



North Carolina Department of Revenue

Michael F. Easley
Governor

Reginald S. Hinton
Secretary

August 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 Results, July 1, 2007 – June 30, 2008
Revenue Projections, July 1, 2008-June 30, 2009

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 within our Tax Compliance organization in the Department of Revenue (DOR).

Our Tax Compliance personnel focus on enforcement of the revenue laws and education of the citizens of our state about compliance requirements. 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 to increase compliance with the tax laws. These initiatives commenced July 1, 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, 2008 – June 30, 2009.

Exhibit 3 lists some of the key initiatives that are part of the Department's long-term collection plan for the fiscal year 2008-2009.

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 June 30, 2008.

Exhibit 5 reflects the total of tax debt collections by tax type for the period July 1, 2007 – December 31, 2007 and the months of January 1, 2008 through June 30, 2008.

Exhibit 6 is a summary, for the fiscal year 2007-08, on the use of the proceeds of the 20% collection assistance fee imposed by G.S. 105-243.1.

cc: Amna Cameron,
Fiscal Research

Exhibit 1 - Department's Existing Initiatives

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.
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.
Automated Installment Agreements – The Department works with taxpayers to establish installment payment agreements to repay past-due tax debts.
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.
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. The U.S. Customs Service, Wildlife Resource Commission, Southeastern Association of Tax Administrators, and manufacturers of all terrain vehicles and watercraft provide these data sources.
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.
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.
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-rata percentage, tax withheld to refund request, and various state tax credits.
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.
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.
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.

Exhibit 1 (continued)

<p>Individual Income - Schedule A & C – Audit selection criteria identify potential individual income tax returns with abusive Schedule A and/or Schedule C deductions. These returns overstate itemized deductions. Other returns filed with Schedule C will understate gross business income and/or overstate business expenses.</p>
<p>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.</p>
<p>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.</p>
<p>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.</p>
<p>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.</p>
<p>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.</p>
<p>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.</p>
<p>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).</p>
<p>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.</p>
<p>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.</p>
<p>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.</p>
<p>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.</p>
<p>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 tax liability.</p>

Exhibit 1 (continued)

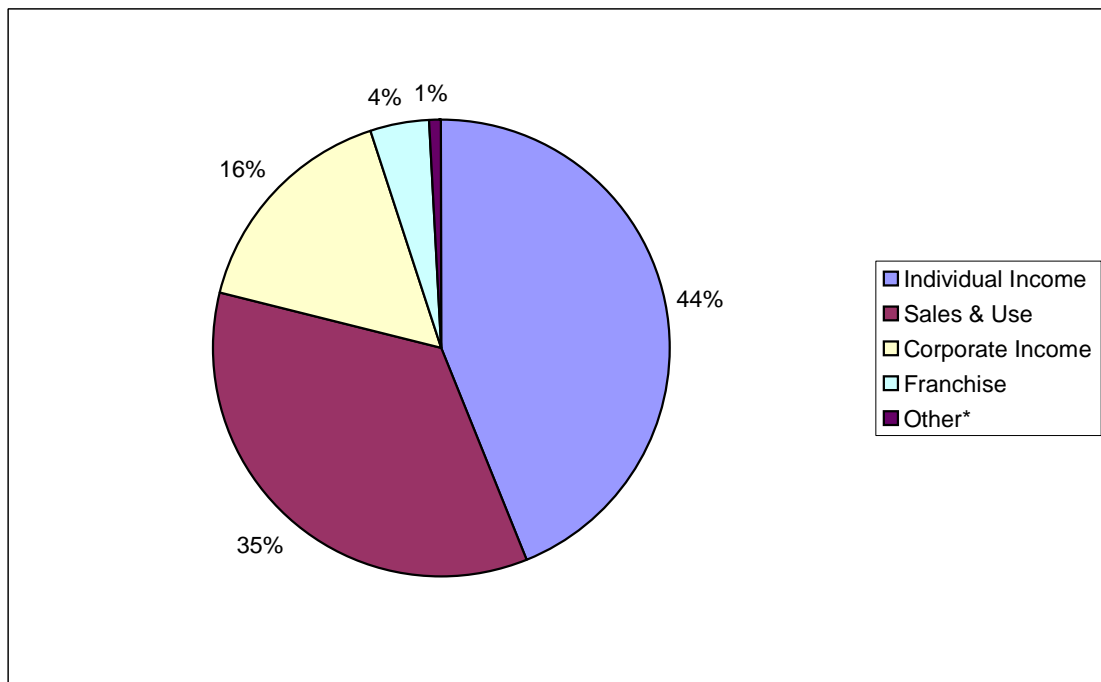
State Contracts – Information is provided to DOR from the Department of Administration, the University System and other governmental agencies about contracts awarded for construction services. The information details the amount of the contract, type of work performed, as well as date work is to commence. 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 in an attempt to avoid the general sales tax rate is an initiative worked by Examination field personnel.

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

Exhibit 2 - Revenue Projections by Tax Type
July 1, 2008 – June 30, 2009

Tax Type		Collections
Individual Income*	\$	235,400,000
Sales & Use		187,250,000
Corporate Income		85,600,000
Franchise		22,470,000
Other**		4,280,000
Total Revenue Projected	\$	535,000,000



* Individual Income includes: individual income taxes, employer withholding taxes and amounts due on partnership returns.
** Other includes: license and excise taxes, insurance premium tax, and estate/gift taxes.

Exhibit 3 - Long-Term Collection Plan
July 1, 2008 – June 30, 2009

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 2008-2009.

**Exhibit 4 -Tax Debt Collections by Age of Account
July 1, 2007 - June 30, 2008**

Age of Assessment s	20% Fee Warning	Other DOR Collection	Totals
	Letters	Efforts	
0-30 days	\$	\$21,709,303	\$21,709,303
31-60 days		38,420,888	38,420,888
61-90 days	6,569,240	23,928,848	30,498,088
91-120 days	15,772,215	9,755,597	25,527,812
121-180 days	31,913,608	30,312,191	62,225,799
181-365 days	29,154,719	66,035,317	95,190,036
366-730 days	25,728,061	47,477,846	73,205,907
Older than 730 days	1,219,984	30,682,245	31,902,229
Totals	\$110,357,827	\$268,322,235	\$378,680,062

Total Final Assessment Collections	\$378,680,062
Collections – Proposed Audit Assessments	\$403,634,436
Grand Total- Tax Debt Collections (July 1, 2007 – June 30, 2008)	\$782,314,498

Exhibit 5
Grand Total -Tax Debt Collections By Tax Type
July 1, 2007 – June 30, 2008

Tax Type	7/1/07 - 12/31/07	Jan	Feb	Mar	Apr	May	Jun	Total
Individual Income *	\$ 148,883,414	\$ 23,078,566	31,168,033	\$24,730,284	\$29,506,483	\$24,205,750	\$21,424,353	\$ 302,996,883
Sales & Use	117,525,023	11,563,789	22,155,890	11,071,779	11,716,300	16,689,432	12,485,265	203,207,478
Corporate	182,309,122	23,589,122	2,610,619	8,600,378	21,144,722	3,653,170	7,572,974	249,480,107
Franchise	6,459,232	736,898	1,078,395	1,670,420	4,125,810	1,255,016	-772,986	14,552,785
Other **	7,764,877	2,394,501	187,355	119,045	280,879	239,408	1,091,180	12,077,245
TOTAL	\$ 462,941,668	\$61,362,876	\$57,200,292	\$ 46,191,906	\$ 66,774,194	\$ 46,042,776	\$ 41,800,786	\$782,314,498

* Individual Income includes: individual income taxes, employer withholding taxes and any amounts due on partnership returns.

** Other includes: license and excise taxes, insurance premium tax, and estate/gift taxes.

Exhibit 6 -Use of Proceeds of 20% Collection Assistance Fee
July 1, 2007 –June 30, 2008

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

	FY 2007-2008	TOTAL
14700/1660 - Examination and Collection		
Salaries and Benefits (111 Positions)	<u>\$5,774,378</u>	\$5,774,378
14700/1661 - Project Collect Tax		
Salaries and Benefits (48 Positions)	\$2,630,552	
Contractual Services	150,795	
Maintenance	0	
Travel	61,495	
Communication and Data Processing	758,188	
Supplies	34,830	
Equipment (Office, Hardware and Software)	63,336	
Legal Expenses	61,272	
Other Administrative Expenses	<u>22,155</u>	\$3,782,623
14700/1662 - Taxpayer Call Center		
Salaries and Benefits (110 Positions)	\$3,766,321	
Contractual Services	8,646	
Utility/Energy Services	24,538	
Maintenance	2,350	
Rent/Leases	651,755	
Travel	53,062	
Communication and Data Processing	982,953	
Supplies	40,278	
Equipment (Office, Hardware and Software)	0	
Other Administrative Expenses	<u>5</u>	\$5,529,908
GRAND TOTAL		<u><u>\$15,086,909</u></u>