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## FISCAL IMPACT REPORT

ORIGINAL DATE 1-27-2006

SPONSOR Arnold-Jones LAST UPDATED 2-3-2006 HB 390

SHORT TITLE Increase Penalty for Failure to Pay Taxes SB \_\_\_\_\_

ANALYST Dearing

### REVENUE (dollars in thousands)

	Estimated Revenue		Subsequent Years Impact*	Recurring or Non-Recurring	Fund Affected
	FY 2007	FY 2008			
<b>Provision:</b>					
Lower interest rates	(3,970)	(4,030)	(6,100)	Recurring	General Fund
Increase penalties	3,370	3,540	4,000	Recurring	General Fund
<b>Net</b>	<b>(600)</b>	<b>(490)</b>	<b>(2,100)</b>	<b>Recurring</b>	<b>General Fund</b>
Lower interest rates	(1,450)	(1,480)	(2,200)	Recurring	Local Governments
Increase penalties	1,240	1,300	1,460	Recurring	Local Governments
<b>Net</b>	<b>(210)</b>	<b>(180)</b>	<b>(740)</b>	<b>Recurring</b>	<b>Local Governments</b>

(Parenthesis ( ) Indicate Expenditure Decrease)

#### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Administrative Office of the Courts (AOC)

Taxation and Revenue Department (TRD)

#### SUMMARY

##### Synopsis of Bill

House Bill 390 amends Section 7-1-13.1 NMSA 1978 such that:

Two sets of changes are proposed to the penalty and interest provisions in the Tax Administration Act:

- 1) Current rate of 15% interest paid on unpaid tax penalties (underpayments) and taxpayer overpayments is amended to follow federal guidelines in setting the punitive and overpayment rate found in Section 6621 of the Internal Revenue Service code, which is determined using the federal funds rate as a base-formula,
- 2) Maximum penalty for failure to pay tax or to file a return due to negligence or disregard of Department rules or regulations would be increased from 10 percent to 16 percent of the tax due. As under present law, penalty is imposed at a rate of 2 percent per month up to the maximum.

3) Minor editorial changes within the NMSA 1978

The effective date of the provisions of this act begin July 1, 2006.

**FISCAL IMPLICATIONS**

Under current law, the penalty imposed on outstanding tax amounts is calculated at 15% of the amount outstanding. Enactment of this legislation has the effect of adopting the federal method of calculation of this rate, as described in Section 6621 of the Internal Revenue Service (IRS) code, “Interest Rates; Underpayments and Overpayments.” Enactment of the federal method for calculation of the punitive rate establishes the federal short-term interest rate (“Federal Funds” rate as determined in the first month of each quarter, rounded to the nearest full percentage point) as the base from which to calculate the interest rate applied to outstanding underpayments and overpayments of both personal as well as corporate income taxes.

FY 2005 interest collections were approximately \$16 million, while interest payments were \$2.5 million. Thus, the provision which results in a *current\** lowering of interest rates is a net revenue loser. Fiscal impacts of the interest rate changes increase over time because a substantial part of the obligation is incurred on liabilities that have been owed for several years. Impacts level out by FY 2010 at the levels shown under “Subsequent Years Impact.”

FY 2005 penalty collections were \$6.75 million, 95 percent of which was due to payments at the maximum rate of 10 percent. The increase to 16 percent is estimated to represent a proportional increase in that portion of total penalties.

Approximately 25 percent of all interest and penalty obligations accrue to Local Governments due to their share of revenues like the gross receipts tax, compensating tax, etc.

*current\*, the rate would currently be lowered, however, as the fed funds base rate is variable, there is the potential that in subsequent periods, dependent on prevailing interest rates, this component of this enactment could result in a higher penalty rate. The current rate applied to these underpayments and overpayments by the Taxation and Revenue Department is 15%. Because the Fed Funds rate varies quarterly and is set (targeted) by the Federal Open Market Committee and so changes with the economic condition and activity of financial markets. Accordingly, the fiscal impact of enactment of this legislation could vary with the Fed Funds rate. In general, though, the revenue impact would be negatively impacted as the average Fed Funds rate has been historically lower than 12% (i.e., 12%+3% vs. current 15%). In general, over last fifty years, the Fed funds rate has been as low as 1.13% (2003)\* and as high as 16.29% (1981).<sup>1</sup>*

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<sup>1</sup> Please see attachments, Short-Term Federal Funds Rate by Year; and Section 6621 of IRS code.

Accordingly, the following rates are established in Section 6621 of the IRS code under various circumstances.

*Overpayments:*

<u>Corporate Overpayment</u>	<u>Fed Funds + 2%</u>
Portion of Corp. Overpayment in excess of \$10,000	Fed Funds +.5%
<u>Personal Overpayment</u>	<u>Fed Funds + 3%</u>
Corporate Overpayments for “large” (in excess of \$10,000) over <u>in the quarter beginning 1, April</u>	<u>Fed Funds+2.5%</u>

*Underpayments:*

<u>Corporate Underpayments</u>	<u>Fed Funds + 3%</u>
Corp. Underpayments de- termined to be “large” under- payments as established in Personal Underpayment	Fed Funds + 3%
<u>Section 6601 of IRS code</u>	<u>Fed Funds + 5%</u>
Corporate Underpayments for “large” underpayments <u>in the quarter beginning 1, April</u>	<u>Fed Funds + 7%</u>

Accordingly, the current rate applied to these underpayments and overpayments by the Taxation and Revenue Department is 15%. Because the Fed Funds rate varies quarterly and is set (targeted) by the Federal Open Market Committee and changes with the economic condition and activity of financial markets. In general, over last fifty years, the Fed funds rate has been as low as 1.13% (2003)\* and as high as 16.29% (1981).<sup>2</sup>

**SIGNIFICANT ISSUES**

1) Internal Revenue Bulletin: 2004-11, dated March 15, 2004 provides that

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under section 6621(a)(1), the overpayment rate beginning April 1, 2004, is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Taxpayers have argued with the Department for several years that the 15 percent rate of interest imposed on their under payments is too high compared with prevailing market interest rates. The U.S. Government has responded to this problem by adjusting its interest rate regularly to more closely reflect market rates. This bill would bring the State into conformity with that policy.

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<sup>2</sup> Please see attachments, Short-Term Federal Funds Rate by Year; and Section 6621 of IRS code.

## **PERFORMANCE IMPLICATIONS**

The courts are participating in performance-based budgeting. As a result of challenges to the law and its provisions, this bill may have an impact on the measures of the district courts in the following areas:

- Cases disposed of as a percent of cases filed
- Percent change in case filings by case type
- Clearance rate

## **ADMINISTRATIVE IMPLICATIONS**

Changing the interest rate on under- and over-payments to the rate established by the IRS will require systems changes and will complicate the manual calculation of interest. The IRS interest can change quarterly, the interest calculation tool and information systems will have to be able to keep track of the effective interest rates for each period during the life of a liability and compute the interest due. The bill will require changes to all instructions, publications and forms to reflect the changes in the interest rates and penalty. If the interest and penalty are changed effective July 1, 2006, then the instructions for the annual PIT, CIT, FID and PTE returns will be incorrect for the last half of 2006, affecting late filers and extension filers.

## **CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP**

Duplicates SB 318; Conflicts with HB 383 and 384, and SB 319 and 321.

## **WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL**

Status quo.

**Attachment # 1, IRS rules for Calculating Delinquent Tax Penalty Rate**

[http://www.irs.gov/irb/2004-11\\_IRB/ar11.html](http://www.irs.gov/irb/2004-11_IRB/ar11.html)

**Interest rates; underpayments and overpayments.** The rate of interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 2004, will be 5 percent for overpayments (4 percent in the case of a corporation), 5 percent for underpayments, and 7 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 2.5 percent.

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under section 6621(a)(1), the overpayment rate beginning April 1, 2004, is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under section 6601 on any large corporate underpayment, the underpayment rate under section 6621(a)(2) is determined by substituting “5 percentage points” for “3 percentage points.” See section 6621(c) and section 301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and section 301.6621-3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter. Section 6621(b)(2)(A) provides that the federal short-term rate determined under section 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following such taxable year also applies during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1 percent, the rate is increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding. Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of January 2004 is 2 percent. Accordingly, an overpayment rate of 5 percent (4 percent in the case of a corporation) and an underpayment rate of 5 percent are established for the calendar quarter beginning April 1, 2004. The overpayment rate for the portion of a corporate overpayment exceeding \$10,000 for the calendar quarter beginning April 1, 2004, is 2.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning April 1, 2004, is 7 percent. These rates apply to amounts bearing interest during that calendar quarter.

Under section 6621(b)(2)(B), the 4 percent rate that applies to estimated tax underpayments for the first calendar quarter in 2004, as provided in Rev. Rul. 2003-126, 2003-52 I.R.B. 1249, also applies to such underpayments for the first 15 days in April 2004.

**House Bill 390 – Page 6**

Interest factors for daily compound interest for annual rates of 2.5 percent, 4 percent, 5 percent, and 7 percent are published in Tables 58, 61, 63, and 67 of Rev. Proc. 95-17, 1995-1 C.B. 556, 612, 615, 617, and 621.

Annual interest rates to be compounded daily pursuant to section 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

Attachment #2

[http://www.federalreserve.gov/releases/h15/data/Annual\\_Dec./H15\\_FF\\_O.txt](http://www.federalreserve.gov/releases/h15/data/Annual_Dec./H15_FF_O.txt)

DATE	FFO
1955	1.79
1956	2.73
1957	3.11
1958	1.57
1959	3.31
1960	3.21
1961	1.95
1962	2.71
1963	3.18
1964	3.5
1965	4.07
1966	5.11
1967	4.22
1968	5.66
1969	8.21
1970	7.17
1971	4.67
1972	4.44
1973	8.74
1974	10.51
1975	5.82
1976	5.05
1977	5.54
1978	7.94
1979	11.2
1980	13.35
1981	16.39
1982	12.24
1983	9.09
1984	10.23
1985	8.1
1986	6.8
1987	6.66
1988	7.57
1989	9.21
1990	8.1
1991	5.69
1992	3.52
1993	3.02
1994	4.21
1995	5.83
1996	5.3
1997	5.46
1998	5.35
1999	4.97
2000	6.24
2001	3.88
2002	1.67
2003	1.13
2004	1.35
2005	3.22

