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A special report from the
Policy Advice Division of Inland Revenue

Use-of-money interest rates and underpayment rate method changes

The use-of-money interest (UOMI) rates and the method for calculating the underpayment rate were changed by Orders in Council on 22 June 2009.

- The UOMI underpayment rate has been reduced from 9.73% to 8.91%.
- The UOMI overpayment rate has been reduced from 4.23% to 1.82%.

These rate changes apply to any amount of unpaid or overpaid tax from 29 June 2009.

This special report explains how the rates are set.

UOMI objectives

The UOMI rates are a cornerstone of the tax compliance system in New Zealand. The legislated twin objectives of the UOMI provisions are to:

- fairly compensate the party (either the Crown or the taxpayer) that does not have the use of its money; and
- encourage taxpayers to pay the right amount of tax at the right time.

The rate-setting framework places more emphasis on the second objective, since it is not possible to achieve both with a single overpayment and underpayment rate. The underpayment rate attempts to reflect the fact that the government is an involuntary and unsecured lender, and is unable to assess the actual credit-worthiness of each taxpayer. The overpayment rate is designed to discourage taxpayers from using Inland Revenue as an investment opportunity.

Case for reviewing the rates at this time

When the UOMI rates were last reset, at the start of March this year, Ministers decided that the rates would be reviewed annually from now on, although officials would monitor interest rate movements and report to Ministers.

Overpayment rate

Since March, the official cash rate has reduced twice, which has resulted in corresponding reductions in the 90-day bank bill rate. Because of these reductions the overpayment rate of 4.23% was one of the best rates available, and there is evidence that taxpayers were starting to overpay their tax to take advantage of this rate. This type of behaviour is contrary to the policy intention of the UOMI rates and constituted a significant fiscal risk.

This rate was reset using the existing method. This method uses the Reserve Bank of New Zealand (RBNZ) 90-day bank bill rate minus 100 basis points (1%).¹

Underpayment rate

In order to maintain consistency between UOMI rates and reflect the reductions in the market rates, the underpayment rate was also reviewed.

Underpayment rate method

Changing the underpayment rate using the previous method (which was set in February this year) would have resulted in the underpayment rate reducing to 7.32%.

This rate would have been too close to the cost of finance that is available to many small and medium-sized enterprises (SMEs) and individual taxpayers (especially for those who have fixed mortgages at higher rates for example, those on 9% mortgages fixed for three or so years). This would have resulted in tax deferral and fiscal risk concerns and would be contrary to the objective of encouraging taxpayers to pay the right amount of tax on time. These concerns are behind the government's decision to change the method of setting the underpayment rate.

Instead of using the RBNZ 90-day bank bill rate plus 450 basis points (4.5%)², the new method of setting the underpayment rate is now based on the floating first mortgage new customer housing rate plus 250 basis points (2.5%).³

New series

While a number of series could be used as the basis for calculating the underpayment rate, the critical factor is the desired rate that will encourage taxpayers to pay the right amount of tax at the right time, rather than the specific type of series that is used. Furthermore, as noted above, the most suitable underpayment rate should reflect the fact that the government is an involuntary and unsecured lender, and cannot assess the actual credit-worthiness of each taxpayer.

¹ Taxation (Use of Money Interest Rates Setting Process) Regulations 1997.

² Taxation (Use of Money Interest Rates Setting Process) Amendment Regulations 2009.

³ Taxation (Use of Money Interest Rates Setting Process) Amendment Regulations (No 2) 2009.

The floating first mortgage new customer housing rate series reflects the variable first mortgage interest rate offered to new borrowers for residential property, weighted by each surveyed institution's total lending outstanding for housing purposes. This series was selected as the new benchmark for calculating the underpayment rate because:

- It is likely to be more indicative of the cost of finance for many businesses (particularly small and medium enterprises) and individual taxpayers.
- The Reserve Bank has a high level of confidence in this series and considers that it would be a good benchmark to use in calculating the UOMI underpayment rate.
- Given the Reserve Bank's recent projection of low interest rates for a prolonged period, this series should provide a more stable and appropriate benchmark during this period than the 90-day bank bill rate.

Margin

A judgment call is required in determining the margin to be added to the benchmark series in calculating the underpayment rate. Some taxpayers may consider that charging a margin above the benchmark series is too harsh because the rate is higher than their cost of borrowing. However, as mentioned earlier, the rate must be applied across a diverse group of taxpayers with different risk profiles which affect their cost of borrowing. Furthermore, the margin seeks to take account of:

- the fact that the government is an unsecured creditor in respect of underpayments of tax (whereas financing rates reflect the provision of security to lenders);
- the incentive for tax deferrals across the population of taxpayers in a climate where there are many taxpayers with a higher cost of finance than the "floating first mortgage new customer housing rate series"; and
- the volatility of interest rates in a period of a global credit crisis and the practical difficulties in changing UOMI rates quickly and frequently to accommodate such volatility.

The 250 basis point margin seeks to ensure that taxpayers have incentives to pay the correct amount of tax at the right time (as well as incentives to pay their taxes before meeting other financial commitments), without being unduly harsh to those taxpayers who make honest mistakes or unintentionally underpay their instalments of provisional tax (which is an inherently difficult tax to determine with accuracy).

It is recognised that each additional basis point in the basis point margin imposes extra costs on taxpayers when they underpay their taxes. However, it is considered that any margin below 250 basis points does not provide sufficient incentives to taxpayers with varying costs of finance, nor does it provide sufficient buffer to manage the volatility in interest rates in a time of credit market crisis. As noted above, there are existing mechanisms available to taxpayers to reduce the adverse impact of high UOMI rates, including provisional tax pooling and the ratio method of paying provisional tax (which allows taxpayers to reduce UOMI exposure by more closely aligning the payment of provisional tax to the earning of income).

Wider review of provisional tax rules

Importantly, the method for setting the underpayment rate will be further considered and consulted on as part of a proposed wider review of provisional tax issues. This review is on the government's tax policy work programme and is intended to begin within a year. Consequently, the focus of making the current changes is to address fiscal risks and reflect a downwards movement in interest rates (while managing the incentives to defer tax). In the interim, officials will continue to monitor movements in the underlying interest rate series.