COMPTROLLER of MARYLAND
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January 2, 2014

Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis MD 21401

Honorable Thomas V. "Mike" Miller, Jr.
President, Senate of Maryland
State House
Annapolis MD 21401

Honorable Michael E. Busch
Speaker, Maryland House of Delegates
State House
Annapolis MD 21401

Dear Governor, President and Speaker:

As required by Chapter 425 of the General Assembly of Maryland's 2013 legislative session, the Office of the Comptroller submits this report. The law requires that the Office of the Comptroller report specific findings and any recommendations to the Governor and the General Assembly concerning:

- the impacts of recent changes to the Local Reserve Account established to comply with §2-606 of the Tax – General Article, including the process by which revenue is distributed from the Account and the current and future unfunded liabilities for the Account; and

- the impacts of altering interest paid on tax deficiencies and refunds imposed under §13-603 and §13-604 of the Tax – General Article.

The enclosed report presents the conclusions drawn from the aforementioned analysis.

I hope this information is useful to you. If you have any questions or concerns, please do not hesitate to contact my office.

Sincerely,

Andrew M. Schaufele

Executive Summary

As required by Chapter 425 of the General Assembly of Maryland's 2013 legislative session, the Office of the Comptroller has studied the implications of recent changes to the Local Reserve Account, including the process by which revenue is distributed from the account and any current and future unfunded liabilities, as well as the effect of altering the interest rate paid on tax deficiencies and refunds. In light of this study, the Office of the Comptroller submits the following general findings and recommendations:

- administrative determinations concerning the implementation of judicial changes can significantly affect both the revenue implications and the degree to which different stakeholders are impacted. In the event of court decisions which significantly alter tax liability, the General Assembly of Maryland is best suited to determine how to properly administer the change;

- when received, revenue from income tax payments become a liability to the State to the extent that the payment represents a local income tax liability; however, this revenue may not be due to the local governments for up to four years after receipt of the payment;

- recent legislative actions affecting the Local Reserve Account have created unfunded liabilities within the State's balance sheets;

- assuming future tax deficiencies and refunds remain consistent with prior years, for every one percentage point decrease in the interest rate on refunds and tax deficiencies, total net State and local income tax revenues will decrease by approximately $10.6 million per fiscal year;

- barring any additional extraneous alterations to the Local Reserve Account or the State discontinuing the collection of local income tax revenues, the diminished cash within the Local Reserve Account does not pose a significant threat to the State's ability to fund its outstanding liabilities;

- if the resolution of court cases significantly increases the amount owed in refunds from prior tax years, the Local Reserve Account may not have sufficient cash reserves to pay out these refunds until the associated revenue is pulled back from the local governments; and

- if the economy experiences a significant contraction, funds may need to be allocated to the Local Reserve Account in order to meet the State's local income tax obligations.

The remainder of this report provides additional analytical details on the findings listed above, as well as background information on the Local Reserve Account – including the amount reserved in the fund as well as how the money is distributed out of the fund, unfunded liabilities, and the interest paid on tax deficiencies and refunds. Readers who are interested in the technical details of the following report are encouraged to review the Appendix.

Overview of the Local Reserve Account

Each county and Baltimore City is required by State law to levy an income tax on individuals residing within their boundaries on the last day of the taxable year. The State collects the local income tax and ultimately distributes the amount, less an administrative fee, to the taxpayer's local government of residence. When received, local income tax revenue becomes a liability to the State, as either tax revenue owed to the local government or a refund of local income tax owed to the taxpayer. The State maintains the Local Reserve Account, within which is reserved cash to offset the estimated amount of outstanding local income tax liability.

The State receives income tax payments over the course of the year through withholding and estimated payments. Absent from the withholding and estimated payments is information on the actual year-end liability of the taxpayer or the jurisdiction in which the taxpayer resides. As a result, the State is unable to determine if the taxpayer overpaid their liabilities, and will receive a refund on their payments, or underpaid their liabilities, and will owe additional money, and is also unable to determine to which local government the revenues are due. This information will not be known until a final return is received from the taxpayer, after which the payment is referred to as "allocated"; however, according to law, the State must distribute a significant portion of the amount owed to the local governments before the payments are allocated through the reception of an income tax return.

Generally, the filing date for a final return related to these payments is April 15 of the calendar year following the tax year when the income tax liability was accrued. If the taxpayer files for an extension, they are not required to file a final return until October 15 of the calendar year following the tax year. Taxpayers may file an original or amended return related to these payments within three years from the date the original return was due and still be within the statute of limitations. Therefore, the "final" return may not be received by the State for up to four years after payment is received. As a result of the time-lag between receipt of payment and the final return, the State will not know the true liability on local income tax collections until almost four years after the payment is received.

Overview of Local Income Tax Distributions

For purposes of this report, the collections of local income tax revenue will be separated into three categories; collections which will be:

1. allocated to a final return by the final filing date of the year (October 15);
2. allocated to a final return after the final filing date but before the statute of limitations expires; and
3. unallocated after the passage of the statute of limitations.

As required by the Annotated Code of Maryland, the State does not distribute the collections which it estimates will fall in category two until allocation. These revenues remain a liability to the State until allocation, which may not occur for up to four years. Collections estimated to fall in categories one and three are distributed prior to allocation. When these distributions are made, the State's estimated liability to the local government is decreased by the corresponding amount.

The Office of the Comptroller is tasked with estimating the amount of yearly collections attributable to each category as the calculations are largely not codified. As the revenue must be distributed before data on the current year is available, each percentage calculation is formed using data from prior tax returns. As a result, if the amount owed in State or local income tax is not consistent with prior years, potentially through alterations such as legislative actions or court decisions, the ability of the Office of the Comptroller to accurately estimate the amount owed to the local governments may be diminished.

Ultimately, the amount of income tax revenue that is due to each local government is the amount of income tax revenue received from its residents, rather than the amount the Office of the Comptroller distributes in advanced payments. The local governments are liable to the State for any amount overpaid through the accelerated distributions. Furthermore, if penalty or interest is received for local tax liabilities, the amount is distributed to the local government. The difference between the estimated and actual amount owed to the local governments is reconciled through subsequent distributions.

Recent Law Changes which Impacted the Local Reserve Account

Historically, the Local Reserve Account has had a positive fund balance, consisting of assets to offset any outstanding liabilities. Some of these assets – e.g. the assets required for category two revenues – may sit in the Local Reserve Account for up to four years. Over the past ten years, multiple bills have been signed into law targeting these idle moneys. In total, transfers and advanced distributions to the local governments have resulted in a reduction of approximately $1.4 billion of cash in the Local Reserve Account relative to the absence of these legislative actions. The cash in the account at the end of November 2013 was $10.7 million. The cash in the reserve in the same month of 2008**,** prior to the majority of the aforementioned cash-reducing legislative activities, was $1.3 billion. Transfers to the General Fund which have not been repaid total $932.2 million, although annual payments from the General Fund to the Local Reserve Account of $33.3 million are scheduled for fiscal years 2021 through 2026, totaling $200.0 million.

At the same time, other legislative actions have increased the variance of the percent of total income tax collections due to the local governments and the timing of income tax payments from year to year, complicating the accurate estimation of the revenue due to the local governments prior to allocation. Two of the most significant changes were the alteration of the local income tax from a piggyback tax – where the income tax owed to the local governments was a straight percent of the amount owed to the State government – to a percent of State net taxable income, and the introduction of much more graduated State income tax brackets. Following this change, any reform to the State income tax in a given year alters the share of total income tax collections which are due to the local governments. Given that the Office of the Comptroller uses prior tax year information to estimate the local income tax liability accrued from total income tax collections, there may now be more non-economic variation in the distribution of local income tax revenue to the local governments, especially following State income tax reform.

As the local income tax revenues have been ongoing, and the State reserves funds to finance unpaid liabilities from past tax years, the State has been able to meet its current financial obligations using money that would have otherwise remained, in some cases for up to four years, in the Local Reserve Account. Therefore, barring any extraneous alterations, such as any further cash balance adjustments, the

State cancelling its duties as a fiduciary collection agent for the local governments, or a sharp economic contraction, the current diminished cash balance in the Local Reserve Account does not pose a significant threat to the State's ability to pay its liabilities on local income tax collections. However, according to Generally Accepted Accounting Principles, this activity has created unfunded liabilities in the General Fund.

Current and Future Unfunded Liabilities for the Local Reserve Account

The transfers of revenue from the Local Reserve Account to the General Fund correlate to an unfunded liability of $932.2 million. This unfunded liability will exist until an equivalent amount is allocated to the Local Reserve Account. Four transfers of revenue from the Local Reserve Account to the General Fund have been enacted through recent legislative action. The legislation which instituted $916.8 million of the fund transfers included repayment provisions for the full amount in future years; however, two repayment provisions, totaling $716.8 million, were cancelled through subsequent activity of Maryland's General Assembly. The repayment of $200.0 million is still codified in law, through annual installments of $33.3 million from fiscal year 2021 to fiscal year 2026.

Additionally, the amount of General Fund revenue that is required above the amount budgeted is an unfunded liability. As a result, to the extent that other legislative changes complicate the accurate estimation of local income tax liability, any deficiencies will exist as an unfunded liability if additional funds are not budgeted to the Local Reserve Account. However, any attempt at quantifying the unfunded liability resulting from these changes currently or in the future would implicitly include a substantial variance. Furthermore, the Office of the Comptroller is unable to forecast the future unfunded liabilities, as these liabilities depend on future activity, such as the resolution of court cases which increase the amount of revenue dedicated to interest payments on tax refunds.

Impact of Altering Interest Rates on Refunds and Tax Deficiencies

Historically, the amount received for interest payments from taxpayers has far exceeded the amount owed by the State; however, the amount owed on refunds can vary depending on events in a year, such as verdicts of court cases. The estimates below assume past data to forecast the effect of altering the interest rate on tax deficiencies and refunds. If the disposition of refunds and tax deficiencies in future years differs from prior years, these forecasts may need to be revisited.

The interest rate for tax deficiencies and refunds accrued in calendar year 2014 has been set at 13%. The annual rate for interest on tax deficiencies has been 13% since 1994, while the interest rate on refunds has been 13% since 2007, when the interest rates on tax deficiencies and refunds were made equivalent. This is the interest rate applied to personal, withholding, corporate, fiduciary, death (estate and inheritance), and sales and use tax collections.

According to current law, any refunds that are awarded for claims in prior years accrue interest at the rate set for that calendar year. As a result, barring action by the General Assembly, the 13% annual interest rate will apply to any refund claims that are awarded for calendar years 2013 or 2014 for claims filed since 2007. If the law is changed to alter the interest rate for prior years, it is not known what effect this will have on interest payments already awarded or received by the State, upon which a 13% interest was applied.

The table, below, provides the payments received for interest on State and local tax deficiencies over the past five fiscal years, separated by type of tax collections:

Interest Received for Tax Deficiencies

Fiscal Year	Personal	Withholding	Fiduciary	Corporate	Sales and Use	Death Taxes	Total
	Tax Type						
2009	78,370,199	7,115,599	631,456	28,787,204	9,629,694	1,808,275	**126,342,427**
2010	86,052,822	5,730,954	310,494	39,482,517	10,231,946	1,051,988	**142,860,721**
2011	89,786,238	6,006,639	220,778	28,205,861	9,300,555	1,329,265	**134,849,336**
2012	109,369,733	6,154,435	453,428	30,025,997	11,785,631	745,831	**158,535,055**
2013	113,387,505	6,194,068	437,385	31,699,730	7,579,571	920,286	**160,218,545**

The table, below, depicts the payments by the State for interest on State and local tax refunds over the past five fiscal years:

Interest Paid on Refunds

Fiscal Year	Total *
2009	**466,698**
2010	**673,408**
2011	**177,977**
2012	**225,958**
2013	**70,532**

**Information on interest paid on refunds by tax type is not readily available.*

It is estimated that for every 1 percentage point reduction in the interest rate – assuming the change is for all future calendar years beginning in calendar year 2014 – net State income tax revenues would decrease approximately $8.0 million and local income tax collections would decrease by approximately $2.6 million per fiscal year. This reduction would phase in, as a greater percent of the total interest would be on returns filed in calendar years with the lower applicable interest rate. The interest received for local income tax obligations for the second half of fiscal year 2015 would be distributed to the counties on July, 2015. Thus, altering the interest rate for calendar year 2015 and forward would not affect local income tax revenues until fiscal year 2016. This is exhibited in the table, below:

Reduce Interest to 12% Beginning in Calendar Year 2015 ($ Millions)

	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19
State	-	(2.0)	(5.0)	(8.0)	(8.0)	(8.0)
Local	-	-	(1.3)	(2.0)	(2.6)	(2.6)
Total	**-**	**(2.0)**	**(6.3)**	**(10.0)**	**(10.6)**	**(10.6)**

Decreasing the interest rate by 1 percentage point only in calendar year 2015 would result in the estimated revenue impact displayed in the table, below:

Reduce Interest to 12% Only in Calendar Year 2015 ($ Millions)						
	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19
State	-	(2.0)	(2.0)	-	-	-
Local	-	-	(1.3)	-	-	-
Total	**-**	**(2.0)**	**(3.3)**	**-**	**-**	**-**

Conclusion

A variety of legislative changes over the past ten years have significantly diminished the cash reserved within the Local Reserve Account. While current administrative practices most likely could be continued with no risk of the fund running short of cash at fiscal year-end, there is a risk that the fund could fall short during the year, most likely for the November or February distributions, as evidenced by the $10.7 million balance at the end of November 2013. Should there be a substantial change in current practices, particularly changes that reduce taxpayer liabilities for past periods, the Local Reserve Account may not have enough cash to finance the increased refunds for taxpayers until revenues are recovered from local governments (most likely through offsetting against current period distributions). This is likely the case even if the interest rate on tax deficiencies and refunds is altered.

Appendix

- Section 10-106 of the Tax – General Article requires that each county and Baltimore City levy an income tax on individuals residing within their boundaries on the last day of the taxable year.

- Section 10-902 of the Tax – General Article generally requires that each individual, partnership, or corporation required to file quarterly estimated income tax returns pay:

    1. at least 25% of the estimated income tax shown on the declaration or amended declaration for a taxable year:

        i. with the declaration or amended declaration that covers that year; and

        ii. with each quarterly return for that year; and

    2. any unpaid income tax for the year shown on the income tax return that covers that year, with the return.

- Section 10-820 of the Tax – General Article generally requires an individual required to file a declaration of estimated income tax for a taxable year to complete and file with the Comptroller:

    1. an initial declaration on or before April 15 of that year; and

    2. a quarterly estimated income tax return on or before June 15, September 15, and January 15 after the filing of the initial declaration.

- Section 10-906 of the Tax – General Article generally requires that each employer or payor shall:

    1. withhold the income tax required from their employee; and

    2. pay to the Comptroller the income tax withheld for a period with the withholding return that covers that period

- Section 10-822 of the Tax – General Article requires an entity required to withhold income tax to complete and file with the Comptroller a withholding tax return annually, quarterly, monthly or within 3 business days after the pay-period. The frequency with which the entity is required to file the withholding tax return increases with the amount reasonably expected to be withheld over the specified period.

- Section 10-820 of the Tax – General Article requires an individual or partnership required to file a return for a taxable year to complete and file with the Comptroller an income tax return:

    1. on or before April 15th of the next taxable year; or

    2. if the income tax is computed for a fiscal year, on or before the 15th day of the 4th month after the end of that year.

- Section 10-823 of the Tax – General Article allows the Comptroller to extend the time to file an income tax return for up to 6 months for an individual or, if an individual is out of the United States, for up to 1 year.

- As required through Section 2-606 of the Tax – General Article, for a given tax year's collections, the amount that the State holds in reserve until allocation to a return is the amount of estimated and withholding payments which the Office of the Comptroller estimates will remain unallocated by the final filing date of the year (October 15) but which will become allocated before the statute of limitations for filing expires, plus the estimated amount owed in refunds for returns that will be allocated before the final filing date of the year.

- As required by Section 2-610 of the Tax – General Article, the State distributes the amount of withholding and estimated payments the Office of the Comptroller estimates will be claimed on a final return by October 15 (category 1). Five periodic payments are to be made:

    1. for the 1st 3 quarters of the State's fiscal year, as often as practicable but at least each quarter; and

    2. for the 4th quarter of that year:

        i. before the last quarter of that year for the months of April and May; and

        ii. before August 31, for the month of June.

- The steps which are employed by the Office of the Comptroller in making the five periodic distributions (category 1) are:

    1. estimate the percent of the receipts which will be attributable to each local government – adjusting for local tax rate changes;

    2. estimate the percent of the receipts which will not be refunded to taxpayers;

    3. deduct a certain amount for administrative costs; and

    4. distribute this amount to the local governments.

- As required by Section 2-606 of the Tax – General Article, the amount which is estimated will remain unallocated after the expiration of the statute of limitations is to be distributed to the local governments in June of each year. The State is to reconcile the amount three years later.

- The steps which are employed by the Office of the Comptroller to make the June distribution (category three) are:

    1. estimate the amount of withholding and estimated payments which will remain unallocated after the statute of limitations for filing a final return expires; and

    2. distribute an estimated percent – irrespective of local tax rate changes – of this amount to each local government.

- While the timing of these payments is codified in law, the only calculation which is codified is the formula used to estimate the amount of unallocated revenues to distribute to each local government (step 2 of the category three). The Office of the Comptroller is tasked with formulating the calculations which are not codified.

- Local tax rate changes are the only adjustment accounted for in the current year distribution calculation, and this adjustment is exclusively performed on the expedited distribution of withholding and estimated payments – Section 2-606 of the Tax – General Article directs the Office of the Comptroller on how to apportion the pool of unallocated revenues to the local governments through the June distribution and excludes adjustment for law changes.

- For a given tax year, five reconciliation distributions are made to the local governments, in:

    1. June of the calendar year following the tax year;
    2. August of the calendar year following the tax year;
    3. September of the calendar year following the tax year;
    4. November of the calendar year following the tax year; and
    5. January, two calendar years following the tax year.

- Interest and penalty received on all prior tax year payments is distributed to the local governments two times a calendar year, in:

    1. January for the first half of the current fiscal year; and
    2. July for the second half of the prior fiscal year.

- Disparity Grants included in the budget bill of Maryland's General Assembly are distributed to the local governments on a quarterly basis, in September, December, March, and June for the respective fiscal year.

- Delinquent payments– i.e., revenue which is attributed to tax years for which the final reconciliation distribution has been performed – is distributed to the local governments two times a calendar year, in:

    1. March for the first half of the current fiscal year; and
    2. October for the second half of the prior fiscal year.

- Revenue from the tax activity of fiduciaries is distributed to the local governments two times a year, in:

    1. March for the first half of the current fiscal year; and
    2. October for the second half of the prior fiscal year.

- Chapter 493 of the 1999 legislative session altered the local income tax from a piggyback tax – where the income tax owed to the local governments was a straight percent of the amount owed to the State government – to a percent of State net taxable income. Following this legislative change, the liability-to-collection proportion has exhibited greater variation from year-to-year, with the most pronounced variation typically following State income tax reform.

- Chapter 3 of the first legislative special session of 2007 and Chapter 10 of the legislative session of 2008 altered the income tax rates and personal exemption amounts, beginning in tax year 2008. Additionally, in tax year 2011, the millionaire's bracket, initially instituted through Chapter 10 of the legislative session of 2008, expired. Most recently, through Chapter 2 of the first legislative special session of 2012, the tax rates and exemptions were altered again, beginning in tax year 2012.

- Chapter 430 of the legislative session of 2004 expedited the payment of unallocated revenues (category three) to the local governments. Prior to this chapter's inclusion in Maryland law, revenue estimated to be attributable to both categories two and three was held in the Local Reserve Account until allocation or the expiration of the statute of limitations. Any remaining unallocated revenue would then be apportioned and distributed to the local governments. Chapter 430 required that the Office of the Comptroller estimate the amount of revenue attributable to category three, distribute this revenue to the local governments each June, then reconcile the amount three years later – after the statute of limitations expired. This law change effectively lowered the amount of cash in the Local Reserve Account, while increasing the volatility in the reconciliation payments.

- Chapter 487 of the legislative session of 2009 transferred $366.8 million from the Local Reserve Account to the General Fund. The legislation included a repayment provision of $36.7 million annually beginning in fiscal year 2013 through diminished distributions to the local governments. This repayment provision was subsequently removed from law through Chapter 1 of the first legislative special session of 2012.

- Chapter 484 of the legislative session of 2010 included two transfers from the Local Reserve Account, one of $350.0 million to the Education Trust Fund and another of $200.0 million to the General Fund to be used to fund the Maryland Medicaid Program. Repayment provisions were included for both transfers, $50.0 million annually to be repaid by the State from fiscal year 2014 until fiscal year 2021 and $33.3 million annually from fiscal year 2021 to 2026, respectively. The repayment provision for the $350.0 million transfer was subsequently removed form law through Chapter 425 of the legislative session of 2013. The repayment provision for the $200.0 million remains codified in law.

- Chapter 425 of the legislative session of 2013 transferred $15.4 million from the Local Reserve Account to a special fund in the Department of Transportation for the purpose of providing transportation grants to municipalities. There was no repayment provision for this transfer.

- While all the transfers out of the Local Reserve Account currently qualify as unfunded liabilities to the State, there are some noteworthy accounting differences between the transfers. As earlier stated, the transfer of $366.8 million through Chapter 487 of the legislative session of 2009 differed from the $350.0 million and $200.0 million transfers of Chapter 484 of the legislative session of 2010, as the transfers were to be repaid by decreased distributions to the local governments and from General Fund revenues, respectively. As the $366.8 million was due to be repaid by the local governments, the transfer did not become an unfunded liability of the General Fund until the repayment provision was cancelled. At that point, the General Fund had an unfunded liability of $366.8 million for the revenue decrease. This is different from the other two transfers of $350.0 million and $200.0 million which, as they contained repayment provisions from the General Fund, created an unfunded liability in the General Fund for the revenue reduction at the time of transfer.

- As required by Section 13-603 of the Tax – General Article, interest is generally paid on refunds from the forty-fifth day after the claim is made, except in instances where the overpayment was made through an error or mistake of the claimant. Interest on deficiencies begins to accrue from the day the taxpayer is obligated to pay the tax.

- As required by Section 13-601 of the Tax – General Article, interest on unpaid inheritance tax begins:

    1. 30 days after the tax on which is determined;

    2. on the original due date, if there is no formal administration of the estate and the tax is not paid within 30 days after the date on which the tax bill is mailed; or

    3. 30 days after the original due date, if an alternative payment schedule for inheritance tax is allowed.

- As required by Section 13-601 of the Tax – General Article, interest on unpaid Maryland estate tax begins 9 months after the date of death of the decedent and applies to all Maryland estate tax that is not paid by that date, including a payment made in accordance with an alternative payment schedule.

- As required by Section 13-604 of the Tax – General Article, the annual interest rate for the next calendar year is set by the Office of the Comptroller on or before October 1 of each year, and is the greater of:

    - 13%; or

    - 3 percentage points above the average prime rate of interest quoted by commercial banks to large businesses during the State's previous fiscal year, based on determination by the Board of Governors of the Federal Reserve Bank.

- Chapter 1 of the first legislative special session of 1992 increased the annual rate from the greater of:

    - 12%; or

  - 2 percentage points above the average prime rate of interest quoted by commercial banks to large businesses during the State's previous fiscal year, based on determination by the Board of Governors of the Federal Reserve Bank.

- Chapter 587 of the 2006 legislative session set the interest rate on refunds equal to that of tax deficiencies, beginning in calendar year 2007. Prior to this legislation, the interest on refunds was equal to 2 percentage points above the average investment yield on the State money for the State's previous fiscal year, rounded to the nearest whole number.