

## QUESTIONS WE'VE BEEN ASKED

# Can a payment that compensates for the time value of money be taxable income if it is outside the statutory definition of “interest”?

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All legislative references are to the Income Tax Act 2007 unless otherwise stated.

### Key provisions

Income Tax Act 2007 – ss CA 1(2), CC 4(1) and YA 1

**REPLACES: [QB 09/03](#) *Decisions on application of CA 1(2) – common law interest and income under ordinary concepts***

## Question

**Can a payment that compensates for the time value of money be taxable income if it is outside the statutory definition of “interest”?**

## Answer

**Yes. If a payment to compensate for the time value of money is outside the scope of the statutory definition of “interest” in the Act, the payment may still be income under a provision other than s CC 4(1) (which taxes interest). For example, such a payment may be taxed as income under ordinary concepts (under s CA 1(2)), if it has the necessary characteristics of income, or it may be taxed as income under another provision.**

**This means that a payment described as interest may be taxable income, even if it is outside the scope of the statutory definition of “interest”.**

## Explanation

1. In 2009, the Commissioner issued a Question We’ve Been Asked titled [QB 09/03](#) *Decisions on application of CA 1(2) – common law interest and income under ordinary concepts*. QB 09/03 sets out the Commissioner’s view on the decision in *CIR v Buis and Anor* (2005) 22 NZTC 19,278 (HC) and what it means for the potential taxability of certain payments under s CA 1(2). In QB 09/03, the Commissioner did not agree with the judgment to the extent it suggested that s CA 1(2) could not apply to common law interest payments that did not fall within the specific provision taxing interest (s CC 4(1)).
2. The Commissioner’s interpretation of the law has not changed. As in QB 09/03, the Commissioner still considers that a payment for the time value of money can be taxable as income under ordinary concepts in s CA 1(2) or under another provision. However, on review, the Commissioner now considers that the judgment in *CIR v Buis* can be read consistently with the Commissioner’s view on how s CA 1(2) applies. This item concerns the Commissioner’s interpretation of the judgment in *CIR v Buis*, not the Commissioner’s interpretation of the law. This item does not concern the correctness of the conclusion reached in *CIR v Buis* that the particular Accident Compensation Corporation (ACC) payments at issue in that case were not income.
3. This item clarifies the Commissioner’s view, which is summarised below:

- The relevant enquiry under s CA 1(2) is whether an amount has the character of income, and this is consistent with the decision in *CIR v Buis*.
- The outcome in *CIR v Buis* is confined to its particular facts concerning the tax treatment of certain penalty payments made under the Accident Compensation scheme.
- *CIR v Buis* does not stand for a broader proposition that payments that compensate for the time value of money (described in QB 09/03 as common law interest) cannot be income under ordinary concepts or income under another provision.
- The decision in *CIR v Buis* is not inconsistent with the role of s CA 1(2) as a supplement to the specific income provisions of the Income Tax Act.

## Background

### CIR v Buis

4. *CIR v Buis* concerned whether payments made to two claimants under s 72 of the Accident Rehabilitation and Compensation Insurance Act 1992 (now the Accident Compensation Act 2001) were assessable income.<sup>1</sup> The payments were described in s 72 as “interest”, but were not within the statutory definition of “interest” in s OB 1 of the Income Tax Act 1994 (now s YA 1) as they were not payments for money lent.
5. The Commissioner argued in *CIR v Buis* that the payments were interest under the common law definition of that concept. On that basis, the Commissioner argued that the payments were income under ordinary concepts for the purpose of s CD 5 of the Income Tax Act 1994 (now s CA 1(2)).
6. France J determined that the ACC payments in question were not income under ordinary concepts. At paragraphs [45] to [49], France J stated the following in relation to the Commissioner’s argument:

**[45] The Commissioner’s proposition is that the payment is interest at common law and therefore caught by s CD 5. In my view this gives s CD 5 too broad a scope in**

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<sup>1</sup> The equivalent provision is now s 114, but as the provision is set out differently, this item does not make any statements about the taxability of payments under this newer provision or whether the provision has changed in substance.

**that it gives it an application that is in conflict with other parts of the** [Income Tax Act 1994].

[46] **One can hardly imagine a more encompassing provision than s CE 1** [which captured interest payments as gross income under the Income Tax Act 1994, now section CC 4(1)]. It is not a case of the Act, despite its comprehensibility, not addressing a particular situation. **Section CE 1 starkly captures all interest payments as gross income.** On its face the Commissioner should not need s CD 5, but the “problem” lies with the definition of “interest”. It fixes interest by reference to the concept of money lent, and it is common ground that makes it inapplicable to the s 72 payment.

[47] The important aspects of the s OB 1 definition, however, are the opening words:

Interest, **in relation to the deriving of gross income**, means ...

[48] **In my view s CD 5 must be read subject to this since it deals with gross income. The Act defines what interest is for gross income purposes, and that must apply to both ss CD 5 and CE 1.** The contrary argument is that there are two definitions of interest – the statutory one, and the common law one, and both continue by virtue of s CD 5. I prefer the view that the s OB 1 definition, expressed as it is as capturing the concept of interest for gross income purposes, applies to both ss CD 5 and CE 1. Such an approach accords with ordinary statutory interpretation principles concerning general and specific provisions. It also accords with s AA 3(1) which places weight on the reading of the statute in context.

[49] I accordingly conclude that, **since the Commissioner relies on s CD 5 applying on the basis that the payment is interest, the argument fails because s OB 1 defines interest exhaustively** for the purpose of determining if a payment is gross income. **It is appropriate, however, to address the underlying proposition of the Commissioner that s CD 5 applies.**

[Emphasis added]

7. France J then went on to consider whether the ACC payments were income under ordinary concepts on any other basis, and concluded that they were not.

## QB 09/03

8. QB 09/03 stated the following regarding the reasoning in *CIR v Buis*:

In *Buis* and *Burston* France J held that section CD 5 of the Income Tax Act 1994 (now section CA 1(2)) could not apply to tax common law interest payments, because interest could be taxed only under the provision dealing with interest so defined (section CE 1 of the Income Tax Act 1994 (now section CC 4(1))). **In his Honour's view, common law**

**interest payments were not taxable because they did not come within the definition of "interest" in section OB 1 of the Income Tax Act 1994** (now section YA 1).

[Emphasis added]

9. QB 09/03 stated that the Commissioner does not accept the correctness of that aspect of the decision as a generally applicable principle, and intends to have the matter considered further by the courts when an opportunity arises in the future.
10. This statement was made because the Commissioner was, and remains, of the view that amounts that might be described as interest at common law can be taxable as income under ordinary concepts (under s CA 1(2)), or under other provisions, if those amounts have the necessary characteristics to be income under the relevant provision. This means an amount that might be described as common law interest is not excluded from taxable income purely because it is outside the statutory definition of interest.

## Commissioner's view after reconsideration

### CIR v Buis

11. The Commissioner has reviewed QB 09/03 and reconsidered the judgment in *CIR v Buis*. The Commissioner now considers that the decision in *CIR v Buis* does not preclude time value of money payments from being income under a provision other than s CC 4(1).
12. At paragraph [49], France J states that the statutory definition of interest in s OB 1 of the Income Tax Act 1994 "defines interest exhaustively" for the purpose of determining whether a payment is taxable. The Commissioner's view is that those comments were specifically responding to arguments the Commissioner raised in the context of the case. It is considered France J was not suggesting that all payments that could be described as common law interest were precluded from taxation. Instead, he was disagreeing with the specific argument raised in the case that the ACC payments were taxable **on the basis** that they were described as "interest".
13. It is correct that the s YA 1 definition defines the concept of "interest" exhaustively for the purposes of the Income Tax Act and its predecessors. This means that a payment cannot be income by virtue of being "interest" if it is outside the s YA 1 definition. However, this does not preclude a payment that might be thought of or described as interest from being income under another provision, and France J's judgment is not inconsistent with this.

14. This interpretation is supported by France J's comment at paragraph [49] that it was appropriate to address the underlying proposition that the payments in that case were income under ordinary concepts, and by the following consideration of this in the judgment. In determining whether the payments were income under ordinary concepts, France J considered the various characteristics of income and the nature of the payments in question — that is the relevant enquiry under what is now s CA 1(2). France J concluded that the payments did not have the required characteristics of income. Instead, he stated there were indications that the payments were a penalty Parliament had adopted to encourage the efficient disposal of ACC claims.
15. On reflection, for these reasons the Commissioner no longer considers *CIR v Buis* stands for a broader proposition that time-value-of-money payments cannot be income under ordinary concepts or income under another provision if they are outside the statutory definition of interest. The Commissioner considers that *CIR v Buis* is consistent with her view that the relevant enquiry under s CA 1(2) is whether an amount has the character of income. How an amount may be described or how it is defined at common law is not determinative. The outcome, in terms of the taxability of the payments at issue in *CIR v Buis*, is confined to the particular facts of that case and the nature of the specific ACC payments being considered under s 72 of the Accident Rehabilitation and Compensation Insurance Act 1992.
16. The Commissioner considers that France J's comments about the exhaustive nature of the definition of "interest" are not inconsistent with the role of s CA 1(2) as a supplement to the specific income provisions (in Part C of the Income Tax Act). As noted above, those comments were made in the context of the Commissioner's argument that the ACC payments were taxable as income under ordinary concepts **on the basis of being interest**.
17. The Commissioner therefore takes the view that this comment was not intended as a wider statement about the interaction between s CA 1(2) and specific income provisions. As France J went on to address whether the payments were income under ordinary concepts on any other basis, this indicates he was treating s CA 1(2) as supplementary to the specific provision for taxing interest. Section CA 1(2) operates as a catch-all provision to cover amounts that have the characteristics of income but are not within any of the specific income provisions. It cannot widen the scope of any of the specific provisions, or override their application, but it can be used to tax amounts that are outside these provisions if those amounts have the character of income.
18. The interaction of s CA 1(2) and specific income provisions in the context of *CIR v Buis* was briefly raised in [QB 09/01](#) *Payments made in addition to financial redress under Treaty of Waitangi settlements – income tax treatment*.

The effect of the conclusion in *Buis* that the statutory definition of "interest" is exhaustive is that amounts that would have been income under ordinary concepts (being interest under the common law) may not be income. **This result appears to be inconsistent with the relationship between section CA 1(2) and specific provisions defining income. The role of section CA 1(2) is to supplement specific provisions of the Act defining income:** see *Tillard v C of T* [1938] NZLR 795; *Louisson v C of T* [1942] NZLR 30; Discussion Document on Rewriting the Income Tax Act 1994 (September 1997). This result is also inconsistent with the purpose of the statutory definition of "interest" which was amended in order to widen rather than narrow the meaning of "interest" for income tax purposes: *Marac Life Assurance Ltd v CIR* (1986) 8 NZTC 5,086.

**However, in *Buis* the court went on to consider whether the payment in question was income under ordinary concepts on any other basis, and found in that case that it was not income.**

[Emphasis added]

19. As QB 09/01 clarifies that in *Buis* the court went on to consider whether the payment was income on any other basis, it is considered that this QWBA is not contradictory to QB 09/01. However, to the extent that the comments in QB 09/01 may be viewed as inconsistent with the view in this item regarding the interaction between s CA 1(2) and specific income provisions, this QWBA supersedes QB 09/01.

## Tax treatment of payments outside the definition of "interest"

20. If a payment is made to compensate for the time value of money, or may otherwise be described as "interest", but is outside the statutory definition, whether it is taxable needs to be considered on a case-by-case basis. This is true of any payment or receipt. The answer will usually depend on a number of factors. Generally, the following three features are relevant in considering whether a payment is income:<sup>2</sup>
- Income is something that comes in.
  - Income is generally periodic, recurrent and regular.
  - Whether a particular receipt is income depends upon its quality in the hands of the recipient.
21. However, many payments made to compensate for the time value of money or otherwise described as interest may be one-off payments rather than made periodically or regularly. Lack of regularity or periodicity does not necessarily mean a

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<sup>2</sup> Set out by Richardson J in *Reid v CIR* (1985) 7 NZTC 5,176 (CA).

payment is not income. In these circumstances, the most relevant factor will likely be the nature of the payment in the hands of the recipient, which involves considering what the payment is for.

22. In *CIR v Buis*, the payments were determined to be in the nature of a penalty, despite s 72 of the Accident Rehabilitation and Compensation Insurance Act 1992 referring to them as “interest”. On the other hand, if a payment of “interest” were made in relation to mistakenly underpaid salary or wages, this would likely be taxable as employment income. Similarly, a payment to compensate for late payment under a compensation clause in a contract (commonly referred to as “default interest”) would likely be income under ordinary concepts, if not income under another provision (for example, business income under s CB 1).
23. It is noted that if a payment is income but not within the definition of “interest”, it may not have identical tax treatment to a payment within the definition of “interest”. Specifically, payments of interest within the scope of s CC 4(1) will generally be resident passive income or non-resident passive income, and will therefore be subject to withholding under the RWT or NRWT rules. If a payment is described as interest but is outside the definition in s YA 1, such as default interest in the previous example, it will not be subject to this withholding.<sup>3</sup> The specific tax treatment will depend on the provision taxing the income, not the terminology that may be used to describe the payment.

## References

### Legislative References

Income Tax Act 2007 – s CA 1(2), CC 4(1) and YA 1

### Case References

*CIR v Buis and Anor* (2005) 22 NZTC 19,278 (HC)

*Reid v CIR* (1985) 7 NZTC 5,176 (CA)

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<sup>3</sup> Unless the payment is otherwise captured by the RWT or NRWT rules.

## Other References

[QB 09/01](#) *Payments made in addition to financial redress under Treaty of Waitangi settlements – income tax treatment*

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