



Pat McCrory
Governor

Jeffrey Epstein
Secretary

September 1, 2016

MEMORANDUM

TO: The Honorable Phil Berger Senator Bob Rucho, Co-Chair
 President Pro Tempore Senator Bill Rabon, Co-Vice Chair
 Senator Jerry Tillman, Co-Vice Chair
 Revenue Laws Study Committee

 The Honorable Tim Moore Representative Bill Brawley, Co-Chair
 Speaker of the House Representative Jason Saine, Co-Chair
 Representative Stephen Ross, Co-Vice Chair
 Revenue Laws Study Committee

FROM: Jeffrey Epstein
 Secretary, North Carolina Department of Revenue

 John Correllus
 Director, Government Data Analytics Center

SUBJECT: Semi-Annual Report:
 Progress Report NCDOR – GDAC February 1, 2016– August 31, 2016

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 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, 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 from of S.L. 2015-259, Sec. 7.3.(b).

NCDOR's overall strategy for identity theft refund fraud and non-identity theft refund includes an increase in voluntary compliance and reduction occurrences. Therefore, response to (1) one 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 Examination Division and Office of Taxpayer Advocate continue streamlining the process for early detection of potential identity theft refund fraud. NCDOR and GDAC utilize multiple information sources including direct contact by impacted taxpayers as a result of lost or stolen credit card or other finance related occurrence.

Provisions of G.S. 105-259 preclude NCDOR from providing detail 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, implemented several enhancements to the existing refund fraud program for fiscal year ending June 30, 2016. The



number of cases determined to be identity theft refund fraud doubled from the prior fiscal year (2014/2015: 1,389; 2015/2016: 3,449). This noticeable increase in refund fraud correlates to increases nationally, and is consistent with incidents of identity theft refund fraud over the past decade. Due to the increase in case volume annually, the Examination Division is streamlining criteria to improve case prioritization based on refund savings and revenue recovery. As a result of real-time information reporting of NC-3 and accelerated data warehouse processing, the Examination Division expects refund fraud cases and corresponding tax savings to increase substantially. Additional enhancements for this coming fiscal year include an initiative designed to identify taxpayers who inflate income tax withholding amounts resulting in an inflated refund. This analysis will also identify employers who fail to remit the appropriate amount of tax withheld from their employees. A review of NCDOR refund fraud program statistics indicates continued growth in case volume with higher levels of complexity within each case. With the significant financial investments made by the General Assembly to combat refund fraud, NCDOR will substantially increase refund tax savings.

- Statistics from fiscal year 2009/2010 reflects the Examination Division identified 6,883 cases and realized refund savings of \$8.6 million.
- Compared to fiscal year 2015/2016 the Examination Division identified 24,290 cases and realized tax savings of \$32 million.

The Discovery Section of NCDOR's Examination Division is comprised of 11 staff members. Over the years, the Examination Division has temporarily re-allocated duties during peak filing season to assist with fraud detection and case disposition; however, the opportunity cost is reflected in reducing or stopping work on other compliance initiatives and revenue recovery efforts.

Assisting taxpayers in the recovery of their personal identifying information (PII), is a manual process. It requires 1) skilled auditors to screen every tax return that is suspended by the automated fraud systems, and 2) coordinating with taxpayers to confirm their PII to protect their identity from future fraudulent use. To achieve the highest level of customer service, the NCDOR will need to reallocate staff resources and consider requesting appropriations for specialized positions to assist with case volume and bilingual taxpayers.

3) Tax Compliance by Business Professionals and Alcohol Vendors

The Examination Division 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.

Number of Reports by Business/Industry:

- 1) ABC Boards: 152
- 2) Beer and Wine Wholesalers and Independent Breweries: 135
- 3) Occupational Licensing Boards: 42



NCDOR made every attempt to receive data from each business industry in a similar format so that it could be readily utilized for advanced data analytics to determine statewide tax compliance. However, with all new initiatives, there are certain inconsistencies between data submissions which is requiring the deployment of staff and vendor resources to make manual data modification before the analytics can be utilized. In order to improve consistency and therefore utility of the taxpayer data, NCDOR will ask the Revenue Laws Study Committee to examine the possibility of requiring electronic data submission and consideration of a non-filer penalty.

Because of the data submitted already by the listed taxpayers under G.S. 105-251.2, the Examination Division has developed an audit initiative designed to identify non-compliance within cash intensive businesses. 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, improve audit results, and solidify case attributes should litigation of the case ensue. Additional information reporting will increase auditor efficiency within the identification of non-compliance and audit process.

NCDOR will recommend to the Revenue Laws Study Committee to consider requiring all IRS 1099K information be reported to the NCDOR. Currently taxpayers (predominantly credit card vendors) are required to report 1099K information to the IRS only and North Carolina does not receive the data set until years later. The delayed data reduces its useful life with regards to effective audit opportunities and for collection actions. Adding the 1099K annual filing requirement would ensure North Carolina remains at the cutting edge of tax compliance.

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 several short-term and long-term projects. G.S. 105-259 precludes NCDOR from providing specific details regarding data and standards used to determine selection of audit candidates. However, automation of previous manual processes has allowed the Examination Division to re-allocate 5,721 direct audit hours and realize efficiency gains of over \$5.3 million. Through coordinated efforts of the Examination Division, SAS, and most importantly GDAC, phase I of NCDOR's advanced data analytics tool set designed to improve the audit selection of non-compliant taxpayers is complete. This tool set will reduce administrative research hours, prioritize audit selection, and more efficiently allocate direct auditor hours. This fiscal year NCDOR and GDAC's coordinated efforts will focus on five pilot audit initiatives and phase II of the advanced data analytic program.