



COMMONWEALTH of VIRGINIA

Department of Taxation

December 20, 2007

TO: Ronald L. Holt
Deputy Tax Commissioner

THROUGH: William J. White
Assistant Tax Commissioner

FROM: Mark C. Haskins
Director, Policy Development

A handwritten signature in black ink, appearing to read "MCH", is written over the name "Mark C. Haskins" in the "FROM:" field.

SUBJECT: Electronic Funds Transfer

Questions have recently arisen about TAX's authority to impose penalties when payments are mailed that were required to be made by Electronic Funds Transfer ("EFT"), and TAX's procedures for imposing and collecting such penalties.

Authority to Impose Penalty

In certain cases, *Va. Code* § 58.1-202.1 requires taxpayers to remit tax payments by EFT. The statute does not expressly impose penalties for failure to use EFT, instead of mail. However, *Va. Code* § 58.1-9 was also amended at the same time that EFT payments were made mandatory to provide:

B. When remittance of a tax payment is made by electronic funds transfer, receipt of funds available for withdrawal, in a bank account designated to receive such payments by the person to whom such payment is required to be made, on or before midnight of the day such payment is required to be made without penalty or interest, shall constitute payment as if such payment had been made before the close of business on the last day on which such tax may be paid without penalty or interest.

Thus, the effect of requiring remittance by EFT is the elimination the "mailbox" rule for timely payments of tax, which is set out in subsection A of § 58.1-9. Instead of looking at the postmark to determine the timeliness of a payment, we look to when funds become available for withdrawal. While a check mailed early could theoretically be deposited early enough to be available for withdrawal on the due date, there would have to be sufficient time to allow for delays caused by mail, our processing, and the bank's rules on availability.



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For all practical purposes no checks mailed to us will be timely paid when EFT is required. Given the nature of our processing procedures, we would not have the records to match payments to deposits and evaluate availability for withdrawal. Any taxpayer claiming timely payment would have to show us when the check cleared their bank, and we would have to presume that the funds became available to us on the next banking day. Therefore, when payments required to be remitted by EFT are mailed, existing law gives us the authority to treat them as late and to apply the applicable penalty.

Authority to Collect Penalty

TAX cannot collect a tax or penalty until it has been assessed. This is set out in *Va. Code* § 58.1-1812 procedures for billing omitted tax, which refers to tax and penalty being assessed. Our refund match authority in § 58.1-1823 allows us to reduce refunds for "past-due taxes, penalties and interest **which have been assessed**" (emphasis added). Regulation 23 VAC 10-20-150 also refers to assessing penalties, and "assessment" is defined in subsection E of 23 VAC 10-20-160 (form clearly labeled "Notice of Assessment" etc.).

Therefore, the law does not support TAX's current practice of applying payments to EFT penalties in its system and reducing refunds by accumulated EFT penalties without ever formally notifying the taxpayer that penalties have been assessed and that payments have been applied to those penalties. Before we can collect a penalty or offset refunds for a penalty we must have assessed the penalty before, or at least contemporaneously with, the collection action.

The failure to send notices of TAX's actions to taxpayers may cause administrative problems for both TAX and taxpayers. A common example is taxpayers who direct that an income tax refund be applied to estimated tax for the next taxable year. If we reduce the refund without telling the taxpayer, then the taxpayer's returns for the next taxable year will claim the wrong amount for estimated payments, requiring another adjustment by TAX. When the taxpayer eventually realizes that there is a discrepancy between his records and TAX's records, customer service representatives may have to research several taxable years to trace the problem.

Another common problem is that when payments intended as tax are applied to penalties without notice to the taxpayer, and we subsequently issue a bill for the amount shown as due in our accounts, the bill will characterize the amount due as "tax" not penalty. For example, withholding payments mailed during the month will incur penalty and the payments will be applied first to penalty, then to tax. When the reconciliation

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return is filed our accounts will show all penalties paid, but a balance of unpaid tax, which is what will be billed.

This billing procedure also causes tax compliance problems. Penalties are not deductible for federal income tax purposes, and through conformity, they are not deductible for Virginia income tax purposes either. Failure to notify taxpayers that a penalty has been imposed and collected may lead taxpayers to believe that the redirection of their payments was for tax or interest and to erroneously deduct payments applied to penalty.

As a matter of law, **TAX must assess** any penalties associated with mailing an EFT-required payment before, or at least contemporaneously with, applying payment toward the penalty. Moreover, as a matter of good customer service, taxpayers should be notified of any adjustments to tax, penalty, or interest which affect the application of a taxpayer's payments.

Notification of EFT Requirement

The EFT Guide (attached) states that TAX will annually review a taxpayer's filing history and notify the taxpayer if EFT is required. Taxpayers receive only one notice per tax type. Subsequent annual reviews trigger notices only to taxpayers newly subject to EFT. The review dates vary by tax type. Corporate tax EFT notification may have issues.

First, it is not clear from the EFT Guide whether an EFT requirement applies to all of the payment types associated with corporate income tax: estimated, extension and final. While the paragraph (page 4) referring to estimated tax is clear, the paragraphs referring to extension and final payments use language ("if you submit your tax payment by EFT") which implies that using EFT for these payments is voluntary. These provisions of the Guide would need revision to clarify whether using EFT for such payments is voluntary or required, or explicit language should be included in the letters notifying corporations of their EFT requirements for corporate income tax.

Second, it appears that corporations do not receive an annual notice of EFT requirements, but are notified once. The first notices were sent in 1998 (one year after mandatory EFT was adopted in 1997). However, TAX did not begin imposing EFT penalty for corporate income tax payments until IRMS went live. Because of the 22-month cycle of payments for a taxable year, it appears that the EFT penalty issue for corporate income tax is only now coming to the attention of taxpayers.

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For these reasons it may be prudent to reissue EFT letters with respect to corporation income tax to remind them of the requirement, clarify the application to extension and final payments, and inform them that penalties are now being assessed when EFT-required payments are mailed. Similar letters may also be desirable for sales and withholding tax at regular intervals or as a first warning when an EFT-required payment is mailed. Efforts should also be made to ensure that the letters go to the correct address for each tax type, as large corporations often have different departments handling each tax.

Calculation of EFT Penalties

The penalties that apply when an EFT-required payment is mailed, and therefore treated as late, vary by tax type.

Sales tax payments are required by the 20th of each month and a late payment penalty is imposed under § 58.1-635 at 6% per month or fraction thereof. When a check for an EFT-required payment is mailed on or before the 20th, the funds can reasonably be expected to become available for withdrawal within one month, so the payment by check would incur a late payment penalty of 6% or \$10.00, whichever is more.

Withholding tax payments for employers large enough to be subject to EFT (average monthly liability of \$20,000 or more) are due 3 banking days after the close of a federal semi-weekly period if at least \$500 of Virginia tax has been withheld. § 58.1-472. Failure to timely pay subjects the employer to a penalty of 6% per month or fraction thereof. § 58.1-475. When a check for an EFT-required payment is mailed on or before the due date, the funds can reasonably be expected to become available for withdrawal within one month, so the payment by check would incur a late payment penalty of 6% or \$10.00, whichever is more. It should be noted that the payment is due 3 to 7 days after an employee is paid, so it will be impossible for an employer who is required to remit by EFT to mail a check early enough to avoid a late payment penalty.

Corporate income tax involves several types of payments, estimated, extension, and the final payment with a return, which have different penalties associated with them. The EFT Guide (September 2003) states that the average monthly liability will be calculated by dividing the annual tax by 12. This is logical and reasonable. Although payments for a taxable year are actually made over a period of as much as 22 months, corporations would be making payments for two taxable years in some of those months. The EFT Guide states that a corporation will be notified in January if it is required to make EFT payments.

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Estimated payments are due on the 15th of April, June, September and January (calendar year filers). Once the corporation has been notified that it is required to remit its estimated tax by EFT, its quarterly estimated payments will be deemed late if paid by check. Late, omitted or insufficient estimated payments are subject to the penalty under § 58.1-504 for each late quarterly payment. This is not a flat 6% penalty, but is calculated like interest. Form 500-C is used for this purpose.

This penalty cannot be calculated or assessed until the tax return is filed and the actual tax liability is known. Because a check for an EFT-required payment would not be timely even if received on April 15, the penalty would be calculated as if no payment had been received for the first quarter. The April 15 payment would be processed, deposited and available for withdrawal by the time the second quarter's payment is due on June 15 and may be credited toward the second installment. If the second installment is also paid by check on the due date, it would not be credited toward the second installment, so the corporation would still be liable for an estimated payment penalty with respect to the second quarter.

Extension payments must be made by April 15 or the 15th of the 4th month following the close of the taxable year. There are two penalty situations that may arise with extension payments. The payment may be timely and properly remitted, but the amount is not sufficient to equal 90% of the tax due. In that case the normal extension penalty would be imposed after the return is filed. In the other case, the EFT-required payment would be deemed late if mailed. In that case none of the amount deemed paid after April 15 would be counted toward the 90% requirement to avoid an extension penalty after the return is filed.

The final payment due with the return would be deemed paid after the return is filed if an EFT-required payment is mailed with the return. In that case the full amount of tax liability would not be deemed filed on or before the filing of the return, the extension would be void, and a 30% late filing penalty would be imposed on any tax paid after the original due date (which would include any EFT-required extension payment that was mailed).

Summary

The following table summarizes the calculation of the various penalties that may be imposed when EFT-required payments are mailed.

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Penalties For Payments Mailed When EFT Required		
Payment Type	Penalty Type	Calculation
Sales Tax	Late Payment (§ 58.1-635)	6% of the payment
Withholding Tax	Late Payment (§ 58.1-475)	6% of the payment(s) mailed during the month; assessed when the reconciliation return is filed
Corporate Estimated	Estimated "addition to tax" (§ 58.1-504)	The current interest rate times the underpayment from the due date of each installment to the unextended due date of the return. A mailed installment is deemed late, but will be credited when calculating the penalty for subsequent installments.
Corporate Extension	Extension (§ 58.1-453)	0.5% per month or fraction thereof times the amount by which the total tax exceeds all estimated payments. The extension payment does not reduce the penalty because it is deemed late.
Corporate Final	Late Payment (§ 58.1-455)	30% of the amount by which the total tax exceeds the total estimated payments. An EFT-required extension payment will not reduce the penalty if it was mailed and therefore deemed late.