CHAPTER 5: THE GENERAL INTEREST CHARGE

This Chapter outlines the operation of the General Interest Charge (GIC) and explores its implications for self assessment. The GIC applies a uniform rate of interest to late payments of any type of tax, compounding daily from when the tax was originally due. This means that, where a taxpayer under assesses their liability, a substantial amount of GIC may have accumulated before the Tax Office informs the taxpayer of the shortfall. The Chapter discusses whether the way the GIC applies to shortfalls is consistent with a fair balance between the rights of individual taxpayers and protecting the revenue for the benefit of the whole community. Some alternative approaches are canvassed.

The GIC applies a uniform rate of interest to all overdue tax debts, whether or not a taxpayer has acted knowingly to create the debt. The GIC compounds daily from the day the tax was due until all tax and accrued GIC have been paid. The GIC is tax deductible.[1]

This Review has not been asked to examine the application of the GIC to tax debts in general. However, the GIC has implications for self assessment where, following an error by the taxpayer, an amended assessment is issued requiring the payment of further tax. As the 'due date' for that additional primary tax will be the same as that for the original assessment, the GIC will apply to that shortfall from the original due date. It is this 'shortfall GIC' — the GIC that accumulates prior to the shortfall being identified — that is the focus of this Chapter.

Views have been expressed in consultations that the GIC payable on shortfalls can be excessive and that the Tax Office is too reluctant to remit GIC. Industry representatives have also expressed the view that requiring taxpayers to apply for remission is unfair and impractical.

1. Paragraph 25-5(1)(c) *Income Tax Assessment Act 1997*.

5.1 How the GIC works

The GIC was introduced in 1999 to simplify a complex array of penalties and interest charges applying to late payments and tax shortfalls.[2] In most cases, the GIC reforms reduced the rates imposed by between 3% and 23%. However, in the case of shortfalls of income tax, the new charges exceeded the previous interest rates (originally by 4%, now by 3%).[3]

Prior to the introduction of the GIC, income tax shortfalls were subject to a (tax deductible) interest charge equal to the Treasury Note Yield rate plus 4%. The GIC rate was originally set by adding an 8% uplift factor to the Treasury Note Yield base rate. This base rate reflected the simple cost to Government from delayed receipt of revenue, and also served as the interest rate that taxpayers received from the Tax Office on their overpayments. The uplift factor was set to encourage the payment of tax liabilities when due and discourage the ongoing use of tax debts as a source of business or private finance. In part, it recouped the cost of collection and compensated Government for credit risk. The uplift factor was not intended as a culpability penalty.[4]

The structure of the GIC was amended in 2001, as Treasury Notes were no longer being issued on a regular basis. The bank bill rate series published by the Reserve Bank was found to be a suitable proxy, and adopted as the new base rate. At that time the uplift factor was reduced, as the Government considered that a 7% margin over the base rate was 'sufficient to support the policy objective that taxpayers should pay their tax liabilities on time.'[5] The 7% uplift factor over the base rate still places the GIC, intentionally, among 'high' commercial rates.

The nominal annualised GIC rate is divided by the number of days in the calendar year to obtain the daily interest rate, which is applied on a compounding basis to the balance owed by a taxpayer at the end of each day. The GIC rate is adjusted quarterly to reflect movements in the base rate.

For the quarter January to March 2004, the GIC rate is 12.31% per annum (0.03363388% per day). Allowing for daily compounding, this would be equivalent to a

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2. The Small Business Deregulation Task Force reported confusion among small business over how penalties were determined (Commonwealth of Australia 1996, *Time for Business: Report of the small business deregulation task force*, Commonwealth of Australia, Canberra – the Bell Report pp. 44–45). In response, the Government considered the complexity of penalty arrangements to be the major factor behind taxpayer confusion and misunderstanding, and asked the Tax Office to develop options for simplification (Commonwealth of Australia statement by the Prime Minister, the Honourable John Howard, MP 1997, *More Time for Business*, Commonwealth of Australia, Canberra).
3. Taxation Laws Amendment Act (No. 5) 1998, Explanatory Memorandum, paragraphs 1.45–1.47.
4. Culpability penalties are discussed in Chapter 4.
5. Taxation Laws Amendment Act (No. 3) 2001, Supplementary Explanatory Memorandum, paragraph 4.6.

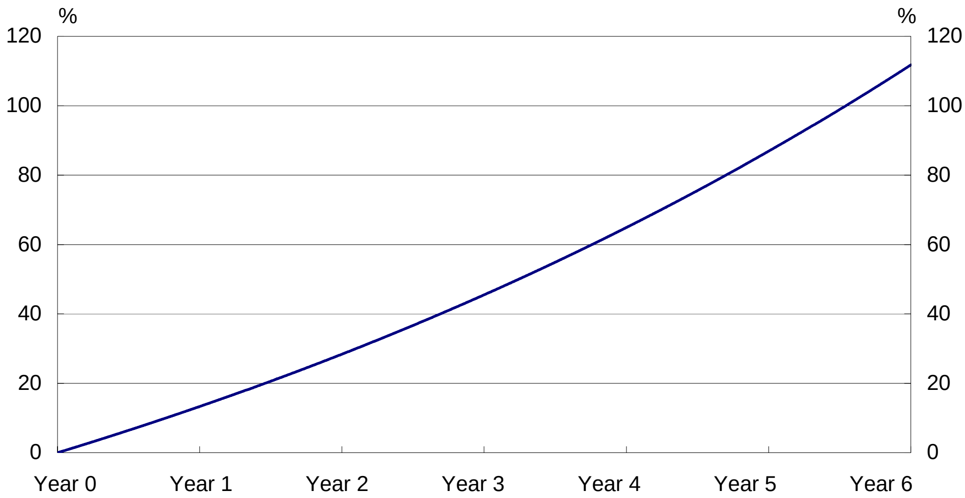
simple interest rate of 13.1% per annum. That is, a $100 underpayment left to compound daily at the GIC rate would grow to $113.10 over a year.

In recent years, the GIC rate has varied between 11% and 14%. For ease of discussion, this Chapter will adopt a 12.5% GIC rate unless stated otherwise.

5.1.1 Compounding effect

The amount of the GIC resulting from a shortfall will escalate over time, due to the effects of compound interest. Figure 5.1 presents, as a percentage of the shortfall, the GIC that would accrue at an interest rate of 12.5%, for periods up to six years.

Figure 5.1: Accumulation of 12.5% GIC as percentage of shortfall



At a GIC rate of 12.5%, interest charges would be approximately 28% of the shortfall after two years and 65% by the end of the normal four year review period. Where the shortfall arises from a tax avoidance scheme, a longer six year review period applies, exposing the taxpayer to GIC up to 112% of the tax shortfall.

In many (but not all) cases, these figures exaggerate the adverse impact that the GIC would have on a taxpayer, as they account for neither the interest that would have been payable to an alternate finance provider, nor the tax deductibility of the GIC.

5.1.2 Remission of the GIC

Broadly speaking, the Tax Office has the power to remit all or part of the GIC in any of the following circumstances:[6]

- The taxpayer did not cause the delay and has taken reasonable mitigating action.
- The taxpayer caused the delay, but has taken mitigating action, and it is fair and reasonable to remit.
- There are special circumstances by reason of which it would be fair and reasonable to remit.
- It is otherwise appropriate to remit.

The Tax Office, in interpreting how this power should be used, places significant emphasis on the presumption under the legislation that the GIC should normally apply. For example, although the last criterion appears very broad, the Tax Office's Receivables Policy states[7] that decisions to use this power 'will not usually be concerned with the circumstances of a particular taxpayer'.

The presumption that the GIC should apply is also reflected in the practice of usually requiring taxpayers to apply for remission, rather than it being initiated by the Tax Office.

If the Tax Office decides not to remit an amount of GIC in full, the taxpayer cannot use the normal objection and review provisions to obtain a review on the merits of the Tax Office's decision. However, the taxpayer can use administrative law actions to challenge whether a decision not to remit was according to law.

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6. The precise wording of these powers is at section 8AAG of the *Taxation Administration Act 1953*. Guidance on how the Tax Office interprets the various remission categories can be found in the Receivables Policy, Chapter 93 (see footnote 7 of this Chapter). Under the *Commissioner's Guarantee*, the GIC will always be remitted where a taxpayer relies on information in *TaxPack* that is misleading.
7. Australian Taxation Office 2003, *Australian Taxation Office Receivables Policy*, Australian Taxation Office, Canberra: <www.law.ato.gov.au/atolaw.htm> paragraph 93.5.24.

5.1.3 International comparisons

Table 5.1 presents key aspects of the interest charges on shortfalls in Australia, Canada, New Zealand, the UK and the US. Each country has a discretionary power to remit interest charges. Further details can be found at Appendix 4.

Table 5.1: Interest payable on tax shortfalls

Country	Rate of interest	Interest tax deductible?
Australia	Bank Accepted Bill rate plus 7%	Yes
Canada	Canada 90 day Treasury Bill rate plus 4%	No
New Zealand	NZ business base lending rate plus 2%	Only for businesses
United Kingdom	4.75% for corporations which pay their tax in quarterly instalments	Only for corporations
	6.5% for individuals and corporations which pay their tax annually	
United States	Federal short term rate plus 3% for individuals	Only for corporations

5.2 Impact of the GIC on shortfalls in different circumstances

This section outlines factors influencing the impact of shortfall GIC on various taxpayers. The range of possible impacts is illustrated through fictional cameos. Although not drawn from actual cases, the cameos demonstrate the different impacts that can arise from the imposition of the GIC on an amended assessment.

The extent to which these impacts are consistent with the policy objectives, including administrative workability, are addressed later. However, it should be noted that, given the size and inherent complexity of the tax administration system, arrangements will inevitably represent a balance of these competing considerations, rather than being fine tuned to the circumstances of each taxpayer.

An important issue in analysing the impact of the GIC on a taxpayer is the taxpayer's alternative borrowing rate. A 12.5% tax deductible GIC rate would be a significant loan benefit for an individual otherwise borrowing at a non-deductible overdraft rate of 15%. So, even when the GIC applies, for some taxpayers the net result is a cheap loan, whereas for others, it is a significant cost. Between these two extremes, the GIC can be seen as neutralising, to various extents, loan benefits received from the shortfall.

Another consideration is how the shortfall funds are applied. If they are invested, the net impact of the GIC will largely depend on the return from the investment, after allowing for the cost of liquidating or refinancing the investment. If the shortfall funds are applied to consumption, the shortfall might provide no loan benefit at all for some taxpayers — even before the GIC is considered.

Larger enterprises tend to carry ongoing, tax deductible debt as part of their financing structure. Consequently, a shortfall would be more likely to have displaced normal borrowing, and the GIC would primarily be a cost of finance issue. Representatives of larger businesses have argued that the GIC rate is consistently well above their normal borrowing rate.

Cameo 1: Large low-risk business

MegaCorp is a 'blue chip' company and borrows at about the bank bill rate. About six years ago, MegaCorp engaged in a complex financing arrangement for a project and claimed substantial deductions. In a subsequent audit, the Tax Office rejected certain deductions, which MegaCorp disputed. Hoping for a favourable outcome, MegaCorp agreed to extend the period of review beyond the statutory four years. About five years after the original 'due and payable' date, the Tax Office issued an amended assessment for $100 million plus $85 million in GIC. No penalties were applied, as the Tax Office considered MegaCorp to have taken reasonable care and to have had a reasonably arguable position. Had MegaCorp assessed correctly, it would have borrowed an additional $100 million in the marketplace, at 5.5%, incurring interest costs of around $30 million. Interest costs would be tax deductible in either case.

For healthy small to medium businesses, the GIC premium over their normal borrowing rates would vary.

Cameo 2: Healthy small business

XYZ Industries is a large family business with a strong credit rating and asset backing, readily able to borrow at benchmark overdraft rates. The Tax Office issued the firm with a revised assessment around three years after the original 'due and payable' date for $100,000 plus $45,000 of GIC. Had XYZ Industries assessed correctly, they would have borrowed an additional $100,000 at 8.5%, incurring interest costs of around $30,000. Interest costs would be tax deductible in either case.

For individuals with debt, because the interest would not normally be tax deductible, the net impact of the (tax deductible) GIC could be negligible (in the case of home mortgages) or significantly favourable to the taxpayer (in the case of consumer credit).

Cameo 3: Mortgagee

Mary earns a good income and lives to a strict budget, with any variations in receipts and expenditures absorbed by her mortgage account, which has an interest rate of 7%. The Tax Office issued Mary with a revised assessment for $10,000 plus $2,060 of GIC around 18 months after the original 'due and payable' date. Had Mary assessed correctly, she would have incurred an additional interest cost on her mortgage of around $1,100, which would not have been tax deductible. Mary subsequently received a tax deduction for the GIC, leaving her with a net GIC cost of $1,060. Allowing for the mortgage interest incurred prior to claiming a tax deduction for the GIC in her next return, Mary was financially no worse off, despite the inadvertent error.

Cameo 4: Consumer credit

Peter runs a small business. On a recent holiday to Europe, he made a number of brief visits to some potential suppliers he heard about from someone he met on the plane, and subsequently claimed what he thought was a reasonable proportion of his holiday as a business expense on his tax return. He applied the funds from the tax deduction toward his substantial credit card debt, which was incurring interest at 15%. Around 18 months after the original 'due and payable' date, Peter, who was close to paying off his trip, received an amended assessment that disallowed most of his claim for the European visits, creating a tax debt of $10,000 plus $2,060 GIC. Had Peter assessed correctly, he would have incurred an additional interest cost on his credit card account of around $2,500, which would not have been tax deductible. Peter subsequently received a tax deduction for the GIC, leaving him with a net GIC cost of $1,060. Allowing for the credit card interest incurred prior to accessing this tax benefit in his next return, Peter was $1,300 better off financially, despite the inadvertent error.

Where an individual has, in effect, invested the shortfall funds, the net impact of the GIC will depend primarily on the gap between the returns on those investments and the GIC rate. A personal investor is unlikely to receive the GIC rate in ordinary circumstances, given its equivalence to a high commercial rate. Indeed, a personal investor perceiving themselves as saving, rather than borrowing, could face a net impact from shortfall GIC that was greater than for low risk businesses. Further, they might face difficulty in liquidating financial investments.

Cameo 5: Conservative personal investor

Fred invested the net proceeds from share sales in a term deposit at 5%. Due to an error in his capital gains tax calculation, Fred received a revised assessment around a year after the original 'due and payable' date for a further $1,000 plus $133 of (tax deductible) GIC. Over that period, Fred had only earned $50 from having deposited that extra $1,000 (taxable at the top rate).

In other cases, the shortfall funds will have been applied (effectively) to consumption. In these cases, there is a real prospect that the discovery of the shortfall itself will cause significant problems. That is, while the individual might have enjoyed the goods and services purchased with the shortfall, the ultimate cost may prove too high. This would be more likely where the individuals would not otherwise have borrowed to make those purchases. In such cases, the net impact of the GIC could be the full GIC amount.

Cameo 6: Tax shortfall spent on consumption

Tom and Ingrid are a middle aged couple. Ingrid inherited a rental property and used savings to finance substantial renovations. Ingrid incorrectly claimed the renovation cost as a deduction, rather than capitalising the improvements, and received a sizeable tax refund. Later that year, they spent what they understood to be their residual savings of $25,000 on an extensive overseas trip. Ingrid returned to an amended assessment for $25,000 plus over $3,000 in accrued GIC, with an adverse impact on the lifestyle they were otherwise expecting. Tom had previously decided against accepting his parent's offer of an interest free loan for such a trip because they did not think it would be worth the sacrifices needed to pay off the trip in a reasonable time.

Very small businesses can display mixed characteristics, compared with larger businesses and individuals. Like larger businesses, a very small business might always carry ongoing, tax deductible debt as part of its financing structure. However, if the business is operating at its borrowing limit, a shortfall amount is unlikely to displace other borrowing. Rather, there is a significant possibility that the shortfall would have been ploughed back into the business — possibly providing a return lower than the GIC rate.

In other cases, apparently spare funds arising from a shortfall might be withdrawn by the proprietor for consumption spending.

Cameo 7: Struggling start-up business

Phil accepted a redundancy package so he could develop and commercialise a software product he had created, but failed to achieve significant sales. He was on the point of returning to salaried employment when the business received a sizeable tax refund, which he went on to use for both business and personal living expenses. Subsequently, the business received a revised assessment for $10,000 plus $640 for six months' GIC.

5.3 Policy goals for the GIC in shortfall cases

The operation of the GIC is indifferent between the taxpayer who assesses correctly and leaves $100 of the assessment unpaid, and the taxpayer who under assessed by $100, but pays the full amount of the original assessment.

This section discusses the appropriateness of this 'one size fits all' approach. A key consideration is the extent to which the functions served by the GIC in the normal tax debt case are applicable to the shortfall case. Other important policy issues are tax deductibility and administrative simplicity.

Three conceivable benchmarks for evaluating the GIC in relation to shortfalls are that it should:

- ensure that non-compliant taxpayers do not receive an advantage — in the form of a free loan — over those who meet their tax liabilities by the due date
- provide a positive incentive for taxpayers to take steps to ensure they assess correctly
- compensate Government for the cost of delayed tax payments.

5.3.1 Neutralising the loan advantage

As mentioned in the first dot point above, the GIC serves to ensure that non-compliant taxpayers do not receive an advantage — in the form of a free loan — over those who meet their tax liabilities by the due date. This function of the GIC is relevant both to shortfalls and late payments of assessed tax.

As demonstrated in the cameos presented above, the loan benefit from a shortfall can vary from nil to greater than the GIC. Accordingly, the 'shortfall interest rate' required to neutralise any loan benefit from a shortfall could range from zero to the full GIC rate.[8]

5.3.2 Incentive to assess correctly

The uplift factor in the GIC is intended to encourage taxpayers to pay their tax liabilities on time. However, in the inadvertent shortfall case, which is central to the self assessment context, there will be no apparent tax debt until an assessment is amended. This contrasts with the late payment case, where the tax liability will have been crystallised in an assessment, the taxpayer will know that a debt is payable, and can choose the best way to minimise interest charges.

Consequently, in the shortfall context, the 'incentive to pay on time' function of the GIC primarily translates to an incentive to assess correctly. That is, the threat of the GIC (being at a high commercial rate) should encourage taxpayers to take steps to ensure they assess correctly and avoid 'aggressive' interpretations of the law.

However, the GIC attaching to a shortfall will also depend on the length of time before the shortfall is detected, rather than simply reflecting the shortfall amount or the error that caused it.

5.3.3 Compensating the government for delayed payment

The other function served by the GIC is to compensate government for the impact of late payments. Delays in tax receipts due to late payment or under assessment of tax mean that government borrowing and interest costs are higher than otherwise need be.

The 7% uplift factor means that the GIC would generally more than compensate government for its interest costs, which are in the region of the base rate, allowing some contribution to cover collection costs and default risk. In cases of remission, the Tax Office is often unwilling to go below the base rate, for the reason that this would entail a cost to government.

Given the possibility for inadvertent errors in the tax system, it could be argued that government should sometimes accept delay in revenue collection without full compensation.

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8. The full GIC rate should be taken to provide a ceiling for any shortfall interest rate, as this is the most that a taxpayer would be charged for knowingly not paying an assessed tax amount.

Other arguments for a more generous approach include:

- Due to its responsibility for providing information on tax law interpretation, the Tax Office has some influence over the likelihood of taxpayer errors.
- The cost to government from shortfalls will often depend on how long the Tax Office takes to identify and correct those shortfalls.
- Taxpayers can feel that they face a 'lottery' over the timing for the amendment of their shortfall. Where an audit program progressively amends assessments, the total revenue delay cost from those amendments might not depend significantly on the order in which the assessments are reviewed, but the cost to a particular taxpayer could. For those taxpayers who do not receive a loan benefit, being reviewed later rather than earlier is disadvantageous.

5.3.4 The impact on the GIC of tax deductibility

The GIC is currently tax deductible, as are the cost of income producing loans and certain other costs related to tax obligations, such as tax agent fees. Therefore, where shortfall GIC is to be remitted, it might be appropriate to have regard to the ultimate after tax impact of the GIC on particular taxpayers.

5.3.5 Administrative workability

The preceding sections have explored various impacts that the shortfall element of the GIC might have on taxpayers in a range of circumstances. However, administrative workability must form a key consideration. As noted above, the GIC was a response to pressures for a simple, more transparent regime that applies across all taxes.

An alternative system will not be viewed as fair if, by being tailored to an individual's confidential circumstances, the reasons for differences in the treatment of various taxpayers are not transparent.

5.4 Possible alternative approaches

The approaches below seek to address the concern expressed in preliminary consultations that the rate of the GIC is generally too high for shortfall cases, especially where several years elapse between the original assessment and amendment.

There are two possible mechanisms for implementing the approaches. One would be to alter the formal legal benchmarks for imposing interest charges on shortfalls. Another would be to give effect to those benchmarks by altering the Tax Office's remission powers. For convenience, the latter route is used below in presenting the approaches.

Unless otherwise indicated, all current features of the GIC would remain the same, including tax deductibility.

If any of the following approaches were adopted, it may be necessary to reconsider the appropriateness of the culpability penalty rates (set out in Chapter 4).

5.4.1 Approach A: Remit the GIC down to a cap

Under this approach any shortfall GIC in excess of a cap (say, 25% of the shortfall) would be remitted. Once an amended assessment has been issued, the GIC will apply at the normal (statutory) rate from that date on any amount unpaid.

The principle underlying this approach would be that a shortfall should not be treated more harshly simply because it took longer to be identified, after a reasonable time for identification has elapsed. The cap would address arguments that the Tax Office has an incentive to delay amending assessments.

With a cap, the period over which shortfall GIC would effectively accrue would vary with movements in interest rates. This is consistent with an objective that the GIC should not become disproportionately high compared with the amount of the shortfall. Table 5.2 shows the time it would take the GIC to reach a 25% cap for GIC rates from 10% to 15%. At recent GIC rates, a 25% cap would be consistent with the Tax Office identifying and acting on any shortfalls in about two years.

Table 5.2: Time for the GIC to reach a 25% cap

GIC rate (%)	Months
10.0	27
12.5	21
15.0	18

No taxpayer would pay more GIC than under the present arrangements.

As discussed earlier, many (but not all) taxpayers would derive some loan benefit from a shortfall in their assessment, prior to the additional tax being paid. Where assessments are amended beyond the point at which a cap came into effect, those loan benefits would tend to erode or even surpass the impact of the (capped) GIC. To preserve the incentive effect, an alternative way to implement this approach might be to only partly remit shortfall GIC beyond the cap. That is, full GIC would apply until the cap were reached, after which the GIC would be remitted to a lower rate.

5.4.2 Approach B: Remit the GIC beyond a set period

Under this approach, once a set period (say, two years) had passed from the date of the original assessment, any further shortfall GIC would be remitted. Once the amended assessment had been issued, the GIC would then apply from that date on any amount still unpaid.

This approach would also protect taxpayers from the GIC impact of long review periods. However, it would not cap the size of the GIC in proportion to the shortfall as consistently as Approach A. The extent to which the GIC on a given shortfall could accrue in the two year period would depend on the interest rate. Table 5.3 shows the GIC after two years as a proportion of shortfall for GIC rates from 10% to 15%.

Table 5.3: Two years' GIC as a proportion of shortfall

GIC rate (%)	Percentage of shortfall
10.0	22.1
12.5	28.4
15.0	35.0

Adopting this approach would principally reflect a concern with the impact of long review periods, rather than with the direct proportionality of GIC to the size of the shortfall. As with Approach A, an alternative way to implement this proposal would be to only partly remit GIC after the set period, to preserve the impact of the GIC accumulated up to that point.

A more direct means of protecting taxpayers from the GIC impact of long review periods would be to reduce the actual review periods. The potential for reducing review periods is discussed in Chapter 3.

5.4.3 Approach C: Remit uplift factor

Under this approach, the uplift factor for shortfall interest would be remitted to some lower standard. As with other approaches, once the amended assessment had been issued, the GIC would apply from that date on any amount unpaid.

As an alternative, remission of all or part of the uplift factor could be confined to GIC charges after a cap or time limit is reached, along the lines discussed in Approaches A and B above.

5.4.4 Tax Office initiated remission

At present, the Tax Office generally only remits following an application by the taxpayer. The act of applying for remission arguably imposes unnecessary compliance costs, especially where there are clear grounds for the power to be exercised in a taxpayer's favour.

In initial consultations, practitioners have suggested that the present system would be improved if the Tax Office initiated remission of the GIC more frequently. In some instances, this remission could happen as a matter of course. For example, if the 'capping' concepts discussed above were adopted, remission to give effect to them would be applied without the need for individual application.

The rationale for this approach would be to streamline the administration of remission and interest compliance costs in an environment where remission became more common. It may also reduce the need for taxpayers to involve tax agents in the process.

5.4.5 Standardisation of tax deductibility

An idea that has been raised to eliminate the current diversity in after tax shortfall GIC outcomes would be to replace tax deductibility with an offset. The offset would apply to the GIC in general, and be set for individuals at around the top tax rate, and for companies at the rate of 30%.

Alternatively, tax deductibility could be abolished entirely on all GIC, with a commensurate reduction in the uplift factor.

5.5 Questions for consultation

5.A **Should the GIC be set at a level to provide a positive incentive to encourage taxpayers to take steps to ensure they assess correctly? Or should this be dealt with exclusively under the penalty regime?**

5.B **Is the rate of the GIC excessive against this principle?**

5.C **Are the approaches identified in this Chapter suitable to address identified concerns with the GIC? If so, by what mechanism should the approaches be implemented? Are there cases where full GIC should continue to apply to shortfalls?**

5.D **What priority should be given to simplicity in considering any changes to the current GIC regime? Should different market segments be treated differently for GIC purposes? Is it feasible to move away from a single, comprehensive system?**

5.E **Should remission of the GIC be initiated by the Tax Office in more circumstances? If so, what criteria should be used?**

5.F **Should the benefit from tax deductibility of the GIC be standardised, to eliminate the impact of varying tax rates? If so, how should this be achieved?**