Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873
Email: fiscal.bureau@legis.wisconsin.gov • Website: http://legis.wisconsin.gov/lfb

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Underpayment Interest for Federally Extended Filing Dates (General Funds Taxes -- Income and Franchise Taxes)

CURRENT LAW

Under current law, individuals (including estates, trusts, and partnerships) and corporations that make estimated tax payments during the tax year generally owe interest if they underpaid their estimated payments for taxes by $500 or more during the tax year. Similar provisions apply to pass-through entities that underpay their estimated withholding payments (for those that are required to make estimated withholding payments). Underpayment interest (UPI) accrues at a rate of 12% per year for the period of the underpayment.

However, UPI does not apply under current law for individuals and corporations if the taxpayer qualifies for a federal extension of time to file their return due to a presidentially declared disaster, or a terroristic or military action. This provision does not apply for pass-through entities.

Current law also allows the Secretary of the Department of Revenue (DOR) to waive UPI (for individuals and pass-through entities) if the Secretary determines that, because of casualty, disaster, or other unusual circumstances, it is not equitable to impose interest. This provision does not apply for corporate filers.

State law specifies that, for individuals, the period of the underpayment means the time period from the due date of the installment until either the 15th day of the 4th month beginning after the end of the taxable year (April 15 for calendar-year filers), or the date of payment, whichever is earlier. For corporations and pass-through entities, the period of underpayment means the time period from the due date of the installment until either the date on which the corporation or pass-through entity is required to file a return for federal income tax purposes, not including any extension, under the Internal Revenue Code (IRC), or the date of payment, whichever is earlier.

Normal (or delinquent) interest accrues on any tax amounts left unpaid after the established periods of underpayment for individuals, corporations, and pass-through entities. Normal interest accrues at a rate of 12% per year, while delinquent interest accrues at a rate of 18% per year. Current law specifies that no normal interest is required during the period of an extension for taxpayers who qualify for a federal extension of time to file due to a presidentially declared disaster, or a terroristic or military action. For corporations and pass-through entities, no interest is required during the extension period and for 30 days after the end of the extension period.

DISCUSSION POINTS

1. The provisions under current law that specify that UPI does not apply for individuals and corporations if the taxpayer qualifies for a federal extension of time to file their return due to a presidentially declared disaster were created under 2009 Act 28. Act 28 also specified that normal interest would not accrue during the extension period in the case that a taxpayer qualified for an extension of time to file due to such a disaster. While Act 28 was enacted in 2009, the federal filing date was not extended for tax year 2009, and these provisions did not play an active role in Wisconsin tax policy until 2020.

2. On March 13, 2020, President Trump declared a national emergency (which remains in effect) in response to the coronavirus pandemic. Following this declaration, the U.S. Department of Treasury and the Internal Revenue Service (IRS) announced on March 21, 2020, that the deadline for filing federal income tax returns was extended from April 15, 2020, to July 15, 2020. Taxpayers who owed final individual income tax or corporate income/franchise tax payments, or owed estimated income tax payments that would have otherwise been due on or after April 15, had until July 15 to make such federal payments, without incurring any interest or penalties, regardless of amounts owed by a taxpayer.

3. Under Wisconsin law, the DOR Secretary provided similar treatment in that state income and franchise taxpayers with federal tax filing due dates on or after April 1, 2020, and before July 15, 2020, had until July 15, 2020, to file their state income and franchise tax returns for tax year 2019, or to make their estimated payments otherwise due during that period, without interest, penalty, or UPI applying until July 15. As a result of the federal actions described above, state law waived all UPI owed on tax year 2019 estimated payments for all taxpayers with a taxable year ending December 31, 2019, and for certain other filers with an original or extended due date on or after April 1 and before July 15, 2020. It is estimated that the suspension of UPI for tax year 2019 reduced state income and franchise tax collections by $31.5 million.

4. On March 17, 2021, Treasury and the IRS again extended federal filing deadlines from April 15, 2021, to May 17, 2021. However, this extension only applied to final individual income tax payments for tax year 2020. The first installment of estimated tax payments for tax year 2021 calendar year filers remained due on April 15, 2021. Therefore, as required under current law, the DOR Secretary waived all UPI on tax year 2020 individual income tax estimated payments for all taxpayers with a tax return due date on or after April 15, 2021 (extended to May 17, 2021). It is estimated that the suspension of UPI for individual income taxpayers for tax year 2020 reduced state tax collections by $24.0 million.

5. While DOR cited current law as its authority for extending income/franchise tax filing deadlines, the statutes were somewhat ambiguous. To address this ambiguity, the Legislature passed 2021 Assembly Bill 18, which was signed into law as 2021 Act 40, on May 21, 2021. Act 40 modifies current law to establish the due date for state individual income tax returns as the date required to file the corresponding federal income tax return, not including any extension, to the IRS. Prior to Act 40, state law specified that individual income tax returns were due on or before April 15, for calendar year filers, or on or before the 15^{th} day of the 4^{th} month following the close of the fiscal year for non-calendar year filers. In contrast, state law for corporations already specified the due date for state corporate income/franchise tax returns as the date required to file the corresponding federal income tax return, not including any extension, to the IRS. Therefore, Act 40 provides consistency between individual and corporate state tax filing deadlines, while also clarifying that any future federal filing extensions are to be adopted by the state for both individual and corporate taxpayers.

6. However, the definition for the period of underpayment, as it relates to UPI, was not similarly updated in statute. For calendar year filers, UPI only accrues for individuals until April 15, regardless of when the individual is required to file for federal income tax purposes. However, for corporations and pass-through entities, UPI accrues until the date in which such taxpayers are required to file for federal income tax purposes. Therefore, if a taxpayer were to qualify for a federal extension of time to file for reasons other than a presidentially declared disaster or terroristic or military action, corporations and pass-through entities would owe UPI that would accrue during the extension period, while individuals would not. After these dates, normal or delinquent interest would accrue if the taxpayer had not yet filed their return.

7. If the Committee desires to provide consistent statutory treatment of UPI for individuals, corporations, and pass-through entities, it could modify the definition for the period of the underpayment for individuals to reference the "date on which the individual is required to file for federal income tax purposes, not including any extension, under the Internal Revenue Code", rather than the "15th day of the 4th month beginning after the end of the taxable year" (Alternative 1). Note that this modification would increase UPI on individuals when the original federal due date is extended for reasons other than a presidentially declared disaster, offset by lower normal or delinquent interest owed under current law (which may have otherwise accrued had the due date not been extended and the taxpayer filed late). Additionally, given the modified language related to individual income tax filing deadlines, as a result of Act 40, this alternative would provide consistency in language and treatment among individual income tax provisions as they apply to UPI and tax return filing dates.

8. Prior to deliberation of Act 28, a 2008 legislative proposal prepared by DOR recommended that state law be amended to prevent normal interest and UPI from accruing during a federal extension period that results from a presidentially declared disaster, or terroristic or military action, to align state treatment of interest accrual with federal treatment of interest accrual. However, rather than only eliminating UPI that would accrue during the extension period under the specified circumstances, Act 28 served to eliminate all UPI for individuals and corporate tax filers, in addition to waiving UPI that would accrue during the extension period, if affected by specified federal tax extensions.

9. As noted, the 2009 Act 28 provision did not affect Wisconsin taxpayers until 2020. If DOR's 2008 recommendation was the true intention of the Act 28 provision, the Committee may wish to modify current law to reflect this intention. The Committee could specify that the provision relating to the federal extension of time to file would only waive UPI that would otherwise accrue during the federal extension period, similar to how the accrual of interest is suspended under federal law, rather than all UPI for the applicable tax year (Alternative 2). The Committee could extend this provision to apply to pass-through entities to provide consistent statutory treatment for all income and franchise tax filers. If this provision had been in effect for tax years 2019 and 2020, the estimated foregone revenue from waiving UPI would have been considerably lower.

10. One possible rationale for the waiver of all UPI, if the taxpayer qualifies for a federal extension of time to file their tax return due to a presidentially declared disaster, is to provide relief to taxpayers who are struggling financially as a result of the disaster. For example, it is possible that some taxpayers who underpaid their tax year 2020 estimated payments did so due to financial hardship resulting from the coronavirus pandemic. However, this was likely not true for underpayments of tax year 2019 estimated payments, as most estimated payments for tax year 2019 were due prior to the start of the coronavirus pandemic. Failure to timely pay the full estimated payments was likely not attributable to hardships resulting from the pandemic for most corporations, and nearly all individuals, in tax year 2019. Therefore, the Act 28 provision resulted in a tax break for individuals and corporations that underpaid their taxes, regardless of the impacts from the coronavirus pandemic, while providing no tax benefit for timely filers.

11. As such, the Committee may wish to consider whether state law should require the waiver of all UPI for taxpayers qualifying for a filing extension due to a presidentially declared disaster, which may eliminate interest for taxpayers who were unaffected by the disaster and did not timely remit payments. As previously mentioned, current law allows the DOR Secretary to waive UPI for individuals and pass-through entities on a case-by-case basis if the Secretary determines that, because of casualty, disaster, or other unusual circumstances, it is not equitable to impose interest. This provision allows the waiver of UPI by the DOR Secretary to be optional for impacted filers, rather than required for all filers.

12. To allow the Secretary to waive UPI on a case-by-case basis, the Committee could take the following actions: (a) modify current law to state that no UPI is required if the Secretary of Revenue determines that, because of casualty, disaster, <u>including a presidentially declared disaster or terroristic or military action</u>, or other unusual circumstances, it is not equitable to impose interest; (b) expand this provision to apply to corporations; and (c) delete the waiver of UPI provisions related to the federal extension of time to file (Alternative 3). Under this alternative, a taxpayer qualifying for a federal extension of time to file would owe UPI, unless the Secretary determines that it is inequitable to impose the interest. However, current law would still suspend normal and delinquent interest that would otherwise accrue during the extension period. Additionally, the alternative would provide consistent treatment of UPI for individuals, corporations, and pass-through entities.

13. Finally, if the Committee is satisfied with how UPI is treated under current law, it could chose to take no action (Alternative 5).

ALTERNATIVES

1. Modify the definition for the period of the underpayment for individuals, estates, trusts, and partnerships, to reference the "date on which the individual is required to file for federal income tax purposes, not including any extension, under the Internal Revenue Code", rather than the "15th day of the 4th month beginning after the end of the taxable year". Specify that this provision first applies to UPI accruing on the effective date of the bill.

2. In addition to Alternative 1, modify the current law provisions that waive UPI for taxpayers qualifying for a federal extension of time to file due to a presidentially declared disaster, or terroristic or military action, to only apply to UPI that would otherwise accrue during the extension period. Adopt this provision to also apply for pass-through entities. Specify that this provision first applies to UPI accruing on the effective date of the bill.

3. In addition to Alternative 1, delete the current law provisions that waive UPI for taxpayers qualifying for a federal extension of time to file due to a presidentially declared disaster, or terroristic or military action. Modify current law related to individuals, estates, trusts, partnerships, and pass-through entities required to make estimated withholding payments to state that no UPI is required if the Secretary of Revenue determines that, because of casualty, disaster, <u>including a presidentially declared disaster or terroristic or military action</u>, or other unusual circumstances, it is not equitable to impose interest. Adopt this provision to also apply for corporate filers. Specify that this provision first applies to UPI accruing on the effective date of the bill.

4. Take no action.

Prepared by: Sydney Emmerich