# Practitioner's viewpoint: Deductibility of UOMI and interest on funds borrowed to pay tax, 10 December 2009

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*While the application of the use of money interest (UOMI) regime in Pt VII of the Tax Administration Act 1994 is generally well understood, there remains confusion over the deductibility of UOMI imposed on taxpayers for the underpayment of tax. In this article, Mark Keating, senior lecturer in taxation at the University of Auckland Business School, examines the rules that apply to the deductibility of UOMI. The author identifies a number of inconsistencies in the UOMI regime and highlights problems with the timing rules for when UOMI is incurred. He also contrasts the treatment of UOMI with the deductibility of interest borrowed by taxpayers to pay tax by the due date.*

**Background to use of money interest regime**

The UOMI regime has operated for more than a decade[1] . Section 120A(1) explains the purpose of UOMI is to "*compensate the Commissioner for the loss of use of money through taxpayers paying too little tax*" and "*to encourage taxpayers to pay the correct amount of tax on time*".

As the Commissioner is quick to point out, the UOMI regime applies both to overpayments and underpayments of tax, and stipulates that "*interest payable under this Part is not a penalty*". Nevertheless, due to the disparity in the rates of interest applicable to taxpayers and the Commissioner, many taxpayers undoubtedly feel UOMI unnecessarily penalises taxpayers for what are often minor or innocent errors.

In August 2008 the Tax Committees of the NZLS and NZICA issued a rare Joint Submission to the Minister of Revenue strongly criticising aspects of the disputes process, including the UOMI regime, and recommended extensive reform[2] . The Submission advised that:[3]

> "The use of money interest system and how it operates in the context of the disputes resolution procedures and challenge procedures needs to be reconsidered."

The appendix to the Joint Submission expanded on this concern at para 14(d).

> "The Law Society and NZICA believe that while a use of money interest regime is inevitable in terms of the design of an efficient tax disputes system, that the current regime (which involves taxpayers paying 14.24% for underpaid tax, with the Inland Revenue paying 6.66% for overpaid tax) involves too wide a differential. If there is a substantive dispute as to whether tax is due in the first place, and the taxpayer is unable to fund a voluntary payment of tax to stop the interest accruing, the use of money interest regime gives rise to very serious financial risk for taxpayers (which must be reported in their accounts). … We believe the rate differential between the Inland Revenue's paying rate and the taxpayer's paying rate is far too wide and needs to be reviewed. The use of money interest regime has become a penalty on taxpayers and requires reconsideration."

The Joint Submission proposed a number of possible reforms to the regime, including suspending UOMI or reducing the applicable rate (to approximately bank deposit rates) during the statutory disputes process (para 14(e)). To date, those proposals have not been adopted by the Commissioner — although an extension of the tax pooling regime to reassessments following a tax dispute was recently enacted (see s RP 17B of the *Income Tax Act 2007*). The rates of UOMI were subsequently reduced to 8.91% for debit UOMI and 1.82% for credit UOMI as from 29 June 2009.

But any reassessment invariably results in the imposition of considerable UOMI. Not surprisingly, most taxpayers who incur this additional expense seek to claim UOMI as a deduction for income tax. Unfortunately, the entitlement to deduct UOMI is not certain.

**Entitlement to deduct UOMI**

While payments of "*tax*"[4] are non-deductible under s BD 1, UOMI is expressly excluded from that definition. Accordingly, UOMI imposed under Pt VII is treated as "interest" for the purpose of the *Income Tax Act 2007*. Deductibility of UOMI therefore depends upon meeting the statutory requirements in s DB 6 and/or s DB 7. Section DB 7 provides that all interest, including UOMI, is deductible for most companies. The deductibility of UOMI by most companies (other than a LAQC or one that derives exempt income) is therefore relatively clear.

By contrast, s DB 6 is the general interest deductibility rule applicable to all other taxpayers. This section requires that the interest expense comply with the criteria of the general permission in s DA 1. A deduction is permitted only if the underlying funds were applied to the operation of the taxpayer's business or in deriving the taxpayer's income. Cases such as *Pacific Rendezvous Ltd* v *C of IR* (1986) 8 NZTC 5,146, *Eggers* v *C of IR* (1988) 10 NZTC 5,153 and *C of IR* v *Brierley* (1990) 12 NZTC 7,184 are therefore applicable.

Under s DB 6 interest cannot be deducted by taxpayers who do not use the underlying funds to derive income or carry on their business. Case law is clear that a taxpayer cannot deduct interest expenses for funds that were applied to private purposes or on-loaned to associated taxpayers at a reduced rate. Where that occurs, as no or little income is derived, the required nexus will not exist: see: *Harley v C of IR*; *Jenkins* v *C of IR* [1971] NZLR 485, *Ure* v *FC of T* 81 ATC 4100 and *Case* S5 (1995) 17 NZTC 7,036.

The funds "borrowed" for the purposes of UOMI are presumably the amount of tax wrongly underpaid. This therefore requires an examination of the use to which the money not paid in tax was put by the taxpayer. This is a question of fact.

In many instances, particularly involving individual taxpayers, there are often insufficient records to establish how their funds have been applied. Often a taxpayer will contend the underpayment of tax was applied to the funding of their business, was used to purchase income-producing assets, or to reduce the need for further borrowing. In order to satisfy the statutory criteria in s DB 6, it may be necessary to produce records to show:

- if the funds were allegedly retained within the business, there would be additional working capital, and a corresponding increase in equity or the taxpayer's current account
- if the funds were allegedly applied to the reduction of business debt, the level of debt within the business would have reduced, or
- if the funds were allegedly applied to the purchase of additional assets, those assets would clearly be identifiable.

However, even when surplus funds have been loaned to the taxpayer's business, whether it be a private company or trading trust, those funds were often advanced interest-free, and therefore generated no assessable income.

More commonly, extra funds available to a taxpayer as a result of the underpayment of tax are used to support the taxpayer's lifestyle or the purchase of private assets. In either case it may be extremely difficult to demonstrate the relevant funds were used to derive income. The nexus required under s DB 6 will therefore be absent. Likewise, if the funds were distributed from the taxpayer's business and/or were applied by the taxpayer towards private expenditure, the purchase of domestic assets or the repayment of non-business debts, the nexus is not met. The use of other capital sums or borrowings by the taxpayer, even during the same income years, would not satisfy the nexus test regarding the underpayment of tax: *Case* E66 (1982) 5 NZTC 59,365 and *Case* H10 (1986) 8 NZTC 160.

In all instances the focus is on how the funds retained by the taxpayer were used — funds that should have been paid in tax for which UOMI was incurred. Only where that use satisfies the nexus test can the resulting UOMI be deducted.

**When is UOMI incurred?**

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Even when UOMI meets the requirements for deductibility, there remains uncertainty over when it is incurred. While UOMI theoretically accrues in each period the unpaid tax remained outstanding, in terms of s 120E, s EF 5 provides that UOMI is not spread but instead is deemed to have arisen in a single income year. Section EF 6 stipulates that, while the total amount of UOMI accrued over a number of years, it is deemed to have been incurred as a lump sum.

In most instances UOMI is deemed to have been incurred in the income year to which the assessment giving rise to the UOMI relates. However, where that liability results from the reassessment of a taxpayer in a later income year, for example following an investigation and tax dispute, UOMI is deemed to have arisen in the following year.

Despite this deeming provision, it is expected that the test for how the underpaid tax was used, and thus whether the UOMI is deductible, will involve an examination of how those funds were used over the entire period from when the underlying tax was properly due. Certainly, it would be odd if deductibility depended upon how the taxpayer had used the funds only in the year of reassessment or the following year.

**More generous rules for deduction of UOMI under the 2007 Act?**

It is interesting that the rewritten *Income Tax Act 2007* involved the rewording of the UOMI rules in subpart EF. In particular, the former wording in s ED 6 of the *Income Tax Act 1994* adopted neutral language to the effect that UOMI was "*incurred*" in a particular income year. This wording left open the question of whether the UOMI that had been incurred was nevertheless deductible under the normal rules in s DB 6.

By contrast, s EF 5(1) adopts the more assertive language that "*A deduction for interest payable by a person to the Commissioner under Part 7 … is allocated to the income year …*". Such wording appears to assume that UOMI is not merely incurred in the relevant income year but is "*a deduction*" in that year. Only if the taxpayer dies, goes into liquidation, or otherwise ceases to exist, is there an express requirement for the normal interest deductibility requirements to be satisfied under s DB 6.

Does this change in wording signify a deliberate (or even accidental) change in policy that UOMI is deductible in all instances? Such a conclusion is unlikely. Certainly, s ZA 3(3) stipulates the provisions of the *Income Tax Act 2007* should be interpreted simply as the rewording of the former provisions and "*are intended to have the same effect as the corresponding provisions*". Furthermore, the possible change in the scope of the UOMI rules is not one of the intended policy changes listed in Sch 51 to the 2007 Act. Accordingly, while on its face the wording of s EF 6 would appear to provide that UOMI is automatically deductible, such an interpretation is unlikely to be upheld.

**Comparison with money borrowed to pay tax**

If UOMI is not deductible in all instances, what is the tax treatment of money borrowed by the taxpayer to pay a tax liability in order to avoid the imposition of UOMI? Can a taxpayer deduct the cost of interest incurred on funds borrowed to pay a tax liability?

In short the answer is that such interest is normally deductible. This conclusion is based upon a number of older cases permitting deduction of interest incurred by taxpayers on funds borrowed to pay tax rather than sell income-producing assets. The leading case on this point is the Court of Appeal decision in *Public Trustee* v *C of T* [1938] NZLR 436 where trustees of an estate had to borrow funds to pay death duties. Their only alternative had been to sell assets to raise the funds for the death duties but instead they borrowed and incurred interest, which they deducted against the income generated from the assets retained by the estate.

The Commissioner declined to permit a deduction for interest incurred by the trust on the grounds it generated no additional income. However, the Court of Appeal ruled in favour of the taxpayer on the grounds that, provided the expenditure was not involuntary and had been used to retain business (not private) assets, then deduction of the interest was permitted.

The Australian case *Begg* v *FC of T* (1937) 4 ATD 257 had facts similar to *Public Trustee* and was also decided in the taxpayer's favour. A liability for interest paid on moneys borrowed by an executor to pay succession and estate duties was deductible because it preserved an income earning asset.

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The Inland Revenue Department (IRD) issued an initial policy statement in 1992[5] and then amended it in 2006 with interpretation statement IS0082: *Interest deductibility — Public Trustee v CIR*[6]. The interpretation statement dealt with interest deductibility, including the scope and application of the *Public Trustee* principle. The 1992 policy statement contains a number of examples of when a taxpayer may borrow money and claim a deduction for different types of expenditures. Example 5 deals specifically with borrowings to pay tax. It states:

> "Company A, which is in business, has insufficient funds to pay its tax. Rather than realize assets which produce assessable income, it borrows money to make the payment. Is the interest on the money borrowed to meet the company's tax obligations deductible?
>
> Application: The interest is fully deductible since it is necessarily payable in carrying on a business for the purpose of gaining or producing assessable income. The interest is payable in preserving assets required for the business of the taxpayer. In terms of the principles in Public Trustee there is sufficient nexus with the income earning process to satisfy the test for deductibility."

By contrast, Example 6 of that 1992 policy statement concludes interest will not be deductible by sole traders or private individuals to pay their tax — but there is no explanation as to why the *Public Trustee* principle would not equally apply to individual taxpayers who have income-earning assets.

The 1992 policy statement was partially superseded by the 2006 interpretation statement. The relevant portion dealing with the *Public Trustee* case states [para 131–132]:

> "Interest is deductible if a taxpayer establishes that the capital was borrowed to meet involuntary expenditure to retain assets used in producing assessable income. However, if the capital was borrowed for purposes quite alien from the income producing asset (such as meeting personal obligations), the interest will not be deductible. The onus is on the taxpayer to establish that the interest is deductible, and what portion of it is deductible."

The interpretation statement continues:

> " … the taxpayer must at least prove that the borrowing prevented a realization of income earning assets. Also, the Commissioner has clarified that a private use of the funds will not on its own prevent a deduction of the interest, and, that in such a situation, interest may be deductible if there is another use of the borrowed funds that has a sufficient connection with assessable income to establish deductibility."

The IRD policy therefore permits taxpayers to borrow funds to pay their tax, on the basis it is presumed that borrowing prevented the need to sell business assets, and therefore the interest is deductible, under the principle of the *Public Trustee* case. Where taxpayers have both private and business assets, it is generally presumed funds were borrowed to preserve the income-earning assets. Only where a taxpayer has no income-earning assets to preserve will a deduction be precluded. Accordingly, the rules regarding deduction of interest on funds borrowed to pay tax are more generous than the rules regarding deduction of UOMI incurred on the underpayment of that tax.

**Conclusion**

There is an obvious inconsistency between the limited deductibility of UOMI and the generous deductibility of interest borrowed to pay tax. The deduction of UOMI for most taxpayers is subject to the requirements of the general permission, which requires taxpayers to prove the funds were applied to a business or the purchase of an income earning asset. This is a factual test that may be difficult for many private taxpayers to satisfy. By contrast, under the *Public Trustee* principle, interest on borrowed funds is deductible in full on the grounds the retention of income-earning assets is generally presumed.

Furthermore, interest incurred on borrowed funds is immediately deductible in the years in which it arises, whereas UOMI is deemed to have been incurred in a lump sum, either in the year in which the underlying assessment giving rise to that liability arises or in the subsequent year. This deferment of the deduction of UOMI again punishes taxpayers. Such a difference is bad policy in that both types of expenditure involve an expense of interest incurred on funds paid (either on the due date or subsequently) to satisfy the taxpayer's liability. It is suggested the Commissioner consider aligning the rules for deductibility of UOMI with the more

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generous interest deduction rules. The current inconsistency causes both confusion and unfairness and ought to be corrected.

**Footnotes**

1 The current regime was enacted by s 36 *Tax Administration Amendment Act (No 2) 1996*, with application from the 1997/98 income year. The regime was introduced as part of a larger package of reforms, including the shortfall penalties regime, aimed at encouraging taxpayer compliance, and punishing non-compliance.

2 *Joint Submission on the Disputes Resolution Procedure in Part IVA Tax Administration Act 1994 and the Challenge Procedure in Part VIIIA Tax Administration Act*, Taxation Committee of NZLS and National Tax Committee of NZICA, August 2008.

3 Covering letter to Joint Submission at para 4(c).

4 As defined in s 3(1) Tax Administration Act.

5 *Tax Information Bulletin* ¶39-108 Vol 3, No 9, June 1992 at p 14.

6 *Tax Information Bulletin* ¶186-104 Vol 18, No 6, July 2006 at p 9.