Governor-Elect Perdue
Transition Advisory Group Sessions
Session Summary 13

Revenue

November 21, 2008

Session Arranged by the
Governor-Elect Perdue Transition Team

Session Facilitated by the
Small Business and Technology
Development Center (SBTDC)

Report Prepared by the
UNC-Chapel Hill School of Government

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SECTION 1. **Executive Summary**

Technology, taxpayer outreach, budget concerns, and workforce recruitment and retention were the main topics of discussion during the revenue/tax advisory group meeting. Although a relatively large number of participants attended the morning briefing and question-and-answer session with the Department of Revenue (DOR), attendance dropped off sharply for the afternoon brainstorming and prioritizing session. The limited number of viewpoints represented should be considered when reviewing the issues and recommendations presented in Section 5.

SECTION 2. **Process Used in Session**

The session began with a morning presentation about the current administration's efforts in the topic area, including issues, opportunities, and challenges.

In the afternoon, invited participants discussed pressing issues in the topic area and participated in an exercise for developing possible solutions and recommendations for the issues. Further, the audience participated in an exercise to prioritize the issues. Finally, the audience broke into self-selected groups to discuss solutions and recommendations.

See facilitator agenda (Appendix 1) for details about the process devised and used by facilitators from the Small Business and Technology Development Center (SBTDC).

SECTION 3. **Participant List**

SBTDC facilitators: Tim Janke and Penny Godfrey

UNC-Chapel Hill School of Government reporters: Chris McLaughlin and David Owens

UNC-Chapel Hill MPA student note taker: KC Tydgat

Perdue Transition Team representative: Dan Gitterman

Attendees:

Mandy Ableidinger	Randy Barnes	Kim Brooks
Susan Burgess	Linda Carlisle	Geoffrey Clasper
Elizabeth Colcord	Jess Dorrance	Allan Felton
Kenny Flowers	Ralph Gildehaus	John Goodman
Lucy Gorham	Bo Gregory	Jack Harper
M. Herring	Reggie Hinton	Kay Hobart
Michael Houser	Canaan Huie	Ken Hunter
Mark Johnson	Jim Kleckey	Elaine Mejia
Charles Mercer	Linda Millsaps	Nancy Pomeranz
Freda Porter	Fran Preston	Greg Radford
Jannelle Ratcliff	Andy Sabol	Rob Schofield

Marvin Smarr	Karl Smith	Eva Stein
Richard Sullivan	Adam Terando	William Turnier
Wally Tyson		

SECTION 4. **Significant Issues, Opportunities, and Challenges Identified in Morning Sessions about Current Administration Efforts**

Led by Secretary Reginald Hinton, DOR officials conducted a briefing of the department's operations and strategic planning, ending with a discussion of the issues, challenges, and opportunities it faces in the coming years. The topics discussed in most detail both during the briefing and in the subsequent question-and-answer session are addressed below; the entire DOR PowerPoint presentation is included in the electronic supplementary material. Also included in the electronic supplementary material is the November 2008 "FutureCast," an internal report intended to "identify important strategic issues, risks, challenges, and opportunities for the DOR during the next decade."

Implementation of New Technology

DOR is replacing its fourteen-year-old Integrated Tax Administration System software and several smaller systems, including the Unauthorized Substance System, the Java Enabled Tax System, and the Revenue Collection and Analysis System, with the new Tax Information Management System (TIMS). The vendor for the new software system is CGI Technologies and Solutions.

DOR describes TIMS as a "transformational system" which will "fundamentally change how we operate as an agency." According to DOR, new TIMS capabilities include

- more detailed internal reporting and sharing of taxpayer information, which should improve the department's ability to solve taxpayer problems;
- more extensive automation of recurring manual processes and improved efficiency of document processing;
- faster and more accurate processing of returns, payments and refunds; and,
- integrated accounting of all tax revenues, enabling faster reporting to other state agencies and the General Assembly.

A more detailed explanation of the need for a new technology system and the capabilities of TIMS can be found in DOR's "Expansion Budget Request and Justification" ("TIMS Budget Request"), included in the electronic supplementary material.

DOR plans a seven- to eight-year implementation period for TIMS and related software improvements. This multi-phased approach anticipates the implementation of TIMS over 2008–11, then the implementation of related e-services and compliance, reporting and analysis components over 2011–13 and, finally, the implementation of a customer relations component over 2013–14.

The budget for the entire software implementation is $106 million. Forty-five million dollars has already been funded, apparently through allocation of existing DOR collection fee revenue. At the briefing session, DOR stated that it needs $25 million in funding during the 2009–10 legislative session to continue the TIMS implementation. DOR provided more detail regarding system funding in the TIMS Budget Request:

> The Department recommends that $40.0 million from the Department of Revenue fee receipts be used to pay for the $106.0 million e-Business Program. . . . Since 2001, when legislation was enacted to allow for imposition of a 20% collection assistance fee on all outstanding tax due debt, the Department has collected more than $55.1 million in receipts. Expenditures related to the collection fee have totaled $23.5 million with net (unspent) receipts of $31.6 million on deposit in a non-reverting (DOR) budget code. A projection of anticipated costs and projected fee receipts during the Six-Year Funding Model indicates a net balance of $46.2 million at June 30, 2013. The Department believes it is fiscally sound, based on prior years' collections and expenditures, to expend up to $40.0 million to fund the program and recommends an expenditure of $20.0 million for the first biennium (2007-2009) and up to $20.0 million over the next two bienniums, leaving a balance of $66.0 million to be funded by the General Assembly over the three bienniums.
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> G.S. 105-243.1 would have to be amended to allow funds from the collection assistance fee to be used to fund the e-Business Program. The Department strongly believes using receipts from the collection assistance fee is proper, particularly given the fact that the funds were collected from taxpayers who owed overdue taxes to the State and paid the fee. An integrated tax system is the foundation upon which all tax-processing activities is built and without an up-to-date system to address the collection of all taxes, then the Department will only marginally continue to succeed in one of its very basic core business functions, "the collection of taxes due and payable to the State". Collection assistance fee receipts are adequate and available and the Department recommends a change in the law to allow use of fee receipts to fund DOR's e-Business strategy, the next transformational program of the NC Department of Revenue.

As detailed in its Six-Year Funding Model spreadsheet, included in the electronic supplementary material, DOR anticipates that TIMS will begin to produce fiscal savings in fiscal year 2010, with those savings first beginning to exceed system costs in fiscal year 2013. DOR projects net fiscal benefits over the 2007–19 period of just under $175 million.

Recruiting and Retaining Top Talent

Secretary Hinton and his assistant secretaries all touched upon the challenge of recruiting and retaining talented employees. According to Secretary Hinton, for many years the DOR auditing department served as a training ground for private industry. After gaining relevant work experience, auditors were often recruited away from DOR by private employers who could offer substantially higher pay. While DOR has taken several steps to resolve this situation and similar concerns, maintaining a high-quality workforce remains a challenge.

DOR realizes that it cannot compete with private employers purely on the basis of salaries and has begun to focus on other job benefits that might make public service more attractive than private industry, despite the pay differential. With regard to recruitment, DOR is committed to participating in more college job fairs, with hope of capitalizing on the apparent increased interest in public service among younger job-seekers. With regard to retention, in addition to offering variable work schedules and telecommuting options, DOR has made substantial investments in staff development. Through its Revenue Leadership Academy, the department identifies employees with the talent and ambition to rise to executive level positions and offers training in the skills they will need for continued advancement within DOR.

Salary limitations continue to be a concern. DOR has created "banded" positions in an effort to more closely track market-rate salaries, but in many cases it lacks the funding to follow through with the process. To remain competitive in the job market, DOR believes it will need to invest more in compensation packages, particularly as it looks to recruit new employees to replace the many experienced staff who are already eligible for retirement. One solution proposed by DOR was for the General Assembly to allow a portion of lapsed salaries to be used as one-time bonuses for top employees.

Budget Flexibility

Especially in light of the recently mandated state budget cuts, DOR believes it should be granted some relief from traditional state budget restrictions. For example, DOR believes it could benefit from the same budget flexibility found in the state university system. DOR would like to be rewarded for good financial management by allowing it to retain and reallocate as needed any budget surpluses it maintains.

Because DOR is the only state agency that collects revenue for all aspects of state government, DOR believes that it may not be appropriate for it to be subject to the same across-the-board budget cuts as are other state departments. The recent spending reductions have hindered DOR's ability to fill over twenty vacant auditor positions and seven vacant collection positions. Because DOR estimates that each auditor produces over $3 million in annual assessments and each collector produces over $1 million in annual tax collections, the current vacancies could be costing the state over $67 million in lost tax revenue each year. According to DOR, the more its budget is cut, the more state revenues will decrease and the more other agencies' budgets will suffer. One proposal was for DOR to receive all of its funding from a certain percentage of the tax receipts it generates, an expansion of the existing approach under which DOR retains twenty percent "collection assistance fees" on delinquent tax collections.

SECTION 5. **Key Issues and Recommendations**

During the SBTDC-led group "brain writing" session, the advisory group focused its discussion on five key issues raised during the morning DOR briefings:

- Addressing falling tax revenues
- Budget flexibility

- Recruiting and retaining top talent
- Taxpayer outreach
- Technology

Specific concerns and recommendations raised by the advisory group are discussed in detail below.

Addressing Falling Tax Revenues

Discussion regarding this issue touched upon tax policy as well as DOR operations.

From a policy perspective, several members of the advisory group thought it imperative that the state develop a more effective method of collecting sales and use taxes on Internet sales. The members who raised this issue believe that local retailers are unfairly penalized when out-of-state retailers escape all taxation on sales over the phone or Internet to North Carolina consumers.

Andy Sabol, the director of DOR's Sales and Use Tax division, explained that the taxation of out-of-state businesses is largely limited by the United States Constitution and by United States Supreme Court case law. In general, retailers who do not have a physical presence in the state may not be required to collect sales taxes from their customers. As a result, the state is forced to rely on voluntary reporting of use tax obligations by taxpayers. Since DOR has included a use tax line item on income tax forms, use tax collections have risen from several hundred thousand dollars per year to roughly five million dollars per year. However, DOR estimates that taxpayers fail to report between $200 and $400 million in use taxes every year.

In an effort to capture some of those lost sales and use taxes, the state is a party to the multi-state Streamlined Sales and Use Tax Agreement, the purpose of which is to "simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance . . . [and to] improve[e] sales and use tax administration systems for all sellers and for all types of commerce. . . ." The entire agreement and more details about the effort are available at www.streamlinedsalestax.org.

When asked about DOR's efforts to collect delinquent taxes, Alan Felton, assistant secretary for tax compliance, stated that total outstanding taxes are just over $500 million. About $25 million of that amount is owed by taxpayers who are under the protection of the bankruptcy courts, which effectively stays all collection efforts. DOR estimates that $370 million in back taxes are actually collectible, with 75 percent of that figure currently subject to collection efforts. Staff vacancies and budget cuts have limited DOR's ability to pursue collection efforts as robustly as the department would prefer. The advisory group offered the following recommendations for improving DOR's tax collections in a difficult economic environment:

- Closely examine the existing tax code for deficiencies/unintended loopholes;
- Hire specialized auditors for complex businesses so that they will better understand the industry and intricate transactions;
- Study other states' experiences using defined factors to "grade" revenue sources in an effort to address revenue volatility;

- Increase efforts to reduce taxpayer errors, especially foreign-born taxpayers using Individual Taxpayer Identification Numbers (ITINs) rather than Social Security numbers, through additional outreach and second-language phone assistance and forms, as well as small business education and enhanced Web-based support; increase monitoring of third-party preparers and create a certification process for such individuals; and,
- Focus less on strategic planning and more on core DOR missions of tax compliance and collection, which should include examining the efficiency of collection efforts for discrete taxes and targeting new efforts on areas most likely to generate improved collection of substantial sums.

Budget Flexibility

The advisory group was sympathetic to DOR's budget concerns but questioned whether it would be appropriate to treat DOR different from all other state agencies. The group believed that if DOR could demonstrate how budget flexibility would positively impact the state revenues, both the General Assembly and the public would be more supportive of a new approach to funding DOR. The group suggested that it might be reasonable for DOR to have the authority to reallocate or carry forward a certain percentage of specific budgetary line items if the department spent less on those line items than anticipated. The group did not believe that the entire DOR budget should be based on tax collections, as it might foster in its employees a more predatory attitude toward taxpayers.

Recruiting and Retaining Top Talent

The advisory group offered the following recommendations to improve DOR's recruitment and retention efforts:

- Recruit outside of North Carolina and emphasize quality-of-life issues;
- Limit short-term temporary hires to avoid morale and continuity concerns;
- Employ rotational assignments to expose future leaders to all aspects of DOR;
- Encourage flexible work arrangements and job sharing while remaining careful not to jeopardize information security;
- Create career paths from the community college system for candidates with skills particularly relevant to DOR;
- Provide education benefits for employees who commit to remaining at DOR;
- Explore a fellowship model that permits private sector accountants to work at DOR for specified time periods; and,
- Offer performance-based bonuses—although some group members raised concerns about how this compensation option might negatively impact the department's attitude toward taxpayers.

Taxpayer Outreach

The issue of low-income taxpayer outreach, especially outreach concerning the Earned Income Tax Credit (EITC), was raised by several members of the advisory group, including Susan Burgess, Charlotte City Council member and mayor pro tem, and Lucy Gorham, director of the EITC Carolinas initiative at MDC, Inc. They and other members of the advisory group were concerned that the recent economic downturn will impact low-income taxpayers disproportionately, meaning that DOR outreach efforts will be increasingly important to help these taxpayers benefit from all applicable tax reduction opportunities.

Burgess asked how DOR could better inform low-income families about the EITC. Linda Millsaps, assistant secretary for tax administration, indicated that DOR considers the EITC a priority and attempts to publicize this particular tax credit through internal marketing efforts and partnering with external groups such as EITC Carolinas. She pointed out that DOR's "Strategy Map," distributed to all attendees, includes as one of its "critical internal processes" the need for "education, marketing, and outreach services [to be] proactive, coordinated, tailored, and timely."

The group offered the following specific recommendations for improving low-income taxpayer outreach:

- Encourage use of the EITC to pay third-party tax preparers, which would motivate those preparers to confirm EITC eligibility for all clients;
- Expand support of community efforts from organizations such as the North Carolina Bar Association, the North Carolina Association of Certified Public Accountants, and Volunteer Income Tax Assistance programs run by churches, colleges, and service organizations;
- Create an internal taxpayer advocate and an external advisory board to meet on a regular basis concerning DOR outreach; and,
- Streamline and simplify appeals for small taxpayers.

Gorham asked if a move to mandatory electronic filing of tax returns, which was one possibility raised by the department during its presentation, would serve as a barrier to low-income taxpayers who are not required to file a return but who must do so if they wish to benefit from the refundable EITC. Secretary Hinton acknowledged this concern, promising to continue increasing opportunities for free electronic filing and providing education to external partners who work directly with low-income taxpayers. He stated that budgetary concerns place limits on the amount of outreach DOR may conduct on this issue and others that are important to low-income taxpayers. Several participants believed it more appropriate to incentivize electronic filing rather than to make it mandatory.

Technology

Although DOR entertained several questions about the TIMS implementation process during the question-and-answer session, it became apparent during the afternoon "brain-writing" session that the advisory group had a number of outstanding questions about technology issues, including the following:

- What will happen if DOR is not allocated another $25 million in the next legislative session?
- Does DOR have the capacity to cover future TIMS implementation costs with its own collection fee revenue?
- How will TIMS affect staffing needs throughout DOR, both during the implementation process and after its completion?
- How will TIMS provide adequate security for sensitive taxpayer information?
- How will TIMS affect DOR's relationships with local governments, in particular with the sales tax allocation process?

Information security was perhaps the top concern among these issues. Specifically, the group wanted to hear more from DOR regarding its focus on insuring the confidentiality of taxpayer information, as well as its commitment to adopting and implementing security procedures after the new technology is in use.

The group was unclear as to the costs and financing of the new system, especially regarding the consequences of a budget shortfall in the upcoming legislative session. The group did not understand what DOR could or would do if it were not allocated the $25 million it seeks in the next two years. Neither the DOR briefing nor the subsequently provided TIMS budget request provided a clear answer to this question.

The advisory group thought it imperative that DOR make the new technology serve its needs and not vice versa. An example of how the current technology system fails to achieve this objective was provided during the DOR question-and-answer session, when an audience member asked why DOR frequently failed to provide copies of correspondence and notices to taxpayers' attorneys, even after those attorneys file the required power-of-attorney forms with DOR. In response, a DOR official indicated that the current technology system does not permit a taxpayer account to be "flagged" with the notation that the taxpayer has legal representation. The advisory group was concerned that DOR might suffer similar constraints on its customer service if the new technology system is not tailored specifically for the needs of DOR and its customers.

The advisory group also raised questions about TIMS's compatibility with other state departments and with federal agencies and about its ability to better facilitate taxpayers' access to tax benefits as well as other support programs such as food stamps. DOR officials emphasized the goal of "seamless" service for taxpayers, hoping to avoid answers such as "you'll have to talk to another office" in response to taxpayer questions. The advisory group viewed the new technology system as the key component of such seamless service, not only among state departments but with federal agencies as well.

Electronic Supplementary Materials

- Appendix 1: Facilitator agenda provided by the Small Business and Technology Development Center (SBTDC)
- Agency transition reports and other documents provided for session