



North Carolina Department of Revenue

Roy Cooper  
Governor

Ronald G. Penny  
Secretary

**MEMORANDUM**

TO: Joint Legislative Commission on Governmental Operations Co-Chairs:  
The Honorable Phil Berger      The Honorable Tim Moore  
President Pro Tempore              Speaker of the House

Senate Committee on Finance:  
Senator Jerry Tillman  
Senator Tommy Tucker

House Committee on Finance:  
Representative Bill Brawley, Senior Chair  
Representative Jason Saine, Senior Chair  
Representative Kelly Hastings  
Representative Susan Martin  
Representative Mitchell Setzer  
Representative John Szoka

FROM: Ronald G. Penny  
Secretary of Revenue

DATE: February 7, 2018

SUBJECT: Tax Compliance Initiatives and Results, July 1, 2017 – December 31, 2017  
Revenue Projections, July 1, 2017 - June 30, 2018

This semi-annual report to the Joint Legislative Commission on Governmental Operations and to the Finance Committees is prepared pursuant to G.S. 105-256(a)(8). This report reflects a collaborative effort among certain divisions within the N.C. Department of Revenue (NCDOR).

The NCDOR administers the tax laws, determining taxes due to the State, collecting delinquent taxes, and providing tax education and service to citizens of the State, in an impartial, uniform, and professional manner.

The NCDOR has implemented various initiatives designed to address non-compliance and to recapture lost General Fund revenue. Results of each initiative are tracked to ensure proper allocation of tax compliance personnel. The following provides a brief description of the data included in Exhibits 1-6, which are attached.

**Exhibit 1** briefly describes many, but not all NCDOR initiatives designed to identify noncompliance, recapture lost General Fund revenue and increase voluntary compliance.

**Exhibit 2** reflects revenue projections from the collaborative efforts noted in this report. These revenue projections are estimates by tax type and are presented for the fiscal year July 1, 2017 – June 30, 2018.

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

**Exhibit 4** provides the results of our collaborative collection efforts. The exhibit provides information regarding the age and collection of assessments for the period.

**Exhibit 5** reflects the total of tax debt collections by tax type for the period.

**Exhibit 6** is a summary, for the period July 1, 2017 – December 31, 2017 on the use of the proceeds of the 20% collection assistance fee imposed by G.S. 105-243.1.

## Exhibit 1 – Department’s Existing Initiatives

**4% ITIN Withholding** - 4% ITIN W/H is an initiative based on the statute requiring 4% withholding on payments to ITIN holders, subject to certain provisions. Non-compliance has been identified in this area. The Department receives certain Form 1099 payment information from the IRS and then, by comparing this data to Departmental records, the Department identifies possible instances of underreporting for potential audit.

**Automated Attachments**-- This initiative establishes an automated matching process and issues an attachment/garnishment based on best available levy source.

**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.

**Bilingual Team** - The Department launched a team dedicated to bilingual issues in mid-2006 and has been reviewing cases since 2003. This team reviews documents written in a foreign language, and arranges to speak with taxpayers whose native language is not English. Some of the non-compliance issues that recur include: taxpayers claiming dependents and exemptions for family living in another country; taxpayers claiming a false number of dependents and a wrong filing status; taxpayers filing returns with false names, ITIN numbers, and Social Security numbers; and taxpayers failing to report all income.

**Business Intelligence** – The Examination Division has established a Business Intelligence (BI) section to mine new and existing data in order to discover new compliance initiatives and enhance current initiatives. The BI section will continue the Department’s partnership with GDAC and SAS to create audit models, develop a structure for third party data and enhance data mining capabilities using SAS BI tools. This section will also allow for the streamlining of audit processes through automation, improved audit selection and allocation of resources, as well as identify new areas of non-compliance by the development and continual improvement of databases and advanced data analytics.

**CIBA** – As a result of non-compliance in cash intensive businesses, the Examination Division created the Cash Intensive Business Audit team. This team identifies and conducts complex audits of cash intensive businesses, audits which generally involve indirect audit methods to reconstruct records. Team members also serve as resources for other staff that may be engaged in audits of businesses of a similar nature.

**CP2000 Adjustments** - The Department of Revenue receives CP2000 tapes from the Internal Revenue Service under the terms of a data sharing agreement. Information on the CP2000 tapes represents the results from an IRS match of information returns such as forms W-2 and 1099 that are filed by employers, banks, businesses and other payers. This information is matched against individual income tax returns. An automatic adjustment is made to the taxpayer’s account to create an assessment for the amount of tax, penalty and interest due.

**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 the state. The NCDOR utilizes a number of matching data sources to identify these purchases. Individual taxpayers are contacted for the recapture of this revenue.

**Convenience Stores** - The Examination Division has determined non-compliance within this cash intensive business classification. These audits are generally complex and require indirect audit methods. Multiple data sources and data analytics aid in the identification of non-compliance.

**Corporate Income and Franchise Taxes: Non-Fileers** –This examination initiative identifies non-filers from ITAS and external data sources, including both state and federal agency sources.

**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.

**Desk Audits – Individual Income Tax Groups** - The Central Exam Section establishes audit selection criteria utilizing selection views in the Department’s Portfolio Warehouse for individual income tax audits.

## Exhibit 1 – Department’s Existing Initiatives (Cont.)

**Discovery/Special Projects** - The individual income tax audit program administered by the Discovery/Special Projects group utilizes report criteria, analytic and query tools, predefined rules for scoring returns and data received from Employment Security Commission and NC3. The initiative focuses on audit selection, fraud detection, the prevention of identity theft, and the identification of fraudulent preparer cases. Fictitious returns are identified and referred to the Criminal Investigations Section of the Tax Enforcement Division to determine criminal or civil disposition.

**Federal Refund Offsets** – The NCDOR sends State debt information to the Internal Revenue Service, which then offsets any federal tax refunds due for repayment of state tax debts.

**FIRM** - The Financial Institution Record Matching (FIRM) process was implemented in 2011. The process facilitates our Automated Attachment (AA) process. The Department of Revenue recently expanded the FIRM process by hiring a third party vendor to manage a data exchange with all financial institutions that have nexus in North Carolina.

**Flow through Audit Group** - The Flow through Audit Group audits partnerships, S-Corporations, individuals and C-corporations receiving income from a flow through entity. The team reviews and analyzes tax returns filed by flow through entities to identify areas of non-compliance. In addition, the team utilizes queries against taxpayer historical data as a methodology to identify potential audit leads.

**Fraudulent Preparer** - Fraudulent Preparers are paid tax preparers that are identified in conjunction with the Fraudulent Preparer Returns initiative. Central Examination refers the preparer cases to the local Field Examination offices. The local Field Examination office conducts an examination of the paid preparers’ returns, requesting that specific documentation to substantiate all deductions/expenses be furnished at the established examination appointment.

**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 Section for possible prosecution. At the conclusion of the investigation by CI or prosecution of the “paid preparer,” the individual income tax returns of the *clients* of the “paid preparer” are referred for examination.

**IMF/IRTF AGI (Adjusted Gross Income) Match** - The Department of Revenue receives the Individual Master File (IMF) and the Individual Returns Transaction File (IRTF) tape from the Internal Revenue Service each year under the Federal/State IRS Data Exchange Program. This contains Federal tax records for taxpayers with a North Carolina address. With this data, the Central Exam Section is able to compare the Adjusted Gross Income (AGI) per the IMF master file to the AGI shown on the North Carolina individual income tax return. The system creates an automatic assessment if the AGI per the IMF is greater than the AGI per the North Carolina return.

**Individual Income - Schedule A & C** – Tax Auditors use selection views in Portfolio Warehouse to identify potential individual income tax returns with abusive Schedule A and/or C deductions. These returns overstate itemized deductions. Other returns filed with Schedule C will understate gross business income and/or overstate business expenses. The Business Intelligence section will assist with queries and audit selection.

**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.

**Information Reporting** - The Department identified non-compliance within the bar and restaurant business classifications. The new reporting requirements for the ABC Boards and alcohol distributors to the Department will provide invaluable information related to this, and other, initiatives.

**Income Shifting and Transfer Pricing** – This group will be responsible for assisting auditors in reviewing intercompany transactions. Many of these intercompany transactions have been used by corporations to minimize their North Carolina income taxes. The group will employ a transfer pricing database to assist in the determination of fair market value of intercompany transactions.

## **Exhibit 1 – Department’s Existing Initiatives (Cont.)**

**Inflated Withholding** – The initiative identifies individual taxpayers that overstated the amount the NC tax withheld or understated the wages claimed on their individual income tax return compared to the amount reported by the employer.

**Internet Retailers** – This examination initiative is designed to identify internet retailers who have not previously registered or filed returns with the State and bring them into compliance.

**Interstate Examination Section Audit Initiatives** - The Interstate Examination Section is primarily tasked with conducting field examinations of taxpayers located throughout the United States. Many of these examinations are conducted from satellite offices located in the major metropolitan areas of the U.S. These examinations often involve the nation’s largest taxpayers and the most complex issues. These include Fortune 500 audits and Amended Returns/Refund Claims.

**IRMF (Individual Return Master File) Non-File Assessment** - The Department of Revenue receives the IRMF file through the Internal Revenue Service’s Data Exchange Program for taxpayers that have an income source whereby the payee or payer resided in North Carolina. Using this extract, the Department identifies taxpayers who have a North Carolina income source record but have not filed a North Carolina tax return. The NC-3 initiative has been incorporated into the IRMF initiative. The Department reconciles the employer provided W-2’s to verify employees filed an individual income tax return. The IRMF data is used in conjunction with the NC-3 and Federal/State data to ensure all income sources are included in the Notice of Intent to Assess sent to delinquent taxpayers.

**IRTF (Individual Return Transaction file) Non-File Assessment** - The NCDOR receives information through the Internal Revenue Service’s Data Exchange Program for taxpayers who filed a federal income tax return with a North Carolina address. The Individual Returns Transaction File (IRTF) contains all the fields currently transcribed from Forms 1040, 1040A or 1040EZ and their accompanying forms and schedules. IRTF information is obtained from the tax return as originally filed by the taxpayer. The IRTF data is used in conjunction with the NC-3, and Federal/State data to ensure NC tax withheld is included in the Notice of Intent to Assess sent to delinquent taxpayers.

**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. Specially trained revenue officers perform this function for the Department.

**MeF Queries**– Specific criteria are used to query electronically filed individual income tax returns to identify fraudulent preparers, fictitious, and abusive tax returns. Identified tax returns are selected for potential audit candidates.

**Motor Fuels** - Motor Fuels auditors and support staff moved to the Examination Division on May 1, 2011. These auditors provide audit coverage across North Carolina and maintain a presence in various service center locations. Primary initiatives include International Fuel Tax Agreement, International Registration Plan, diversion, exporter, and terminal supplier.

**MSA Team (Master Settlement Agreement)** - The Department of Revenue is tasked with tabulating and reporting the annual sales of certain cigarettes and roll-your-own tobacco products to the Attorney General’s office. Because the escrow payments required of certain companies under the Master Settlement Agreement are calculated based on this information, it is crucial that it be as accurate as possible. Field and desk audits of tobacco manufacturers, distributors, wholesale and retail dealers are performed to help ensure the accuracy of this reporting, as well as to increase compliance with tobacco excise tax requirements. This audit work of this dedicated team adds to N.C.’s due diligence and protection of the MSA as required by the Agreement.

**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 all appropriate tax schedule(s).

## **Exhibit 1 – Department’s Existing Initiatives (Cont.)**

**Non-Resident Real Estate Conveyances** – Non-resident individual income tax non-filers are identified from Form 1099NRS or electronically through County register of deeds offices. 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 of real property located in this state.

**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.

**POS Initiative** – Non-compliance has been identified via the modification of sales data in Point of Sale systems. The intent is to identify taxpayers that may have artificially reduced their Sales Tax liability by manipulating their POS system’s software and reports. Suppression may occur manually or programmatically.

**Professional Associations** - Professional Associations is a revenue generation project whereby queries are run in the ITAS system filtered by various NAICS codes and other information such as gross receipts, total assets, and whether or not the taxpayer is registered for Sales & Use Tax. The intent is to identify these specific types of business organizations to determine possible non-compliance issues.

**Revenue Agent Reports (RAR)** – Through the Federal Data Exchange Program, the Internal Revenue Service furnishes to the NCDOR 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.

**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.

**Returned Mail Automation--** This collections initiative seeks to increase our efficiency in resolving returned mail. Tools and process changes will reduce the time needed to locate a better address for the taxpayer and reinitiate contact, either by mail or other channels.

**S-Corporations** - The S-Corporations initiative is a revenue generation project whereby queries are run against S-Corporations in the ITAS system filtered by information such as gross receipts, total assets, and whether or not the taxpayer is registered for Sales & Use Tax. The intent is to identify S-Corporations to determine possible non-compliance issues.

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

**Vendor Garnishment--** This effort establishes a matching process where State agency payments made to vendors are matched against tax debts automatically, and payments are offset if a tax liability is owed to the State.

**Voluntary Disclosure Program**-This initiative is designed to promote compliance among taxpayers, who have not previously registered or filed a return with the Department and who want to voluntarily discharge a tax liability.

**Withholding NC-3 Employer Under Reporter** - The Withholding tax group reviews withholding NC-3 returns (annual reconciliation) that are in suspense. After reviewing the account, they perform line item adjustments to generate assessments or refunds.

**Withholding NC-5Q Reconciliation** - The Withholding tax group reviews NC-5Qs that are underpaid and/or no payment is posted to the account period(s). The NC-5Q is an information quarterly reconciliation return for accelerated withholding taxpayers. After a review and analysis of the account periods by Information Processing Technicians, office audit cases are set up and line item adjustments are performed to generate assessments or refunds for taxpayers in appropriate cases.

**Under Reporter/Non-filer** – The initiative identifies employers that have either under reported the amount of NC Income tax withheld or have withheld tax from employees and failed to register, file and remit income tax withheld.

**Exhibit 2 - Revenue Projections by Tax Type  
 July 1, 2017 – June 30, 2018**

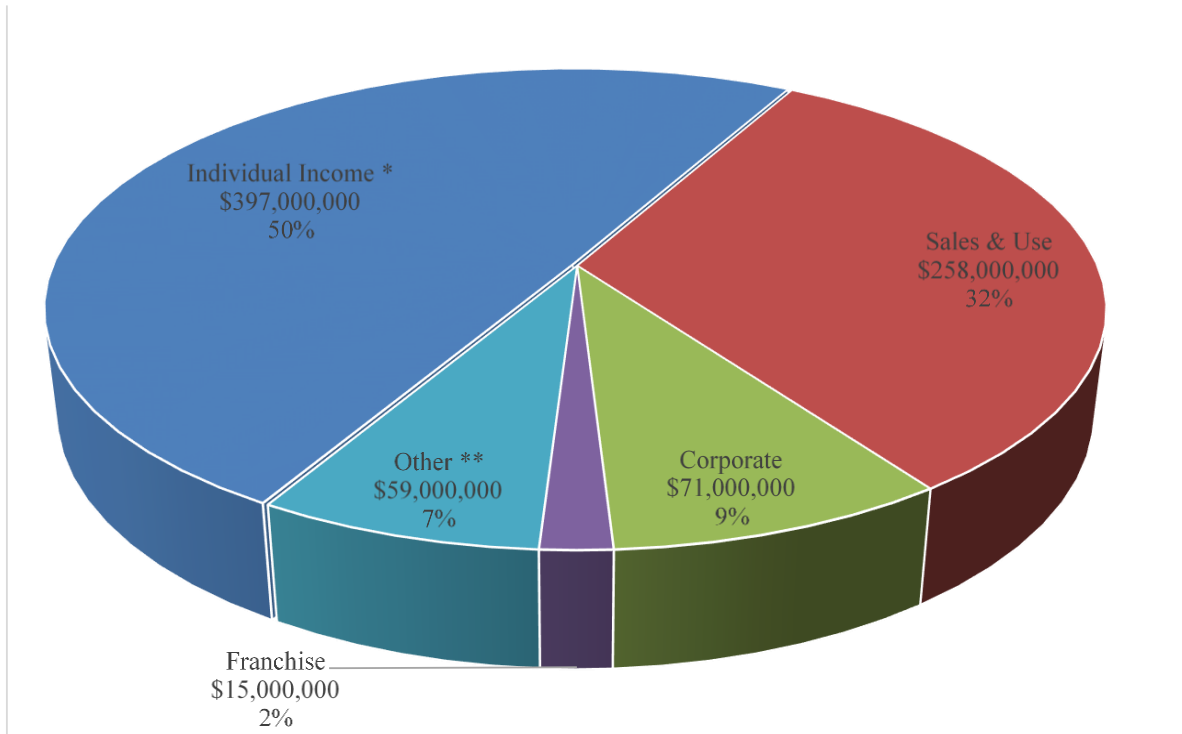
<b>Tax Type</b>	<b>Goal</b>
Individual Income *	\$397,000,000
Sales & Use	\$258,000,000
Corporate	\$71,000,000
Franchise	\$15,000,000
Other **	\$59,000,000
<b>TOTAL</b>	<b>\$800,000,000</b>

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

\*\* The category "Other" includes License and Excise Taxes, Insurance Premium Tax, Machinery Equipment, 911 Service Charge, Gift/Inheritance and other Tobacco Products

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

\*\* Other includes: license and excise taxes, insurance premium tax, estate/gift taxes, unauthorized substance, and motor fuels.



**Exhibit 3 - Long-Term Collection Plan**

**July 1, 2017 – June 30, 2018**

**Long Term Collection Plan**

- **Enhanced Case Management Tools** — A key component of the Department’s collection strategy are enhanced tools for managing the collection process. Risk scoring of accounts and an enhanced work-flow engine will enable the Department to ensure the highest possible return on investment from the collection process.
- **Improved Information Exchange** — Information is the life-blood of the collection process. The Department continuously looks for new methods of securing and utilizing data to aid in locating debtor taxpayers and assets that may be subject to levy.
- **Performance Measures** — The Department 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 strategies for collection and to allocate resources in an effective manner.
- **Notice to File for Business Non-filers**— The Department is currently developing a combined multi-pronged Examination/Collection Division initiative. This initiative will utilize multiple data sources including recently enacted legislation regarding information reporting requirements. One component of the initiative will utilize data analytics to determine potential tax liability and automate the process for submitting a Notice to File a business return for identified taxpayers. This process will expedite the assessment and collection process as well as increase voluntary compliance as a result of data sources made available through information reporting.

**Exhibit 4 -Tax Debt Collections by Age of Account  
July 1, 2017 – December 31, 2017**

Age of Assessments	20% Fee Warning	Other DOR Collection	Totals
0-30 days		\$41,774,871.73	\$41,774,871.73
31-60 days		\$43,903,132.71	\$43,903,132.71
61-90 days		\$15,475,296.87	\$15,475,296.87
91-120 days	\$18.30	\$6,532,685.67	\$6,532,703.97
121-180 days	\$1,620,697.20	\$16,599,002.93	\$18,219,700.13
181-365 days	\$5,133,966.79	\$39,496,834.25	\$44,630,801.04
366-730 days	\$6,262,502.83	\$41,982,680.66	\$48,245,183.49
Older than 730 days	\$6,288,098.70	\$31,965,086.79	\$38,253,185.49
<b>Totals</b>	<b>\$ 19,305,283.82</b>	<b>\$237,729,591.61</b>	<b>257,034,875.43</b>

Total Final Assessment and Delinquent Collections	<b>\$257,034,875.43</b>
Collections – Proposed Audit Assessments	\$210,885,564.93
<b>Grand Total – Tax Debt Collections (July 1, 2017 – December 31, 2017)</b>	<b>\$459,920,440.36</b>



**Exhibit 5**  
**Grand Total -Tax Debt Collections by Tax Type**  
**July 1, 2017 – December 31, 2017**

<b>Tax Type</b>	<b>July</b>	<b>August</b>	<b>September</b>	<b>October</b>	<b>November</b>	<b>December</b>	<b>Total</b>
Individual Income *	\$57,864,587.22	\$30,703,369.34	\$61,759,653.60	\$44,421,640.24	\$46,305,129.43	\$43,078,251.06	\$292,132,630.89
Sales & Use	\$13,998,223.59	\$3,356,740.65	\$22,587,028.48	\$12,964,532.91	\$10,615,374.99	\$8,408,659.12	\$71,930,559.74
Corporate	\$4,972,100.00	\$796,946.57	\$11,324,185.12	\$14,072,164.00	\$21,030,114.92	\$1,874,673.93	\$54,070,183.54
Franchise	\$1,263,032.27	\$923,778.60	\$33,058,587.24	\$3,114,257.00	\$(2,762,243.88)	\$1,258,016.43	\$36,855,427.66
Other **	\$532,484.40	\$591,314.61	\$10,756,467.74	\$261,661.66	\$133,031.85	\$656,678.27	\$12,931,638.53
<b>TOTAL</b>	<b>\$78,630,427.48</b>	<b>\$44,372,149.77</b>	<b>\$139,485,922.18</b>	<b>\$74,834,255.81</b>	<b>\$75,321,407.31</b>	<b>\$55,276,277.81</b>	<b>\$459,920,440.36</b>

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

\*\* The category "Other" includes License and Excise Taxes, Insurance Premium Tax, Machinery Equipment, 911 Service Charge, Gift/Inheritance and Other Tobacco Products.

**Exhibit 6 – Use of Proceeds of 20% Collection Assistance Fee**

North Carolina Department of Revenue

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

(General Statute 105-256)

	<b>FY 2017-18</b>	<b>TOTAL</b>
	<b>July '17 - Dec '17</b>	
<b>14700/1661 - Project Collect Tax</b>		
Salaries and Benefits (336.57 Positions)	\$10,678,394	
Contractual Services	\$1,500,099	
Rent/Leases	\$471,236	
Maintenance	0	
Travel	92,293	
Communication and Data Processing	341,447	
Supplies	6,858	
Equipment (Office, Hardware and Software)	650	
Legal Expenses	754	
Other Administrative Expenses	31,274	<b>13,123,004</b>
<b>14700/1662 - Taxpayer Call Center</b>		
Salaries and Benefits (137 Positions)	\$3,045,232	
Contractual Services	85,305	
Utility/Energy Services	10,119	
Maintenance	1,900	
Rent/Leases	123,127	
Travel	8,271	
Communication and Data Processing	226,711	
Supplies	6,257	
Equipment (Office, Hardware and Software)	8,156	
Other Administrative Expenses	2,206	<b>3,517,283</b>
<b>GRAND TOTAL</b>		<b><u><u>\$16,640,288</u></u></b>