

eliminating the Department's mandatory extension form needed to receive an extension of time to file franchise, corporate income, and individual income tax returns.

To correspond with the reporting requirements of S.L. 2017-204, this report is broken down into various components to explain to the Revenue Laws Study Committee the Department's current process and possible alternatives for the future.

1. NCDOR Extension Process Today

The Department currently requires taxpayers to file a North Carolina extension application form to receive an extension of time to file an individual income tax return, partnership income tax return, income tax return for estates or trusts, or a franchise and corporate income tax return. A taxpayer who submits an application for extension by the original due date for a given year will be granted an automatic six month extension for filing a return. If the extension application is received after the original due date of the return, the extension request is denied and the taxpayer is sent a Notice of Extension Denied.

Importantly, the Department **does not accept any federal extension form in lieu of the North Carolina extension form**. Therefore, if a taxpayer fails to file a North Carolina application for extension on or before the statutory due date, the tax return is delinquent and subject to interest and all applicable penalties provided by law.

Taxpayers may also submit a payment with the extension application but a payment is not required by statute. However, an extension of time for filing a tax return does not extend the time for paying the tax due. Any tax due but unpaid by the original due date will incur a failure to pay (FTP) penalty on the amount of tax due, as well as statutory interest.

NCDOR currently processes the following extension forms:

- Form D-410, Application for Extension for filing Individual Income Tax Return
- Form D-410P, Application for Extension for filing Partnership, Estate, or Trust Tax Return
- Form CD-419, Application for Extension for filing Franchise and Corporate Income Tax Return

Taxpayers have the option to file these extension forms and pay tax due through the following methods:

- Modernized eFile (MeF)¹. Taxpayer purchases software from third-party vendors and files the extension form online using the vendor's application.
- NCDOR web site. Taxpayer files the extension and pays tax due through the Department's online filing application. Paper extensions may be hand delivered to a NCDOR office.

¹ Modernized e-File is a web-based system designed and developed by the Internal Revenue Service that allows for the electronic filing of corporate, individual, and partnership tax returns through the Internet. The Department currently utilizes MeF software licensed from an outside vendor to download both federal and State returns from the Internal Revenue Service for processing.

- Mailing a paper form. Taxpayer files an extension form and pays any tax due through the U.S. mail. Extension forms are available from third-party vendors or from the NCDOR web site.

2. Statistics on Current Extension Process

2015 and 2016 State Extensions Filed

The following is the total number of extensions filed for Individual Income, Corporate, Franchise and Partnership for tax year 2015:

- Individual Income 228,651
- Corporate 104,459
- Franchise 96,574
- Partnership 49,327

The following is the total number of extensions filed for Individual Income, Corporate, Franchise and Partnership for tax year 2016:

- Individual Income 186,687
- Corporate 94,213
- Franchise 84,291
- Partnership 52,353

The following is the total number of failure to file penalty assessments generated by the Department from April to October for Individual Income, Corporate, and Partnership for tax years 2014 and 2015, along with the total amount assessed for each tax year:

| Tax Year - 2015 | | |
|------------------------|------------------------------|------------------------|
| Tax Type | Number of Assessments | Amount Assessed |
| Individual | 37,104 | \$3,552,193.92 |
| Partnership | 613 | \$332,763.31 |
| Corporate | 4,842 | \$292,071.63 |
| Totals | 42,559 | \$4,177,028.86 |

| Tax Year - 2016 | | |
|------------------------|------------------------------|------------------------|
| Tax Type | Number of Assessments | Amount Assessed |
| Individual | 39,624 | \$3,658,847.15 |
| Partnership | 426 | \$101,447.05 |
| Corporate | 4,099 | \$229,985.03 |
| Totals | 44,149 | \$3,990,279.23 |

3. Summary of Interviews with Selected States

NCDOR contacted the South Carolina, Pennsylvania, Maine, and the Rhode Island Departments of Revenue to discuss each state's extension process. These states were chosen based on research available to the Department which showed these states grant extensions to file income tax returns based on approved federal extensions.

The information obtained from each state is summarized below:

South Carolina:

- If payment is due, taxpayers are instructed to file a South Carolina extension and pay the tax due by the April due date.
- Taxpayers are instructed to include a copy of the federal extension when they file but no validation is done and the state extension does not depend on this being attached.
- The South Carolina return has a check box to indicate that a federal extension has been filed.
- If the box is checked, the return is processed as if a 6 month extension had been granted.
- If the South Carolina return with the box checked is filed by the October deadline, then no failure to file penalty is assessed.
- If the box is not checked, then no extension is allowed and failure to file penalty is assessed.
- If there are questions or discrepancies, South Carolina will check to see if a copy of the federal extension was included with the South Carolina return and/or request the taxpayer to send a copy and make adjustments accordingly.
- The failure to pay penalty will apply if the taxpayer does not pay 90% of the tax by the April due date.
- Corporate and Partnership returns have check boxes but allow the 6 month extension regardless of whether the box is checked.

Maine:

- Maine's tax extension is automatic.
- There are no state extension applications to submit or special boxes on the returns.
- As long as the taxpayer files the Maine return by the October deadline no failure to file penalty is assessed.
- Maine instructs the taxpayer to pay at least 90% of the tax by the April due date using the Maine extension payment form (paper and electronic options).
- If the taxpayer does not pay at least 90% of the tax by the April due date, then the failure to pay penalty and interest will apply.
- Corporate and Partnership are similar to Individual Income tax.

Pennsylvania:

- If payment is due, Pennsylvania instructs taxpayers to file a Pennsylvania extension and pay the tax due by the April due date.
- If the taxpayer has an approved federal extension and does not owe Pennsylvania tax, then they are not required to file a Pennsylvania extension.
- The taxpayer is instructed to include a copy of the federal extension or confirmation number with the Pennsylvania return when filed.
- The Pennsylvania return has a check box to indicate that a federal extension was filed.
- If the box is checked, the return is processed as if a 6 month extension had been granted.
- If the box is not checked, then no extension is allowed and failure to file penalty is assessed.
- If there are questions or discrepancies, Pennsylvania will review and adjust accordingly.
- Similar process for Corporate and Partnership.

Rhode Island:

- If payment is due, Rhode Island instructs taxpayers to file the Rhode Island extension and pay all of the tax due by the April due date.
- If no payment is due or a refund is due Rhode Island grants an automatic extension. No form indicators used.
- If the taxpayer files by the October deadline for a refund or payment is less than 20% of liability, then no failure to file penalty is assessed.
- If the taxpayer files after the April due date but by the October due date and owes 20% or more of their liability, the taxpayer is assessed the failure to file and failure to pay penalties. No extension is presumed.
- The taxpayer is instructed to include a copy of the federal extension with their Rhode Island return. But the attached federal extension is not used to determine who is allowed an extension to file.
- Similar process for Corporate. Partnership does not have an income tax.

4. Possible Options for NCDOR Extension Process Beginning in 2019

Option 1:

Do nothing and continue with NCDOR's current process. The Department will continue to require taxpayers to file a North Carolina application for extension and will not accept a federal extension in lieu of the State extension.

Option 2:

NCDOR will implement procedures similar to the state of Maine. Specifically:

- The Department will automatically give taxpayers an additional six months to file certain individual and business tax returns, moving the filing deadline to file tax returns to October 15th for annual filers.
- The additional time to file will be an automatic extension, which means there would be no form or application for the taxpayer to submit.
- The additional time to file the return is contingent on the following:
 - The taxpayer files the return with the Department on or before the additional six months expires.
 - The taxpayer pays any tax due by the original due date.
- A taxpayer who files a tax return after the original due date (but before the 6 months has expired) and who does not pay at least 90% of the North Carolina tax liability shown due on the return by the original due date will not be granted a State income tax extension. As such, the taxpayer is subject to both the failure to pay penalty (10% of the net tax due shown on the return) and the failure to file penalty (5% per month of the net tax due shown on the return for each month the return is late; maximum 25%).
- A taxpayer who files a tax return after the original due date (but before the 6 months has expired) and who pays at least 90% of the North Carolina tax liability shown due on the return by the original due date is granted a State extension.
- A taxpayer who files a franchise or income tax return after the additional six months expires will not be granted a State extension and is subject to both the failure to pay penalty (10% of the net tax due shown on the return) and the failure to file penalty (5% per month of the net tax due shown on the return for each month the return is late; maximum 25%).
- NCDOR will instruct taxpayers who owe franchise tax or income tax to file a North Carolina extension and to pay the tax due by the original due date.
- There is no requirement to include a copy of the federal extension with the State tax return.

Option 3:

Implement procedures similar to the state of South Carolina. Specifically:

- If tax is due, NCDOR will require a taxpayer to file a State application for extension and pay the tax due by the statutory due date.
- If no tax is due and the taxpayer files a timely federal extension, the taxpayer will not be required to file a North Carolina extension form.
- The North Carolina income tax returns will be revised to include a check box to indicate the taxpayer has filed for and obtained an extension to file a federal income tax return with the Internal Revenue Service.
- When the taxpayer files the North Carolina tax return after the original due date and the return reflects no tax due or an overpayment, the Department will grant the taxpayer a six

month extension from the original due date if the taxpayer checks the federal extension check off box. The federal extension should be attached to the filed State tax return.

- When the taxpayer files a North Carolina tax return after the original due date and the return reflects tax due, the taxpayer will only be granted a six month extension if the taxpayer requested a State extension on or before the original due date. NCDOR will maintain the existing 90% rule for the assessment of the failure to pay penalty. As such, a taxpayer that owes tax and who has been granted a State extension will only be assessed a failure to pay penalty if the taxpayer fails to pay 90% of the tax owed by the original due date. A taxpayer that owes tax and who does not file a timely state extension will be assessed both the failure to file penalty and the failure to pay penalty.
- If the federal extension box is not checked, the due date of the return will remain unchanged unless the taxpayer received a State extension. Penalties will be assessed according to statute Note. A taxpayer who does not owe tax is not subject to penalties, even if the return is filed late.

5. Legislative Recommendation

Pursuant to the instruction of the 2017 General Assembly, the Department and the NCACPA met several times to consider the various options to eliminate the Department's mandatory extension form currently needed to receive an extension of time to file franchise, corporate income, and individual income tax returns. All options were considered in light of the administration of North Carolina's tax laws and as a part of an examination of the Department's existing computer systems. After considering all options, the Department recommends Option #3 to the Revenue Law Study Committee.

Under current law, G.S. 105-263(b), the Secretary is authorized to extend the time in which a person must file a tax return with the Secretary. The statute also requires taxpayers to comply with any application requirements set by the Secretary. Today, the Secretary uses administrative rules to provide guidance to taxpayers regarding extension requirements.

If the Revenue Laws Study Committee concurs with the recommendation of the Department, the Department may need to adopt new administrative rules to clarify the requirements for obtaining an extension of time to file tax returns. In addition, the Department will need to modify its existing tax forms to add a new extension indicator and will need to modify the Department's receivable system ("ITAS") to recognize and process the new extension indicator. Moreover, existing system rules will need to be updated. Implementation of the recommendation will result in increased cost to the Department. Upon request, the Department will provide a cost analysis to the Revenue Laws Study Committee.