HB 789

Department of Legislative Services

Maryland General Assembly
2016 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 789 (Delegate Rosenberg)
Ways and Means

Tax Procedure - Assessments, Penalties, and Interest Rate on Tax Deficiencies and Refunds

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This bill alters the calculation of the annual interest rate that the Comptroller sets for tax deficiencies and refunds by setting the rate equal to the federal underpayment interest rate imposed under Section 6621 of the Internal Revenue Code (IRC). The bill also requires the Comptroller to assess specified penalties if a person is imposed a penalty by the Internal Revenue Service (IRS) under specified circumstances and requires a person who is subject to these IRS penalties to submit an information statement to the appropriate State tax agency.

The bill takes effect January 1, 2017.

Fiscal Summary

State Effect: General fund revenues decrease by $7.4 million in FY 2017 due to the decrease in interest income revenues. Transportation Trust Fund (TTF) revenues decrease by $0.1 million and Higher Education Investment Fund (HEIF) revenues decrease by $0.1 million in FY 2017. Future year estimates reflect projected interest revenues and interest rates. Potential significant increase in general fund expenditures in FY 2017 due to one-time implementation costs at the Comptroller's Office.

($ in millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
GF Revenue	($7.4)	($39.1)	($21.9)	($20.8)	($20.7)
SF Revenue	($0.2)	($1.2)	($0.6)	($0.6)	($0.6)
GF Expenditure	-	$0	$0	$0	$0
Net Effect	($7.6)	($40.3)	($22.6)	($21.4)	($21.3)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local income tax revenues decrease by $6.3 million in FY 2017 and by $8.4 million in FY 2021. Local highway user revenues decrease by $15,300 in FY 2017 and by $42,000 in FY 2021. No effect on local expenditures.

Small Business Effect: Potential meaningful. Small businesses could realize reduced interest charges to the extent they are making late tax payments.

Analysis

Bill Summary: Within 90 days after a taxpayer receives a final determination issued by the IRS, a taxpayer is required to submit to the appropriate State tax agency a statement of the amount and nature of a penalty imposed by the IRS if the IRS imposed or increased a penalty against the person.

In addition to other penalties currently assessed, the Comptroller must assess a penalty on a person if the IRS imposed a penalty on the person under Section 6662 of the IRC. The assessed penalty is equal to:

- a maximum of 4% for the portion of the underpayment of the person's federal tax liability attributable to (1) negligence or disregard of a federal rule or regulation; (2) a substantial understatement of income tax; (3) a substantial valuation misstatement under Chapter 1 of the IRC, unless the penalty described below applies; (4) a disallowance of claimed tax benefits due to a transaction lacking economic substance; or (5) an inconsistent estate basis; and
- if the IRS imposed a penalty under Section 6662(H) or (J) of the IRC, a maximum of 8% of the unpaid tax attributable to (1) one of more gross valuation misstatements or (2) an undisclosed foreign financial asset understatement.

The Comptroller must interpret and apply a penalty consistent with the analogous penalty provision under Section 6662. If a person is relieved of federal income tax liability under Section 6662, the bill specifies that there shall be a rebuttable presumption that the person is entitled to equivalent relief from the penalty imposed by the Comptroller to the extent that, for the same taxable year, the person has an understatement of moneys owed under the Tax-General Article that is attributable to the same erroneous item(s) to which the person's federal income tax liability was attributable.

Current Law:

State Tax Interest and Penalty Procedures and Requirements

If the IRS issues a final determination that increases federal taxable income, federal estate, or federal generation-skipping transfer tax on a federal return, the State assesses additional tax on income tax (Maryland taxable income), Maryland estate tax (federal credit or State death tax), Maryland generation-skipping transfer tax (federal credit), or public service company franchise tax (gross receipts) as applicable.

Within 90 days after a taxpayer receives a final determination issued by the IRS, the taxpayer is required to submit to the appropriate State tax agency a statement of the increase and, if the taxpayer is contending the increase, an explanation for the contention.

The Comptroller is generally required to assess interest from the due date of the tax to the date on which the tax is paid if a taxpayer fails to pay a tax due, fails to pay an installment when due, or pays an estimated amount that is less than certain thresholds. Except as otherwise provided by law, the Comptroller pays interest on a tax refund if certain conditions are met from the forty-fifth day after the date of the claim to the date of the refund.

By October 1 of each year, the Comptroller must set the annual interest rate for tax refunds and monies owed to the State for the next calendar year at a rate equal to the greater of 13%, or three percentage points, above the average prime rate of interest in the previous fiscal year, based on information from the Federal Reserve Bank. Interest may not be assessed on penalties.

In general, the Comptroller is required to assess a penalty not exceeding (1) 10% of the unpaid tax when a return is not filed or tax not paid (25% under the income tax or alcoholic beverages tax) or (2) 25% of the amount of tax underpaid or underestimated. The Comptroller is required to assess an additional penalty of 25% if a person does not comply with a notice and demand for a return. The Comptroller is also required to assess specified penalties if a person fails to keep certain records under specified circumstances, fails to provide an income tax withholding statement, or files a false, fraudulent, or frivolous tax return. For reasonable cause, the Comptroller may waive interest and penalties assessed against a person.

Federal Underpayment Rate

Under Section 6621(A)(2) of the IRC, the interest rate that applies to underpayments of tax and to penalties, additional tax, and erroneous refunds is the federal short-term rate, rounded to the nearest percent, plus three percentage points (the underpayment rate). This rate generally applies to all underpayments, except a higher rate is imposed for large corporate underpayments (short-term rate plus five percentage points) as specified in Section 6621(C)(3). The federal short-term rate is generally determined for the first month of each calendar quarter, and that rate goes into effect for the following calendar quarter.

Background: The IRS announced that federal interest rates for the first quarter of 2016 will remain at 3% for underpayments, and 5% for large corporate underpayments. Of the 44 states that impose an income tax, the typical interest penalty rate currently imposed is 4%. Of those states, only Oklahoma (15%) and Wisconsin (18% for delinquent payments) have higher rates than Maryland. The current interest penalty rates in surrounding jurisdictions are Delaware (6%), District of Columbia (10%), Pennsylvania (3%), Virginia (5%, adjusted quarterly), and West Virginia (9.5% for the first half of 2016).

In fiscal 2014, the Comptroller's Office collected the following amounts of interest: $34.2 million from the individual income tax and fiduciary returns; $4.3 million from the corporate income tax; $2.1 million from income tax withholding; and $2.6 million from sales tax returns. A further amount was collected from interest ($2.2 million) from pass through entities on sales tax assessments. The Comptroller's Office typically pays out less than $1.0 million in interest annually, depending on the year, for the various taxes.

State Revenues: The bill (1) alters the State interest rate for late payment of taxes and tax refunds by setting the rate equal to the federal underpayment interest rate and (2) requires the Comptroller to assess certain penalties against a person if the IRS imposed a penalty against the person under Section 6662 of the IRC.

Based on the amount of current interest collected on late taxes, interest paid on tax refunds, projected interest rates, and penalties generated by the bill, general fund revenues will decrease by $7.4 million, TTF revenues will decrease by $159,300, and HEIF revenues will decrease by $57,800 in fiscal 2017, which represent approximately one-half of the estimated annual revenue decrease for that fiscal year.

The estimated changes in interest payments shown in **Exhibit 1** are based on the difference in interest rates that would be applied by the Comptroller's Office under the bill compared to the estimated effective interest rates under current law in each tax year. The federal short-term rate is expected to increase over time, rising to around 3.5% by mid-calendar 2018. For purposes of this estimate, the average of interest payments received and paid over a six-year period (fiscal 2009 through 2014) was used to estimate future year changes due to annual fluctuations in the amount of payments received. This amount was then adjusted to account for increased tax compliance efforts instituted over the past several years. The amount of penalties generated is based on the total amount of applicable penalties imposed by the IRS by federal fiscal year, adjusted for Maryland's share of the economy and for differences in the penalty rates specified by the bill.

State Expenditures: The Comptroller is required to assess penalties against specified taxpayers who are subject to certain IRS penalties. The Comptroller's Office advises that it will incur estimated programming expenses of $500,000 in fiscal 2017 in order to capture and process the necessary information from the IRS reported on federal tax returns.

Exhibit 1
State and Local Revenue Impacts
Fiscal 2017-2021

	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
State Revenues					
Interest Rate	($9,546,800)	($44,180,400)	($26,518,900)	($25,458,100)	($25,458,100)
Penalties	1,915,300	3,959,100	3,997,700	4,074,600	4,155,200
Net Effect	**($7,631,500)**	**($40,221,300)**	**($22,521,200)**	**($21,383,500)**	**($21,302,900)**
General Fund	($7,429,800)	($39,125,300)	($21,938,900)	($20,828,300)	($20,749,100)
HEIF	(57,800)	(313,800)	(166,700)	(158,900)	(158,500)
TTF-MDOT	(144,000)	(782,200)	(415,600)	(396,200)	(395,200)
Total	**($7,631,500)**	**($40,221,300)**	**($22,521,200)**	**($21,383,500)**	**($21,302,900)**
Local Revenues					
TTF-LHUR	($15,300)	($83,100)	($44,100)	($42,100)	($42,000)
Income Tax	(6,318,600)	(10,531,000)	(8,775,800)	(8,424,800)	(8,424,800)
Total	**($6,333,900)**	**($10,614,100)**	**($8,820,000)**	**($8,466,900)**	**($8,466,800)**

HEIF = Higher Education Investment Fund
TTF = Transportation Trust Fund
MDOT = Maryland Department of Transportation
LHUR = local highway user revenues

Local Fiscal Effect: Local revenues will decrease as a result of a decrease in local highway user revenues distributed from the corporate income tax and from local income tax revenues. Local governments receive a portion of personal income tax interest penalty revenues. These distributions are made biannually, with the first distribution made in the first month of a fiscal year based on interest collections from the second half of the preceding fiscal year. The second distribution is made in January and is attributable to interest received in the first half of that fiscal year. Total local revenues will decrease by $6.3 million in fiscal 2017 and by $8.5 million in fiscal 2021, as shown in Exhibit 1.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Internal Revenue Service, Moodys.com, Department of Legislative Services

Fiscal Note History: First Reader - March 2, 2016
md/jrb

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