STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/23/01**	Bill No:	**SB 825**
Tax:	**Sales and Use Special Taxes**	Author:	**Poochigian**
Board Position:	**Support, Board-sponsored**	Related Bills:	**AB 2612 (2000)** **AB 464 (1999)** **AB 1208 (1999)**

BILL SUMMARY

This bill would revise the interest calculation provisions in Board-administered tax and fee programs so that the same rate of interest is applied to both underpayments and overpayments of tax.

ANALYSIS

Current Law

Under existing law, persons who are late in payment of their tax obligations are required to pay a penalty (10 percent of the tax), plus interest on the unpaid tax from the date the tax was due to the date it was paid. Persons who have overpaid their tax to the state are granted credit interest on the overpayment (when it is determined that the overpayment was not intentional or a result of carelessness) from the first day of the calendar month following the month during which the overpayment was made to the last day of the month following the date upon which the refund is approved by the Board.

Prior to July 1, 1991, there was no difference between the rate of interest paid by the Board to taxpayers on overpayments of tax and the rate of interest paid by taxpayers to the Board on underpayments of tax. However, AB 2181 and SB 179 (Chapters 85 and 88, respectively, Statutes of 1991) significantly changed the computation of *credit* interest (interest paid on overpayments of tax). Those measures provided that interest on underpayments is calculated based on specified provisions of the Internal Revenue Code, plus three percentage points. As of January 1, 2001, that rate is set at 12 percent. Interest on overpayments of tax is based on the bond equivalent rate of 13-week treasury bills auctioned. Effective January 1, 2001, that rate is 6 percent. Therefore, under current law, there is a 6 percent difference in the rate of interest paid on overpayments and the rate of interest assessed on underpayments.

Proposed Law

This bill would amend Section 6591.5 of the Sales and Use Tax Law to require that interest paid with respect to both underpayments and overpayments of tax be calculated at the modified adjusted rate per annum, determined by specified provisions of the Internal Revenue Code, plus three percentage points. Since the various Special

Taxes laws currently reference Section 6591.5, the interest on both underpayments and overpayments of taxes or fees under the Board-administered Special Taxes programs would also be calculated in accordance with this bill.

Background

The July 1, 1991 legislation that revised the method of computing interest was proposed by the Department of Finance as part of the Governor's package to resolve the budget deficit. That legislation was prompted by the 1990 decision in *Aerospace Corporation v. State Board of Equalization* involving sales in California by U. S. Government contractors. As a result of that decision, U.S. Government contractors were entitled to refunds of overpayments of taxes previously paid to the Board on specified transactions with the U. S. Government. Because of the potentially significant amount of tax and the period of time the overpayments occurred, these refunds would have included a very significant amount of credit interest. By reducing the interest rate, naturally, the state did lose such a significant amount of revenue.

Provisions similar to this bill have been introduced in prior Legislative Sessions: AB 2972 (Mays, 91-92), AB 2083 (Takasugi, 93-94), AB 3487 (Andal, 93-94), AB 1189 (Takasugi, 95-96), AB 222 (Takasugi, 97-98), AB 464 (Maldonado, 1999-2000), AB 1208 (Assembly Revenue and Taxation Committee, 1999-2000), and AB 2612 (Brewer and Maldonado, 1999-2000).

Assembly Bill 464 was held in suspense in the Assembly Appropriations Committee. Assembly Bill 222 was amended early in 1998 to instead provide for a one percent increase in the credit interest rate, and, with that amendment, was held in the Senate Appropriations Committee. Assembly Bill 1189 failed passage in the Senate Appropriations Committee. Assembly Bill 3487 and AB 2083 both failed passage in the Assembly Revenue and Taxation Committee. AB 2972 passed the Legislature, but was vetoed by the Governor. In his veto message, Governor Wilson stated the following:

> Legislation enacted last year (Chapter 85, Statutes of 1991) established a separate, lower rate for state and local sales tax refund liability. Chapter 85 was enacted to minimize the impact of accruing interest as a result of the Aerospace decision. This bill would reverse that legislation, thereby reinstating the higher rate on refund liability.
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> Imposing a lower rate for refunds minimizes the impact on the state in the event of large taxpayer refund liability. Imposing a higher rate on amounts owed by taxpayers serves as an incentive for taxpayers to remit those amounts in a timely manner as well as to comply with the law. I do not wish to change these incentives.

The interest equalization provisions were amended out of AB 1208 on January 3, 2000 in the Senate Appropriations Committee. Assembly Bill 2612 (Chapter 607, Statutes of 2000), as introduced, would have equalized the interest rates. However, the bill was amended and enacted to provide that it is the intent of the Legislature to require that the rate of interest accruing on both overpayments and underpayments of sales and use tax be determined in the same manner.

COMMENTS:

1. **Sponsor and purpose.** This bill is sponsored by the Board of Equalization in an effort to eliminate the 6-point disparity that currently exists in the rate of interest charged on late payments and the rate of interest paid on refunds. Since the interest on U.S. government contractor refunds has been settled, it seems logical and equitable to reestablish prior law and equalize the interest rates between refunds and liabilities. This would address the concerns of many taxpayers who view this disparity as extremely unfair.
2. **This bill is consistent with the Legislature's stated intent to correct the interest rate disparity.** Assembly Bill 2612 (Chapter 607, Statutes of 2000), as enacted, provides that it is the intent of the Legislature to require that the rate of interest accruing on both overpayments and underpayments of sales and use tax be determined in the same manner.
3. **Other major taxing agencies don't have such a disparity.** According to the Franchise Tax Board, its interest rate on both underpayments and overpayments is the same--currently, 8 percent compounded daily. The Internal Revenue Service has no disparity in interest rates for underpayments and overpayments – currently 9 percent compounded daily.
4. **This bill would *not* change interest charged on *late* payments of taxes.** The Governor's veto message on AB 2972 (referred to previously) indicates that interest provides an incentive to pay as well as to comply with the law and that he does not want to change these incentives. This bill would not change the rate of interest charged on late payments (underpayments) of tax. It is only intended, and will only change, the interest rate paid on overpayments. Therefore, the incentives provided in the law to encourage prompt payment of taxes would remain intact and would not be affected by the enactment of this measure.
5. **The justification for the interest rate differential no longer exists.** The entire basis for the lower credit interest rate was to reduce the amount of interest associated with the *Aerospace* refunds. Since the settlement agreement on repayment of the refunds has been finalized, there is simply no justification now to have the 6-point discrepancy in the credit interest rate.

COST ESTIMATE

Notification and programming costs attributable to the change of the credit interest rate would be absorbable, as would the claim for refund provisions.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

During calendar year 1999, the Board paid $12.8 million in credit interest on sales and use tax refunds of $144 million. This interest was paid at a rate of 5%. If the credit interest rate had been 11%, the Board would have paid $28.2 million in interest, an increase of $15.4 million. ($12.8 million x 11% / 5% = $28.2 million).

The Board also currently pays about $2.4 million in credit interest each year for the Special Taxes programs. This interest was paid at a rate of 5%. If the credit interest rate had been 11%, the Board would have paid $5.3 million in interest, an increase of $2.9 million. ($2.4 million x 11% / 5% = $5.3 million).

Since a change in the interest rate would affect interest accrued only after the effective date of any legislation, the full effect of changing the credit interest rate will take a number of years to be fully realized. The current interest rates are 6% for overpayments and 12% for underpayments. Increasing the overpayment rate from the current 6% to 12% would have a total first year effect for both programs of about $1.5 million. The full effect of $18.3 million would be felt in the fourth year.

Revenue Summary

The increased credit interest payments from increasing the credit interest rate from the current 6% rate to 12%, for the next four fiscal years, assuming a January 1, 2002 effective date, would be as follows:

Increased Credit Interest Payments

	State					
Year	Special Taxes	Sales & Use Tax	Total	Local	Transit	Total
2001-02	$ 237,273	$ 795,455	$1,032,728	$ 357,955	$ 106,591	$ 1,497,274
2002-03	1,694,805	5,681,818	7,376,623	2,556,818	761,364	10,694,805
2003-04	2,813,377	9,431,818	12,245,195	4,244,318	1,263,864	17,753,377
2004-05	2,900,000	9,722,222	12,622,222	4,375,000	1,302,778	18,300,000

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