THE FLORIDA LEGISLATURE

Report No. 96-13

Office of Program Policy Analysis And Government Accountability

John W. Turcotte
Director

November 4, 1996

REVIEW OF INTEREST AND PENALTY PROVISIONS FOR TAXES ADMINISTERED BY THE DEPARTMENT OF REVENUE

REPORT ABSTRACT

- State law requires taxpayers to pay different levels of interest and penalties for late and incorrect tax payments that vary based on the type of tax.
- The law, however, should be changed to treat taxpayers more consistently and to encourage voluntary compliance with tax laws.
- The state interest rate charged for corporate income taxpayers is lower than the interest rate charged other taxpayers and may be too low for encouraging timely payment of tax.
- The penalty for late payment of intangible tax is substantially higher than what is charged for late payment of other taxes and should be reduced.
- In addition, the Department's process for reviewing and approving penalty waivers is inefficient and does not assure that taxpayers are treated consistently.

PURPOSE OF REVIEW

The Office of Program Policy Analysis and Government Accountability (OPPAGA) was directed by the Joint Legislative Auditing Committee, in response to a request by the Senate Ways and Means Committee, to examine penalty and interest provisions for taxes administered by the Department of Revenue. As part of our review, we examined: (1) the interest and penalties for sales and use, corporate income, and intangible taxes to determine whether they were at levels needed for encouraging voluntary compliance; and (2) how consistently and efficiently the Department administers interest and penalty provisions.

BACKGROUND

The state levies and collects taxes to fund state and local government operations. The state benefits when taxpayers voluntarily comply with state tax laws because pursuing owed taxes is costly. For example, although 97% of state tax collections are paid voluntarily, approximately 80% of the

Department of Revenue's staff are employed to collect the remaining 3% of total tax collections. Therefore, the state achieves greater efficiency when taxpayers pay owed taxes timely and correctly.

To optimize voluntary compliance, states establish financial inducements for taxpayers to make timely and correct payment of owed taxes. These incentives, which create a considerable cost difference to the taxpayer between timely and late payment of owed taxes, include discounts for early payment and sanctions (e.g., interest and penalty charges) for late or incomplete payments. Florida tax laws authorize discounts for early payment of the personal intangible tax. In addition, Florida tax laws impose interest and penalty charges on taxpayers for violations of state tax laws, such as failing to make timely payments of owed taxes. The law also specifies how the Department should calculate the amount of interest and penalty owed by taxpayers.

Interest Provisions. The Department assesses an interest charge on the amount of owed tax to taxpayers who do not pay owed taxes in a timely manner. The law establishes two interest rates: a variable rate for corporate tax, which equals the "Adjusted Prime Rate" rounded to the nearest full percent and may be adjusted by the Department every six months; and a fixed 12% annual rate for all other taxes. [1] The variable interest rate for corporate tax was established in 1986 and was set at 9% as of September 1996. The fixed interest rate for all other taxes was set by law at 12% in 1976.

Penalty Provisions. In addition to charging interest, the law also authorizes the Department to assess penalties to taxpayers who violate tax laws. The law authorizes the Department to assess penalties based on the type of tax (e.g., sales, corporate, and intangible) and the type of violation (e.g., late or nonpayment of owed taxes, filing an incomplete return, and tax evasion). Most penalties were doubled effective January 1, 1993. For example, the maximum penalty for nonpayment of the state sales tax went from 25% to 50% of the amount of tax that is owed.

Identifying Tax, Penalty, and Interest. The Department uses three major activities to identify individuals or businesses that owe taxes and to impose interest and penalties on taxpayers who violate state tax laws. First, the Department has an automated process that compares information about who has filed tax returns to information about registered taxpayers to identify delinquent taxpayers. After the taxpayer submits the return, the amount of tax, penalty, and interest owed is identified. [2] Second, the Department has an automated billing process that determines whether taxpayers filing returns have paid the correct amount of taxes and identifies the amount of additional tax, penalty, and interest owed. [3] Third, Department staff audit taxpayers to determine whether taxes have been underpaid and then identify the additional tax, interest, and penalty owed.

[1] "Adjusted Prime Rate" means the average predominant Prime Rate quoted by commercial banks to large businesses.

[2] A delinquency is when a taxpayer does not submit an expected return to the Department.

[3] A computer program initially identifies tax payment errors, which are reviewed by Department staff before bills are mailed to taxpayers. A bill is generated when a taxpayer submits a late or incorrect return to the Department.

The Department collected approximately $100 million in interest and penalties assessed from sales tax bills and delinquencies mailed in fiscal year 1994-95 and from audit assessments made in fiscal year 1994-95. [4] (See Exhibit 1.)

Exhibit 1
The Department Collected Approximately $100 Million in Interest and Penalties Assessed From Sales Tax Bills and Delinquencies and From Audit Assessments

Interest and Penalty Collections
Fiscal Year 1994-95
(In Millions of Dollars)

	Interest	Penalty
Sales Tax		
Bills	$ 3.6	$34.8
Delinquencies	1.1	3.8
Audits - All Taxes	48.5	8.0
Total	**$53.2**	**$46.6**

Source: Department of Revenue data.

Waiver Provisions. Because there may be valid reasons why taxpayers fail to make timely or correct payments of owed taxes, the law authorizes the Department to waive interest and penalties under certain circumstances. Interest can be waived if the Department has doubt as to collectibility or liability of the taxpayer. For example, the Department may waive the interest charge on a taxpayer who is financially unable to pay both taxes and interest. In such cases, collecting the owed taxes is more beneficial to the state. Penalties can also be waived if the noncompliance was due to reasonable cause and not due to willful negligence, willful neglect, or fraud. Acceptable reasons include death or illness of the tax preparer, natural disasters, and the Department providing inaccurate written advice to the taxpayer.

Department staff said that in recent years the Department has generally been approving more penalty waivers as a strategy for collecting more of the owed taxes. Approximately $21.4 million (one-third of all penalties assessed for valid sales tax bills mailed in fiscal year 1994-95) were subsequently waived by the Department. [5]

STATUTORY INTEREST RATE PROVISIONS

Tax policy experts we interviewed observed that interest rates charged by the state should encourage timely tax payments and ideally should have three characteristics. **First**, the interest rate should be variable to reflect market conditions for borrowing money and should be tied to a recognized interest rate, such as the Prime Rate or the 13-week U.S. Treasury bill rate. **Second**, the interest rate charged by the state should be high enough to encourage businesses to pay taxes in a timely manner. If the state's interest rate is lower than the current commercial loan borrowing rate, then businesses may opt to use owed taxes for short-term operating capital as the cost of paying interest to the state is less than the cost of a loan. **Third**, the interest rate should not be too much above the commercial

[4] Due to limitations of its current management information systems, the Department does not maintain complete information about the amount of interest and penalties collected.

[5] Valid bills equal the value of the bills issued by the Department minus the value of bills corrected because Department staff later determined that the bill was sent to the taxpayer in error.

loan borrowing rate because the interest assessed by the state would then serve as an additional penalty.

We identified two problems with the state's interest rates:

- The statutory interest rate for corporate income taxpayers has been lower than the commercial loan borrowing rate available to most businesses. Therefore, it is questionable whether the statutory interest rate for corporate taxpayers provides an incentive for taxpayers to make timely tax payments; and

- The statutory interest rate charged for other taxpayers is fixed and does not fluctuate with market conditions. Thus, in recent years it has been at times lower than the commercial loan borrowing rate and may not have served as an incentive to encourage timely payments. At other times the statutory interest rate was higher than the commercial loan borrowing rate and may have served as an additional penalty.

The state's interest rate charged for corporate income taxpayers may not be high enough to encourage timely payment of taxes because it is lower than the commercial loan borrowing rate available to most businesses.

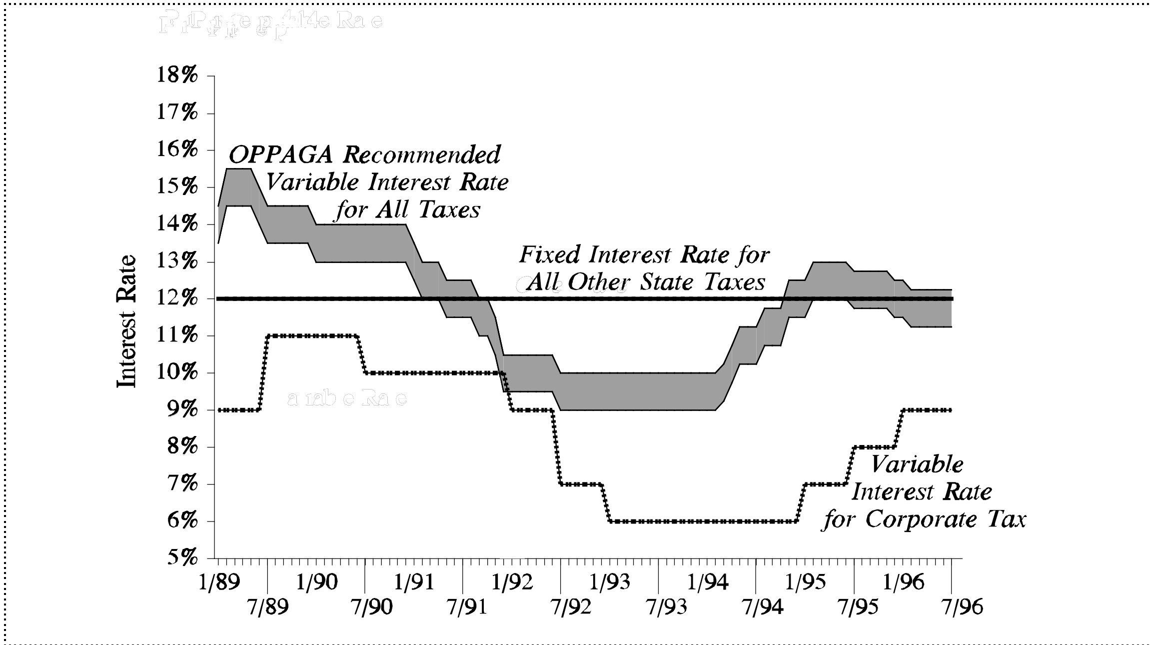
Since January 1993, the interest rate for the corporate income tax has been lower than the commercial loan rate available to most businesses. Lending officials said that the commercial loan borrowing rate that applies to most businesses is 1% to 3% above the Prime Rate. The Prime Rate is the rate banks charge their most creditworthy borrowers. The state charges corporate income taxpayers an interest rate that equals the "Adjusted Prime Rate" rounded to the nearest full percent, which has been historically below the typical commercial loan interest rate. As a result, the corporate income tax interest rate may not serve as a sufficient incentive to encourage voluntary compliance because businesses may use owed taxes for short-term operating capital as the cost of paying interest to the state is less than the cost of a loan. Lending officials recommended that the state set the interest rate at 3% to 4% above the Prime Rate to encourage timely tax payments.

A related problem is that as of July 1996, the interest rate charged for corporate income taxpayers was three percentage points lower than the interest rate for all other taxpayers. Exhibit 2 displays the difference between the corporate income tax interest rate, the interest rate for all other taxes, and the interest rate recommended by lending officials (i.e., 3% to 4% above the Prime Rate). The state corporate income tax rate should be changed to a rate that is used for other taxpayers and encourages voluntary compliance.

The interest rate for other taxes does not adjust to changing market conditions. At times in recent years the interest rate has been too low to encourage voluntary compliance while at other times it has been so high that it may have served as an additional penalty.

Because the annual interest rate charged for other state taxes is fixed at 12% and does not fluctuate with market conditions, over the past seven years there have been times when the interest rate was either lower than or higher than the commercial loan borrowing rate. As a result, at times the interest rate was too low to encourage voluntary compliance and at other times so high that it may have served as

Exhibit 2
Florida Currently Uses Different Interest Rates for Different Taxes, and Interest Rates Can Be Too Low to Encourage Timely Payment of Taxes



Source: Department of Revenue and U.S. Federal Reserve Board data.

an additional penalty. For example, as shown in Exhibit 2, during 1993 and 1994 the 12% interest rate was six percentage points higher than the interest rate charged to corporate income taxpayers and was as much as three percentage points higher than the interest rate that lending officials recommended the state charge for late payments. However, at other times the interest rate was lower than the recommended interest rate. For example, prior to January 1991 the 12% interest rate was as much as three percentage points lower than the recommended interest rate. Thus, the interest rate for other state taxes should be changed to a rate that adjusts to changing market conditions and encourages voluntary compliance.

STATUTORY PENALTY PROVISIONS

Penalty rates should be high enough to create a financial incentive for taxpayers to file returns correctly and on time. However, if the penalties are too high, they may discourage businesses that have not filed tax returns to come forward and pay owed taxes. In addition, high penalties may give the Department an unfair advantage when settling tax disputes with taxpayers. For example, Department staff may offer to waive a high penalty if the taxpayer agrees not to challenge the amount of tax and interest owed. The taxpayer may agree to this offer in order to avoid the risk of the high penalty, even though they believe the bill may be unjustified.

Because Florida's penalty rates were doubled effective January 1, 1993, we reviewed penalty rates to determine whether they were at levels needed for encouraging voluntary compliance. We reviewed the tax administration literature, compared Florida's sales tax penalties to the penalties established in other states, and compared Florida's statutory penalties for the various taxes administered by the Department of Revenue.

We determined that there is no consensus about what level of penalties are optimal for encouraging voluntary compliance. Florida's penalties for sales tax are generally higher than other states' penalties. However, a reduction in sales tax penalties could have adverse effects on voluntary compliance and a negative fiscal impact. In addition, Florida's statutory penalty levels for the intangible tax are high compared to other Florida taxes and should be reduced to be more comparable to penalties for other taxes.

There is no consensus about what level of penalties are optimal for encouraging voluntary compliance.

Penalty rates vary widely among states and there is no evidence to support which penalty rate is optimal for encouraging voluntary compliance. For example, the maximum penalties for failure to pay sales taxes on time ranged, among the 45 states that have a sales tax, from a low of 5% to a high of 65% of the amount of tax due. Florida's maximum penalty for failure to pay sales taxes on time is 50%. In addition, we were unable to identify any research or any consensus among the revenue officials we interviewed from 12 other states about the levels of penalties needed to encourage voluntary compliance. Some revenue officials indicated that the threat and enforcement of high penalties is necessary to achieve voluntary compliance, while others believe that taxpayer assistance and education efforts coupled with low penalties are sufficient to encourage voluntary compliance.

While current sales tax penalty levels in Florida are high compared to other states, a reduction in sales tax penalties could have adverse effects on voluntary compliance and a negative fiscal impact.

Our comparison of Florida's penalty rates for sales tax indicated that these rates are high compared to other states. (See Exhibit 3 for examples of penalty rates.) Based on 1994 data, there are only four other states whose penalties for the same violation are the same as or higher than Florida's. The penalty rate for most states (30 of 45) is in the 10% to 25% range. Although Florida's sales tax penalties are higher than other states, comparative information is not available on the compliance rate before and after the increase in Florida's penalties in January of 1993. As a result, it is not clear what effect increasing or decreasing penalty rates have on voluntary compliance. Therefore, we concluded that reducing sales tax penalties would not be advisable because any reduction in sales tax penalties would likely have a negative fiscal impact for the state. For example, Department collections for sales tax bills and delinquencies totaled approximately $35 million for fiscal year 1994-95. A reduction in the maximum sales tax penalties (e.g., from 50% to 25%) would result in a negative fiscal impact of $17.5 million to the state.

Exhibit 3
The Amount of Penalty for
Late Payment of Sales Tax Varies by State

Penalty for $1,000 of Owed Tax

State	3 Months Late	6 Months Late
Florida	**$300**	**$500**
California	100	100
New York	120	150
North Carolina	250	350
Ohio (includes additional charge which acts as a penalty)	100	650
Texas		
1 or 2 occurrences	200	200
3 or more occurrences	250	250

Source: Information provided by state taxing agencies as of January 1, 1996.

The penalty levels for the intangible tax are high compared to other state taxes and should be reduced to be more comparable to penalties for other taxes.

The statutory penalty for filing corporate or sales taxes one day late is 10%, while intangible taxpayers who file one day late receive a 40% penalty. Thus, individuals who pay intangible taxes late are penalized more severely than other taxpayers. In addition, the penalty for filing an intangible tax return late can be higher than the penalty for intangible tax evasion, a more serious tax law violation. For example, the penalty for filing an intangible tax return three years late would be 140% of the amount of tax due, while the penalty for willful evasion of the intangible tax is 100% of the amount of tax due. Due to these statutory penalty provisions, the penalty assessed by the Department for late filing and payment of taxes can be substantial compared to the amount of tax owed. For example, a 1996 Department taxpayer audit for a three-year period determined that an individual who underpaid $5,618 in intangible tax was assessed a penalty that equaled $7,965.

DEPARTMENT'S ADMINISTRATION OF PENALTY WAIVERS

The Department's process for reviewing and approving penalty waivers is inefficient because it is time-consuming to assess penalties that are ultimately waived and the process does not assure that taxpayers are treated consistently.

According to s. 213.01, F.S., the Legislature's intent is that the revenue laws of the state be administered in a fair, efficient, and impartial manner. We identified two problems with the Department's administration of penalty waivers that impedes its ability to be efficient and to treat taxpayers consistently. First, the Department's practice of generally approving penalty waivers for taxpayers with no prior violations is inefficient because it is time-consuming for Department staff to assess penalties that are ultimately waived. Second, the Department has not developed sufficient policies and procedures to assure that taxpayers under similar circumstances are treated consistently.

Department considers taxpayer compliance history when waiving penalties rather than when penalties are assessed. Florida law does not currently authorize the Department of Revenue to consider compliance history and assess penalties based on a taxpayer's

number of prior offenses. As a result, penalty assessments are the same for taxpayers with one violation as they are for taxpayers with multiple prior violations.

However, the Department's rules provide that it may consider history of timely payments when granting penalty waivers. In practice, Department staff said that it generally approves penalty waivers for taxpayers who have no prior violations, regardless of the circumstances relating to their failure to make timely and correct payments. This practice is intended to improve voluntary compliance among repeat offenders because repeat offenders must pay penalties that first-time offenders get waived. Of the 17 staff we interviewed, 13 reported that taxpayer payment history is the most common factor considered in deciding whether to grant penalty waivers.

This practice of approving waivers for first-time offenders is inefficient because it is time-consuming for Department staff to prepare and send penalty assessment notices, then review and ultimately waive these penalties. Authorizing the Department to consider compliance history at the start of the process would be more efficient. For example, central office collections staff said that an automatic waiver of penalties for first-time offenders would reduce their workload substantially. Estimates of workload reduction ranged from 20% to 50% among the selected sample of eight staff we interviewed. Reducing the amount of time spent on waiving penalties would allow central office staff to devote more time to collecting owed taxes. [6]

Tax administration officials in states that base their penalty assessments on the number of the taxpayer's prior violations indicated that such a system may be more effective in encouraging voluntary compliance among repeat offenders. However, limitations with the Department's database may impede its efforts to consider taxpayer history in the penalty assessment process. For example, Department staff said there were problems with the accuracy of taxpayer compliance history information contained in the Department's database. In addition, Department staff said that it would be difficult to consider taxpayer compliance history in the penalty assessment process because it takes at least two months to process tax returns and correct tax bills. As a result, the ability to make timely assessments based on taxpayer compliance history is currently not feasible.

The Department does not assure that taxpayer penalty waiver requests are reviewed and approved consistently by staff, which allows taxpayers to be treated differently under similar circumstances. To assure fairness to all taxpayers, the Department should consistently approve penalty waivers for taxpayers making requests for similar reasons. We identified three impediments to the Department's ability to treat taxpayers consistently in approving penalty waivers:

- The Department has not established clear policies and procedures for how taxpayer history is to be considered in approving penalty waivers. To implement its responsibilities for approving penalty waivers, the Department has issued

[6] In Report No. 95-39 (February 27, 1996) we reported that due to the volume of sales tax delinquencies and bills issued, Department central collections staff have been unable to call all taxpayers before referring the accounts to the field offices for further collection efforts. Early telephone contact is considered an efficient way to collect owed taxes. Reducing central office waiver activities would allow these staff to call more taxpayers and improve the efficiency of Department efforts to collect owed taxes.

guidelines that describe acceptable reasons for waiving penalties. However, the guidelines do not clearly indicate how the taxpayer's filing history should be considered by Department staff when reviewing penalty waivers. For example, the guidelines do not provide clear instructions as to whether taxpayers who have no late tax payments within the past year should be granted penalty waivers;

- Department staff interpret the penalty waiver provisions differently, which may result in taxpayers being treated inconsistently under similar circumstances. In presenting hypothetical taxpayer situations to 17 Department staff who are responsible for waiving penalties, we found that staff reached different conclusions regarding whether to grant waivers. For example, for a taxpayer making late payments for the third time in six months, 8 staff members said they would waive penalties assessed if the taxpayer filed a monthly sales tax return 20 days late due to taxpayer computer failure. However, the remaining 9 staff members we interviewed said they would not approve the penalty waivers under the same circumstance; and

- Department management staff do not review the consistency of penalty waiver decisions made within each office. As a result, taxpayers who request penalty waivers for the same reasons may be treated differently. Department staff are authorized to make penalty waiver decisions within certain dollar threshold levels according to their position. These decisions are typically not reviewed by management staff. As a result, the Department may approve penalty waivers inconsistently, which is unfair to taxpayers.

RECOMMENDATIONS

Interest Levels

To serve as an incentive for businesses to make timely tax payments and to treat all taxpayers consistently, we recommend that the Legislature adopt a variable interest rate that applies to all taxpayers and is higher than commercial loan borrowing rates. This could be accomplished by deleting references to interest rates currently contained in subsections of statutes dealing with various taxes and amending Ch. 213, F.S., general tax provisions, to require a single interest rate for all taxes. Adopting an interest rate that is 3% to 4% above the Prime Rate (8.25% as of August 1996) could result in a positive revenue increase to the state in the short-term. For example, if the new variable rate were set at four percentage points above the Prime Rate as of August 1996 rounded to the nearest whole number (12%), then it would be the same as the 12% interest rate currently used for most taxes. Because the 12% interest rate is four percentage points higher than the current interest charged to corporate income taxpayers, there would be a slightly positive increase in revenues to the state. For example, we estimated a $4.3 million increase in revenues to the state if the corporate income tax rate were increased from 8% to 12%.

Penalty Levels

In order to make the penalties for intangible tax violations more comparable to other taxes, we recommend that the Legislature amend s. 199.282, F.S., to reduce the penalty for late payment and filing of intangible taxes to be comparable to the 10% penalty for the corporate tax, which is also collected annually. However, a study conducted by the

House Community Affairs Committee in May 1996 estimated there would be a negative fiscal impact to the state of approximately $5.3 million if this recommendation were implemented.

Penalty Waivers

The Department will need to continue granting penalty waivers because there will always be valid reasons why taxpayers fail to make timely and correct payments of owed taxes.

However, the current penalty waiver process could be improved to be more efficient and to treat taxpayers more consistently. To assure greater efficiency in the penalty waiver process, the Legislature could consider implementing one of three options:

- If the Legislature concurs with the Department's practice of granting penalty waivers for first-time offenders and treating repeat offenders more severely, then the Legislature should consider amending state tax laws to authorize the Department to assess penalties based on the number of the taxpayer's prior offenses. This could be accomplished by establishing a penalty schedule that treats repeat offenders progressively more harsh with each repeated offense or assessing an additional penalty for being a chronic offender. This would allow repeat offenders to be assessed a higher penalty than first-time offenders and may serve as more of a deterrent to repeat offenders. In addition, this would allow the Department to shift resources from waiving penalties to collecting owed taxes. However, Department staff indicated that implementation of such a system may not be currently realistic due to limitations with the Department's computer information systems;

- Alternatively, if the Legislature wants the assessment of penalties to be uniform regardless of taxpayer history and wants the Department to treat all offenders, whether first-time or chronic, the same, then the Legislature could amend the law to prohibit the consideration of taxpayer history for granting waivers; and

- If the Legislature wants the Department to continue to consider taxpayer history during the penalty waiver process, then we recommend that the Department consider implementing one of two options. The first option would involve changes in the Department's policies and procedures. For example, the Department's guidelines could be clarified to more clearly address how staff are to review and approve penalty waivers. In addition, management staff could conduct periodic reviews of samples of penalty waiver decisions made by staff at all threshold levels to assure greater consistency. To minimize the subjective nature of the penalty waiver process, the second option would involve implementing an "expert" or knowledge-based system. An expert system could potentially eliminate or substantially reduce individual biases and provide a more consistent decision making process. Currently, there are several other applications of this technology within state government. For example, the Florida Department of Environmental Protection has about six of these applications, mostly dealing with permitting and administrative functions.

AGENCY RESPONSE

October 25, 1996

Mr. John W. Turcotte
Director
Office of Program Policy Analysis
& Government Accountability
Post Office Box 1735
Tallahassee, Florida 32302

Dear Mr. Turcotte:

Pursuant to the provision of Section 11.45(7)(d), Florida Statutes, the Department is responding to the recommendations for the review of Interest and Penalty Provisions for Taxes Administered by the Department of Revenue.

We have no objections to the Legislature adopting uniform interest rate that applies to all taxpayers. To minimize public confusion, we recommend any revision to the interest rate be made annually or semi-annually.

Your audit notes that Florida's current penalty provisions for intangible tax are high in comparison to other states. These high penalty rates were implemented in 1993 after the Legislature enacted an amnesty program for all taxes. The intangible tax penalty was set substantially higher due to the perception of excessive non-compliance for this tax. We have no objections to the Legislature amending the penalty level.

In response to the Department's policy to differentiate treatment of taxpayers based on filing performance or reason for non-compliance, the Department released a policy in October on the application of administrative waivers based on the taxpayer's profile. The Department will determine if this policy is being adhered to and is consistent with legislative intent.

I appreciate the professionalism displayed by your audit staff during the review. If further information is needed, please contact Tom Berger, our Inspector General, at 488-4328.

Sincerely,

/s/ L.H. Fuchs

LHF/mo

This project was conducted in accordance with applicable evaluation standards. Copies of this report may be obtained by telephone (904/488-1023 or 800/531-2477), by FAX (904/487-3804), in person (Claude Pepper Building, Room 312, 111 W. Madison St.), or by mail (OPPAGA Report Production, P.O. Box 1735, Tallahassee, FL 32302).
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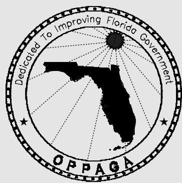
THE FLORIDA LEGISLATURE
OFFICE OF PROGRAM POLICY ANALYSIS AND GOVERNMENT ACCOUNTABILITY



OPPAGA MISSION STATEMENT

This office provides objective, independent, professional analyses of state policies and services to assist the Florida Legislature in decision-making, to ensure government accountability, and to recommend the best use of public resources.