North Carolina Department of Revenue

Roy Cooper
Governor

Ronald G. Penny
Secretary

February 25, 2020

<u>MEMORANDUM</u>

TO: The Honorable Phil Berger
President Pro Tempore

Senator Jerry Tillman, Chair
Senator Ralph Hise, Chair
Senator Paul Newton, Chair
Senate Finance Committee

The Honorable Tim Moore
Speaker of the House

Representative Julia Howard, Senior Chair
Representative Mitchell Setzer, Senior Chair
Representative John Szoka, Senior Chair
Representative Debra Conrad, Chair
Representative Stephen Ross, Chair
Representative Harry Warren, Chair
House Finance Committee

FROM: Ronald G. Penny
Secretary, North Carolina Department of Revenue

J. Eric Boyette
Secretary and State Chief Information Officer,
North Carolina Department of Information Technology

John Correllus
Chief Data Officer and Government Data Analytics Center Director,
North Carolina Department of Information Technology

SUBJECT: Semi-Annual Report:
Progress Report NCDOR – GDAC July 1, 2019– January 31, 2020

This semi-annual report is prepared pursuant to Session Law 2015-259, Section 7.3.(b) (House Bill 117). This report reflects a collaborative effort by the North Carolina Department of Revenue (NCDOR) and the North Carolina Department of Information Technology's Government Data Analytics Center (GDAC). NCDOR and GDAC are required to provide progress reports to the Revenue Laws Study Committee on:

1) Prevention or reduction of the occurrence of stolen identities and refund fraud.
2) Elimination of fraudulent returns.

3) Tax compliance by business professionals and alcohol vendors.
4) Coordination of efforts between the Department of Revenue and the Government Data Analytics Center to identify and integrate into the Department's operations and procedures the most effective and accurate processes and scalable tools available to reduce refund fraud, payment of fraudulent returns, and business tax compliance.

NCDOR's mission is to administer the tax laws and collect the taxes due the State in an impartial, uniform, secure, and efficient manner. To support this mission, the Examination Division's primary objective is to identify noncompliance with state tax laws, audit the books and records of individuals and businesses not in compliance, and assess and collect unpaid revenue owed to the State. The Examination Division implements various operational strategies to realize the lowest possible operating cost per dollar of revenue assessed. All operational decisions and audit initiatives adhere to five pillars that serve as the foundation for the Division's strategic plan. These pillars are:

- Audit selection
- Quality audits
- Accountability
- Resource Alignment
- Employee Development

Through the partnership with GDAC, NCDOR has identified short-term and long-term projects to:

1. Enhance efficiency through automation;
2. Streamline and improve audit candidate research and selection;
3. Utilize specific data sources, selection criteria, and data analytics to identify non-compliance within specific industries;
4. Compile multiple data sources to identify new areas of non-compliance

This report is broken into four components to correspond with the reporting requirements of S.L. 2015-259, Section 7.3.(b).

NCDOR's overall strategy for identity theft refund fraud and non-identity theft refund fraud includes an increase in voluntary compliance and reduction of occurrences. Therefore, response to (1) is included in item (2).

1) **Prevention or Reduction of the Occurrence of Stolen Identities and Refund Fraud**
2) **Enhancements to Identification of Fraudulent Returns and Refund Fraud**

The Agency, in partnership with SAS and GDAC, utilizes multiple internal and external data sources, data analytics, reported occurrences of stolen information, and a specialized team of auditors as a base for the refund fraud program. The refund fraud program must be technologically current and agile to maintain a status of continual evolution to keep up with current fraudulent schemes.

The Agency remains committed to utilizing technology and resources in combating the reported occurrences of compromised Personally Identifiable Information (PII) from individuals and companies. The Examination Division and the Office of Taxpayer Advocate continue to enhance the process for receiving claims of compromised personal information and integrating this data into the identity theft refund fraud program. The enhanced process to detect identity theft refund fraud combined with the streamlined process to collect information from individuals and companies reporting compromised information will aid in ensuring tax returns filed using stolen PII will be stopped prior to issuance of a refund.

Provisions of N.C.G.S. §105-259 preclude NCDOR from providing details regarding the specific data and standards used within the process to determine identity theft refund fraud and non-identity theft refund fraud.

However, the Examination Division, with SAS and GDAC, implements enhancements to the refund fraud program each year which include updated analytics, new technology, and identifying criteria for newly emerged tax fraud schemes. The enhancements are developed, tested, and implemented immediately preceding the current filing season. As a result of the increase in refund fraud cases each year and limited resources, enhancements to the refund fraud program include but are not limited to improvements in case prioritization and elimination of false positives. The high adoption rate from taxpayers reporting real time NC-3 W2 and 1099 information electronically, integrated with enhanced data analytics, will substantially improve the ability to capture identity theft refund fraud and ensure (1) refund tax savings is optimized and (2) taxpayers who have been victims of identity theft will realize an efficient method of meeting their tax filing obligation. The division is also able to operationalize detection of inflated withholding, real time, as a result of electronic NC-3 reporting, which will also minimize erroneous refunds. Filings of fraudulent refund returns occur throughout the year with the peak realized during the first four weeks following the IRS's date set for accepting tax returns. During fiscal year ending June 30, 2019 NCDOR realized refund tax savings of $36 million. For period July 1, 2019 through January 31, 2020, we have realized $23.5 million in refund fraud tax savings. Refund fraud statistics for the entire current fiscal year will be available at fiscal year ending June 30, 2020.

The Examination Division routinely reallocates staff to different initiatives and programs to ensure efficiency and maximize the Agency's return on investment. The number of permanently assigned staff in the Discovery Section of NCDOR's Examination Division has been increased from 19 to 20 to ensure proper resource alignment for the entire year.

3) Tax Compliance by Business Professionals and Alcohol Vendors

The Examination and Tax Analytics Divisions worked directly with ABC Boards, Beer and Wine Wholesalers, Independent Brewers, Occupational Licensing Boards, and their vendors to implement a streamlined process for submitting required information to NCDOR. Currently, the information is required to be submitted to NCDOR electronically. The Examination and Tax Analytics Divisions' staff continues to work with the taxpayers, NCDORIT, GDAC, and SAS to reduce formatting errors and enhance the submission of data.

Specific formatting criteria was published and communicated to taxpayers to ensure NCDOR received the information in a consistent format that could readily be utilized for compliance initiatives. Information this year required extensive cleansing to make the data available for data analytics when aggregated with other data sources. The project to host the platform using SAS Global Hosting and US Professional Services was implemented in 2019 for data collection to ensure a streamlined reporting process and efficient flow for identification of non-compliance and subsequent audit initiatives.

Because of the data submitted already by the entities listed in N.C.G.S. § 105-251.2, the Examination Division has developed multiple audit initiatives involving different business classifications designed to identify non-compliance within the cash intensive business industries and recover unreported cash transactions. This initiative requires extensive training to educate a designated group of NCDOR auditors on a new indirect audit method made possible by the investment in GDAC analytics. This method, in conjunction with the information reporting received by the taxpayer will streamline the audit process, reduce unproductive direct audit hours, ensure accurate audit results, and solidify case attributes should litigation of the case ensue. Additional information reporting will increase auditor efficiency with identification of non-compliance and the audit process.

1099K information reporting was codified, requiring Payment Settlement Entities to file electronic 1099K information in 2018. This real time reporting will enhance the existing cash intensive business audit program in addition to aid in identification of taxpayers that underreport sales transactions among broader business classifications.

Electronic submission of all information returns in a format prescribed by NCDOR has been codified for 2019. The penalty provisions included in N.C.G.S. § 105-236 (a) (10) c & d apply. If the informational returns are not filed by the due date and submitted in the proper format, this new requirement will increase the rate of submission and data submitted correctly.

4) **Coordination of Efforts Between NCDOR and GDAC to Identify and Integrate into the Department's Operations and Procedures, the Most Effective and Accurate Processes and Scalable Tools Available to Reduce Refund Fraud, Payment of Fraudulent Returns, and Business Tax Compliance**

NCDOR's partnership with GDAC has resulted in short and long-range deployment of specific programs designed to streamline audit processes and realize efficiency gains, improve audit selection and resource allocation by specific data analytical tools, and identify new areas of non-compliance by utilizing multiple data sources and analytics. N.C.G.S. § 105-259 precludes NCDOR from providing specific details regarding data and standards used to determine selection of audit candidates. As a result of the automation of one component of NCDOR's audit process, the Department has realized an efficiency gain of $5.3 million annually.

A partnership between Examination Division, Tax Analytics Division, GDAC, and SAS has been a catalyst in the development of many new audit initiatives and enhancement of existing initiatives. One component of SAS analytics is designed to enhance NCDOR's audit selection of taxpayers not in compliance. During fiscal year ending June 30, 2019,

information reporting coupled with enhanced SAS analytics NCDOR realized $13.5 million in total assessments. For period July 1, 2019 through January 31, 2020, we have realized $10.8 million in total assessments. SAS analytics total assessments for the entire current fiscal year will be available at fiscal year ending June 30, 2020. The division continues redesigning and enhancing analytics regarding the Schedule C audit initiative, which identifies taxpayers operating home-based businesses that inflate expenses and underreport income. An increased return on investment per case as well as overall non-compliance revenue generated by this initiative is expected. The continued partnership with GDAC and SAS enables us to continue to implement the multiple phases of the Advanced Data Analytics model designed to reduce administrative research hours, prioritize audit selection, identify new areas of non-compliance, and more efficiently allocate direct auditor hours.

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