

CALTAX COMMENTARY: IN THE INTEREST OF FAIRNESS, STATE SHOULD PAY FAIR INTEREST

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The concept of fairness comes up frequently during tax policy discussions, usually in subjective terms of whether people are paying their "fair share."

While fairness is in the eye of the beholder, there should be no doubt that one aspect of California's tax system is patently unfair, and cries out for change. That is the state's refusal to pay interest on all tax refunds.

Under current law, when a corporation underpays its state income tax, it is liable for 4 percent interest in addition to the unpaid tax and various penalties. But if the same corporation overpays, the Franchise Tax Board pays no interest on the refunded amount.

Things aren't any better at the State Board of Equalization. If you owe taxes to the BOE, be prepared to pay an additional 7 percent in interest (and you will be charged for a full month's worth of interest, even if your payment is only a couple days late). If the BOE owes you a refund, you will receive no interest at all.

It wasn't always this way. The FTB's rate for corporate income tax refunds bounced around from 2003 to 2009, from a high of 5 percent in 2007 to a low of 1 percent in 2003 and 2004. Since July 1, 2009, the rate has been 0 percent. The BOE's interest rate for refunds also went up and down in the 2000s, hitting a high of 6 percent in 2001, and dropping to absolute zero as of July 1, 2009.

Even when the tax agencies paid interest, the rates were lower than they should have been. When the BOE was paying 6 percent interest on refunds, it was collecting a whopping 12 percent on deficiencies. When the FTB was paying 1 percent interest on corporate income tax refunds in 2003, the rate assessed on deficiencies was 5 percent.

The interest inequity came about not because it is a good policy, but because of politics and money. In 1990, the Court of Appeal held in *Aerospace Corporation v. State Board of Equalization* that the taxpayer was entitled to a refund of sales and use tax payments on overhead materials, including office supplies. State lawmakers realized that the refund would be large, and that the case likely would trigger refund claims from others, so they decided to save money for the state by lowering the interest rate on refunds.

Apologists for this questionable maneuver might argue that the state budget was in dire straits at the time, and desperate times called for desperate measures. But surely the budget is stable enough now to correct the situation.

There have been more than two dozen legislative attempts to equalize interest rates, but all have failed. The most vocal opponents are state employees' labor unions.

The unions, which seem more interested in money for salaries and pensions than in fairness for taxpayers, claim that if interest was paid on all refunds, corporations would intentionally overpay their taxes so they could get a guaranteed return from the state.

The flaw in that claim is that existing law makes it a crime to intentionally overpay taxes with the intention of gaming the system, so any business that attempted such a strategy would be taking an untenable risk. If this law isn't enough, legislators undoubtedly can devise other ways to thwart gaming while still treating honest taxpayers fairly.

Two years ago, Assemblyman Bill Brough carried legislation to use the same interest rate at the BOE for refunds and deficiencies, stating that the bill "attempts to fix a gross inequity in the law."

CalTax supported the effort, and noted that no-interest refunds are especially unjust given that California requires taxpayers to pay disputed taxes before they can challenge them – and the challenges can take many years.

The BOE also supported the bill, and noted that since interest is simply a charge for the use of funds, it should be equal regardless of whether the state is the giver or receiver.

Interest rate equity is a simple, long-overdue step toward fairness.