



Presentation to the
COMMISSION ON
MARYLAND'S FISCAL STRUCTURE

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October 10, 2002

COMPLIANCE PROPOSALS

As this Commission goes about its work of examining Maryland's tax structure, the Comptroller's Office wishes to make sure that it is aware that substantial additional revenues can be raised from the existing tax structure through more efficient collection and compliance measures. Members of the Commission may recall that the 1992 General Assembly bridged the gap between revenue needs for fiscal 1993 and beyond with politically possible tax increases and a list of collection, compliance and revenue acceleration measures. Among the measures adopted were accelerating the due date of sales tax returns, cutting the sales tax vendor discount, requiring that business tax payments of more than \$20,000 be made electronically, increasing the minimum interest rate on overdue taxes by 1%, requiring tax clearances on state contracts of more than \$100,000 and tightening the sales tax resale exemption.

There are any number of similar measures which could be considered. For today's hearing, we have selected five for discussion. They are (1) streamlining the bank attachment process; (2) requiring tax clearances on licenses issued by the Department of Labor Licencing and Regulation; (3) increasing the sales tax auditing staff; (4) accelerating quarterly withholding tax returns to the 15th of the month; and (5) lowering the threshold for tax payment through electronic funds transfer. Depending upon interest rates and other factors, these five measures alone would increase state revenues by \$21 million to \$33 million in fiscal year 2004 and by \$28 million to \$43 million in fiscal year 2005.

Issue: **Increase audit staff**

Current Law: The Comptroller's Office may employ only as many auditors as included in the State Budget.

Action Required: Increase in PINs and associated funding for the Compliance Division in the State's budget.

Analysis: The Compliance Division currently employs 35 permanent and 1½ contractual sales tax auditors, along with eight supervisory sales tax auditors who carry a small caseload. Sales tax audits are currently the most revenue-productive audits, but only 0.6% of all accounts are audited each year. Based on current results, each additional auditor added to staff would bring in about \$500,000 of general revenues annually, at a cost of about \$44,400 annually for salary and benefits, for a net increase of \$455,600.

As diminishing returns to sales tax audits are not currently apparent, every dollar spent on this activity results in a net benefit to the State. The number of new auditors who can be brought on are limited, however, by demands for training, space, and other requirements. Ten new auditors per year could be effectively absorbed by the Comptroller's Office, along with associated support, including another hearing officer and clerical staff.

A number of states have cut back on auditing and collection activities over the past two years. Eight states, however, have increased these functions substantially, including Ohio, South Carolina, Arizona, California, Delaware, Hawaii, Maine and Kansas. While South Carolina's revenue department has absorbed a 24.5 percent budget reduction over the past two years, they were allowed funds to hire more than 20 new collections and audit employees which will result in more than \$10 million in additional revenue. Kansas' legislature authorized the hiring of 75 additional auditors last year, and the Ohio tax department has just secured funding for an additional 87 auditors.

Fiscal Impact:	FY 2004	\$3.5 million
	FY 2005	\$8.1 million
	FY 2006	\$9.2 million

Issue: **Streamline bank attachment process**

Current Law: When a tax lien is issued, the Comptroller must get a court judgement for authority to attach a bank account (Tax General §13-815 *et seq.*). After hearing back from the court, the Comptroller then notifies banks of the names and amounts of the accounts to be attached by certified mail. When the banks respond as to whether or not they hold the proper account, the Comptroller must then go back to court for a condemnation (process follows Maryland Rule 2-645 *et seq.*). This process can easily take 90 days or more.

Action Required: Statutory change.

Analysis: The Comptroller proposes a model along the lines of what Massachusetts adopted in 1992, and which would also make this process similar to the process used for salary garnishments. The Comptroller would still have to go to court to file a tax lien, but would be authorized to then execute the judgement without further cause to go back to court.

The Massachusetts Commissioner of Revenue described their old process as “lengthy, painstaking, and expensive for both [the Department of Revenue] and the financial community....This case-by-case approach to collecting money could never hope to get to the assets that data suggested...were accumulating in bank accounts.” With the cooperation of the financial community, a law was enacted to require financial institutions and the Department of Revenue to electronically match their data on delinquent taxpayers and child support debtors in order to more efficiently process attachments. Massachusetts has determined that this program “is far more effective than any previous effort to levy financial institution accounts.”

Eliminating back-and-forth with the courts and allowing for group actions to execute **liens which have already been filed** will allow for much more expeditious receipt of funds (several weeks instead of several months), and would allow for many more attachments than does the current case-by-case process. Last year, under the current cumbersome process, \$4.3 million was recovered from about 4,100 attachments.

Fiscal Impact:	FY 2004	\$10 - \$15 million
	FY 2005	\$10 - \$15 million

FY 2006 \$8 - \$10 million

Issue: **Require the Department of Labor, Licensing and Regulation (DLLR) to verify State license holders' certifications of compliance with tax law**

Current Law: State license holders must certify that they are current on State taxes, but there is no action required by DLLR to verify that certification (Business Occupations and Professions, §1-204).

Action Required: Statutory change.

Analysis: Although holders of licenses issued through DLLR are required to certify that they have paid all undisputed taxes or have made satisfactory arrangements to do so, no follow-up by DLLR is required to verify the certifications, and none currently takes place. DLLR licenses a variety of occupations and professions, from accountants and architects to plumbers and bay pilots to cosmetologists and barbers. Roughly 170,000 licenses are issued by DLLR annually.

As part of the application/renewal process, DLLR could send social security numbers, central registration numbers or federal employer identification numbers of applicants to the Comptroller's Office, which would report back to DLLR those applicants who are not current on their State tax liability and have not entered into payment plans with the Comptroller. At that point, it may be appropriate to provide applicants a certain period of time to resolve their outstanding liabilities, at which time the license may be issued. If the applicant does not resolve any outstanding liabilities, DLLR would reject the application. Under current regulations, DLLR would have to hold a hearing for each rejected application; this process could be streamlined.

Such processes are currently in place with county liquor boards. Several million dollars of delinquent State taxes are remitted to the Comptroller's Office each April 30, because county liquor boards hold up alcoholic beverage license renewals for outstanding tax liabilities. Similarly, the Comptroller's Office works with the Maryland State Police in the renewal of detective licenses to resolve outstanding withholding and personal income tax liabilities.

There are a number of other professions which are licensed by the State, but which are not regulated by DLLR. Additional law changes would be required to apply the same procedure to these license holders.

The Comptroller's Office has undertaken discussions with DLLR about this issue, and response thus far has been positive. DLLR currently does not issue licenses if they are notified by the Child Support Enforcement Administration of the Department of Human Resources that an applicant is delinquent in his child support obligations.

Fiscal Impact:	FY 2004	\$5 - \$10 million
	FY 2005	\$5 - \$10 million
	FY 2006	\$2 - \$5 million

Issue: **Lower the threshold for tax payments via electronic funds transfer (EFT)**

Current Law: Any single business tax payment of \$20,000 or more must be paid via electronic funds transfer. Generally, the Comptroller cannot require payment by EFT for amounts under \$20,000 (Tax General, §13-104(a)(2)).

Action Required: Statutory change.

Analysis: Requiring more taxpayers to pay their taxes electronically would benefit the State through increased interest earnings due to quicker deposits, and through administrative savings. Increasing the number of taxpayers who pay through EFT could be accomplished by lowering the \$20,000 threshold, and also by requiring that once a taxpayer exceeds the threshold, the taxpayer is always required to pay by EFT.

Currently, about two-thirds of both sales tax and income tax withholding revenue is received electronically, as is about four-fifths of corporate income tax revenue. Assuming that the funds are deposited to the State's account an average of 2.5 days faster through EFT, the current requirement garners the State roughly \$1.4 million in interest (at 3%) from these taxes. Since an additional one-third of revenues are received non-electronically, the State stands to gain roughly \$700,000 at 3% (\$1.4 million at 6%) if those payments are received electronically. Lowering the threshold to \$10,000 would take in most of this amount; lowering it to \$5,000 would take in almost all of this amount. Additional earnings would be halved in the first year, assuming the new requirements take effect January 1.

Administrative expenses would be reduced if the threshold were lowered because the state pays 45 cents for each sales tax return and 18 cents for each withholding return received through a lockbox. At a \$10,000 threshold, the savings would total about \$25,000; at a \$5,000 threshold, the savings would be about \$75,000; and at a \$1,000 threshold, the savings would be about \$275,000. These savings would increase dramatically if taxpayers were required to pay by EFT all the time once they made an initial electronic payment. At a \$10,000 threshold, the savings would be over \$90,000; at \$5,000, the savings would be almost \$200,000, and at \$1,000, the savings would be over \$550,000.

Importantly, the Comptroller will have available free Internet filing of withholding returns beginning in February 2003, and free filing of sales tax returns in July 2003. These transactions will be cost free for both the taxpayer and the Comptroller.

Administrative savings would also be achieved through a reduction in postage and printing costs beginning in fiscal year 2004. There are roughly 130,000 sales tax accounts and 80,000 withholding accounts, so savings for printing and postage for payment books, instructions and forms could total \$100,000 or more annually, depending on the threshold. Since less than 10% accounts which are not required to pay by EFT pay between \$10,000 and \$20,000 per month, and many of them pay electronically anyway, substantial savings would not be realized unless the threshold were reduced to \$5,000 or \$1,000, which would bring in about 25% of remaining accounts and nearly all remaining accounts, respectively.

Fiscal Impact:	FY 2004	\$0.4 - \$0.9 million
	FY 2005	\$0.9 - \$2.0 million
	FY 2006	\$0.9 - \$2.0 million

Issue: **Make withholding due date the 15th of every month**

Current Law: In general, the due date for filing a withholding return is the 15th of the succeeding month. For the four months following the end of a calendar quarter, however, the due date is the 30th (Tax General, §10-822(2)).

Action Required: Statutory change.

Analysis: Due dates for withholding returns covering the last month of a calendar quarter have been the 30th of the succeeding month, rather the 15th, to coincide with the due date for quarterly federal withholding returns. Although the due date for federal returns is the 30th of the month following the end of a quarter, the due date for payment of federal withholding does not change (taxpayers with more than \$100,000 of semi-weekly or monthly liability must make a deposit within one business day of the end of a pay period; most others must pay by the Wednesday or Friday following the end of a pay period).

The State withholding return is the same every month; there seems to be no reason additional time would be required once a quarter. Changing the withholding due date to the 15th of each month will result in about fifteen days of interest earnings on about 40% of about \$8 billion of withholding, or about \$4 million annually at 3% (\$8 million annually at 6%).

Fiscal Impact:	FY 2004	\$2 - \$4 million
	FY 2005	\$4 - \$8 million
	FY 2006	\$4 - \$8 million

Letter on Streamlined Sales Tax Project from Comptroller William Donald Schaefer to Governor Parris N. Glendening, President Thomas V. Mike Miller, and Speaker Casper R. Taylor, Jr., dated September 16, 2002.

The Delaware Holding Company Issue

The staff of this Commission has requested a report on the status of the “Delaware Holding Company” corporate income tax issue now pending before the Court of Appeals in three cases argued in early January of 2001.

By way of background, Maryland is one of just 11 corporate income tax states which is a “separate entity” state. This means that Maryland’s corporate income tax is calculated on the separate income of each corporation doing business in Maryland, including each separate subsidiary of a commonly-controlled enterprise. In contrast, the majority of states require combined reporting by related entities.

Separate entity reporting in commonly-controlled enterprises provides endless opportunities for what is euphemistically characterized as “tax planning.” The tax planning activities at issue in the three cases now pending before the Court of Appeals arise because several state corporate income tax statutes, including in particular those of Delaware and Nevada, do not tax income from intangibles such as trademarks, patents, copyrights and royalties. All that is required to create the illusion of no taxable income is to establish a subsidiary in Delaware, transfer intangibles to it as a contribution of capital and make a charge for the use of the intangibles which is sufficiently high to leave little or no income available for taxation in Maryland. Any cash paid is returned, sooner or later, as a non-taxable dividend, loan or contribution of capital.

The Comptroller’s Office has challenged these transactions on two fronts: by contending that the deductions claimed by the parent companies are a sham and by contending that the Delaware holding companies are doing business in Maryland by virtue of the admitted presence, in Maryland, of the parent company and its unitary relationship with the Delaware holding company subsidiary and the uses of the intangibles in Maryland. In the three cases now pending before the Court of Appeals, involving MCI, Crown, Cork & Seal and Syms, the taxpayers prevailed at both the Maryland Tax Court and circuit court levels. There are 18 other cases and related subsidiary cases held in the Maryland Tax Court pending the outcome of the cases now before the Court of Appeals. A list of all the cases in court is attached. In addition, the Comptroller’s Office is holding another 20 cases and related subsidiary cases in its Hearings and Appeals Section.

At this point, we cannot predict the outcome of the cases now pending before the Court of Appeals. An outright win by the taxpayers can only result in a significant reduction in present revenues as taxpayers who have held back from utilizing this tax minimization scheme will be virtually compelled to implement it. A fact based decision, one which turns upon the extent to which taxpayers are able to give the appearance of substance to their Delaware holding companies, would result in a few windfall

assessment case recoveries in the short-term, but no real difference in the long-term results.

The issue is beginning to attract some national attention. We have attached for your information a reprint of an article from the August 9, 2002 issue of The Wall Street Journal, entitled, "A Tax Maneuver in Delaware Puts Squeeze on Other States."

As a result of Delaware Holding Company and other aggressive tax planning efforts on the part of corporations, the share of total state taxes contributed by the corporate income tax has dropped dramatically over the last 20 years. A report by Michael Mazerov, Senior Policy Analyst of the Center on Budget and Policy Priorities reported to the Revenue Estimation/Tax Policy Conference of the Federation of Tax Administrators on September 30th indicated that over the period 1979 through 2000, the nationwide share had dropped by 27.7% and the Maryland share had dropped by 24.3%. In 1980, Maryland's corporate income tax was 13% of personal income tax receipts; by 2002, it had dropped to 7.6% of personal income tax receipts, despite a significant personal income tax cut and the transfer of the gross receipts taxes on financial institutions and utilities to the corporate income tax.

As Paul Frankel, counsel for many of the Delaware holding company taxpayers, points out in the attached article from the Wall Street Journal, states that don't like the results of the Delaware holding company cases can fix the problem by providing for reporting on a combined basis. What he doesn't say is that his clients will fiercely resist any such change. A more limited approach, one recently enacted by the New Jersey legislature, would be to deny the deductibility of payments for intangibles to related corporations. This latter approach has the advantage of being easily understood as loophole closing but the decided drawback of simply treating one symptom of a much larger problem.

The Comptroller's Office will keep the Commission advised of the impact of any action by the Court of Appeals on the cases now before it.

Summary of Holding Company Cases in Court as of September 23, 2002

“A Tax Maneuver in Delaware Puts Squeeze on Other States,” *Wall Street Journal*,
August 9, 2002