

DRAFT



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

|                  |  |          |                 |
|------------------|--|----------|-----------------|
| Date Introduced: | <b>02/22/05</b>                        | Bill No: | <b>AB 1589</b>  |
| Tax:             | <b>Sales and Use<br/>Special Taxes</b> | Author:  | <b>Villines</b> |
| Related Bills:   |  |          |                 |

**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 July 1, 2004, that rate is set at 7 percent. Interest on overpayments of tax is based on the bond equivalent rate of 13-week treasury bills auctioned. Effective July 1, 2004, that rate is 1 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

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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 not lose such a significant amount of revenue.

Several bills have been introduced since 1991 that are similar to this bill: SB 825 (Poochigian, 2001-02), AB 464 (Maldonado, 1999-00), AB 1208 (Assembly Revenue and Taxation Committee, 1999-00), AB 2612 (Chapter 607, Statutes 2000, Brewer and Maldonado), AB 222 (Takasugi, 1997-98), AB 1189 (Takasugi, 1995-96), AB 2083 (Takasugi, 1993-94), and AB 3487 (Andal, 1993-94).

SB 825 was held in Senate Revenue and Taxation Committee without recommendation. AB 464 was held in suspense in the Assembly Appropriations Committee. The interest equalization provisions were amended out of AB 1208 on January 3, 2000 in the Senate Appropriations Committee. AB 2612, 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.

AB 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. AB 1189 failed passage in the Senate Appropriations Committee. AB 2083 and AB 3487 both failed passage in the Assembly Revenue and Taxation Committee.

### COMMENTS:

1. **Sponsor and purpose.** This bill is sponsored by the author in an effort to eliminate the disparity that currently exists in the rate of interest charged on underpayments and the rate of interest paid on overpayments.
2. **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, 4 percent compounded daily. The Internal Revenue Service has no disparity in interest rates for underpayments and overpayments – currently 6 percent compounded daily.

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3. **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.
4. **This bill would *not* change interest charged on *late* payments of taxes.** 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.

### **COST ESTIMATE**

Notifying taxpayers, revising forms and publications, and programming costs would be incurred in order to change the credit interest rate. A cost estimate is pending.

### **REVENUE ESTIMATE**

#### **Background, Methodology, and Assumptions**

During fiscal year 2003-04, the Board made refunds of \$229.7 million in sales and use tax to which credit interest applied. The amount of credit interest paid on these refunded taxes was \$4.14 million. This interest was paid at a rate of 1 percent. If the credit interest rate had been 7 percent, the Board would have paid \$29.0 million in interest, an increase of \$24.9 million. ( $\$4.14 \text{ million} \times 7 \text{ percent} / 1 \text{ percent} = \$29.0 \text{ million}$ ).

The Board also currently pays about \$750,000 in credit interest each year for the Special Tax and Fees programs. This interest was paid at a rate of 1 percent. If the credit interest rate had been 7 percent, the Board would have paid \$5.25 million in interest, an increase of \$4.5 million. ( $\$750,000 \times 7 \text{ percent} / 1 \text{ percent} = \$5.25 \text{ million}$ ).

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 1 percent for overpayments and 7 percent for underpayments. Increasing the overpayment rate from the current 1 percent to 7 percent would have a total first year effect for both programs of about \$2.4 million. The full effect of \$29.4 million would be felt in the fourth year.

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**Revenue Summary**

The increased credit interest payments from increasing the credit interest rate from the current 1 percent rate to 7 percent, for the next four fiscal years, assuming a January 1, 2006 effective date, would be as follows:

**Increased Credit Interest Payments**

| Year    | State         |                 | Total        | Local      | Transit    | Total        |
|---------|---------------|-----------------|--------------|------------|------------|--------------|
|         | Special Taxes | Sales & Use Tax |              |            |            |              |
| 2005-06 | \$ 364,337    | \$ 1,336,364    | \$ 1,700,701 | \$ 509,091 | \$ 170,545 | \$ 2,380,337 |
| 2006-07 | 2,602,410     | 9,545,454       | 12,147,864   | 3,636,364  | 1,218,182  | 17,002,410   |
| 2007-08 | 4,320,000     | 15,845,454      | 20,165,454   | 6,036,364  | 2,022,182  | 28,224,000   |
| 2008-09 | 4,500,000     | 16,505,682      | 21,005,682   | 6,287,879  | 2,106,439  | 29,400,000   |

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