objective stated in the strategic plan for the Homestead Audit Unit to achieve its mission was to review each property at least once annually. Two factors prohibited achievement of the objective, the use of a time-consuming manual review process and lack of sufficient personnel. Consequently, owners received tax reductions on ineligible properties that might have been detected by the Homestead Audit Unit during the audit process if all properties had undergone periodic reviews.

According to the Manager of the Homestead Audit Unit (HAU), all properties were not audited during fiscal years 1998, 1999 and 2000. The Manager could not provide the Auditor with a list of or statistics on the properties audited by the HAU because the management reporting function in the new tax billing system was inoperable. However, the Manager indicated that properties identified by various sources were subject to selection for audit. Properties were selected based on the results of prior audits conducted by a contractor, and based on undelivered tax bills returned by the U.S. Postal Service to OTR. Voluntary notifications received from owners disclosing property class changes and improper receipt of deductions also triggered audits. Additionally, properties with ownership changes and mail address changes were subject to audit. Records were maintained in a file to document the research performed, relevant communication between the staff and others, and status and results of the audits; however, the Manager did not maintain statistics regarding the number of properties actually audited and the audit results.

The Homestead Audit Unit did not have adequate resources to effectively monitor over 90,000 properties annually during fiscal years 1998, 1999 and 2000. The Homestead Audit Unit, which consisted of three persons during the audit period, did not have sufficient staff, and the audit process consisted of tedious, time-consuming manual verification procedures. The process includes the same manual procedures used in granting tax reductions, which are: 1) obtaining documents from the owner to prove residency, 2) matching property owner, owner mailing address, and other data to data in property tax systems maintained by OTR, 3) matching owner's

name and mailing address to income tax returns maintained by OTR, and 4) researching other appropriate records as needed. As stated previously, the Auditor performed the second and third procedures on a sample of 971 properties and found the procedures to be lengthy and in dire need of automation. The extensive manual process limits the number of properties that can be effectively monitored by a small staff of three persons.

The number of ineligible properties found in our examination of records for the sample properties, and the statement by the HAU Manager that all properties were not audited, confirms that the Program was not effectively administered during the audit period, and as a consequence, owners of a significant number of ineligible properties were not identified and tax reductions received by these owners possibly contributed to tax revenue losses by the District during fiscal years 1998, 1999 and 2000.

RECOMMENDATIONS

1. OTR must enhance the Homestead Audit Unit's resources and automate the data matching steps of the audit process to reduce the time required to perform each audit. This should substantially improve the effectiveness of the Homestead Audit Unit.
2. The Manager of the Homestead Audit Unit must maintain a list of and statistics on the audits conducted annually. This documentation would validate the HAU's performance and accomplishments during each fiscal year.
3. OTR officials should develop performance measures for the HAU relative to homestead and senior citizen property tax reduction audits for inclusion in OTR's annual performance plan.

STANDARD POLICIES, PROCEDURES AND RULES WERE NOT FINALIZED

The Auditor determined that during the period under review, OTR officials had not finalized internal written policies and procedures for managing the Homestead Tax Deduction Program. Pursuant to D.C. Code, Section 47-854, OTR is authorized to develop the forms and procedures necessary to carry out the provisions of the law governing homestead tax reductions. OTR had drafted but not finalized written policies and procedures for processing applications to obtain homestead and senior citizen tax reductions. Written policies and procedures should have been established and finalized for both tax reduction benefits. Final internal written policies and procedures would enable staff to be aware of the procedures necessary to accurately complete each task for processing applications, such as verifying application data, approving applications and entering application information in the Homestead Application Database. Final written policies and procedures would also establish uniformity in performing tasks assigned to more than one staff person.

The Auditor reviewed internal written policies and procedures developed by OTR for processing applications for homestead and senior citizen tax reductions. The policies and procedures were labeled “DRAFT” and were dated October 1, 1998. The draft policies and procedures provide a brief description and purpose of the Homestead Tax Deduction Program. The division within OTR responsible for processing applications is also identified in the draft document, and procedures required to process applications are listed. Revisions were handwritten in the body and along the margins of the draft policies and procedures. For example, one suggested procedure apparently added to the draft was to “determine ownership”, however, specific steps necessary to determine ownership were not included in the draft. A comprehensive procedure to determine property ownership is critical in determining whether properties are eligible for homestead or senior citizen tax reductions, and must be performed before a tax reduction is granted to property owners. The lack of specific, detailed steps essential to determining ownership indicates poor internal controls over the process for granting tax reductions.

D.C. Code, Section 47-854, also authorizes OTR to establish municipal regulations necessary to carry out the provisions of the law governing homestead tax reductions. Specifically, D.C. Code, Section 47-850(e), requires the issuance of rules that implement provisions of the law requiring owners to notify OTR of termination of eligibility, including all possible fines and penalties for failure to properly notify OTR of eligibility termination.

Additionally, D.C. Code, Section 47-863(e), requires the issuance of rules to implement provisions of the law governing senior citizen tax reductions. Rules were published in Title 9 of the District of Columbia Municipal Regulations to carry out provisions of the law for senior citizen tax reductions. However, regulations have not been published to carry out the provisions of the law for homestead tax reductions. Published rules and regulations would ensure that the public is fully informed about the legal requirements for participating in the Program.

RECOMMENDATION

The Deputy Chief Financial Officer for OTR must immediately finalize all policies and procedures relative to the Homestead Tax Deduction Program. Further, regulations must be promulgated in the DCMR setting forth all the requirements for participating in the Program.

2001 LEGISLATION MAY PERMIT CONTINUING TAX REDUCTIONS ON INELIGIBLE PROPERTIES BEYOND FISCAL YEAR 2001

Pursuant to D.C. Law 14-4, the Homestead and Senior Citizen Real Property Tax Amendment Act of 2001, D.C. Code, Sections 47-850 and 47-863, were amended, effective June 13, 2001, to “eliminate the 5-year filing requirement for the homestead deduction and the senior citizen deduction.” Prior to the amendment, each property owner was required to file a new application to obtain homestead and senior citizen tax reductions beyond September 30, 2001, the end of the current five-year filing period. OTR does not have the resources to effectively accomplish a re-application and approval process for over 90,000 properties in the Program; therefore, the amendment relieves OTR of that responsibility and forces OTR to rely on its currently deficient audit process to detect ineligible properties presently in the Program. When property ownership changes, OTR must also rely on the existing cumbersome verification process to identify ineligible properties. OTR officials estimate that approximately 8,000 properties change ownership annually.

It appears that owners of ineligible properties are continuing to receive benefits in fiscal year 2001 because the processes for granting, revoking, monitoring, and calculating tax reductions are ineffective. The Auditor examined fiscal year 2001 records for 108 properties and

found that owners may have received homestead deductions on tax bills issued in March 2001 for 66 ineligible properties, which is 61% of the 108 properties examined. It appears that owners of 27 properties did not live in the properties, and owners of 26 properties were corporations or businesses. Additionally, applications were not found in the Homestead Application Database for 13 properties. Further, in addition to being ineligible for homestead deductions, 26 properties among the 66 properties were also ineligible for senior citizen tax relief.

Numerous changes are needed to improve the management and administration of the Homestead Tax Deduction Program. The District may again lose tax revenue in fiscal year 2001 and may continue to lose revenue in future fiscal years because existing deficient processes allow unqualified property owners to receive homestead tax deductions and senior citizen tax relief.

RECOMMENDATIONS

1. The Deputy Chief Financial Officer for OTR should immediately develop the staff and technical resources necessary to ensure that every Class 1 Property is periodically audited, and ineligible properties are promptly removed from the Homestead Tax Deduction Program. OTR should immediately implement the Auditor's recommendations to improve existing processes used to manage the Program to prevent revenue losses in future fiscal years.
2. OTR must collect all real property taxes, penalties and interest resulting from property owners improperly receiving homestead and senior citizen tax reductions in violation of District law.

CONCLUSION

The District of Columbia may have lost approximately \$44.7 million in real property tax revenue during the review period, excluding penalties of approximately \$8 million or more, because the Office of Tax and Revenue (OTR) did not properly and aggressively manage the Homestead Tax Deduction Program (the Program) during the period covered by this audit. Penalties were not factored into the Auditor's lost revenue estimate because OTR may opt to waive a presently undetermined amount of such penalties that were the result of OTR's internal management deficiencies.

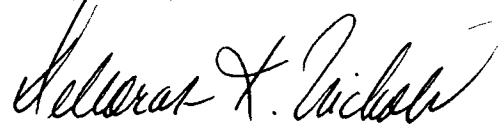
The Homestead Tax Deduction Program was established to provide homestead and senior citizen property tax reductions to qualified residential real property owners. The desired results or benefits for which this Program was established were not sufficiently achieved during the three-year period covered by this audit. It is the Auditor's opinion that this was due in significant part to a lack of effective managerial oversight and direction, in addition to ineffective manual and automated processes used by OTR for granting, revoking, monitoring and calculating these tax reductions. The processes were not fully automated and lacked adequate internal controls to ensure that the tax reductions were properly granted for eligible properties and promptly terminated for ineligible properties.

Although OTR made substantial improvements in the administration of the Homestead Tax Deduction Program prior to, and during the three-year period under audit, the Auditor found that the methodology used by OTR still lacked adequate, effective internal controls to ensure full compliance with the law. Homestead and senior citizen tax reduction applications were not in OTR's records for a significant number of property owners that received these reductions, and data on some tax reduction applications in OTR's records were not adequately screened and validated before tax reductions were granted. In other words, eligibility was often not determined before owner's received tax reductions. Additionally, because of onerous, inefficient manual and automated processes, annual compliance audits of each property, or even a significant percentage of properties in the Homestead Tax Deduction Program, were not conducted in accordance with OTR's Homestead Audit Unit's strategic plan. Consequently, owners received tax reductions on ineligible properties that might have been detected if all or a significant number of properties had undergone periodic reviews. Further, complete rules and regulations were not published to ensure that the public was fully informed about the legal requirements for participating in the Program. As a result, many owners may not have known that they were required to notify OTR when a property became ineligible for the homestead and senior citizen tax reductions.

The conditions discussed above are indicia of OTR's mismanagement of the Homestead Tax Deduction Program during the period covered by this audit. Consequently, property owners may have received homestead and senior citizen tax reductions even though the owners may not have occupied the property. Some owners appeared to have received the deduction on multiple properties at the same time. Additionally, other owners appeared to have received tax reductions that were brought forward from prior property owners. Further, corporations and businesses, ineligible for the Program, appear to have received the homestead tax reduction on residential properties. Program mismanagement, and general failure to adhere to the requirements of the law regarding homestead and senior citizen tax reductions, placed the District at great risk of failing to collect millions of dollars in residential real property taxes.

The Office of the Chief Financial Officer (OCFO) concurred with the Auditor's conclusion that the Homestead Tax Deduction Program needs improvement, agreed with the "spirit" of the Auditor's recommendations, and conceded that as much as \$19 million in potential revenue is still materially affected by inadequate administration of the program. The OCFO also conceded that the material difference between the Auditor's and OCFO's estimated revenue losses arises primarily from the fact that the Auditor included losses from properties participating in the program without an application and the OCFO did not include those properties.

Respectfully,

A handwritten signature in black ink, appearing to read "Deborah K. Nichols", written in a cursive style.

Deborah K. Nichols
District of Columbia Auditor

APPENDICES

APPENDIX 1

HOMESTEAD TYPES

<u>CODE</u>	<u>DESCRIPTION</u>
0	No Homestead
1	Owner Occupied with Exemption
2	Abutting Lot
3	Garage Homestead
5	Senior Citizen with Exemption
A	Owner Occupied without Exemption
B	Senior Citizen without Exemption

Source OTR

APPENDIX II

SAMPLE SELECTION METHODOLOGY

Our sample was taken from a compact disc data file provided by the Office of Tax and Revenue that contained records of 94,948 properties, which were in the Homestead Tax Deduction Program for fiscal year 2000. We used a computer software program, Audit Control Language (ACL), to analyze records in the data file, determine the sample size, and select the sample properties. ACL is a widely-used software for automating many different tasks, including sampling, undertaken during audits.

Using the Homestead Type Code in the records of the data file, ACL determined that owners of 89,119 properties in the data file received tax reductions on two types of residences, owner occupied residences (Type 1 Homestead) and senior citizen owner occupied residences (Type 5). Based on a population of 89,119, we requested ACL to calculate the sample size for record based random sampling with a 90% confidence level, and a 4% expected error rate, and to ensure that an adequate number of properties were included in our audit test, the Auditor randomly selected additional properties for a total sample size of 971 properties.

INSTRUCTIONS

Read this to see how to get the Class 1 property tax rate, homestead deduction and/or senior citizen tax relief.

Please print. Use black or blue ink only — not pencil.

If your form has errors in the pre-printed information, please call the Maps and Titles Unit, on (202) 727-6437, to let us know how to correct them.

If you answer "no" to Question 1 in Part I, do not return this form. Otherwise, return it in the enclosed envelope to the address on the front of this form.

SOCIAL SECURITY NUMBER INFORMATION

Pursuant to 42 U.S.C. 405(c)(2)(C), the Department of Finance and Revenue may request the social security number for tax administration purposes. Inclusion of the social security number is voluntary. The social security number will be used to determine the property owner's eligibility for the homestead deduction and/or senior citizen tax relief.

Part I: Class 1 Property Tax Rate Application

To be eligible for the Class 1 property tax rate:

- the property must be owner-occupied and you must complete Parts I and IV of this form.

You will get the Class 1 property tax rate on a prorated basis, starting the first full month after the date you fill out the properly completed form. After you file, you do not have to file again until 2001, as long as you stay eligible.

Part IA: Class 1 Property Tax Rate Application for Abutting Lot(s)

To be eligible for the Class 1 property tax rate, an abutting lot must have exactly the same ownership as the parent lot (the lot with the house or unit on it) and:

- be immediately adjacent to the parent lot; or
- be a parking space in the same condominium as the parent unit.

Make sure the parent lot is listed in the Property Address box on the front. If there are more than four abutting lots, attach a sheet of paper with the square, suffix, and lot information for them.

Part II: Homestead Deduction Application

To be eligible for the homestead deduction, you must:

- own the property in which you live;
- occupy your property;
- be subject to D.C. income taxation during the period the property gets the homestead deduction; and
- complete Parts I, II, and IV of this form.

You will start to receive the homestead deduction on a prorated basis, the first full month following the date you fill out the properly completed form. You will not have to file again until 2001, as long as you remain eligible.

To find out if you are subject to D.C. income tax, see page 2, Who Must File a Tax Return, of the 1995 or current Individual Income Tax booklet, or call D.C. Income Taxpayer Services, on (202) 727-6104.

The property cannot receive a homestead deduction if it is:

- recorded in a corporation's or business' name, except a partnership in which all partners occupy the property and are subject to D.C. income taxation;
- held in an irrevocable trust;
- not owner-occupied; or
- not occupied by an owner who is subject to D.C. income taxation during the period in which deduction is sought.

You may not get homestead deductions on more than one property at a time.

If you move to a new home, you cannot transfer the homestead deduction from your old home.

If you buy a new home, you may not use the previous owner's deduction. You must apply for your own deduction.

Part III: Senior Citizen Tax Relief Application

To be eligible for senior citizen tax relief:

- you must be 65 years or older;
- you must own and live in your property;
- you and other senior citizens who occupy this property must own 50% or more of the property; and
- total adjusted gross income of everyone living in the home must be less than \$100,000 for the prior calendar year.

Applications for senior citizen real property tax relief will be approved and take effect the first full month after the date the properly completed application is filed and the senior meets the eligibility requirements.

For income information, use last year's total adjusted gross income of everyone living in the home (line 31 of Federal Income Tax Return 1040, line 3 of 1040EZ, or line 16 of 1040A). If more than three people live in the home, attach a sheet of paper with the same information for them.

THIS INFORMATION IS SUBJECT TO AUDIT. PLEASE KEEP ALL SUPPORTING DOCUMENTATION.

APPENDIX IV

PROPERTY TAX CLASSES

<u>PROPERTY CLASS</u>	<u>DESCRIPTION</u>	<u>FISCAL YEAR 2000 TAX RATE*</u>	<u>FISCAL YEARS 1998 and 1999 TAX RATE*</u>
00	Non-Taxable	\$0.00	\$0.00
01	Owner Occupied	\$0.96	\$0.96
02	Non-Owner Occupied	\$1.34	\$1.54
03	Hotel/Motel	\$1.85	\$1.85
04	Commercial	\$2.05	\$2.15
05	Property Not Listed Above	\$5.00	\$5.00

* Tax rate per \$100 of assessed market value

Source OTR and D C Code, Sections 47-812 and 47-813

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March 04, 1997, Tuesday, Final Edition

SECTION: METRO; Pg. D01

LENGTH: 757 words

HEADLINE: Homeowners File Protest At Tax Office; Exemption Confusion Increased D.C. Bills

BYLINE: Vernon Loeb, Washington Post Staff Writer

BODY:

Hundreds of irate District homeowners besieged the D.C. Department of Finance and Revenue yesterday after they were socked with substantial real property tax increases in the weekend mail even though tax rates haven't increased and assessments are frozen.

Maureen Nelson, a tax lawyer from Cleveland Park, said she was "rudely shocked" when she opened her tax bill and saw that her **homestead exemption** had "magically disappeared," increasing the property tax on her \$ 75,000 condominium from \$ 436 to \$ 1,162.

Lawrence E. Berman, a lawyer from Dupont Circle, got a heftier tax bill, too, and yesterday morning headed straight for the department's offices at 441 Fourth St. NW to complain. "It was like a jam scene -- I couldn't even get off the elevator," he said. Aides to Chief Financial Officer Anthony A. Williams, realizing they had a major problem on their hands, quickly acknowledged the error. The department, they said, had revoked the **homestead exemptions** of as many as 5,000 homeowners -- without ever notifying them -- after the homeowners failed to correctly complete new homestead application forms mailed last year.

Officials attributed much of the problem to tighter controls designed to crack down on fraud but said they went too far in cutting people off without notification.

A **homestead exemption** reduces by \$ 30,000 the overall assessment on which an owner-occupied residential property is taxed. It also lowers the tax rate from \$ 1.54 per \$ 100 of valuation to 96 cents per \$ 100.

Those older than 65 who had their **homestead exemptions** revoked because of problems with their applications also lost their senior citizen exemptions, further increasing their tax bills. The senior citizen exemption reduces property tax liability by 50 percent for those in households with combined adjusted gross incomes below \$ 100,000.

"We should have sent out 5,000 notices saying we didn't quite get the correct information," said W. Henry Riley, associate director of the department's real property tax administration.

Riley and Natwar M. Gandhi, deputy chief financial officer for tax and revenue, promised to rectify all problems and send out corrected bills within two weeks. They asked affected homeowners to call 202-727-5380 and leave their name, their telephone number and the square and lot number of their property.

"Within 24 hours, one of us will get back to them and tell them how we can settle their

account," Gandhi said. "We do not want to make their lives difficult, I assure you that."

Riley and Gandhi also said taxpayer assistance tables would be in operation in the lobby at 441 Fourth St. from 8 a.m. to 6 p.m. weekdays for the remainder of this week and next, with Saturday hours a possibility.

D.C. Council member Kathy Patterson (D-Ward 3), who reported receiving 50 calls yesterday from angry homeowners, wasn't fully reassured.

"This does not bode well for the new Department of Finance and Revenue," she said.

"Clearly, there should have been some communication back to the taxpayer," especially since the **homestead exemption** was modified last year and a new, complicated application went out for the first time.

By law, homeowners are required to reapply for the **homestead exemption** every five years. When renewal applications went out in June 1996 to the 70,000 taxpayers then receiving the exemption, Riley said, they were asked for the first time to check a box indicating that they pay D.C. personal income tax. The question, which Riley said could have caused confusion, reflected a new legal requirement designed to prevent people from receiving the exemption while paying personal income tax to another jurisdiction.

The same application was used to determine whether a taxpayer qualified for the additional senior citizen **homestead exemption**. Loss of those exemptions typically means that a homeowner's tax bill more than doubles.

A homeowner with a **homestead exemption** on a property assessed at \$ 100,000, for example, pays the lower, 96-cent rate per \$ 100 on just \$ 70,000 of valuation, amounting to \$ 672 a year. Loss of the **homestead exemption** means the higher, \$ 1.54 rate per \$ 100 would be levied on the full \$ 100,000 assessment, amounting to \$ 1,540 a year.

Revoking those exemptions without notice before sending out tax bills, said lawyer Berman, "is a pretty major decision."

"It's just another example of why D.C. is such a difficult place to live," Berman said. "The bureaucracy doesn't treat you as though they want you to be here."

GRAPHIC: Photo, james m. thresher , W. Henry Riley, left, associate director of real property tax administration, attempts to get crowd of angry District homeowners to form a single line.

The Washington Post, March 15, 1997

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March 15, 1997, Saturday, Final Edition

SECTION: METRO; Pg. D03

LENGTH: 924 words

HEADLINE: D.C. Tax Chief Takes the Heat; Residents Pleased With Response to Yanking of Homestead Exemptions

BYLINE: Vernon Loeb, Washington Post Staff Writer

BODY:

W. Henry Riley III knew he was in for a long week when he stepped off the elevator outside the D.C. government's real property tax administration office March 3 and found hundreds of angry taxpayers waiting for the office to open.

It was well before 8 a.m., and they were steamed, having inexplicably lost **homestead exemptions**, which sent their tax bills soaring.

But Riley, the District's property tax director, has seen worse in his day. And by the time the dust started to settle on this one late last week, he had pulled off a minor miracle in the troubled halls of One Judiciary Square: Taxpayers were going home happy. They came, they complained -- they got help.

Tax specialists in and out of the government credit that miracle to Riley, 50, a top Maryland state property tax official whom Chief Financial Officer Anthony A. Williams lured out of early retirement last summer with the challenge of fixing the District's badly broken property tax system.

"It is the nation's capital, for God's sake," Riley said this week in an interview. "Many of the things that are happening here happened elsewhere, and to be quite honest, they can be fixed. It's not going to happen overnight. But I thought: 'These people need help. What the heck. Let's just try it.' "

The latest fiasco erupted when new property tax bills went out in late February, denying **homestead exemptions** to thousands of homeowners, based on **applications** they must fill out every five years. Now that his troops have fielded close to 20,000 telephone calls and fixed 6,000 individual tax accounts, Riley can say that most who lost their exemptions failed to complete their **applications** properly.

But he is the first to admit that no one's exemption should have been taken away without notification, which is what happened. He also acknowledges that some people never got **applications** and that others filled them out correctly and still lost their exemptions, thanks to data entry errors. And he doesn't excuse the busy signals, filled voice-mail boxes and non-answering operators people get. The department's phone system, he said, badly needs an overhaul.

Not everyone is satisfied. "I've met with Mr. Riley, and he seems to know what he's talking about in terms of tax policy and customer service," said D.C. Council member Kathy

Patterson (D-Ward 3). "But my office is continuing to get many, many, many calls from constituents who have tried to call the property tax office and can't get through or can't get a call back and are very worried about their exemptions. This continues to be a crisis."

Riley doesn't disagree -- he now is trying to identify 5,000 to 6,000 taxpayers eligible for **homestead exemptions** who haven't filed **applications**.

Riley's also the first to admit that the whole mess was his responsibility. Taxpayers should have gotten dunning letters, he said, instead of being cut off without any warning.

"It's horrible to see seniors who could barely walk coming in here -- that's wrong," said Riley, a small, trim man with a balding pate whose crisp attire says boardroom and whose warm, open manner says Sunday school. "And that's why I felt so bad."

It isn't as if he didn't have anything else on his plate. By the time he arrived in September, Williams already had proposed a moratorium on tax assessments citywide after a scandal last year in which one assessor reassessed 9,700 properties on the basis of square footage without leaving the office.

Riley since then has studied the District's nightmarishly complicated property tax regime -- five different tax rates, dozens of special exemptions, 170,000 annual property reassessments -- and proposed what he says is a sane alternative.

Under his plan, which awaits D.C. Council approval, properties would be assessed every three years, as they are in Maryland. Taxpayers could appeal assessments administratively without going to the Board of Real Property Assessments and Appeals, as they do in every state except Alabama.

In the meantime, Riley has the District's assessors out eyeballing the first third of homes and businesses to be reassessed. He also spent the fall supervising an **audit of homestead exemptions**. It caught 6,000 absentee owners erroneously getting the tax break, and resulting lower tax rate, granted to all owner-occupants. Net result: \$ 11 million in new tax revenue.

Riley said most city assessors are competent -- there was just no way any of them could assess 8,000 to 9,000 properties a year, as they were expected to do.

And the city's much-maligned computer-aided mass appraisal network, or CAMA, is perfectly workable, he said. It's just that the D.C. tax officials who bought it under then-Mayor Sharon Pratt Kelly tried to load too much data into it too quickly and ended up with a garbage-in, garbage-out scenario.

Marie Drissel, a tax activist who hounded Riley's predecessors about all manner of glitches and screw-ups, is pinching herself.

"I've gone to him with problems, and they're getting fixed. It's amazing," said Drissel, who noted that Riley has even taught ethics for the International Association of Assessing Officers. "He doesn't assume you know everything, and yet he doesn't put you down. It's a big change, a real big change."

Riley's goal is to rectify the problems of everyone who called or waited in line. He wants to send corrected tax bills by the end of next week. Taxpayers then will have a 30-day grace period to send in their checks -- the original March 31 deadline won't apply.

The Washington Post, March 26, 1997

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March 26, 1997, Wednesday, Final Edition

SECTION: METRO; Pg. B03

LENGTH: 585 words

HEADLINE: New D.C. Tax Bills Will Restore Exemptions

BYLINE: Vernon Loeb, Washington Post Staff Writer

BODY:

Revised property tax bills will go out to more than 33,000 District residents this week in the aftermath of bitter protests that thousands of homestead and senior citizen exemptions were erroneously revoked without notice.

W. Henry Riley III, the District's property tax director, said yesterday that revised bills will be sent to more than 5,000 people who protested the loss of homestead and senior citizen exemptions after the city's initial property tax billing in February.

The city also will send revised tax bills to an additional 4,300 senior citizens who got homestead and senior citizen exemptions last year but did not reapply for them this year. Those who receive revised bills will automatically be granted exemptions, Riley said. In addition, 15,000 property owners who received **homestead exemptions** last year but did not apply for five more years of eligibility will get revised bills granting them another year's exemption.

Riley, a former top property tax official with the State of Maryland, said his office has shifted from the punitive stance that denied **homestead exemptions** without notice on the basis of minor **application** errors to a far more lenient posture under which exemptions will be granted to all who had them last year.

All of the renewed exemptions will be subject to audit later, Riley said. Anyone who is ultimately deemed ineligible after having been granted homestead and senior citizen exemptions will be billed for additional amounts once an audit is complete.

"We can't withstand another onslaught [of complaints], because we're not getting anything else done," Riley said. "We've got to restore some order here. We want to make sure those who are deserving of these exemptions get them. And we want to get our records cleaned up."

Meanwhile, Riley said, revised bills will be going out to almost 9,000 taxpayers who have yet to receive an initial bill. While 5,000 of those billings were delayed for technical reasons, he said, about 4,000 bills that should have been mailed to neighborhoods in Ward 3 mysteriously turned up last week in a box in an empty conference room.

How did they get there? "I have no idea," Riley said.

All property tax bills mailed this week, he said, will be due 30 days from the date marked on the bills. Every mailing, he added, will contain a revised bill, a letter of instruction and an

application for homestead and senior citizen exemptions, which must be completed and returned.

A **homestead exemption** reduces the overall assessment on which owner-occupied residential property is taxed by \$ 30,000 as long as taxpayers can prove that they also pay D.C. personal income tax. A **homestead exemption** also lowers the tax rate for such taxpayers from \$ 1.54 per \$ 100 valuation -- the amount paid by those who rent out their residential properties -- to 96 cents per \$ 100, the Class 1 rate.

The senior citizen exemption reduces property tax liability by 50 percent for those older than 65 who qualify for the **homestead exemption** and have adjusted gross household incomes below \$ 100,000.

Riley said all 33,000-plus revised bills will come with payment envelopes addressed to a post office box in Richmond belonging to First Union National Bank, where the District deposits all of its property tax revenue.

Riley said property owners who have not received any type of property tax bill by mid-April should immediately call the Real Property Tax Administration's customer service center at 202-727-5380.

AGENCY COMMENTS

AGENCY COMMENTS

On August 10, 2001, our draft report was submitted for review and comment to the City Administrator, Chief Financial Officer of the District of Columbia, the Deputy Chief Financial Officer for Tax and Revenue, and the Chief Technology Officer of the District of Columbia. The Office of the Chief Financial Officer submitted draft comments for the Auditor's review on August 30, 2001. On September 19, 2001 and September 24, 2001, the Chief Financial Officer of the District of Columbia provided official comments to the District of Columbia Auditor. Comments were not provided by the Chief Technology Officer of the District of Columbia. Where appropriate, changes have been made to reflect the Chief Financial Officer's comments. The official final comments submitted by the Chief Financial Officer on September 24, 2001 are appended in their entirety as part of this final report. The Auditor expresses appreciation to the Office of the Chief Financial Officer (OCFO) for its cooperation and for the invaluable technical assistance of OCFO staff assigned to facilitate this complex undertaking.

GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Chief Financial Officer

Natwar M. Gandhi
Chief Financial Officer



September 24, 2001

Ms. Deborah K. Nichols
District of Columbia Auditor
717 14th Street, NW- Suite 900
Washington, D.C. 20005

Dear Ms. Nichols

Thank you for the opportunity to comment on your report titled "Homestead Tax Deduction Program Needs Substantial Improvement" (Report). We agree with your general conclusion that this program needs improvement. Indeed, since 1996 the Office of Tax and Revenue (OTR) has worked systematically to bring about improvements in a manner that:

- Emphasizes Revenue Customer Service and does not penalize taxpayers as we go through this transition ,and
- Emphasizes Revenue Generation by allocating the resources of OTR to those audit and collection activities that yield the greatest return.

These improvement efforts are tied to completion of the Integrated Tax System (ITS) project and will be largely completed by the end of FY2002. Then, as OTR moves to full reliance on ITS, the Homestead Program will be as cost effective and efficiently managed as possible under the current legal structure of the program.

The Office of the Chief Financial Officer (OCFO), however, differs with the analysis and findings of the Report in many respects; I comment here on the most critical of these differences.

First, we differ on the matter of who is eligible for the Homestead Deduction (hereafter referred to as the "Credit"). Specifically, the Report applies a "principal residence" standard. However, the portion of the code that applies to Tax Year 2000 requires that the property "is occupied by the owner," and indicates that occupancy can be demonstrated by paid water and sewer bills, paid electric bills, paid gas bills, and /or other items. A residential property that is not rented and whose owner maintains operating utilities may qualify for the Credit. Such properties could appear to be vacant or have billing addresses at other locations or even under names other than that of the property owner.

Second, the OCFO estimates no revenue loss for owners who received the credit and could qualify, but did not have an application on file. These owners did receive the credit without application and would

have received the credit with an application, therefore no revenue is lost (Enclosure 1). These owners were not penalized for administrative issues within OTR. This difference is the major component of the variance in our estimate of \$16 million in lost revenue, and your estimate of \$39.5 million.

The Report states that 6,000 residential real property sales resulted in automatically assigning the homestead exemption to the new owners. (The 6,000 figure represents about 75% of all sales in one given year.) It is the contention of the OCFO that the exemption was not erroneously assigned; but instead was granted because the new owners were eligible to receive the homestead exemption. Nonetheless, our essential disputes about revenue impacts are captured by the two most critical differences described above.

The Office of Tax and Revenue made choices in the period 1998-2000 to allocate "moveable" resources first to Customer Service and to Collection/Audit activities in income, sales, and franchise taxes. This decision produced more than \$176.4 million in direct revenue collections by the Compliance operations-- \$50.5M in FY1998, \$58.5M in FY1999, and \$67.4M in FY2000 (see Enclosure 2). In addition, these direct activities can spark literally hundreds of millions of other tax dollars as taxpayers step up voluntary compliance- the heart of any truly successful tax system. The "cost" of OTR's resource allocation is foregoing up to \$ 16 million in real property tax revenue under the Homestead Program in FY 1998-2000. The Office of Tax and Revenue is and has been working to reduce this loss in the future.

Through a contract with MTB costing \$2 million, \$12.9 million is revenue was collected from a homestead audit across the 1996-1999 period. MTB used Depart of Motor Vehicle data, voter registration, and telephone listings to supplement tax files in this work. Subsequently, OTR added to these "matching" activities a new real property tax file, RPT 2000, and multiple related files, Board of Elections and Ethics files, the legacy Individual Income Tax file, and others. Before the Chief Technology Officer arrived, OTR took the lead in an effort to standardize addresses and names and to attach a common identifier number to files for referencing across agencies. Additional improvements are in the planning and/or development stage, as illustrated in Enclosure 3.

Details of our analysis of the draft report are contained in the attached "Comments on the District Auditor's Report" prepared by my office and submitted to you on September 19, 2001. As we have too little time to respond professionally to the revised report sent to us on September 20, please refer to your draft report in reading this document. At the end of the document is the OCFO's understanding of the methodology used in the Report to prepare your analysis. As we have had no word from your office about the accuracy of this understanding, our comments assume the summary is correct.

Thank you again for the opportunity to respond.

Sincerely,



Natwar M. Gandhi
Chief Financial Officer

Enclosures

Distribution List:

The Honorable Linda Cropp, Chairman
The Honorable Jack Evans
The Honorable Sandra Allen
The Honorable Sharon Ambrose
The Honorable Harold Brazil
The Honorable David Catania
The Honorable Kevin Chavous
The Honorable Adrian Fenty
The Honorable Jim Graham
The Honorable Phil Mendelson
The Honorable Vincent Orange
The Honorable Kathleen Patterson
The Honorable Carol Schwartz
John A. Koskinen, Deputy Mayor and City Administrator

ENCLOSURE #1

**Office of the Chief Financial Officer
Comments on District Auditor's Report Entitled
Homestead Tax Deduction Program Needs Substantial Improvement**

This paper contains the comments requested by the District of Columbia Auditor on the report concerning administration of Homestead and senior citizen real property tax relief. The comments are organized as follows: first, a number of issues concerning the report's estimates of the magnitude of the problem are discussed; second, the report's recommendations are discussed and the progress and plans of The Office of Tax and Revenue (OTR) to improve administration of the program are described.

Magnitude of the Problem

OFCO has recognized since at least 1996 that a significant number of properties improperly receive homestead or senior citizen tax relief and that District revenue is materially affected. Beginning in 1996, the Office of Tax and Revenue (OTR) has undertaken a series of actions, with some yet to come to reduce the associated revenue loss. OFCO estimates that about 16 percent of properties improperly received benefits, in FY 1998 - 2000 and that the three-year total of revenue loss is in the range of \$13 million to \$19 million.

In FY 2001, the District of Columbia Auditor (DCA) undertook a project to estimate revenue loss due to improper homestead and senior credits during FY1998-2000; the OCFO estimate is in response to the DCA work. DCA estimates that of approximately 89,000 properties accorded homestead or senior citizen relief in FY2000, about 31 percent were ineligible for that relief. DCA further estimates that the amount of revenue lost was about \$48.5 over a three-year period. After thorough review of the DCA report, OFCO has concluded that these estimates are exaggerated.

General Concerns

Details of DCA's Study Methods

While it is clear from the report that DCA reviewed a sample of properties and classified some of those properties as "ineligible," the report does not contain a detailed description of the method by which this classification was made. OCFO staff and DCA staff have held discussions of these methods. The appendix to these comments contains our understanding of the process by which the properties were classified.

Legal Matters

A major problem with the DCA report is that it applies a standard for determining "owner occupancy" that is far stricter than provided by statute. Homestead and Senior Citizen benefits are granted by DC statutes to owner occupants of

comparatively small non-transient residential properties. To receive the benefits, the owner occupants must also be subject to DC income tax.

In the report, DCA appear to be applying a "principal residence" standard for occupancy. See pp. 10 and 17, where that phrase appears. On p. 5, the report states that, to obtain homestead or senior citizen relief, the owner must live in the property. The report cites section 47-850(c) as authority. However, that portion of the code that applies to Tax Year 2000 does not contain the phrase "principal residence" and does not require that the owner live in the property to be eligible for relief. The words concerning occupancy in 47-850(c-3)(1)(A)(i) are "Is occupied by the owner." This seemingly trivial distinction gains significance from section 47-813(d-1)(4), which states that, in event of dispute about occupancy, the owner is required to submit at least two items from a list that includes paid water and sewer bills, paid electric bills, paid gas bills, and other items relevant to determining whether a property is occupied. These practical indicia of occupancy imply that a property that is not rented and whose owner maintains operating utilities qualifies as Class 1 property. The only additional requirement for a property to qualify for the homestead deduction is that the owner is subject to D.C. income tax.

In reviewing properties in its sample, DCA staff classified a property as "ineligible" if the owner's mailing address in OTR's real property files or income tax files is different from the street address of the property itself. This classification clearly is not supported by the law.

Concept of Revenue Loss

DCA's concept of revenue loss is not defined in the report. It can only be inferred from the methods used to calculate it. A better way to proceed is to define the concept to be estimated, and then develop suitable methods to estimate it based on that definition.

OCFO's concept is that the "revenue loss" is the difference between (a) the amount of property tax that should have been paid on a set of properties over a specified period of time and (b) the amount of property tax that was paid on those properties during that time. The amount that should have been paid is the amount that would have been paid if tax administration had been fully effective in alerting taxpayers to the legal requirements, and the taxpayers had been fully compliant with those requirements. The amount of property tax that was paid needs no elaboration, but it may be characterized as follows: it is the amount that was paid, given the degree of effectiveness of tax administration that actually occurred and the degree of compliance by the taxpayers that actually occurred. With this concept, it is possible to resolve some questions about proper estimation.

Significance of the Application Requirement

The law clearly requires District property owners to apply for homestead and senior citizen relief before receiving that relief. In the application, each owner is required to attest to the "basic requirements" that the property is occupied by the owner, that the owner is subject to DC income tax, and (in the case of applicants for senior citizen relief) that the owner is aged 65 or older.

Under the OCFO's concept, there is no revenue loss from properties that received the homestead credit and did not have an application on file but did meet the other basic requirements. Why should cases result in "no revenue loss?" Because the amount of tax actually paid is the same as the amount that actually was owed.

Applying OCFO's concept, we first obtain the amount of tax that should have been paid: that is, the amount that would have been paid if tax administration had been fully effective and these owners had been fully compliant with all requirements. In this environment, all requirements, including the requirement to file applications, would have been met. The tax paid on these properties would have been, therefore, the amount owed after application of the homestead and senior citizen discounts. The tax actually paid for these properties was the amount of tax owed after the discounts. That is, the difference between the amount that should have been paid and the amount actually paid is zero.

Significance of Penalties

Under OCFO's concept, penalties clearly should not be included. The law imposes penalties on property owners who improperly receive homestead and senior citizen discounts. DCA's report treats these penalties as revenue lost. Under OCFO's concept, penalties clearly should not be included. With fully effective tax administration and full compliance by taxpayers the tax due would have been paid; the amount of penalties that would have been zero. Therefore, the difference between the amount of property tax that should have been paid and the amount actually paid is unaffected by penalties.

Recoverability of Affected Revenue

Some property tax revenue is not received when it was due because some property owners claim tax relief to which they are not entitled. But, not all of that revenue is "lost." When improper homestead and senior citizen deductions are discovered, the tax deficiencies may be recovered. As systems for identifying such cases are improved, the proportion of deficiencies identified will be increased and recovery may be undertaken on the larger amount. There is no statute of limitations on payment of DC property tax. During FY 2000 \$23.6 million in delinquent property tax was recovered.

Case by Case Review

The central element of DCA's method for this study is case-by-case review of a sample of 971 properties (out of about 89,000 that received homestead and senior citizen discounts in Tax Year 2000). The purpose of the reviews was to classify the properties into three possible groups: ineligible, eligible, and other. The reviews used information from OTR's property tax and income tax files. Visual inspections were also carried out for some or all of the sample properties; the inspections were used to determine which of the properties seemed to be vacant land or abandoned buildings.

There is an important limitation to this procedure, given the statutory meaning of owner occupancy and the large variety of living arrangements in the District: it is not possible to determine whether a property is eligible with the limited amount of data used by DCA's staff. The report in effect acknowledges this difficulty by its occasional use of the language of uncertainty concerning its findings: "...at least 27,600 properties may have wrongfully received ...; "...owners of approximately 31% of the sample properties may have incorrectly..." (p. 10). There is no such diffidence, however, in the report's announcement of its signal finding: "...many owners wrongfully received the reductions, and the District lost at least \$48.5 million in tax revenue..." (p. 9).

Sampling Issues

DCA staff reviewed a sample of 971 properties that received homestead and senior citizen tax relief in Tax Year 2000. We understand that the sample was a systematic random sample chosen from those properties on OTR's master list that received the relief. Analysis by OCFO staff found that several categories of properties were present in the sample in larger proportions than in the "population" of tax relief properties. For example, 29 percent of the properties in the DCA sample did not have valid applications for relief on file, but only 13 percent of the 89,000 properties for which relief was claimed in 2000 did not have valid applications on file. For another example, 34 percent of the owners of the sample properties have property tax billing addresses other than the address of the property in question; only 15 percent of the owners of the 89,000 properties have this condition. Since these two conditions (absence of valid applications and address discrepancies) are indicators in DCA's analysis that properties are ineligible for relief, their overrepresentation in the sample probably results in overestimates of error rates and revenue "loss."

OCFO Estimates

Review of DCA "Ineligible" Cases

In their review, DCA staff found 335 of the 971 cases to be "ineligible." OCFO staff have reviewed these 335 cases, in two stages, to determine the extent of our agreement with DCA's findings. In the first stage, the cases were very quickly reviewed to meet the original deadline of August XXXXX for comment on the DCA report. In that review, OTR analysts found 139 properties for which they disputed DCA's classification as "ineligible; they agreed with DCA's classification for the remaining 196 properties. In the second stage, a second deadline of September 19th had been granted, and OCFO analysts were able to review random samples of 50 of the 139 "disagree" cases and 30 of the 196 "agree" cases. The results of the second stage review are that: 41, or 83 percent, of the sample of disagree cases were found to be ineligible by OCFO; 19, or 65 percent, of the sample of agree cases were found to be ineligible by OCFO. Applying these results to the 139 disagree cases and the 196 agree cases respectively, we get an OCFO estimate that 153, or 16 percent, of the 971 sample properties are ineligible. This estimate does not account for the likelihood that a similar review of the 636 properties classified as eligible or other would find some(probably a small proportion) that, by the standards used by the OCFO analysts, should be classified as ineligible.

For the reviews of DCA's classification, OCFO analysts used data from the Real Property Tax 2000 (RPT 2000) file, from the Homestead Applications file, from an online commercial locator service known as Accurint, from a real property document warehouse known as Landata, and from the list of "ineligible" properties supplied by DCA.

In our review, we attempted to determine whether the owner of the property in October 2000 occupied the property at that time. Unlike DCA, we did not consider absence of a homestead application, a discrepancy between the owner's name and the name of the signer of the application, or a discrepancy between the property's address and the owner's address to be dispositive. Our approach involved exploring whether the people who had the property as a current address (as of October 2000) were owners, and whether the people listed as owners had the property's address as a current address. We did not consider a property to be "ineligible" because the owner had more than one current address, provided one of them was the address of the property in question. We also did not consider a property to be ineligible because multiple individuals with two or more surnames occupied the property, provided one of them was an owner.

Estimates of Revenue Loss

OCFO's method for estimating the revenue loss is the same as DCA's with the following exceptions:

We use our estimates of the number and percentages of ineligible properties, based on the two-stage review of the 335 properties classified as ineligible by DCA.

We do not include penalties or interest in our estimates for reasons explained above.

We make two estimates based on alternative assumptions about the appropriate tax rate to apply to the aggregate amount of improperly claimed homestead deductions. For one estimate, we assume that all properties for which the deduction was claimed were nevertheless eligible for the class-1 tax rate. For the other estimate, we make the same assumption as DCA—that all improperly claimed homestead deductions should be taxed at the class-2 rate.

The result of our calculations is a range of estimates from \$13 million to \$19 million.

District Auditor's Recommendations

OCFO agrees with the conclusion that this program needs improvement. And, we agree with the spirit of DCA's recommendations; in fact we are already in the process of implementing most of them.

The following timeline describes the improvements made in the administration of the Homestead program. Detailed comments concerning each recommendation follow the timeline.

1995 -- District of Columbia placed in receivership. Real property tax programs comprise 24% of city local revenues. Real property tax processing lagged far behind other jurisdictions both in terms of automation and customer service. Programs were manually managed, records were poorly maintained, and documentation was not retrievable. The real property billing system had been developed in the 1960's; on-line data entry was non-existent. No data systems were linked. Paper data entry documents known, as "long tickets" and journal vouchers were required for processing. Tax certificates and corrected tax bills were produced on typewriters. The application of real property tax payments regularly trailed by three months the deposit of the taxpayers' funds

1996 – Major reorganization of the Real Property Tax Administration to stabilize operations and develop a comprehensive plan to revitalize real property initiatives in the city.

OTR contracts with Municipal Tax Bureau (MTB) to audit homestead and senior citizen tax reduction programs. MTB commenced the audit, focusing on tax credits taken in 1991 through 1996 (later expanded to include 1997 credits).

In May 1996 126,000 Homestead Applications were mailed to property owners with a deadline of September 1, 1996. This was the District's 5-year reapplication process as required by existing law. Of the 126,000 pieces mailed, only 70,000 applications were returned.

1997 – Legislation passed to provide: (1) real property tax lien securitization; (2) interest rates that would make for an effective tax sale; (3) a Homestead/Senior Citizen program audit; (4) conversion to a triennial assessment process with a sunset provision in 2001.

Spring tax bills were sent, with approximately 25,000 properties removed from Class 1 tax rates, and homestead and/or senior benefits revoked. The removals were based on failures to respond to the 1996 mailing, incomplete applications, or incomplete data fields for those properties. More than 20,000 homeowners called at city offices protesting removal. The decision was made at the highest levels to reinstate the homestead deduction to all properties receiving the deductions prior to the 1996 mailout.

MTB reviewed 60,000 of the approximately 89,000 properties in these programs. A mailing was done to the audit universe. Based on account analyses MTB billed 16,700 accounts deemed "most probable" to be ineligible for the reductions. More than \$13 million was collected from this effort.

The MTB audit and 1996/7 events highlighted the urgent need for automation and systems improvements, especially to link land records with other databases (Department of Motor Vehicles, voter registration, income tax files, etc.).

1998 – Several automation sub-systems were developed to provide short-term improvements to real property tax management. Systems developed included: (1) an assessment appeals system; (2) a tax certificate system; (3) a tax sale system; (4) a homestead application system; and (5) a computer assisted mass appraisal system conversion. OTR commenced major systems procurements for a complete revamping of all property management programs.

A Homestead Application database was developed to track the status of all homestead applications. This allowed the updating of new applications and loading of data to the old real property billing system.

MTB continued working the collection efforts; staffing applied to resolution of the various homestead and senior citizen programs peaked at 13 contractor and OTR staff.

1999 – Auditing activities continued and then ended in 1999. MTB's contract was concluded, as the most probable receivables were liquidated, leaving the city with more difficult cases to resolve. In all, the MTB/OTR effort audited more than 34,000 accounts of properties receiving the homestead and/or senior citizen deductions.

2000 – The "RPT2000" system came online replacing the legacy system and acting as a bridge between the legacy and the planned Integrated Tax System. Specific homestead and senior citizen indicators were developed in RPT2000, and reports and audits of deductions were handled in-house. Recorder of Deeds and other real property programs were linked for the first time. Property owners whose social security numbers were known could be matched with the income tax filing database for the first time.

Database development and systems linkages were negotiated with key agencies in the city. OTR worked with the Department of Consumer and Regulatory Affairs, and members of the City Council to address vacant and abandoned properties and other real property compliance issues.

District Auditor's Recommendations And OCFO Comments

"OTR must enhance the Homestead Audit Unit's resources and automate the data matching steps of the audit process to reduce the time required to perform each audit. This should substantially improve the effectiveness of the Homestead Audit Unit." (Page 21)

We agree with this recommendation but are concerned about the funds necessary to implement it.

"The Deputy Chief Financial Officer for OTR should immediately develop the staff and technical resources necessary to ensure that every Class 1 Property is periodically audited, and ineligible properties are promptly removed from the Homestead Tax Deduction Program. OTR should immediately implement the

Auditor's recommendations to improve existing processes used to manage the Program to prevent revenue losses in future fiscal years." (Page 24)

We agree with this recommendation and our FY 2002 budget appropriates 3 additional FTE for homestead auditors.

"The Homestead Application Database should be modified to perform additional edits before homestead and senior citizen tax reductions are granted. All OTR computer systems used in the eligibility determination process by the Homestead Unit should be linked to the Homestead Application Database for effective and timely application data matching and verification. For example, the computer systems maintained for recording deeds, assessing property taxes, and processing income tax returns should be linked to the Homestead Application Database." (Page 16)

OTR designed and began linking databases before this audit was initiated, in fact as early as 1999. Land Records Management was bought on line in January 2000 and is used by the Homestead Audit Unit. In the past twelve months we have used database linking and analysis to investigate more than 30,000 homestead accounts. In September 2000 OTR entered real property transfers on line into the RPT 2000 billing system. The DC Land Title/OTR Taskforce in FY2000 facilitated redesign of the property transfer form allowing grantee notification of residential property benefits. Ownership on the systems is current to within two weeks of transfer. Using the database and new form, on May 1, 2001 OTR began auditing all homestead and senior citizen accounts at the time of transfer. If a new application is not filed, the deductions are removed from the property. During 2001 OTR linked various databases with the Homestead Applications File to identify approximately 16,000 property sales that occurred during 1998 to 2001 and resulted in transferred properties receiving the Homestead benefit. It should be noted that during that same time more than 20,000 applications for Homestead or Senior benefits were received. The ability to link these files occurred in March 2001 and OTR is auditing all accounts not having a current application. Homestead Deductions are being withdrawn for approximately 1,700 accounts as a result of this work. Additional analysis is underway and includes linking databases containing telephone number information, voter registration files, motor vehicle licenses, and motor vehicle license plate files. Using our linked databases has also identified more than 18,000 accounts where we had no Social Security Number (SSN) on file for the property owner(s). In the fall 2001 OTR will initiate a program to address these 18,000 property owners and secure this additional identifying data. This will be facilitated if draft legislation is passed requiring the submission of social security numbers and other information critical to tax administration.

"All OTR computer systems used in the process should utilize common identification numbers assigned to real property owners and co-owners for

effective automated data matching. This identification number could be the social security number for individuals or federal tax identification numbers for partnerships, corporations and businesses. The common identification number would automate matching of owners between computer systems to determine proof of ownership and compliance with other legal requirements before granting tax reductions. The federal tax identification number would immediately flag the property owner as a partnership, corporation or business that may not be entitled to receive homestead and senior citizen tax reductions.” (Page 16)

Because it is not a requirement of law, we have not been able to enforce the submission of identifying numbers. We are supporting legislation that would require submission of identifying numbers by property owners.

In 1999 OTR began an address/identifying number standardization project in conjunction with the Department of Consumer and Regulatory Affairs (DCRA), the Department of Public Works (DPW), and the Chief Technology Officer (OCTO). In the spring 2001 a contract was awarded through the Office of the Chief Technology Officer to develop a complete address standard. With the adoption of this plan, all city agencies with the necessary capacity will be able to link data files with our real property records by using a geo-coding methodology. This will make our links with the Department of Motor Vehicles, voter registration, etc., even more effective.

“OTR should develop a mechanism to automate data matching, with assistance from the District’s Chief Technology Officer, from the Homestead Application Database to computer systems in other District agencies using social security numbers and federal tax identification numbers. Matching the owner to: 1) the driver’s license and vehicle registration systems at the Department of Motor Vehicles, 2) the voter registration system at the Board of Elections, and 3) the billing system at the Water and Sewer Authority could additionally confirm the owner’s residence. Matching the owner to records maintained in the vital statistics system at the Department of Health could verify the age and mortality of the owner receiving or applying for tax reductions. Matching the owner to records maintained by the Department of Consumer and Regulatory Affairs could identify vacant properties that are not eligible for tax reductions.” (Page 16)

See the Timeline and comments on other recommendations for information on OTR data matching efforts.

OTR regularly works with the Department of Consumer and Regulatory Affairs to identify and react to properties which are vacant and/or abandoned. OTR recently removed several hundred properties from Homestead eligibility, and we are working tirelessly to manage this initiative. We are dependent on DCRA to identify and maintain an accurate listing. OTR recognizes the importance of these properties to the social landscape of the city and we are exploring new program initiatives to address vacant and/or abandoned properties.

"OTR should develop guidelines, with assistance from the District's Chief Technology Officer, to standardize the format for entering names and addresses into all computer systems available for use in the process of determining eligibility for the homestead tax deduction and senior citizen tax relief. A standard format would facilitate comparison of the owner's mail address to the tax property address to determine whether the owner resides in the property." (Page 16)

OTR has been in an address cleanup and standardization project for the last two years. Working closely with the Department of Consumer and Regulatory Affairs and the Department of Public Works, OTR is updating its tax roll file and making extraordinary progress on address protocols on behalf of the city. As part of the data linking project, and the OTR data warehouse project, the Homestead file name fields have been parsed. The name data cleanup activity will be completed in 2002 as part of the conversion to the Integrated Tax System. This work couples with the citywide efforts through "Clean Hands" and "Teeth in Enforcement" to establish standard name and address protocols for all agencies. The Office of the Chief Technology Officer is working closely with these programs to implement this standardization.

"OTR should ensure that tax reductions are granted only after an application has been filed and eligibility has been definitively determined." (Page 17)

Granting reductions without evidence and/or application is no longer done. Previous situations (mostly in 1997) created administrative exigencies causing some ineligible property owners to be given deductions without filing a formal application. Since the 1997 decisions, as these property owners are identified the deductions are removed. In 2001, those property owners who may have received the benefit based on administrative exigency constitute a very small number. In 1998, 1999, 2000, and 2001 more than 20,000 Homestead applications were filed, while only 16,000 properties transferred. This indicates that the program accuracy improved by a minimum of 4,000 applications during this period. OTR requires and audits applications for these deductions whenever property is transferred

"OTR should program the property tax billing system to automatically terminate tax reductions on properties when ownership changes, thereby forcing new owners to file an application to receive property tax reductions." (Page 19)

It has always been the policy to terminate tax reductions on properties when ownership changes. However, before concerted efforts to automate, and before integrated systems, there were instances when this did not occur. In FY2001 all accounts are now subject to integrated systems review. Further data warehousing and other linkages will refine our abilities. Migration to the

Integrated Tax System in 2002 will enhance our effectiveness and efficiency in this area. All of these efforts are underway.

"OTR should program the tax billing system to prorate tax reductions on a monthly basis when applications are received in accordance with the law." (Page 19)

The RPT 2000 system correctly calculates full year and half year property taxes. Prorating of benefits occurs on property sales taking place in the months between billings. Currently, prorated computations are manually calculated and then uploaded to RPT 2000. Prorated benefits calculations will be automated in the conversion to the Integrated Tax System if that is consistent with law. Currently OTR is monitoring draft Bill 14-101 which, if passed, will eliminate prorating of the Homestead Deduction.

"The Manager of the Homestead Audit Unit must maintain a list of and statistics on the audits conducted annually. This documentation would validate the HAU's performance and accomplishments during each fiscal year." (Page 21)

Records dating back to 1998 are available covering audits conducted through the contract with MTB, as well as individual files of OTR audits. OTR's RPT 2000 system contains report routines that identify each account review, the date of the review, the fields that were changed, and an identifier of the person who made the change. This report is regularly referenced when performing research on accounts. As our systems migrate to the Integrated Tax System OTR will enhance and compile these data as needed. We particularly want to use this capacity for identifying properties for audit contacts.

"OTR officials should develop performance measures for the HAU relative to homestead and senior citizen property tax reduction audits for inclusion in OTR's annual performance plan." (Page 21)

OTR has maintained performance statistics on the Homestead Program for a number of years. We have regularly used these metrics as workload management tools to guide program decisions, customer service initiatives, and workload projections.

"OTR must collect all real property taxes, penalties and interest resulting from property owners improperly receiving homestead and senior citizen tax reductions in violation of District law." (Page 24)

OTR constantly manages compliance programs to ensure that the proper amount of taxes is assessed. Our collection efforts in the Real Property Tax Administration are performing well and having the appropriate long-term effect for the city. Because of past practices the removal of each improper deduction is

evaluated and an appropriate assessment is made. Often these assessments include the levy of appropriate penalties and interest charges. After assessment, we move aggressively to collect all real property taxes, penalties and interest. This includes taking properties to tax sale if assessments are unpaid.

The Homestead Application Verification Process

The Homestead Application Verification Process is illustrated in the accompanying model. This model itemizes the timetable and procedures implemented by OTR to address problems in the Homestead program.

A. 1996

- OTR inherits deeply flawed data files from the old Department of Finance and Revenue

- OTR contracts with MTB to discover inaccuracies in the homestead files and collect revenue due. This program lasted until mid-year 1999 and raised \$13 million in revenue.

- ❖ Files used to secure this result include Extract match against DMV, Voter Registration Phone X-Cross

B. 1997

- Real Property assessments are frozen for 1 year, to help straighten out assessment problems.

1998

- Triennial assessment implanted, to allow all properties to be appropriately re-assessed.

1999

- OTR consolidates and stores all data from the 31 separate files of the Real Property Tax legacy system.

2000

- RPT2000 is implemented to replace the legacy system going forward. RPT2000 is designed to capture Homestead Application Information, Sales Data, and Ownership inform.

A project of data verification begins to include all properties in the Comprehensive Automated Mass Appraisal (CAMA) system. Verification of Real Estate Sales, Ownership Registration, and new lots is incorporated.

October – OTR provides requested file to DCA.

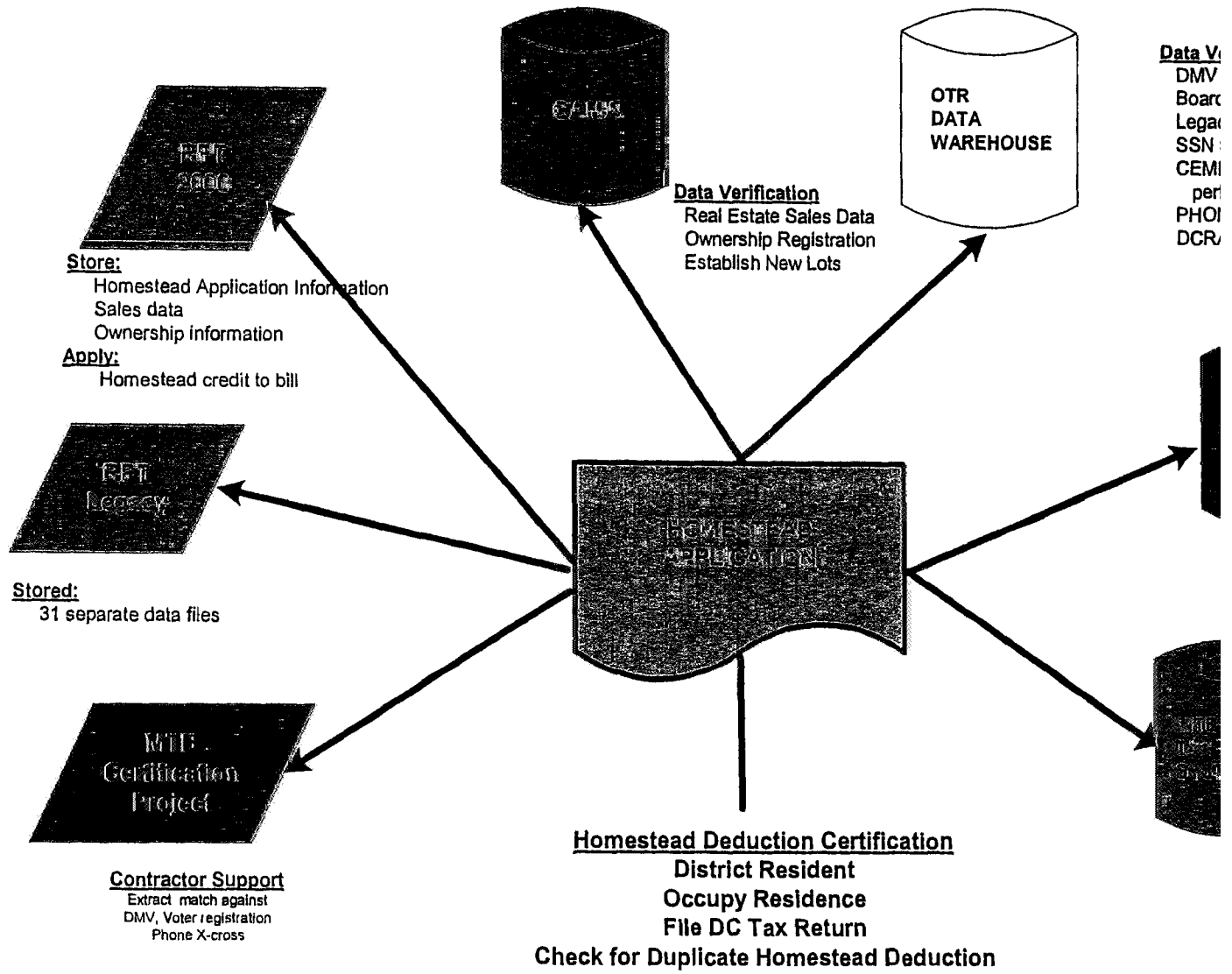
2001

- OTR data warehouse is established. Warehouse allows for matching tax files against the files of:

- ❖ Board of Election

- ❖ Legacy – Individual Income Tax
 - ❖ Telephone
 - ❖ Construction Permits
 - ❖ SSN Searches
 - OTR begins to implement data verification (Name, SSN, address verification, chronology of residence) using external files accessed by use of "ACCURINT"
 - Owners are asked to re-apply for the Homestead Credit.
 - September- DCA issues report on DC Homestead.
- G. 2002- OTR will have the Integrated Tax System in place, allowing full match of individual income files against other files with front-end validation of Income Tax filing, SSN, and Address.

HOMESTEAD APPLICATION VERIFICATION



Data V.
DMV
Boarc
Legar
SSN
CEMI
per
PHOI
DCR

996 1999 2000 2001

Appendix

DC Auditor's Methodology for the Estimates Contained in the Draft Report Entitled Homestead Tax Deduction Program Needs Substantial Improvement

This document describes the understandings of staff of the Office of the Chief Financial Officer (OCFO) concerning the methods used to make the estimates in the subject report. These understandings are based primarily on discussions between OCFO staff and DC Auditor (DCA) staff on September 5. The description is arranged under the following headings: The Sample of Properties for the Study; Assembling Data; Assigning Properties to Compliance Categories; and Making the Estimates.

The Sample of Properties for the Study

The sample for the study was drawn from a computer file known as the Homestead Deduction File that was made available to the DCA staff by the Office of Tax and Revenue (OTR) in November 2000. This file contained, for every property that received a homestead deduction in FY 2000, the square and lot numbers of the property and the homestead code of the property.

The sample was limited to properties in the Homestead Deduction File that had homestead codes of 1 or 5—homestead deduction only or homestead deduction *and* senior citizen discount—for FY 2000. This “population” contained approximately 89,000 properties.

The sample was sized and selected by a computer system called Audit Control Language (ACL), which is a widely-used system for automating many different tasks, including sampling, undertaken during audits. DCA's staff input the requirement that an estimate based on the sample would be accurate within plus-or-minus four percentage points with a probability of 90 percent. ACL, using the Homestead Deduction File, returned the information that a sample of 971 properties would be sufficient to meet the ± 4 percentage points/90 percent requirement, and ACL randomly chose 971 properties and listed their square and lot identifications, and their homestead codes. (In the September 5 meeting, DCA and OCFO staff agreed that ACL's sample size is probably based on standard statistical methods for attaining the desired precision for an estimate of the proportion of the population possessing a particular attribute—such as property ineligible for deductions granted. Similarly, they agreed that the fact that ACL required DCA staff to input an interval to start the sample selection probably indicates that the sample is a systematic random sample rather than a simple random sample.)

Assembling Data

For each of the 971 properties in the sample, DCA obtained data from four different sources: the Real Property Tax 2000 file, also known as RPT 2000, supplied by OTR; drive-by inspections conducted by DCA staff; the Income Tax Return file, supplied by OTR; and the Homestead Application file, supplied by OTR.

Using OTR computers and software, DCA staff viewed the RPT 2000 data and various calculated values for each square-and-lot-number in the sample. DCA obtained at least the following items for each property: the property's street address; the property owner's name; the owner's mailing address; the assessed valuation of the property; and the date of last transfer of the property.

Using the street addresses of the sample properties from the RPT 2000 file, DCA staff performed "drive by" inspections of each sample property and recorded at least the following information for each one: whether the property was unimproved (vacant) land; whether the residence on the property was "boarded up;" or whether the residence otherwise seemed to have been abandoned. The drive-by inspections were performed in March and April 2001. (From the September 5 discussions, it was not completely clear whether all of the sample properties, or only a sample of them, had been inspected by DCA.)

Using OTR computers and software, DCA entered the Income Tax Return file for each property, using the property owner's name obtained from RPT 2000. At least the following items were obtained for each property: the owner's Social Security Number (SSN) and the owner's income tax mailing address.

Using the SSN's obtained from the income tax return file, DCA staff entered the Homestead Application File to locate homestead and senior citizen discount applications filed by the owners of the sample properties. For each application found for a property in the sample, the name of the person who signed the application was obtained. (Many of the applications in this file contain zero in the SSN field.)

Assigning Properties to Compliance Categories

DCA staff established three categories of sample properties: Ineligible, eligible, and other.

"Other" includes all properties that were shown in RPT 2000 as having been transferred during 1998-2000, and all properties that DCA found to be vacant lots or abandoned properties.

Of the 971 sample properties, 335 were found by DCA to be ineligible for FY 2000 tax relief. Ineligible properties were those in the sample that were not "other" properties and had at least one of the following characteristics:

- no application for the property is present in the Homestead Applications File;

- signer of the application for a property is not the owner of that property;

- application for a property has zero in the SSN field;

- no owner name for the property in the RPT 2000 file;

- owner's name in RPT 2000 or in applications file is a business name (trusts, VA and HUD in owner name field do not result in classification as ineligible);

- owner's address in RPT 2000 (including p. o. box) is different from property's address;

- owner's address in the Income Tax Return File (including p. o. box) is different from the property's address;

"Eligible" properties are those that are not classified as other or as ineligible.

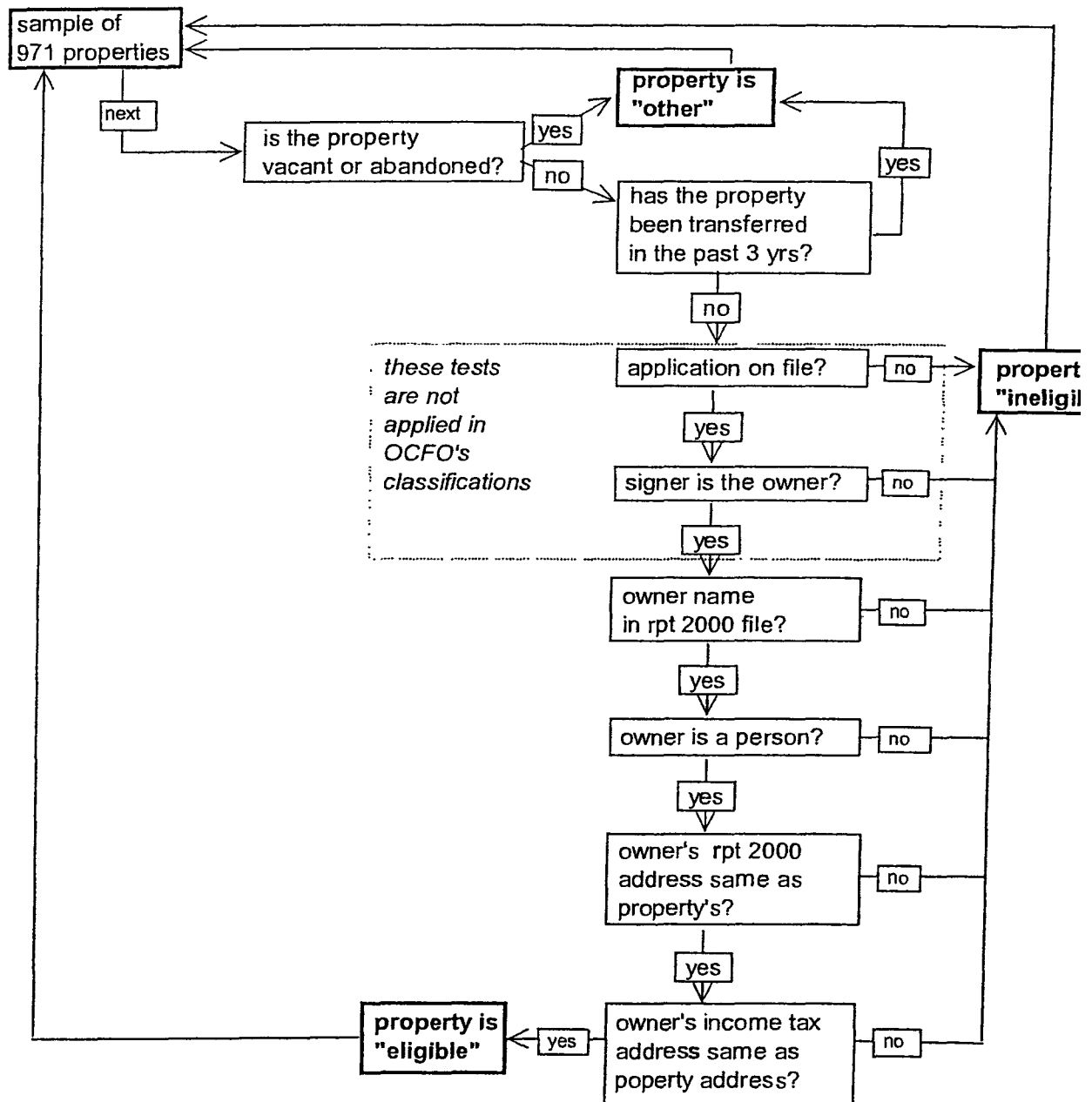
A flow diagram of this process is attached.

Making the Estimates

In the meeting of September 5, DCA staff stated that the estimate in the draft report that 31 percent of the sample properties may have been ineligible was obtained by taking 335 as a percentage of 971. Applying that percentage to the total of approximately 89,000 properties with homestead codes of 1 and 5, produces the estimate of 27,600 properties that "may have wrongfully received homestead deductions".

In a meeting on September 6 DCA staff explained that the estimate of \$48.5 million lost over the 1998-2000 period was made as described in the report, with the clarification that for 1998 and 1999 the estimates for each type of relief (homestead and senior) are made by taking percentages of the estimates for 2000 and adding relevant penalties; the percentages are, for 1999 and 1998 respectively, the percentage of sample properties "ineligible" for 2000 relief that received tax relief for the earlier year.

Auditor's Process for Classifying Sample Properties



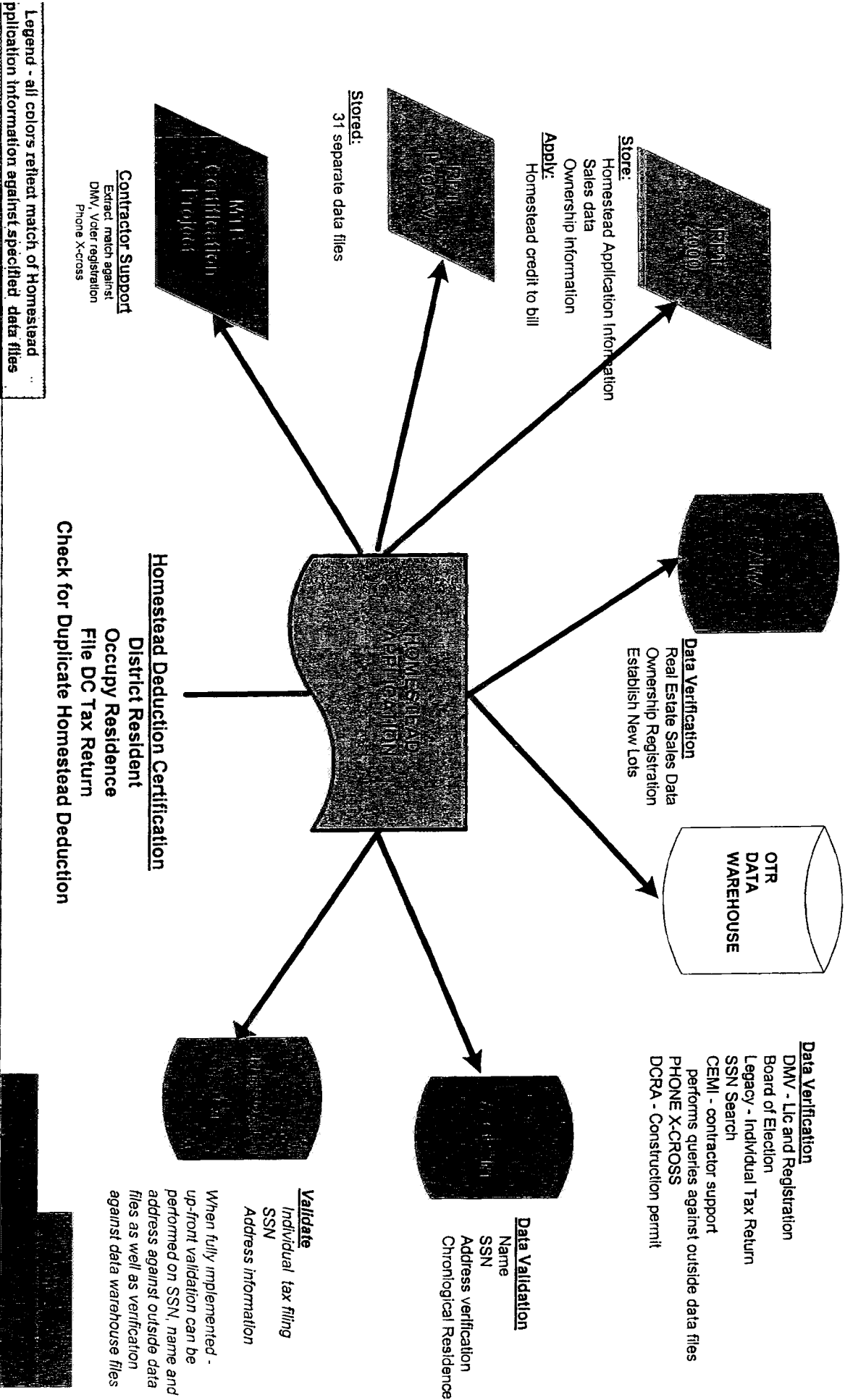
ENCLOSURE #2

**Collection Division
Delinquent Account Collections
1998-2000**

TAX TYPE	1998	1999	2000
Individual	\$12,345,268	\$17,945,175	\$17,684,343
Corporation	\$7,720,204	\$11,374,615	\$20,444,512
Unincorporated	\$2,717,899	\$1,686,971	\$1,916,806
Withholding	\$2,783,124	\$3,301,169	\$4,581,979
Sales and Use	\$18,499,178	\$19,278,879	\$18,811,237
Personal Property	\$5,786,188	\$4,630,354	\$3,555,198
Hotel Occupancy	\$395,910	\$63,376	\$36,297
Public Safety	\$67,815	\$37,282	\$37,305
Arena Fee	\$223,998	\$221,548	\$307,759
TOTAL	\$50,534,584	\$58,539,369	\$66,375,436

ENCLOSURE #3

HOMESTEAD APPLICATION VERIFICATION PROCESS



AUDITOR'S ANALYSIS OF AGENCY COMMENTS

AUDITOR'S ANALYSIS OF AGENCY COMMENTS

In commenting on the Auditor's report, the Chief Financial Officer stated that the "OCFO has recognized since at least 1996 that a significant number of properties improperly receive homestead or senior citizen tax relief and that District revenue is materially affected." The OCFO concurred with the Auditor's conclusion that the Homestead Deduction Program needs improvement, agreed with the "spirit" of the Auditor's recommendations, and conceded: (1) that as much as \$19 million in potential revenue is still materially affected by deficiencies in the administration of the Homestead Tax Deduction Program; and (2) the material difference between the Auditor's and OCFO's estimated revenue losses arises primarily from the fact that the Auditor included losses from properties participating in the program without an application and the OCFO did not consider the lack of an application problematic. We believe that the OCFO's view is based on its mismanagement of the homestead application process in 1996 and the resulting fiasco in 1997. (See Appendix V) Nevertheless, the Office of the Chief Financial Officer raises questions about the Auditor's study and the resulting findings and conclusions. In doing so, the OCFO provides misleading or incomplete information in its comments to make its case. Consistent with Generally Accepted Government Auditing Standards, the Auditor herein presents an analysis of statements made in the OCFO's comments.

I. OCFO'S COMMENT

Details of DCA's Study Methods

While it is clear from the report that DCA reviewed a sample of properties and classified some of those properties as 'ineligible,' the report does not contain a detailed description of the method by which this classification was made. OCFO staff and DCA staff have held discussions of these methods. The appendix to these comments contains our understanding of the process by which the properties were classified.

AUDITOR'S ANALYSIS

The final draft report submitted to the Office of the Chief Financial Officer on September 20, 2001 contained the methodology used by the District of Columbia Auditor to conduct the examination of homestead and senior citizen deductions for fiscal years 1998, 1999, and 2000.

The Auditor conducted a compliance test of a sample of 971 of the 89,000 homestead and senior citizen deductions to determine the frequency of failure to comply with applicable laws and regulations. The ultimate purpose of the test was to

establish the extent of procedural errors and/or non-compliance, and the resulting dollar impact, if any. Our test of compliance was based on the examination, on a sample basis, of documentary evidence maintained by and in the custody and control of the OCFO as well as other relevant available evidence. Moreover, the OCFO's appendix, which contains their understanding of our process, is partially inaccurate.

II. OCFO'S COMMENT

Legal Matters

A major problem with the DCA report is that it applies a standard for determining "owner occupancy" that is far stricter than provided by statute... In the report, DCA appear to be applying a "principal residence" standard for occupancy. See pp. 10 and 17, where that phrase appears. On p. 5, the report states that, to obtain homestead or senior citizen relief, the owner must live in the property. The report cites section 47-850(c) as authority. However, that portion of the code that applies to Tax Year 2000 does not contain the phrase "principal residence" and does not require that the owner live in the property to be eligible for relief. The words concerning occupancy in 47-850(c-3)(1)(A)(i) are "Is occupied by the owner." This seemingly trivial distinction gains significance from section 47-813(d-1)(4), which states that, in event of dispute about occupancy, the owner is required to submit at least two items from a list that includes paid water and sewer bills, paid electric bills, paid gas bills, and other items relevant to determining whether a property is occupied. [Auditor's Emphasis] These practical indicia of occupancy imply that a property that is not rented and whose owner maintains operating utilities qualifies as Class 1 property.

AUDITOR'S ANALYSIS

First, the OCFO fails to complete its quote of D.C. Code, Section 47-850(c)(1)(A)(i), with the following vital phrase "...is occupied by the owner who is subject to income taxation during the period in which the deduction is sought." [Emphasis Added] Second, the OCFO fails to indicate that D.C. Code, Section 47-813(d-1)(4) applies only to the establishment of the class 1 property tax rate. In order for a property to be eligible for the homestead or senior citizen deductions, it must first be classified by the OCFO as a Class 1 property. Third, the use of paid water and sewer bills, paid electric bills, paid gas bills, and other items as indicia of whether an owner occupies more than one property for purposes of legitimately claiming multiple homestead and senior citizen deductions does not, in our opinion, conclusively establish that a property is not rented. Moreover, a shrewd multiple residential property owner may maintain utilities on vacant residential property or include utilities as part of the

rent on residential rental properties in order to maintain the appearance of “owner occupancy” for the purpose of lowering their property tax bill. The property owner, therefore, could improperly claim the homestead and/or senior citizen deduction on rental property or property used for business purposes. Fourth, the OCFO would have had to first make a determination that the property appeared to be ineligible to receive the homestead and/or senior citizen deductions, however, our examination indicated that the OCFO is not doing so on a regular, comprehensive basis.

III. OCFO’S COMMENT

Legal Matters (Cont.)

...DCA staff classified a property as “ineligible” if the owner’s mailing address in OTR’s real property files or income tax files is different from the street address of the property itself. This classification clearly is not supported by the law.

AUDITOR’S ANALYSIS

The OCFO states that the Auditor’s conclusion that a property was ineligible if the owner’s mailing address in the OCFO’s real property files or income tax files was different from the street address of the property itself clearly is not supported by law. However, what the OCFO neglects to address with regard to this issue is that the OCFO must first determine the reason for the difference in addresses before it can conclusively state that the property is eligible to participate in the program. This may ultimately require the property owner to submit evidence to establish the legitimacy of the claimed deduction(s). The Auditor found that the OCFO repeatedly failed to perform its responsibility of determining whether evidence available to it raised a question regarding the legitimacy of the claimed deduction(s), and if, in fact, the OCFO performed this procedure, it failed to resolve the discrepancy with the property owner. The homestead and senior citizen deduction law requires the property owner to be an occupant of the claimed property and if the property owner’s mailing address is different from the property address to which deductions apply, this is an indication that a discrepancy exists and that a more detailed examination of the matter should ensue to resolve the discrepancy. Further, it is in the best interest of the District’s financial health not to assume, in the face of such discrepancies, that there is compliance with the law.

The law requires an owner to be an occupant of the property on which a homestead or senior citizen deduction is claimed. If the owner’s mailing address is not the same as the address of the property on which a deduction is claimed, then this, in the Auditor’s opinion, generally raises questions concerning whether the owner is

occupying the property. Further, if the address on the owner's income tax return does not match the homestead property address and the owner reports rental income and/or depreciation expenses for income tax reporting purposes, these also are indicia that the owner is not an occupant of the property in question.

IV. OCFO'S COMMENT

Concept of Revenue Loss

DCA's concept of revenue loss is not defined in the report. It can only be inferred from the methods used to calculate it. A better way to proceed is to define the concept to be estimated, and then develop suitable methods to estimate it based on that definition.

OCFO's concept is that the "revenue loss" is the difference between (a) the amount of property tax that should have been paid on a set of properties over a specified period of time and (b) the amount of property tax that was paid on those properties during that time. The amount that should have been paid is the amount that would have been paid if tax administration had been fully effective in alerting taxpayers to the legal requirements, and the taxpayers had been fully compliant with those requirements.

AUDITOR'S ANALYSIS

The Auditor's methodology of calculating revenue loss is simple and straight forward. The amount of property tax paid by a property owner who improperly claimed either the homestead or senior tax deduction was not the amount of tax that should have been paid. The Auditor calculated the difference between what was paid with the deduction(s) and what should have been paid without the deduction(s). The difference constituted the amount of revenue that should have been collected by the District but was not because of OTR's ineffective administration of this important program. As a consequence, the revenue is not available to the District treasury until, or unless, the Office of the Chief Financial Officer implements effective measures to collect or recover this tax revenue. The homestead and senior citizen tax administration system reviewed by the Auditor was not effective and a significant number of property owners, during the period reviewed, appeared not to be in compliance with the legal requirements for properly claiming a homestead or senior citizen tax deduction. Further, District law requires the filing of an application in order to receive a homestead deduction. During the period under review, the Council did not pass any legislation removing or suspending this requirement, and the Office of the Chief Financial Officer was not provided with any discernible valid legal authority to ignore compliance with the application requirement as required by law. In conducting this review, the Auditor could not, and did not, ignore the law's requirement for a properly completed application as the basis for receiving the District's homestead and senior

citizen deductions. Without a properly completed application on file as required by law, the Office of the Chief Financial Officer would not know, and cannot now factually assert, that the other basic requirements for a deduction were met unless it reviewed the legitimacy of the 89,000 homestead and senior citizen deductions on the tax roll during fiscal years 1998 through 2000. Correspondingly, the District of Columbia Auditor could correctly assume that the property owner was ineligible to receive the homestead and/or senior citizen deduction when the OCFO could not produce: (1) completed homestead and senior citizen applications required by law; or (2) records indicating that it had verified the legitimacy of properties participating in the program. The taxpayer who pays property taxes without the senior citizen and homestead deductions pays significantly more than the taxpayer who takes advantage of these deductions. Further, the property owner who improperly claims homestead and senior citizen deductions is unjustifiably enriched at the expense of the District government and property owners who have complied with the homestead and senior citizen eligibility criteria.

V. OCFO'S COMMENT

Significance of the Application Requirement

Under the OCFO's concept, there is no revenue loss from properties that received the homestead credit and did not have an application on file but did meet the other basic requirements. Why should cases result in "no revenue loss?" Because the amount of tax actually paid is the same as the amount that actually was owed.

AUDITOR'S ANALYSIS

The OCFO's statement: *Under the OCFO's concept, there is no revenue loss from properties that received the homestead credit and did not have an application on file but did meet the other basic requirements. Why should cases result in "no revenue loss?" Because the amount of tax actually paid is the same as the amount that actually was owed.* completely ignores the basic fact that an application must be on file as required by D.C. Code, Section 47-850(e) and 47-863(g), in order for the OCFO to even assess whether the other basic requirements for participating in the program were met. Without an application on file, the OCFO lacks basic mandatory information to determine whether the property owner meets the statutory eligibility criteria for receiving the deductions.

VI. OCFO'S COMMENT

Significance of Penalties

Under OCFO's concept, penalties clearly should not be included. The law imposes penalties on property owners who improperly receive homestead and senior citizen discounts. DCA's report treats these penalties as revenue lost. Under OCFO's concept, penalties clearly should not be included. With fully effective tax administration and full compliance by taxpayers the tax due would have been paid; the amount of penalties that would have been zero. Therefore, the difference between the amount of property tax that should have been paid and the amount actually paid is unaffected by penalties.

AUDITOR'S ANALYSIS

Again, the District's tax administration system is not fully effective and all taxpayers were not in full compliance with the requirements for receiving the homestead and senior citizen property tax deductions. Except for penalties that must be waived as a result of deficiencies in the OCFO's management of the Homestead Tax Deduction Program, all penalties collected are non-tax revenue required to be imposed and collected by law.

VII. OCFO'S COMMENT

Recoverability of Affected Revenue

Some property tax revenue is not received when it was due because some property owners claim tax relief to which they are not entitled. But, not all of that revenue is "lost." When improper homestead and senior citizen deductions are discovered, the tax deficiencies may be recovered. As systems for identifying such cases are improved, the proportion of deficiencies identified will be increased and recovery may be undertaken on the larger amount. There is no statute of limitations on payment of DC property tax. During FY 2000 \$23.6 million in delinquent property tax was recovered.[Auditor's Emphasis]

AUDITOR'S ANALYSIS

The OCFO states that there is no statute of limitation on the payment of D.C. property taxes. While this may be correct, the OCFO fails to state that tax liens and penalties attach to the property not to the property owner, and that the current reach of the statute is limited to the District of Columbia. In other words, if a non-compliant property owner, particularly a non-resident property owner, sells a property on which he or she improperly claimed the homestead and/or senior citizen deduction(s), the District's ability to recover amounts improperly deducted is based on whether the OCFO discovered non-compliance before or after the sale of such properties. In cases

where it is after the sale, the District's ability to recover improperly deducted property taxes is compromised. In essence, if the OCFO fails to effectively police compliance with the legal requirements for claiming the homestead and senior citizen deductions, the District's ability to recover improperly claimed deductions may be forever lost even in the absence of a statute of limitation. Further, it is important to note that when the OCFO attempted to collect improperly claimed homestead and senior citizen taxes identified by MTB for tax years 1997 and prior, even in the absence of a statute of limitation the OCFO made a determination to write-off \$43 million.

VIII. OCFO'S COMMENT

Case by Case Review and Sampling Issues

The central element of DCA's method for this study is case-by-case review of a sample of 971 properties (out of about 89,000 that received homestead and senior citizen discounts in Tax Year 2000)....There is an important limitation to this procedure, given the statutory meaning of owner occupancy and the large variety of living arrangements in the District: it is not possible to determine whether a property is eligible with the limited amount of data used by DCA's staff.

Analysis by OCFO staff found that several categories of properties were present in the sample in larger proportions than in the "population" of tax relief properties. For example, 29 percent of the properties in the DCA sample did not have valid applications for relief on file, but only 13 percent of the 89,000 properties for which relief was claimed in 2000 did not have valid applications on file. For another example, 34 percent of the owners of the sample properties have property tax billing addresses other than the address of the property in question; only 15 percent of the owners of the 89,000 properties have this condition. Since these two conditions (absence of valid applications and address discrepancies) are indicators in DCA's analysis that properties are ineligible for relief, their overrepresentation in the sample probably results in overestimates of error rates and revenue "loss."

AUDITOR'S ANALYSIS

The Auditor used a statistically significant sample of 971 properties from the OCFO's database receiving the homestead and senior citizen deductions. The audit team conducted the same review that the OCFO *should* have conducted to determine whether available evidence indicated that properties appeared to be eligible or ineligible to participate in the Homestead Program. Where the properties appeared not to be eligible, the OCFO should have requested the affected property owner to provide the appropriate evidence to conclusively establish eligibility. The Auditor did not perform this additional procedure. The "variety of living arrangements in the District" was not within the purview of nor was it relevant to our examination. Instead, our focus was on whether the properties in our sample complied with the eligibility criteria set forth in 47-850(c) and 47-863(b) based on available evidence in

the OCFO's possession. We found that at least 31% of the properties in our sample appeared to be ineligible and that the OCFO needed to perform additional work to conclusively establish their eligibility.

While OCFO officials and staff claimed they found several categories of properties in the sample in larger proportion than in the population, they failed to describe the methodology they used to make this determination. We found the OCFO's statement regarding proportionality troubling for the following reasons:

- If the OCFO used its computerized databases for 1998, 1999, and 2000 to make this determination, there is an immediate problem with their methodology because the address formats are structurally incompatible and there was no way to electronically match property addresses for each database of 89,000 properties for each of the three fiscal years under review. Thus, the OCFO's claim of "overrepresentation" is mere conjecture for which they failed to provide any supporting evidence; and
- OCFO failed to reference the period of time covered by the database they used to determine "overrepresentation." Unless OCFO officials and staff used the same records used by the Auditor for the same period of time covered by the audit, their methodology and conclusions would be materially flawed.