Department of Legislative Services
Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

Senate Bill 95 (Senator Lawlah, *et al.*)
(Joint Committee on the Management of Public Funds)
Budget and Taxation Ways and Means

Income Tax - Employer Withholding - Exemptions

This bill limits to one the number of exemptions an employee can claim for State withholding tax purposes if the individual failed to file a required State income tax return.

The bill takes effect July 1, 2005.

Fiscal Summary

State Effect: Indeterminate increase in general fund revenues beginning in FY 2006. No effect on State expenditures in that administrative expenses to implement the bill's provisions could be handled with existing resources.

Local Effect: Local revenues would increase by an indeterminate amount as a result of increased compliance and withholding from individuals who failed to file returns. Local expenditures would not be affected.

Small Business Effect: Minimal.

Analysis

Current Law: An employer bases State income tax withholding on an employee's wages based on the number of exemptions stated in an exemption certificate filed by the employee. If the employee fails to file an exemption certificate or files an invalid certificate, the employer bases withholding on one exemption. If the Comptroller notifies the employer that the employee has an unpaid tax liability, the employer bases withholding on the number of exemptions, as specified by the Comptroller, that does not exceed the number of exemptions allowed on the employee's prior year's tax return.

Background: The withholding of Maryland income tax is part of the State's "pay-as-you-go" plan of income tax collection. State income taxes are withheld from wages based on the amount of wages and number of exemptions allowed. Increasing the number of exemptions decreases the amount of taxes withheld from wages. This bill proposes to increase withholding taxes imposed on the wages of an individual who has failed to file a required income tax return – regardless of whether the individual had additional tax liabilities for that tax year.

The Internal Revenue Service (IRS) estimates that the voluntary compliance rate for federal income tax is approximately 85%. The resulting tax gap from noncompliance consists of three main components: (1) payment noncompliance; (2) reporting noncompliance; and (3) filing noncompliance. The IRS estimated that nonfiling resulted in a loss of approximately $28.1 billion in individual income tax revenues in tax year 2001, representing approximately 2.4% of total individual income collections. Applying the federal estimate of 2.4% suggests that the State lost approximately $163 million in tax year 2003 personal income tax revenue due to nonfilers. Given that the State currently identifies individuals who filed for federal purposes but not State taxes and the increased mobility of taxpayers on the State level, this estimate likely represents a conservative estimate of the amount of State tax revenues lost to nonfilers.

The Comptroller's Compliance Division currently operates three tax compliance programs focused on nonfiling – a W-2 match program, a federal tax return match program, and a program for State employees. The match programs send notifications to certain individuals who did not file a State income tax return but either had State taxes withheld from wages or filed for federal tax purposes. In each year, 50,000 people are typically sent first notices through the federal tax return match program. Not all of the people who are sent notifications have income tax liabilities. Some have moved to Maryland recently or opted not to file because they are due a refund. Of the 50,000 sent notifications in the federal program, for instance, 25,000 are sent a second notice with an estimated assessment. The Compliance Division advises that the federal tax return match program grossed approximately $14.0 million in fiscal 2004.

During the year, the State receives income tax revenue from withholding and quarterly estimated payments from businesses, which include both State and local taxes. When taxpayers file their tax returns, they report on the return the amount of State and local taxes paid or withheld during the year. In each tax year, fewer individuals and businesses file taxes than had withholdings or estimated quarterly payments – even after taking into account that individuals have three years to file in order to claim refunds. As a result, an unclaimed income tax revenue fund exists that is comprised of withholdings and estimated quarterly payments that were not reported on any income tax returns. For tax year 1999, the State received approximately $105.3 million from the unclaimed income tax revenue and local governments received approximately $61.4 million.

The Comptroller's Office advises that it cannot estimate the characteristics of the individuals who do not file and are the source of the unclaimed income tax revenue fund nor how much of the unclaimed income tax revenue represents unclaimed refunds and how much represents withholdings from taxpayers that owe additional tax liabilities and do not file.

Limited data exist on the federal nonfilers – the last comprehensive analysis was conducted based on 1988 data. **Exhibit 1** details an 1996 IRS analysis of taxpayers who were delinquent in filing a federal tax return in tax year 1993.

Exhibit 1
Delinquent Federal Income Tax Returns in Tax Year 1993
By Type of Return and Size of Tax Liability

Tax Liability	Number	Percent Total
Refund – $1,000 or more	206,600	8.1%
Refund – $500 to $1,000	186,300	7.3%
Refund – under $500	500,300	19.5%
Even	199,400	7.8%
Owe – Under $500	315,400	12.3%
Owe – $500 to $1,000	274,400	10.7%
Owe – $1,000 or more	882,100	34.4%
Total with Balance Due	1,471,900	57.4%
Total with Refund	893,200	34.8%

On balance, more filers owed money than were due a refund. Further, the largest group of nonfilers (approximately 34%) was individuals who had more than $1,000 in tax liabilities. A significant number of nonfilers, however, were due a refund but chose not to file an income tax return.

As part of a recent audit of the Revenue Administration Division (RAD), the Office of Legislative Audits requested that RAD try to identify tax year 2001 nonfilers by matching returns to W-2 and 1099R statements. The match analysis identified approximately 84,000 individuals with reported incomes of at least $20,000 who had not filed a 2001 tax return. The results included 3,096 individuals with incomes of $100,000 or greater. The withholding statements for these individuals reported aggregate gross income of $3.7 billion and Maryland tax withholdings of $193 million (approximately 5% of income). Further, the Office of Legislative Audits reviewed 15 returns with reported incomes above $100,000 for whom minimal taxes were withheld. Although these individuals collectively had reported income of approximately $1.9 million, the taxes withheld totaled $16,482 (less than 1% of income) which could indicate that additional taxes are owed.

State Revenues: The actual increase in State revenues cannot be reliably estimated and depends on the amount of increased withholding taxes imposed, increased collections from delinquent taxpayers, and the decrease in State revenues caused by an increase in taxpayers claiming refunds.

Increase in Withholding Taxes

The bill provides that individuals that have been identified by the Comptroller as not having filed required income taxes can only claim one exemption for withholding purposes. The increase in withholding taxes depends on the number individuals affected, the increase in withholding taxes per individual, and whether or not the individual files a tax return after the increased withholding taxes. To the extent that affected individuals are claiming exemptions that they are not entitled to and do not file a tax return or file a return and have unpaid tax liabilities, State revenues will increase. Increased withholding on individuals who do not have unpaid tax liabilities will increase withholding taxes in the fiscal year in which they are withheld, but can be refunded in either the same or following fiscal year if the individual files a tax return.

The Comptroller’s Office advises that once an individual satisfies an outstanding tax return obligation, the individual would be allowed to claim more than one exemption, to the extent it does not cause underpayment of estimated tax liabilities. However, the bill does not contain a provision that once an individual has filed a required tax return more than one exemption can be claimed.

Increase in Collections from Delinquent Taxpayers

The Compliance Division of the Comptroller advises that an individual who has been identified through existing programs as not having filed a required tax return will be sent notification that unless the individual resolves the matter, the Comptroller will increase withholding taxes on the individual by limiting the number of exemptions claimed. The increase in delinquent tax revenue collected depends on the number of individuals who decide to file the necessary returns in response to the notification; the outstanding tax liability, if any, of the individual, paid above and beyond what existing collection activities would have collected; and the amount of resources the Comptroller devotes to tax compliance in each fiscal year.

Reduction in Revenues Due to Increase Refund Claims

The bill's provisions could decrease the number of State tax nonfilers. As mentioned previously, a large unclaimed income tax revenue fund exists that is composed of withholdings and estimated quarterly payments from individuals and businesses that do not file taxes. If the bill increases compliance, it will decrease the amount of revenue in this fund. Not all of the decrease in the fund represents lost revenue to the State – increased filing will match more withholdings to a tax return regardless of the individual's additional tax liability at the time of filing. If a taxpayer files a return in response to receiving a notification and pays additional tax revenues there will be less unclaimed withholdings in the fund. Revenue loss to the State will only occur if the provisions of the bill increase filing by individuals who are owed a refund. Legislative Services advises that the number of increased filing by individuals owed refunds, and resulting revenue loss, as a result of the provisions of the bill cannot be reliably estimated.

State Expenditures: The Comptroller's Office advises that there would be a minimal annual cost of less than $3,000 in order to notify employers to adjust withholdings for identified nonfilers. Legislative Services advises that these costs can be absorbed within existing budgeted resources.

State distributions to local governments would increase as a result of increased local income tax collections net of the decrease caused by a decrease in distributions from the unclaimed local income tax revenue fund.

Additional Information

Prior Introductions: None.

Cross File: HB 170 (Delegate Heller, *et al.*) – Ways and Means.

Information Source(s): Comptroller's Office, Internal Revenue Service, U.S. Department of the Treasury, Department of Legislative Services (Office of Legislative Audits)

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