



North Carolina Department of Revenue

Michael F. Easley
Governor

Reginald S. Hinton
Secretary

February 1, 2008

MEMORANDUM

TO: The Honorable Marc Basnight Senator John H. Kerr, III
President Pro Tempore Revenue Laws Study Committee Chairman

The Honorable Joe Hackney Representative Paul Luebke
Speaker of the House Revenue Laws Study Committee Chairman

FROM: Reginald S. Hinton *Reginald S. Hinton*
Secretary of Revenue

SUBJECT: Semi-Annual Report: Tax Compliance Initiatives and Revenue Projections,
July 1, 2007 – June 30, 2008

This semi-annual report is prepared pursuant to G.S. 105-256(a)(8). This report reflects the combined efforts of our Collection, Examination, and Taxpayer Assistance Divisions.

The Department of Revenue (DOR) continues to address all aspects of non-compliance with North Carolina's revenue laws through ongoing current and prior initiatives. Non-compliance continues to be identified across all tax schedules administered by this agency. The combined resources of our Tax Compliance divisions address abuses of our voluntary tax compliance system. Our Tax Compliance personnel focus on enforcement of the revenue laws and also seek to educate the citizens our state about compliance issues.

Our plan for addressing non-compliance and enhancing voluntary compliance consists of numerous initiatives implemented by this agency. These initiatives are determined through various analytical techniques utilized to monitor areas of non-compliance within our voluntary tax system. Once identified, we allocate Departmental resources to recover lost General Fund revenue.

P.O. Box 25000, Raleigh, North Carolina 27640
Phone (919) 733-7211
State Courier 51-71-00
Website: www.dornc.com
An Equal Opportunity Employer

Exhibit 1 lists the Department's existing initiatives, as of July 1, 2006, to increase compliance with the tax laws. The Guest Worker initiative and focus on unreported income derived by individuals using an Individual Taxpayer Identification Number (ITIN) represents the Department's newest initiative since July 2006.

Exhibit 2 reflects revenue projections from the combined efforts noted in this report. These revenue projections are estimates by tax type and are presented for the Fiscal Year July 1, 2007 – June 30, 2008.

Exhibit 3 lists a few of the key initiatives that are part of the Department's long-term collection plan for Fiscal Year 2007-2008.

Exhibit 4 provides the results of our combined collection efforts. The exhibit provides information regarding the age and collection of assessments for the period July 1, 2007 through December 31, 2007.

Exhibit 5 reflects the tax debt collections by tax type for the months of July 1, 2007 through December 31, 2007.

Exhibit 6 pertains to use of the proceeds of the collection assistance fee imposed by G.S. 105-243.1 for the fiscal year 2006-07. Expenditures for fiscal year 2007-08 will be reported in the semiannual report to be filed August 1, 2008.

Exhibit 1 - Department's Existing Initiatives July 1, 2006

<p>Abusive Tax Avoidance Transactions (ATAT) – DOR partners with the Internal Revenue Service to identify schemes and recapture lost revenue as a result of involvement of individuals and corporations in abusive tax avoidance transactions.</p>
<p>Audit Selection Criteria – The Department’s Integrated Tax Administration System (ITAS) allows the Examination Division to identify taxpayers that meet certain selection criteria through the use of queries to the system. Those taxpayers meeting the selected criteria are identified as potential audit candidates and will be assigned for examination.</p>
<p>Automated Installment Agreements – The Department works with taxpayers to establish installment payment agreements to repay past-due tax debts.</p>
<p>Bankruptcy Processing – The Bankruptcy Unit within our Collection Division processes and maintains all aspects of cases involving taxpayers who have filed for protection under the US Bankruptcy Code.</p>
<p>Consumer Use Tax – Many North Carolina residents fail to remit and pay the proper use tax on purchases of tangible personal property obtained from vendors outside this state. This agency utilizes a number of matching data sources to identify these purchases. These data sources are the United States Customs Service, Wildlife Resource Commission, and Southeastern Association of Tax Administrators.</p>
<p>Corporate Income and Franchise Taxes: Non-Fileers –This examination initiative identifies non-fileers from ITAS and external data sources. The Employment Security Commission, Internal Revenue Service (IRS), and Secretary of State furnish the external data sources to the Department.</p>
<p>Criminal Procedures – Regionally based revenue officers work with local district attorneys to develop and prosecute misdemeanor cases of willful failure to file or pay state taxes.</p>
<p>Electronically Filed Returns – This initiative focuses on audit selection, fraud detection, and examination of the D400 and related federal schedules that are filed electronically with IRS and DOR. The initiative selects taxpayers for audit based on criteria to identify abuse on the federal Schedule A (Itemized Deductions) and/or Schedule C (Business Profit & Loss), North Carolina pro-ratio percentage, tax withheld to refund request, and various state tax credits.</p>
<p>Federal Refund Offsets – DOR sends debt information to the Internal Revenue Service which offsets any federal tax refunds due for repayment of state tax debts.</p>
<p>Fraudulent Preparer Return – These are returns that have been completed by a “paid tax preparer” and which contain false or fictitious itemized deductions and/or Schedule C business losses. The preparer cases are referred to the Criminal Investigation Division for possible prosecution. At the conclusion of the investigation by CID or prosecution of the “paid preparer”, the individual income tax returns of the <i>clients</i> of the “paid preparer” are referred for examination.</p>
<p>Guest Workers – This audit initiative addresses workers in this state using false or stolen social security numbers that have small amounts or no state tax withheld on wages. These individuals often do not file individual income tax returns. If returns are filed, an Individual Taxpayer Identification Number (ITIN) is used and filing status and dependents claimed are often incorrect.</p>

Exhibit 1 (continued)

Individual Income - Schedule A & C – Audit selection criteria identify potential individual income tax returns with abusive Schedule A and/or Schedule C. These returns overstate itemized deductions. Other returns filed with Schedule C will understate gross business income and/or overstate business expenses.
Individual Income Tax Non-Filers – This initiative identifies North Carolina residents that file federal tax returns but do not file state individual income tax returns based on information provided under the Federal Data Extract Program.
Jeopardy Assessments – When the Department determines that collection of an account is in jeopardy, the law allows the Department to assess non-filed periods and immediately begin the collection process. This action is used primarily to collect business trust taxes.
Large Corporate Cases/Income Shifting – This initiative addresses a number of tax avoidance techniques utilized by corporations to shift net income from taxation by this state through inter-company transactions within a consolidated group or to create expenses between wholly owned subsidiaries to reduce net income taxable in this state.
Levy Officer Program – NC Gen. Stat. §105-242(b) gives the Department the authority to seize and sell personal property. Eight specially trained revenue officers perform this function for the Department.
NC-3: Employer Withholding Reports – This examination initiative focuses on employer withholding reports and identifies employees with no state income tax withheld or under-withheld based on gross wages.
NC-4/W-4: Employee's Withholding Allowance Certificate – The Examination Division reviews taxpayers' NC-4 information submitted to the Department by employers and withholding information provided in electronic format to auditors. This information is reviewed to identify taxpayers claiming excessive withholding tax allowances or exempt withholding status.
Non-File Cross Tax Type Match – The Department's Integrated Tax Administration System (ITAS) allows the Examination Division to match taxpayer information against the system to determine if the taxpayer is properly registered for appropriate tax schedule(s)
Non-Resident Real Estate Conveyances – Form 1099NRS is used to report the sale of real property located in North Carolina by non-residents of this state. Information on this form reflects the seller of real estate, the gross sales price of the real estate, the county in which the real estate is located, and the deed book and page number in which the conveyance is recorded. It is the responsibility of the buyer to provide DOR with the completed Form 1099NRS; however, it is more commonly reported by the closing attorney. Non-residents are required to file a North Carolina income tax return and report any income that is derived from North Carolina sources, including income that is attributable to the ownership in real property located in this state. Individual income tax non-filers are identified from the data obtained from the 1099NRS. Real estate conveyance data is also provided to DOR from local county register of deeds and tax collector offices. Real estate conveyances by non-residents are compared with the DOR Form 1099NRS database and ITAS to determine potential non-filers.
Offer-In-Compromise – NC Gen. Stat. §105-237.1 provides authority to the Secretary to settle tax debt for an amount less than the full amount due in certain limited situations, generally involving financial hardship.
On-Line Notice Payments – The Department provides a system that permits taxpayers to pay tax bills on-line using credit cards or ACH bank drafts.
Responsible Corporate Officers – Responsibility for certain business taxes owed by businesses can be transferred to responsible corporate officers and partners of limited liability companies. This process is used frequently to collect past due business trust taxes such as sales or withholding tax.
Revenue Agent Reports (RAR) – Through the Federal Data Exchange Program, the Internal Revenue Service furnishes to DOR copies of federal audit reports conducted on individuals and corporations. This information is received pursuant to Internal Revenue Code Section 6103(d) and results in subsequent changes to North Carolina taxable income.

Exhibit 1 (continued)

State Contracts – Information is provided to DOR from the Department of Administration, the University System and other governmental agencies about contracts awarded for construction services. The information details the amount of the contract, type of work performed, as well as date work is to commence. The data is reviewed, analyzed and matched against ITAS to determine if the contractor is complying with all tax filing requirements. Selected audit candidates will be contacted for an examination by a field auditor.

Streamlined Sales Tax Agreement Certificate of Exemption – The misuse of the certificate of exemption by purchasers of all-terrain-vehicles and off-road motorcycles claiming to be farmers in an attempt to avoid the general sales tax rate is an initiative worked by Examination field personnel.

William S. Lee Tax Credits – The focus of this examination initiative involves the eligibility and proper calculation of tax credits for individuals and corporations.

Total Net Assessments for the initiatives
(7/1/2007 – 12/31/2007)

\$ 504,387,951

Exhibit 2 - Revenue Projections by Tax Type
July 1, 2007 – June 30, 2008

Tax Type		Collections
Individual Income*	\$	220,000,000
Sales & Use		175,000,000
Corporate Income		80,000,000
Franchise		21,000,000
Other**		4,000,000
Total Revenue Projected	\$	500,000,000

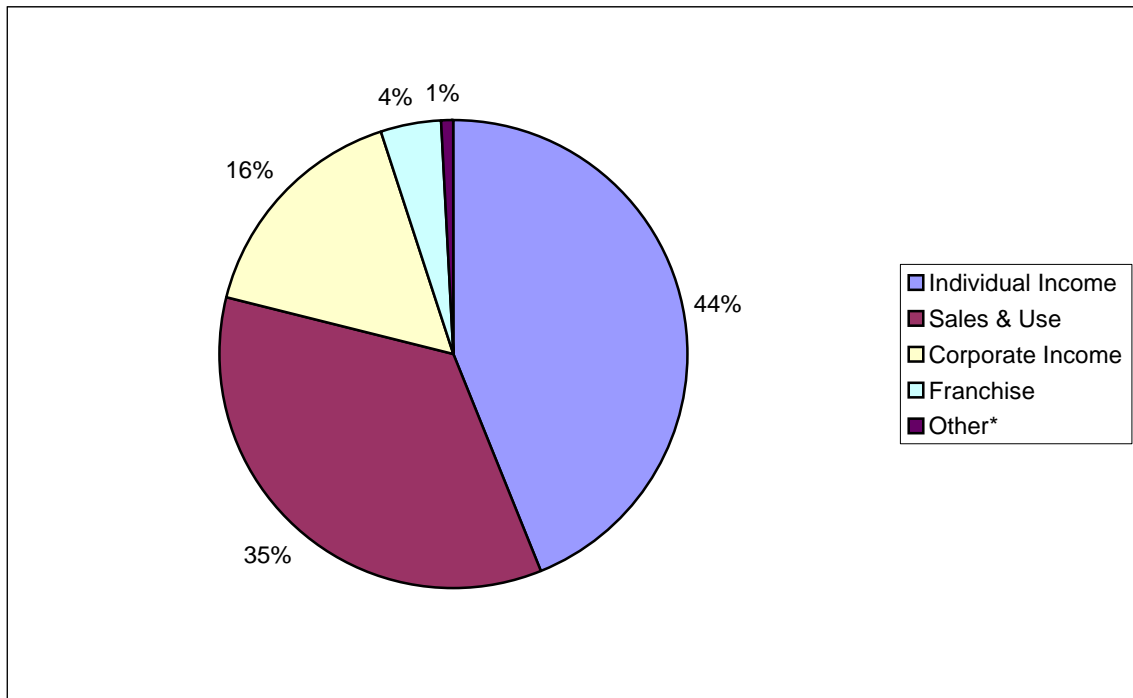


Exhibit 3 - Long-Term Collection Plan
July 1, 2007 – June 30, 2008

The Collection Division has developed a comprehensive long-term collection plan. The primary elements of the plan include key strategies and initiatives as identified below.

Long Term Collection Plan

- ❑ **Improved Information Exchange**— Significant effort is directed to improving collaboration and sharing best practices among the five DOR divisions with primary responsibility for general tax compliance and the collection of delinquent taxes
- ❑ **Increased Use of Special Procedures**—Expanded use of all collection tools, including a more strategic use of jeopardy assessments, transferee liabilities, and successor liabilities.
- ❑ **Organizational Focus**— The Taxpayer Assistance and Collection Center (TACC) is fully integrated into the Department's collection program. This integration allows the TACC to act upon lower dollar cases and lower yield per case. Highly trained revenue officers located throughout the state in our field offices work higher value and more complex collection cases. This strategy enables the Department to boost revenue generation through the efficient allocation of valuable resources, and greater attention to current collection cases (less than 120 days old). Under this strategy, the right collection resources are applied to the right case at the right time.
- ❑ **Performance Measures**— The Collection Division continues to track performance of the collection program through various performance measures. Collections are tracked at the division, office and individual collector level. The data from this tracking effort is used to devise better, more efficient strategies for collection of taxes and to allocate resources in an effective manner.
- ❑ **Reduce Accounts Receivable** – The Collection Division manages the accounts receivable for most of the General Fund taxes levied by the State of North Carolina. Additionally, the Department collects certain tax debts that are distributed back to municipal governments across North Carolina. The Department has been diligent in its efforts to discover and assess taxpayers that are attempting to avoid filing income taxes, hide income or embellish deductions and credits. As such, the Department is seeing record numbers of new liabilities being added to the receivable. The Collection Division is aggressively working to reduce the accounts receivable during Fiscal Year 2007-2008.

**Exhibit 4 -Tax Debt Collections by Age of Account
July 1, 2007 – December 31, 2007**

Age of Assessments	20% Fee Warning Letters	Other DOR Collection Efforts	Totals
0-30 days	\$	\$11,843,775	\$11,843,775
31-60 days		21,185,524	21,185,524
61-90 days	4,322,327	13,094,789	17,417,116
91-120 days	8,397,233	5,519,188	13,916,421
121-180 days	4,082,433	24,597,924	28,680,357
181-365 days	2,459,872	37,358,445	39,818,317
366-730 days	997,356	28,584,842	29,582,198
Older than 730 days	583,565	28,718,827	29,302,392
Totals	\$20,842,786	\$170,903,314	\$191,746,100

Total Final Assessment Collections			\$191,746,100
Collections – Proposed Audit Assessments			\$271,195,568
Grand Total- Tax Debt Collections (July 1, 2007 –December 31, 2007)			\$462,941,668

**Exhibit 5 -Tax Collections By Tax Type
July 1, 2007 – December 31, 2007**

Tax Type	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Total
Individual Income *	\$15,529,506	\$25,692,489	\$22,631,177	\$21,947,295	\$19,903,624	\$17,279,344	\$122,983,435
Sales & Use	5,934,281	20,498,133	24,197,892	12,560,163	7,787,195	7,697,390	78,675,054
Corporate	831,982	5,388,347	1,604,156	835,006	171,533,719	2,115,912	182,309,122
Franchise	549,011	1,283,159	1,879,975	723,960	1,765,002	258,125	6,459,232
Other **	10,311,743	9,552,754	13,985,690	21,610,994	8,141,484	8,912,160	72,514,825
TOTAL	\$33,156,523	\$62,414,882	\$64,298,890	\$57,677,418	\$209,131,024	\$36,262,931	\$462,941,668

* Individual Income includes debts owed by businesses for employee withholding taxes held but not paid.

** License and Excise Taxes, Insurance Premium Tax, and Estate/Gift Taxes.

**Exhibit 6 -Use of Proceeds of 20% Collection Assistance Fee
July 1, 2006 –June 30, 2007**

20% Collection Assistance Fee Expenditures Related to Collection of Overdue Tax Debts

	FY 2006-2007	TOTAL
14700/1660 - Examination and Collection		
Salaries and Benefits (73 Positions)	<u>\$3,641,241</u>	\$3,641,241
14700/1661 - Project Collect Tax		
Salaries and Benefits (48 Positions)	\$2,376,536	
Contractual Services	\$145,289	
Maintenance	11,294	
Travel	15,199	
Communication and Data Processing	398,356	
Supplies	9,220	
Equipment (Office, Hardware and Software)	65,056	
Legal Expenses	60,514	
Other Administrative Expenses	<u>15,745</u>	\$3,097,209
14700/1662 - Taxpayer Call Center		
Salaries and Benefits (47 Positions)	\$3,327,913	
Contractual Services	10,669	
Utility/Energy Services	24,215	
Maintenance	19,361	
Rent/Leases	719,769	
Travel	24,299	
Communication and Data Processing	1,148,814	
Supplies	2,352	
Equipment (Office, Hardware and Software)	98,813	
Other Administrative Expenses	<u>5,096</u>	\$5,381,301
GRAND TOTAL		<u><u>\$12,119,751</u></u>