Regulatory Impact Statement: Customs and Excise Act Review: Regulations: Reduced compensatory interest rate for inadvertent errors

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by the New Zealand Customs Service.

It provides an analysis of options for regulations to:

- prescribe a reduced compensatory interest rate for shortfall payments where the duty payer can demonstrate that it was due to an inadvertent error
- prescribe conditions on the application of the reduced interest rate.

This RIS is one of three addressing administrative details of Customs' new compensatory interest and late payment penalties regime.

The analysis assumes that the following recommendations, made in two other RIS's, will be implemented:

- no compensatory interest or late payment penalties will be charged if the outstanding core duty is less than $1000 (see *Customs and Excise Act Review: de minimis threshold for compensatory interest and late payment penalties*)
- compensatory interest incurred between the date a duty payer is notified of the charges and the date they make payment will be cancelled, as long as the duty is paid by the date specified on the payment notice (see *Customs and Excise Act Review: compensatory interest incurred between notification of an incorrect payment and payment*).

The constraints on the analysis are:

- it is not clear how much compensatory interest will be remitted under the recommended option. The reduction in the amount of interest collected was not factored into the ranking of the options for a reduced interest rate, as none of the options reduced the revenue below the level required to fully compensate the Crown for loss of use of money
- the analysis assumes that prescribing voluntary disclosure a condition of receiving the reduced interest rate will increase voluntary disclosures. However, other changes to the sanctions regime for incorrect duty payments could also impact on the number of voluntary disclosures. Customs will monitor the number of shortfall payments voluntarily disclosed and the number found through audit when the new regime is implemented.

Signed by Anna Cook on 31 July 2017

Anna Cook
Director Policy **31 July 2017**

Executive summary

1 The Customs and Excise Bill provides for compensatory interest to be charged to a duty payer, whenever duty remains unpaid past its due date. This interest is intended to compensate the Crown for the bank interest that could have been earned on the unpaid duty, if it had been paid on time.

2 The Cabinet Economic Growth and Infrastructure Committee (EGI) has agreed that the rate of interest will be prescribed in regulations, and will be based on Inland Revenue's use of money interest, which is currently 8.22 percent per annum [EGI-17-MIN-0019][1]. This is much higher than the actual rate of interest needed to compensate the Crown, but ensures that duty payers do not have an incentive to defer duty payment as a cheap way of financing their business.

3 However, if duty is unpaid due to incorrect or missing information about the value of the goods, and the duty payer was unaware of the error or omission at the time it was made, charging a high rate of interest will not have any positive effects on compliance. The Bill therefore allows for regulations to prescribe that compensatory interest be partially remitted in these circumstances.

4 It is recommended that compensatory interest be remitted to a rate based on the 90-day bank bill rate for inadvertent shortfall errors. The 90-day bank bill rate reflects the rate of return available on bank deposits, and will ensure that duty payers are not charged any more interest than is necessary to compensate the Crown and promote compliance.

5 It is also recommended that duty payers be required to voluntarily disclose the shortfall payment, and pay the outstanding core duty in full by the date specified on the payment notice, in order to be eligible for the reduced interest rate. These conditions will provide strong incentives to duty payers to voluntarily comply with their obligation to pay their duty in full.

Status quo and problem definition

6 Customs duties are charges imposed on goods that are imported into New Zealand and on some domestically manufactured goods. They include tariff duty, excise-equivalent duty and GST on imported goods; and excise duty on domestically produced alcohol, tobacco and fuel.

7 The Bill introduces a system of compensatory interest and late payment penalty charges for people who do not pay their duty in full by the due date. These provisions will replace Customs' current additional duty regime, which is unduly punitive and not transparent in its purpose.[2] This RIS focuses on the compensatory interest component of the new regime.

8 Compensatory interest is intended to compensate the Crown for the bank interest that could have been earned on unpaid duty, if it had been paid on time. It will accrue daily,

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[1] All EGI decisions referred to in this paper are contained in this minute.

[2] Two RISs were prepared relating to replacing the additional duty regime with compensatory interest and late payment penalties. See *Customs and Excise Act Review: Sanctions for incorrect payments* and "Customs and Excise Act Review: Sanctions for incorrect payments – detailed design of a new regime".

and be charged whenever the Crown is deprived of the use of duty that it is entitled to. This includes the following situations:

- **late payment:** when some or all of the duty assessed on an import or excise entry is not paid by the due date

- **shortfall payment:** when an import or excise entry is incorrect, or the goods are not entered, causing a duty payer's duty liability to be under-assessed

- **incorrect repayment:** when a duty payer provides incorrect information to Customs that results in them receiving a repayment of duty that they are not entitled to. This is similar to a shortfall payment, as both are caused by incorrect or missing information.

9 The Bill requires the compensatory interest rate to be set by regulations. EGI has agreed that it should be set at the floating first mortgage rate plus 2.5 percent. This is in line with Inland Revenue's use of money interest, which is currently charged at 8.22 percent. This rate is much higher than the rate of interest needed to fully compensate the Crown, which would be about two percent under current market conditions. Instead, the rate represents the cost of borrowing for businesses. This is necessary to ensure that duty payers do not have an incentive to defer duty payment as a cheap way of financing their business.

10 However, in some cases, an interest rate linked to the cost of borrowing, rather than the Crown's cost of loss of use of money, has no compliance benefits. This occurs when someone makes a shortfall payment, but was not aware of the shortfall at the time it was made.[3] In these cases, the duty payer did not have the opportunity to make a deliberate decision to use the Crown as a source of finance.

11 The Bill therefore allows regulations to prescribe partial remission of compensatory interest for shortfall payments, if the duty payer can demonstrate that it was caused by an inadvertent error. This has the effect of applying a reduced interest rate in these circumstances, and is loosely modelled on the Australian Tax Office's (ATO) reduced interest rate for shortfall payments. The relevant enabling provision also allows the regulations to prescribe further conditions that must be met for the reduced compensatory interest rate to apply.

12 This RIS provides an analysis of options for the reduced compensatory interest rate, and conditions on its application.

[3] EGI also agreed that a reduced interest rate could be applied to incorrect repayments that were caused by an inadvertent error. However, incorrect repayments are so rare that such provisions were not considered necessary at this stage.

Objectives

Interest rate

13 Options for a reduced compensatory interest rate have been assessed against the following objectives:

Objective	Indicator
Minimise financial disadvantage to the Crown	• Interest rate is equal to or greater than the rate of interest available on bank deposits.
Minimise unnecessary costs for businesses	• Minimise the amount that duty payers are charged, over and above what is necessary to compensate the Crown and promote compliance.
Minimise administrative costs for Customs	• Minimise extra costs associated with applying a different interest rate for shortfalls caused by an inadvertent error.

Conditions

14 Options for further conditions on the application of the reduced compensatory interest rate have been assessed as to whether they promote voluntary compliance or provide other administrative benefits.

Interest rate – options and impact analysis

15 Customs has considered the following options for a reduced compensatory interest rate for shortfalls caused by an inadvertent error:

Option 1: no reduction in rate

16 Duty payers would be charged the full compensatory interest rate, based on the floating first mortgage rate plus 2.5 percent, even if their incorrect payment was due to an inadvertent shortfall error. This rate is linked to Inland Revenue's use of money interest rate, which is currently 8.22 percent.

Option 2: 90-day bank bill rate (recommended option)

17 The rate would be set based on the 90-day bank bill rate published by the Reserve Bank of New Zealand (RBNZ). The 90-day bank bill rate is a market interest rate that is a common benchmark for many financial products in New Zealand, and reflects the rate of return available on bank deposits. As at 28 April 2017, this would result in a compensatory interest rate of 1.97 percent.

Option 3: 90-day bank bill rate plus three percent (ATO model)

18 The rate would be set according to the formula used to determine the ATO's shortfall interest rate. This would be based on the 90-day bank bill rate, published by RBNZ, with an added margin of three percent. As at 28 April 2017, this would result in a total compensatory interest rate of 4.97 percent.

19 The following table summarises the impacts of each of the above options on Customs and duty payers:

Key: ✓✗ partially meets the criteria ✓✓ meets the criteria ✗✗ doesn't meet the criteria

	Minimises financial disadvantage for the Crown	Minimises unnecessary costs for businesses	Minimises administrative costs for Customs	Total
Option 1: no reduction (=8.27%)	All options would fully compensate the Crown for loss of use of money, as the rates are all equal to or greater than the market return on bank deposits	✗✗ Duty payers who have made an inadvertent shortfall payment would be charged an amount of interest that is much higher than the rate needed to compensate the Crown. The higher interest is not justified through any compliance benefits, due to the inadvertent nature of the shortfall payment.	✓✓ Customs would not have to spend any extra time considering whether a duty payer was eligible for a reduced interest rate.	2
Option 2: 90-day bank bill rate (=1.97%) **Recommended option**		✓✓ Duty payers who have made an inadvertent shortfall payment would only be charged enough interest to compensate the Crown.	✓✗ Customs may have to spend some extra time investigating whether an error was made inadvertently, in order to determine whether interest should be charged at the reduced rate. However, a minimum threshold of $1000 outstanding core duty will be prescribed for the collection of compensatory interest on shortfall payments. This will limit the amount of time spent reviewing eligibility for the reduced interest rate.	3

Option 3: 90-day bank bill rate + 3% (=4.97%)		✓✗ Duty payers who have made an inadvertent shortfall payment would be charged an amount of interest that is somewhat higher than the rate needed to compensate the Crown. The higher interest is not justified through any compliance benefits, due to the inadvertent nature of the shortfall payment.	✓✗ Customs may have to spend some extra time investigating whether an error was made inadvertently, in order to determine whether interest should be charged at the reduced rate. However, a minimum threshold of $1000 outstanding core duty will be prescribed for the collection of compensatory interest on shortfall payments. This will limit the amount of time spent reviewing eligibility for the reduced interest rate.	**2**

Conditions – description and impact analysis

20 Customs has considered the following possible conditions on the application of a reduced compensatory interest rate for shortfalls caused by an inadvertent error.

Application for reduced rate

21 This condition would require duty payers to make a formal application in order to be eligible for a reduced interest rate for their shortfall payment.

22 A formal application process could lead to time savings for Customs officers, as the costs of making the application could discourage duty payers from applying for remission if they cannot demonstrate that the shortfall error was inadvertent.

23 It is expected that in most cases duty payers will be able to demonstrate that the error is inadvertent. If this is the case, having to review a remission application could actually increase an officer's workload.

Voluntary disclosure of error (recommended)

24 This condition would require duty payers to voluntarily disclose a shortfall payment to Customs, in order for that shortfall to be eligible for a reduction in compensatory interest. Voluntary disclosures must take place before Customs notifies a duty payer that they will be audited.

25 This would provide strong incentives for duty payers to voluntarily disclose a shortfall payment, where otherwise they might have chosen not to disclose it if there is a low risk of the shortfall being discovered through an audit.

Full payment of core duty (recommended)

26 This condition would require duty payers to pay the outstanding core duty in full, by the date specified on the payment notice, in order for a shortfall payment to be eligible for a reduced interest rate.

27 This would strengthen incentives to settle the core debt as soon as possible once it is discovered, ensuring that the Crown does not continue to be deprived of use of money.

Full payment of interest at higher rate

28 This condition would require duty payers to pay compensatory interest on their shortfall payment at the standard interest rate (floating first mortgage rate plus 2.5 percent), in order to be eligible for the reduced interest rate. The difference would then be refunded to the duty payer.

29 This would allow Customs to issue an assessment notice outlining the amount of duty payable, before reviewing any evidence to determine whether the shortfall was due to an inadvertent error. However, the process of refunding the overpaid interest to duty payers is likely to be administratively inefficient.

Consultation

30 Customs consulted the following government agencies on this RIS: the Treasury, Inland Revenue, and the Ministry of Justice. No issues were raised.

31 Customs also undertook targeted consultation with stakeholders who expressed an interest in the compensatory interest and late payment penalty regime. This included major accounting firms, importers and excise stakeholders.

32 Stakeholders were generally supportive of the recommendations made in this RIS. One stakeholder suggested that remission for inadvertent errors should be automatic once a shortfall has been voluntarily disclosed, and another expressed concern about how Customs would determine whether an error is inadvertent and ensure that remission processes are consistent and fair. These issues will be addressed as part of implementation, and discussed with stakeholders.

Conclusions and recommendations

Interest rate

33 It is recommended that shortfall payments caused by an inadvertent error be charged an interest rate based on the 90-day bank bill rate. This will ensure that the Crown is fully compensated for loss of use of money, and that duty payers are not exposed to any unnecessary interest charges. Although this rate is considerably lower than duty payers' cost of finance, it will not increase the risk of deliberate deferral of duty payment, as duty payers will be required to demonstrate that the shortfall error was not made intentionally.

Conditions

34 It is also recommended that duty payers be required to voluntarily disclose the shortfall payment, and pay the outstanding core duty in full by the date specified on the payment notice, in order to be eligible for the reduced interest rate. These conditions will provide strong incentives to duty payers to voluntarily comply with their obligation to pay their duty in full.

35 The options of requiring duty payers to make a formal application for a reduced interest rate, or to pay interest at the higher rate before being eligible for a reduced rate, were both rejected, as it is not clear that they would have net benefits to Customs.

Financial implications

36 When EGI agreed that compensatory interest should be partially remitted for shortfall payments due to an inadvertent error, it was noted that the remission would result in a reduction in the total amount of interest collected by the Crown. It is difficult to estimate how much interest would be remitted if these recommendations were implemented, as Customs does not have reliable data on how many shortfalls are voluntarily disclosed. It is also not clear whether the number of voluntary disclosures will be the same under the new regime. However, the maximum amount of shortfall interest that could be eligible for remission under these provisions is about $250,000 a year.

37 The reduction in the amount of interest collected was not factored into the ranking of the options for a reduced interest rate, as none of the options reduced the revenue below the level required to fully compensate the Crown for loss of use of money.

Implementation plan

38 The regulations proposed in this RIS will be implemented concurrently with the new compensatory interest and late payment penalty regime, which is included in the Customs and Excise Bill. The Bill is currently awaiting its second reading.

39 Customs has developed a comprehensive plan for implementing the Customs and Excise Bill to ensure a seamless transition to the new arrangements.

40 Guidance material is being developed for both internal and external clients. This material will include operational procedures and practical examples for Customs staff and will assist in consistent application of compensatory interest and late payment penalties in line with the overall policy intent. This guidance material will also form the basis of training packages for Customs staff.

41 Prior to implementation, consultation will be undertaken with external stakeholders by way of workshops and feedback on documentation. Following this, external guidance material will be developed to give external clients practical examples on how the compensatory interest, penalties and remissions will be applied. There will be a communications plan associated with the passing of the Bill to publicise the changes.

42 There are no implementation risks that require mitigation.

Monitoring, evaluation and review

43 Under the new regime, Customs will monitor the number of shortfall payments voluntarily disclosed and the number found through audit. A drop in the number of voluntarily disclosed shortfalls, or an increase in the number found through audit, could indicate that the reduced compensatory interest rate is weakening incentives for people to calculate and pay their duty correctly.