



Ralph Campbell, Jr.
State Auditor

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May 30, 2000

Senator Edward Warren, Co-Chair
Representative Margaret Jeffus, Co-Chair
Representative William Wainwright, Co-Chair
Members, Joint Legislative Appropriations
Subcommittee on General Government
Legislative Office Building
Raleigh, North Carolina 27603

Ladies and Gentlemen:

Pursuant to Chapter 415 of the 1999 Session Laws, we are submitting this **Interim Report** on the performance audit of the North Carolina Department of Revenue (Department). Specifically, the legislation directed us to review:

- tax collection and tax auditing activity, with particular attention to the cost, efficiency, and effectiveness of the Integrated Tax Administration System (ITAS) and subsequent automation projects;
- current methods of processing tax returns and payments and the ability to employ the latest technology in this processing;
- internal organization and management structure;
- budgeting and fiscal management;
- and such other issues as may be deemed necessary or desirable by the State Auditor.

Audit Status

Preliminary discussions with legislators and Fiscal Research staff brought out the possible need for outside assistance to evaluate the specific ITAS questions raised in the legislation. In October 1999, the Office of the State Auditor (OSA) began the preliminary research on the Department of Revenue necessary to develop the audit plan. During this period, we confirmed a need for specialized assistance to review and evaluate the Department's ITAS operations. As a result, a Request for Proposal was developed.



In the meantime, an audit team from the Office of the State Auditor, composed of performance, financial, and information system auditors, began on-site work in mid-November 1999. The team conducted interviews with Department staff to gain an understanding of the Department's operations. Previous reports and studies on Department operations were obtained and reviewed. This information was used to identify specific areas where further audit work needed to be conducted and to refine the scope of work detailed in the RFP.

The RFP was issued in early January 2000, requesting proposals be submitted by February 9. Due to the heavy snowstorm experienced in January, the receipt of proposals was delayed until late-February. After review of the proposals, the Office of the State Auditor entered into a contract with KPMG LLP in March 2000.

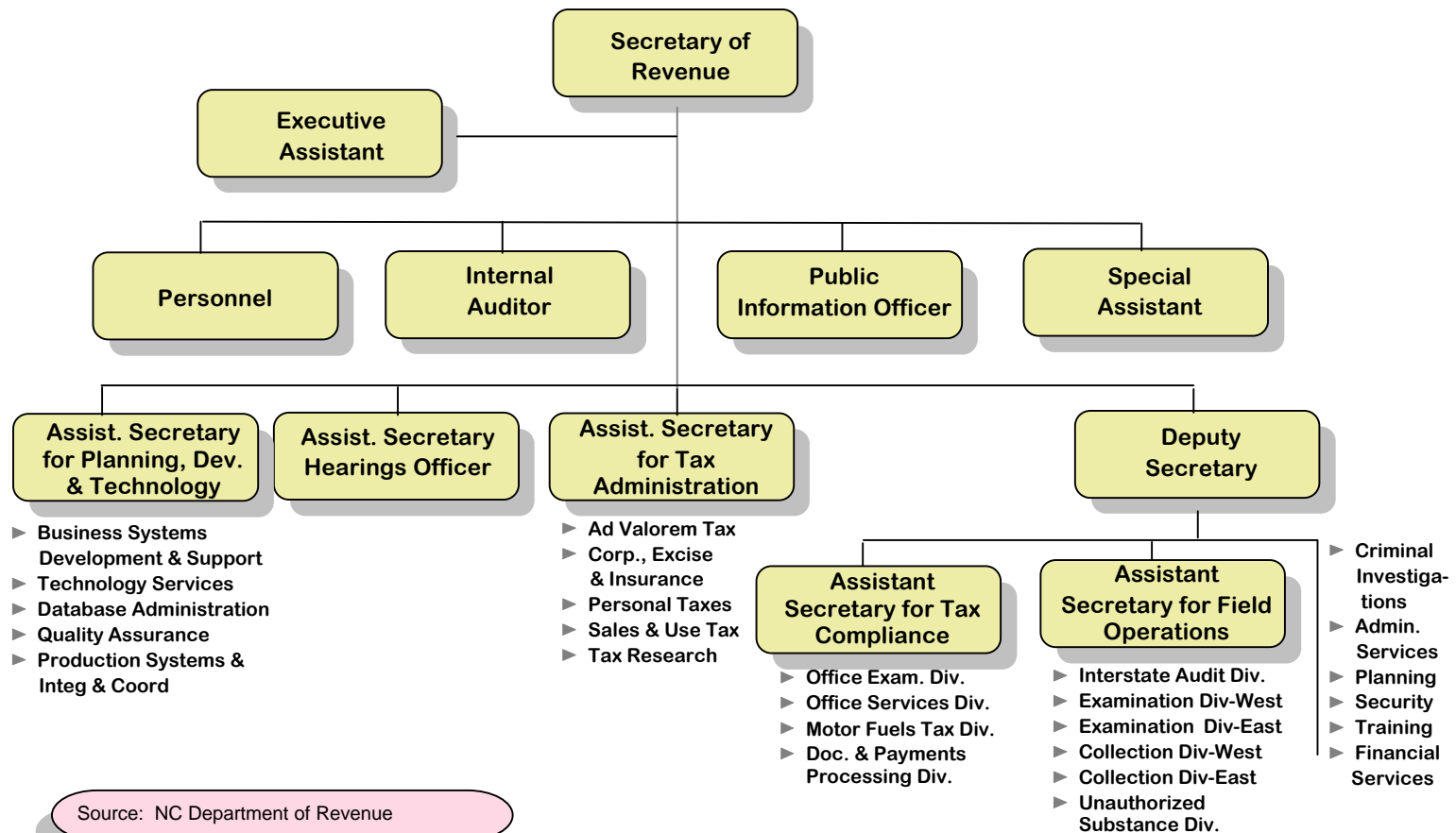
KPMG began on-site work at the Department March 22, 2000, working in conjunction with the State Auditor's audit team. Work is underway in the following areas:

KPMG Focus	OSA Focus
<ul style="list-style-type: none"> • ITAS functionality • Procedures for system changes • ITAS operational performance • Information security • Business continuity planning • Resources and costs • Using automation in the auditing function • Best practices in other states 	<ul style="list-style-type: none"> • Budget and finance • Taxpayer assistance • Bankruptcy procedures • Amended returns • Distribution of local taxes • Refund process • Handling of returned mail • Internal controls over receipt of payments • Motor fuels tax distribution • Procedures for negotiating tax assessment conflicts • Organizational structure and staffing issues

Department Overview

The North Carolina Department of Revenue is charged under GS 143B-217 with responsibility for administering the tax laws of the State of North Carolina and with collecting the taxes due the State. The Department's organizational structure at the beginning of the on-site work featured 17 divisions, totaling 1,279 positions. Exhibit 1 shows the organizational structure as of May 2000. The Department is currently in the process of restructuring and shifting responsibilities.

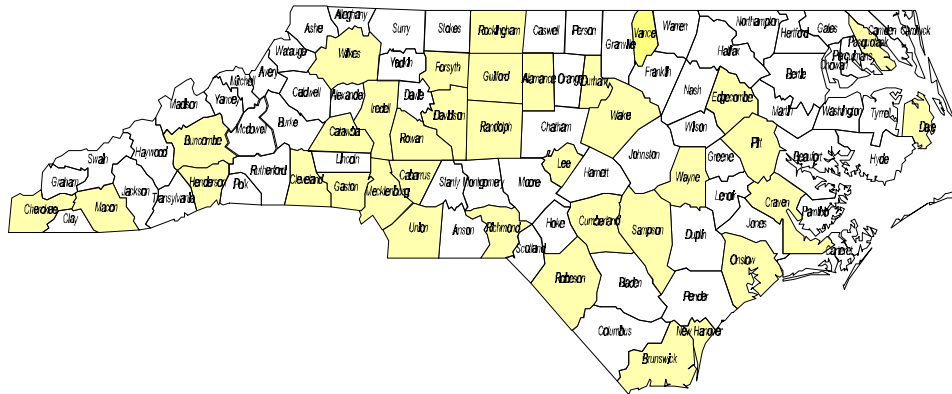
EXHIBIT 1
NORTH CAROLINA DEPARTMENT OF REVENUE
CURRENT ORGANIZATIONAL STRUCTURE
AS OF MAY 2000



As of May 2000, Department personnel are located in 37 cities and towns across the State (see Exhibit 2) and 27 out-of-state field auditors in 18 major metropolitan areas across the United States (Exhibit 3).

EXHIBIT 2

North Carolina Locations

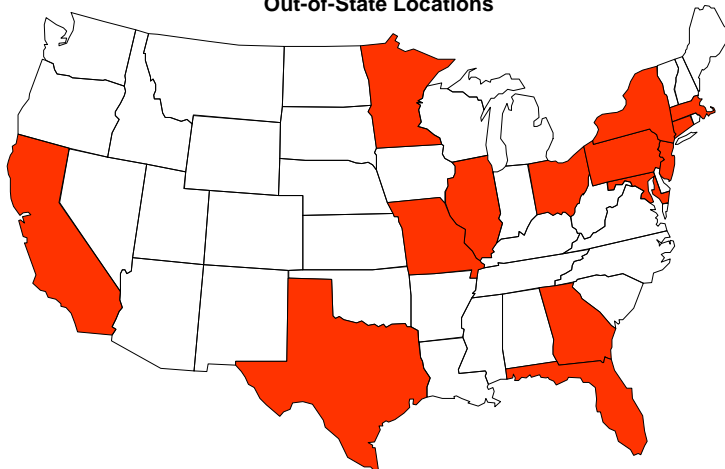


Source: NC Department of Revenue

EXHIBIT 3

Out-of-State Locations

State	# of Positions
California	4
Connecticut	2
Florida	2
Georgia	3
Illinois	2
Maryland	1
Massachusetts	1
Minnesota	1
Missouri	1
New Jersey	1
New York	2
Ohio	2
Pennsylvania	2
Texas	3



Source: NC Department of Revenue

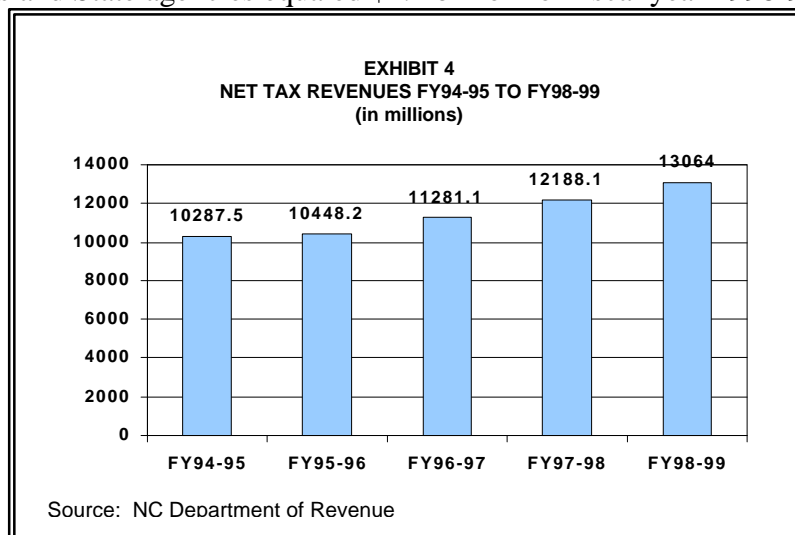
TABLE 1 Number of Returns by Tax Type for FY98-99	
Tax Type	Number of Returns
Inheritance Tax	8,385
Privilege License Tax	79,719
Tobacco Products Tax	4,878
Soft Drink Tax	7,792
Franchise Tax	177,706
Individual Income Tax	
Individual Income*	3,561,871
Estimated Income	808,635
Withholding	2,285,999
Corporate Income Tax	264,220
Sales and Use Tax	2,349,059
Beverage Tax	16,428
Gift Tax	5,862
Intangibles Tax	4
Freight Car Lines Tax	125
Insurance Tax	7,551
Real Estate Conveyance Excise Tax	410
Dry-Cleaning Solvent Tax	196
Primary Forest Products Tax	1,035
Scrap Tire Disposal Tax	37,263
White Goods Disposal Tax	14,878
Motor Fuels Tax	56,444
TOTAL	9,688,460
*Includes partnerships and fiduciary returns	
Source: NC Department of Revenue	

The Department's certified budget for fiscal year 1999-00 is \$84.1 million. Gross collections for fiscal year 1998-99 were \$16.8 billion, with net revenues being \$13.1 billion. For the same period, average daily deposits were \$67.4 million.

The Department processed 9,445,630 returns for fiscal year 1997-98, increasing to 9,688,460 for fiscal year 1998-99. From those, the Department processed 5,897,822 payments, representing 60.9% of the total number of returns.

Approximately 26% of the total returns filed for fiscal year 1998-99 resulted in a refund to the taxpayer. Total refunds for the year were \$1.6 billion, with refunds to individual taxpayers accounting for \$1.053 billion of that amount. Table 1 shows a breakdown of the type of returns filed in fiscal year 1998-99. Net tax revenues collected by the Department for fiscal years

1994-95 through 1998-99 are shown in Exhibit 4. Distributions and transfers to local governments and State agencies equaled \$2.2 billion for fiscal year 1998-99.



In 1987, the Department embarked on a major initiative to redesign and modernize its aging automation environment. Since that time, records indicate that the Department has expended approximately \$54 million, composed of Department reserves and appropriations from the General Assembly, as shown in Table 2. (Note: The numbers in this area are still being confirmed.) A large portion of these funds was used to purchase, modify, and implement the Integrated Tax Administration System (ITAS) and for the Data Capture Project. During this same period, the General Assembly has approved the creation of 193 new permanent positions, as shown in Table 3.

TABLE 2 COSTS OF COMPUTERIZATION FY87-88 TO FY98-99 (numbers shown in bold are for ITAS and Data Capture)	
87-88	\$ 732,720
88-89	4,651,536
89-90	5,091,431
90-91	3,047,331
91-92	0
92-93	0
93-94	3,009,800
94-95	10,558,294
95-96	10,612,862
96-97	4,255,874
97-98	0
98-99	12,272,148
TOTAL	\$54,231,996
Source: NC Department of Revenue	

TABLE 3 CHANGES IN NUMBER OF POSITIONS FY87-88 TO FY98-99				
Fiscal year	Permanent Full-Time	Temporary Full Time	Temporary Part-Time	Temporary Time Limited
87-88	25	20	23	0
88-89	11	17	6	0
89-90	152*	45	3	0
90-91	-31	13	4	0
91-92	-8	107	-25	0
92-93	-12	18	3	0
93-94	9	6	9	0
94-95	41	1	1	0
95-96	-15	9	0	2
96-97	9	68	-10	0
97-98	4	17	41	-2
98-99	8	2	0	1
TOTALS	193	323	55	1
*135 of these positions were for the Taxpayer Amnesty Program Source: NC Office of State Personnel				

These automation upgrades have allowed the Department to initiate electronic filings of returns and electronic transfers of funds (EFT). For fiscal year 1998-99, 652,744 individual income tax returns were filed electronically. Since January 1994, \$35.5 billion have been deposited using electronic funds transfer. Gross EFT collections for business taxes for fiscal year 1998-99 totaled \$9.2 billion.

We now have a good understanding of the operational

procedures used by the Department, and we are in the process of assessing the effectiveness and efficiency of those procedures. We are not at a point, however, where we can detail for you any specific findings or recommendations. The legislation mandated that the final report be submitted by January 1, 2001. Since we realize the importance of this audit to the Joint Appropriations Subcommittee, we are making every effort to complete the work earlier and have the final report to you in October 2000.

May 30, 2000

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We wish to thank Secretary Offerman and the staff at the Department of Revenue for their cooperation thus far in the audit. As always, we stand ready to discuss this interim report with the Joint Appropriations Subcommittee.

Respectfully submitted,

A handwritten signature in black ink that reads "Ralph Campbell, Jr." The signature is written in a cursive style with a large, stylized 'R' and a trailing flourish.

Ralph Campbell, Jr.
State Auditor