



Losing Interest? Disparate Interest Rates Penalize Texas Taxpayers

- Texas taxpayers who underpay taxes pay interest at prime plus one percent; but Texas taxpayers who overpay taxes receive interest based on what the state treasury earns on investments — sometimes only a tenth of the underpayment rate!
- Overpayment is not always inadvertent. It can be mandatory. Taxpayers must pay disputed amounts from an audit before they can get an independent review of their position in state court, which means they have to sue the state for their refund.
- If they win in court, the state's below-market interest rate will not fully reimburse them for the time value of their money; in fact, it will likely not even compensate for inflation. That means the taxpayer may never be fully reimbursed for the state's error.
- Texas is far less taxpayer-friendly than the majority of states. Most states pay a market interest rate on tax refunds, equal to what they charge on tax deficiencies. Some even allow taxpayers to pursue their claims in court without paying amounts in dispute.

Charging penalty and interest on delinquent taxes is a common enforcement tool used by governments to ensure that taxes are paid on time and in correct amounts. However, Texas penalizes taxpayers not only for underpaying their taxes, *but also for overpaying their taxes*. In many cases, the law actually mandates taxpayers must overpay.

If a taxpayer believes a tax is being applied inappropriately, they must pay the amount in dispute before they may sue for a refund and have their day in court. If successful, the taxpayer does get their payment refunded, however, they are penalized by being paid a below-market interest rate that can be less than one-tenth what the state

demands taxpayers pay.¹ On a case appealed all the way to the Supreme Court, this taxpayer interest penalty is often more than half of the amount in dispute!

QUESTION: What's the interest rate on taxes in Texas?

ANSWER: It depends.

If **you owe** taxes to the state, Texas will charge you 4.25% interest.

If the state **owes you** a tax refund, it will only pay you 0.511% interest.

¹ This occurred in 2014. Over the past 20 years the actual interest rate taxpayers have received has averaged less than 40% of the rate the state requires taxpayers to pay.

Few states are as punitive. Roughly three-fifths of the states — 29 — apply the same interest rate whether taxpayers owe or are owed. Of the remaining 21 states, Texas is one of only 14 that requires the taxpayer to pay amounts in dispute prior to going to court (commonly referred to as “pay-to-play”). And of those 14, the disparity in the interest rate between what taxpayers must pay and what they are owed ranks Texas 7th worst.

Best Practices

The Council on State Taxation (COST) prepares an annual review of state tax administration policies. In its annual *Scorecard*² COST explains:

Interest rates should apply equally to both assessments and refund claims. Failure to equalize interest rates diminishes the value of the taxpayer’s remedy of recovering monies to which it is legally entitled. Interest rates are meant to compensate for the lost time-value of money and should apply equally to both parties.

Deficiencies, Refunds, and Resolution

Tax delinquencies rarely stem from tax evasion. Most typically, they involve taxpayers making a good faith effort to pay what is required in the face of incredibly complex issues and uncertain guidance. Very often taxpayers must make their best judgement on positions impacting their tax liability. The tenet of “shareholder primacy” establishes the understanding that corporations will act to maximize their profits while fully adhering to the law. That can be a delicate balancing act when it comes to taxes due.

In a state tax audit, the auditor from the Comptroller’s Office will comb through the taxpayer’s records and may identify amounts they believe the taxpayer should have paid. The taxpayer and the agency will engage in discussions and meetings, but if the two cannot agree, the agency will issue the taxpayer a formal Notification of Audit Results, identifying the amount

Why should the state pay taxpayers any interest at all on refunds?

- A refund is an admission on the part of the state that no tax was due and the amount was assessed or paid in error.
- Texas law requires taxpayers to pre-pay any amount in dispute before they can pursue their case in court and receive an independent review of their claim. Even if the taxpayer is correct in their claim, they have no choice but to pay first.

the state believes it is owed, plus penalty (10% of the tax assessment) and interest. The state calculates interest due based on the “prime lending rate,” (the rate of interest commercial banks typically charge their most creditworthy customers), *plus one percent*.³ For example, if the prime rate is 4.0%, the taxpayer would have to pay 5.0%. The state recalculates the rate each year as the prime rate changes, so if a liability is incurred over several years in the past, a separate interest rate will apply in each year.

Not all audits identify deficiencies, though many do. Occasionally, the audit may identify amounts the taxpayer overpaid, or in other cases, the taxpayer may, in reviewing records on their own, determine that they have overpaid, and request a refund. The process of working a refund claim through the agency is very similar to that of an audit assessment. The agency makes a determination of its position, and may deny the refund. The taxpayer pursues the refund in the same manner it challenges an assessment.

But the similarities end when it comes to reimbursing the taxpayer for the time value of their money. The state does not pay interest at a rate of prime plus one. Instead, the taxpayer is paid interest at a rate equivalent to the *lower* of:

- Prime plus one percent, or
- The rate the state earned on deposits in the treasury during December of the previous calendar year.⁴

² Douglas L. Lindholm and Frederick J. Nicely, Council on State Taxation, *The Best and Worst of State Tax Administration: COST Scorecard on State Tax Appeals & Procedural Requirements*, December 2019.

³ Tax Code Section 111.060(b) requires the Comptroller to charge a rate of interest at the prime rate, as published in *The Wall Street Journal* on the first day of each calendar year, plus one percent.

⁴ Tax Code Section 111.064(a).

Since passage of this provision in 2005, the state has never paid interest at prime plus one, as the treasury has always earned substantially less (Figure 1).

Interest, which is generally intended to reflect the time value of money, *has thus actually become an additional penalty assessed on the taxpayer*. Texas requires taxpayers to pay a rate of interest above what is available on the open market. On the other hand, a taxpayer who *overpays* a tax bill, and is due a refund, is penalized by receiving a rate of interest well below the rate the state charged by the state.

A taxpayer who loses a contested case appeal at the State of Office of Administrative Hearings (SOAH) must pay the amount the state demands in full, including penalty and interest, before filing a refund lawsuit to obtain an independent judicial resolution.

A taxpayer may only appeal final decisions by the Comptroller in state district court. This appeal is the first time the taxpayer receives an independent review of its claim. Because state law requires taxpayers to pay the amount in dispute, tax appeals are suits for a refund even though the taxpayer disagreed with the assessment from the date of the initial tax filing. The optics of suing for a refund are generally negative for the taxpayer, though they are simply following the process dictated in law.

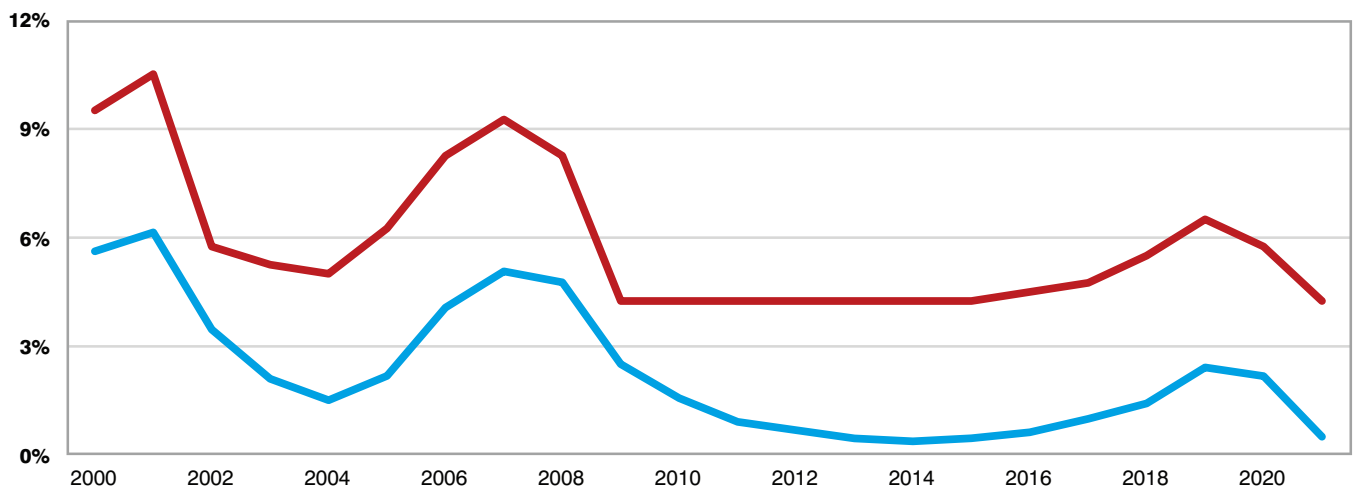
State tax cases must be filed in district court in Travis County.⁵ From there, the case may be appealed to the Third Court of Appeals, and then to the Supreme Court. Given the route from audit, to the State Office of Administrative Hearings, to district, appellate, and then finally to the Supreme Court, it is not unusual for the Supreme Court to hear cases with tax amounts in dispute dating back a decade or more.

Interest Rate Disparity Compounds Over Time

When a claim involves an extended period of time, interest compounds annually, with a separate rate applying for each year outstanding. As the overpayment rate has always been well below the underpayment rate, the disparity will widen over time. For example, a 2010 claim for \$10,000 that was settled at the end of 2020 would involve dramatically different amounts of interest. If the taxpayer owed the state, they would have to pay interest of \$6,696, for a total obligation, excluding any direct penalty, of \$16,696. If the taxpayer was granted a refund on a 2010 \$10,000 claim, they would *receive* \$1,284 in interest, plus their original \$10,000, for a total payment of \$11,284. The taxpayer’s claim is worth 32% less overall, as the interest the taxpayer receives is less than one fifth what the taxpayer would have owed (Figure 2).

⁵ Texas Tax Code Section 112.001.

Figure 1. Disparate Interest Rates for Taxpayers



Source: Comptroller of Public Accounts.

Interest is meant to reimburse for the time value of money — not just inflation, but also an economic return. The state-paid interest rate on refunds has not even kept pace with inflation over the past decade. The taxpayer’s \$10,000 refund claim from 2010 would be worth only \$7,925 in 2020 adjusted for inflation, a loss of \$2,075. The state’s interest payment of \$1,284 would cover only 62% of the amount of the claim lost to inflation.

Taxpayers have a difficult but calculated choice in deciding whether to pursue a disputed claim for refund. They must balance what they will recover if successful against the cost of recovering it.

Recovery costs may include the administrative costs of compiling appropriate records, the time employees and consultants will spend, as well as attorneys’ and other fees. They must estimate the time it will take to get a final court determination, which may mean pursuing the case to the Supreme Court — a process that can take perhaps a decade. That also means taking into account the impact of inflation. With inflation at an annual clip of 2%, a \$10,000 refund claim in today’s dollars would be worth only \$8,200 in ten years; at 4% inflation the \$10,000 would have eroded to \$6,750; and, if inflation is 7% the claim would be worth only \$5,000, or half of what was originally in dispute.

Figure 2. The Effect of Time and Compounding on a \$10,000 Claim

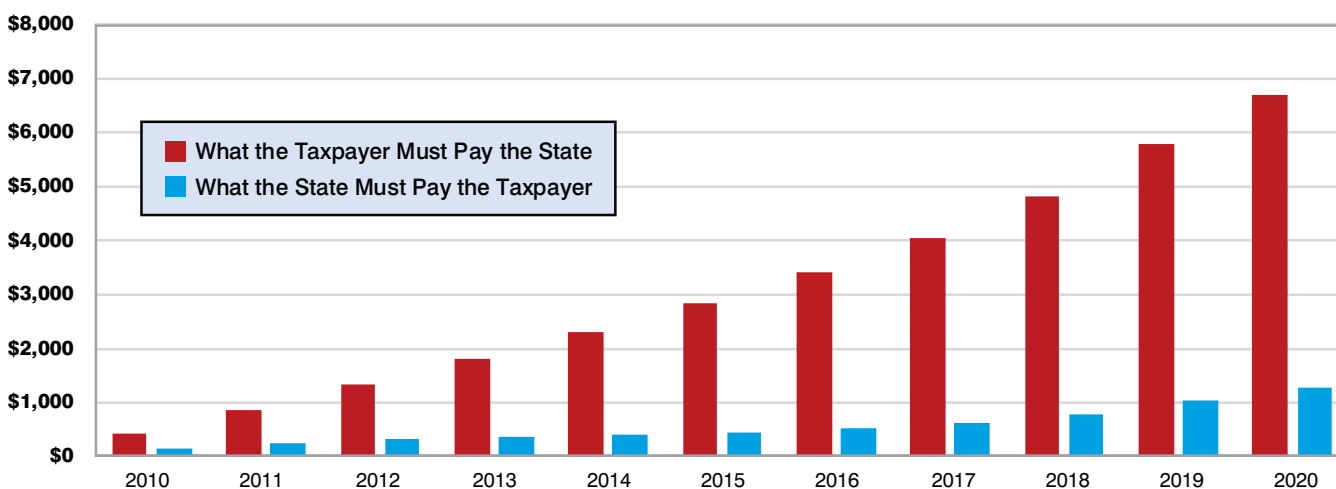
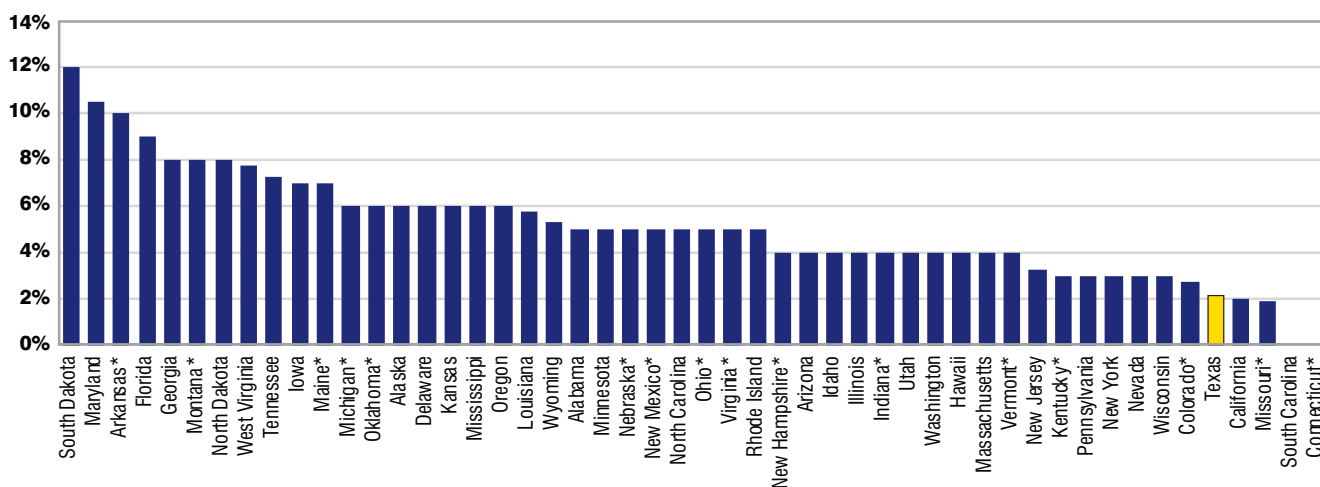


Figure 3. State Interest Rates on Overpayments



Note: * Denotes states in which a taxpayer may get an independent review of their case without having to make payment in advance.

Source: Council on State Taxation/TTARA Research Foundation

Texas' Taxpayer Interest Compares Unfavorably with Other States

In 2020, the interest rate Texas paid on state tax refunds was 5th lowest among the 50 states (Figure 3). Most states reimburse taxpayers at rates somehow tied to either the prime rate or the rates used by the Internal Revenue Service, sometimes plus or minus some amount.⁶

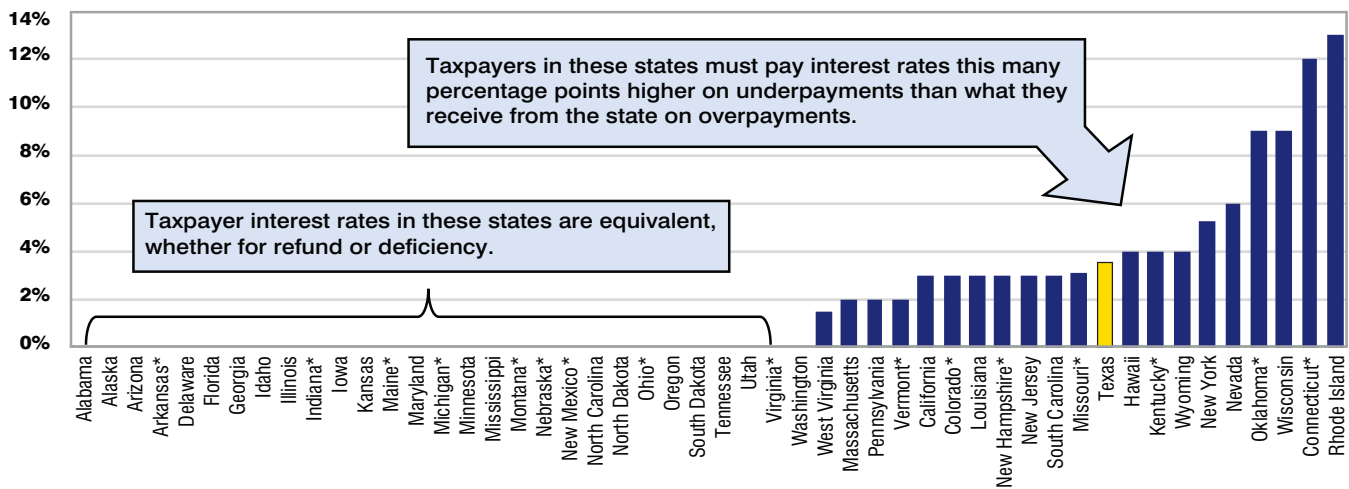
Further, most states (29) offer taxpayers equal interest rates on amounts of tax either underpaid or overpaid (Figure 4). Of the 21 states that penalize taxpayer refunds with lower interest rates, 7 do not require amounts in dispute to be paid in advance prior to going to court for an independent judicial review of their case. Texas is one of only 14 states that requires taxpayers to pay all amounts in dispute prior to judicial review, and then pays a lesser interest rate on refunds in the event the taxpayer wins their case in court.

Conclusion

Unlike the majority of states, Texas charges a different and higher interest rate for tax underpayments (prime plus one percent, in addition to a ten percent penalty) than what it pays on overpayments (the rate of earnings in the state treasury). These unequal rates effectively penalize taxpayers for overpaying their tax and diminishes the value of their claim. Further, the law requires taxpayers to pay any amount in dispute before they may go to court and receive an independent review of their dispute — essentially requiring overpayment even if the taxpayer eventually wins its case. Equalizing interest rates for tax underpayments and overpayments would allow Texas to join states following best practices in state tax administration.

⁶ Some states paying high interest rates, such as South Dakota and Maryland do not pay interest on refund claims attributable to taxpayer error.

Figure 4. The Difference Between Interest States Pay and Interest States Charge



Notes: Some states apply different interest rates for different types of tax. In that event, the difference shown is for the state's general business tax. States with asterisks do not require payment of disputed amounts prior to filing in court.

Source: Council on State Taxation/TTARA Research Foundation

Appendix A State Interest on Underpayments and Overpayments

State	Prepayment Required?	Interest Rates on:		Difference
		Underpayments	Overpayments	
Alabama	Yes ¹	Based on federal underpayment rate (2020 = 4%)	Same as rate on underpayments	0%
Alaska	Yes	3.0% above the Federal Reserve federal funds rate ² (2020 avg = 6.0%)	Same as rate on underpayments	0%
Arizona	Yes	Federal short-term rate plus 3%. (2020 avg = 4%)	Same as rate on underpayments	0%
Arkansas	No	10% interest rate on assessments and refunds.	Same as rate on underpayments	0%
California	Yes	Federal underpayment rate (2020 = 5%)	5% for most taxes, 2% for corporate	3%*
Colorado	No ³	Prime rate plus 3%	Prime rate for refunds equal to or greater than \$5,000 and equal to or greater than 10% of net tax liability. All others, prime rate plus 3%	3%*
Connecticut	No	1% per month	0% for sales/use tax refunds; 0.66% per month for other	12% sales tax; 4% all other
Delaware	Yes, if required by court	0.5% per month	Same as rate on underpayments	0%
DC ⁴	Yes	10% per year, compounded daily	1% above Richmond Federal Reserve Bank discount rate (2.5% in 2020)	6.5%
Florida	Yes	Prime rate plus 4%	Same as rate on underpayments	0%
Georgia	Yes	Prime rate plus 3%; certain refunds based on taxpayer error may be 0%	Same as rate on underpayments	0%
Hawaii	Yes	0.66% per month	0.33% per month with a 90-day grace period	4.0%
Idaho	Yes	Federal mid-term rate plus 2%	Same as rate on underpayments	0%
Illinois	Yes	Federal underpayment rate, adjusted semi-annually	Same as rate on underpayments	0%
Indiana	No	Average state investment yield plus 2%	Same as rate on underpayments	0%
Iowa	Yes, if required by court	Prime rate plus 2%	Same as rate on underpayments	0%
Kansas	Yes	Federal underpayment rate plus 1%	Same as rate on underpayments	0%
Kentucky	No	Prime rate plus 2%.	Prime rate minus 2%.	4%
Louisiana	Yes	8.75% (2020 rate; rates are adjusted annually)	5.75% (2020 rate; rates are adjusted annually)	3%
Maine	No	Prime rate plus 1%.	Same as rate on underpayments	0%

Appendix A, Continued

State	Prepayment Required?	Interest Rates on:		Difference
		Underpayments	Overpayments	
Maryland	Yes, if required by court	Greater of 11% or average prime rate plus 3%. Interest may not be paid on a refund claim if based on "an error or mistake of the claimant not attributable to the State.	Same as rate on underpayments	0%
Massachusetts	Yes	Federal short-term rate plus 4% compounded daily	Federal short-term rate plus 2% simple interest	2%
Michigan	No	Prime rate plus 1%	Same as rate on underpayments	0%
Missouri	No, unless property tax	Adjusted prime rate charged by banks (2020 = 5%)	Annualized average rate on funds invested in Treasury (2020 Avg = 1.9%)	3.1%
Minnesota		Prime rate rounded to the nearest full percent.	Same as rate on underpayments	
Mississippi		One half percent per month.	Same as rate on underpayments	
Montana	No	Prime rate plus 3% (Personal Income = 5%)	Same as rate on underpayments	0%
Nebraska	No	Federal rate plus 3%	Same as rate on underpayments	0%
Nevada	Yes	0.75% per month	0.25% per month	6%
New Hampshire	No, unless required by court	Federal underpayment rate plus 2%	New Hampshire underpayment rate less 3%	3%
New Jersey	Yes	Prime rate plus 3%	Prime rate	3%
New Mexico	No	Federal underpayment rate.	Same as rate on underpayments	0%
New York	Yes	Federal short-term rate plus 7%, generally	Federal short-term rate plus 2% for corporate taxes, generally	5%
North Carolina	Yes	Set annually by the Secretary of Revenue based on market conditions, but must range from minimum 5% to maximum 16% per year	Same as rate on underpayments	0%
North Dakota	Yes	1% per month (sales tax refunds: 10% per year)	Same as rate on underpayments	0%
Ohio	No	Federal short-term rate plus 3%	Same as rate on underpayments	0%
Oklahoma	No	1.25% per month for assessments and refunds	Generally, 6%; personal income tax refunds not paid within 90 days are paid 1.25% per month	9%
Oregon	Yes	Based on IRS underpayment rate	Same as rate on underpayments	0%
Pennsylvania	Yes	Federal underpayment rate, generally.	Federal underpayment rate minus 2%.	2%
Rhode Island	Yes	Prime rate plus 2%, but the rate cannot be less than 18% and or more than 21%	Prime rate	13%
South Carolina	Yes	Federal underpayment rate (5% in 2020)	Refund interest is reduced by 3% through 2021.	3%

Appendix A, Continued

State	Prepayment Required?	Interest Rates on:		Difference
		Underpayments	Overpayments	
South Dakota	Yes	1% per month; refund interest can be denied if due to taxpayer error	Same as rate on underpayments	0%
Tennessee	Yes	7.25% (set annually); taxpayer refund interest begins on date proof of refund is presented	Same as rate on underpayments	0%
Texas	Yes	Prime rate plus 1% (2020 = .75%)	Lesser of the annual rate earned on state treasury deposits during December of the previous calendar year or the prime rate plus 1%. (2020 = 2.18%)	3.57%
Utah	Yes, but waivable	Federal short-term rate plus 2%.	Same as rate on underpayments	0%
Vermont	No	Overpayment interest rate + 2% (2020 = 7.5%)	Prime rate, rounded up to nearest quarter % (2020 = 5.5%)	2%
Virginia	No	Federal underpayment rate plus 2%	Same as rate on underpayments	0%
Washington	Yes	Federal short-term plus 2%	Same as rate on underpayments	0%
West Virginia	Yes	Prime rate plus 5%	Prime rate plus 3%	2%
Wisconsin	Yes, but waivable	12% per year	3% per year	9%
Wyoming	Yes	Average prime rate plus 4%	Average prime rate, only on escrow for taxes paid under protest on appeal	4%
US		5% for large corporations; 3% all others	2% for corporate refunds up to \$10,000, 0.5% for amounts over \$10,000; 3% all others	

Note: This data is derived from *The Best and Worst of State Tax Administration, COST Scorecard on State Tax Appeals & Procedural Requirements* by Doug Lindholm and Fred Nicely, December 2019 by the Council on State Taxation, Washington, D.C. In some instances, interest rates may be equal, but the periods to which they apply can differ for the taxpayer and the state.

¹ Unless taxpayer's net worth is less than \$250,000

² AS Sec. 09.30.070

³ Not for trial court, but required for appeals from trial court decision

⁴ <https://code.dccouncil.us/dc/council/code/titles/47/chapters/42/>