Inland Revenue
Te Tari Taake

EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

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Send feedback to Public.Consultation@ird.govt.nz

Note: In preparing this question we've been asked (QWBA), we consulted with our Policy and Regulatory Stewardship division to determine whether the view expressed is consistent with the policy settings. They advised this area warrants further consideration, but they are not able to consider it for the next bill due to competing priorities. However, we decided to produce this item to provide certainty for Inland Revenue staff and customers in the meantime.

QUESTIONS WE'VE BEEN ASKED

Foreign investment fund (FIF) default calculation method

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This QWBA explains that a person does not have a choice of calculation methods and must use a default method to calculate FIF income if they fail to declare the income in a tax return and later file a voluntary disclosure, or fail to file a tax return by the due date and later provide one with the income.

This item is particularly relevant for natural persons and eligible trustees.

Key provisions

Income Tax Act 2007 – ss EX 44, EX 48

Tax Administration Act 1994 – ss 33, 37

Question

Does a person have a choice of calculation methods for FIF income when they make a voluntary disclosure or file a late return?

Answer

No. No choices are available. Normally, a person has a choice of up to five methods for calculating FIF income, depending on the person and the investment. However, a person must use a default method – usually the fair dividend rate (FDR) method – if they:

- **fail to declare FIF income in a tax return and later make a voluntary disclosure; or**
- **fail to file a tax return by the due date and later provide one with FIF income.**

In some cases, the amount of FIF income will be more than if the person had filed a return that included the income by the due date. This is because they are no longer able to choose a method that results in paying less tax.

Explanation

Introduction

1. This QWBA explains what happens under the FIF rules if a person:
    - fails to declare FIF income in a tax return and later makes a voluntary disclosure; or
    - fails to file a tax return by the due date and later provides one with FIF income.
2. Some people are unsure whether they have a choice of methods to calculate FIF income when they correct their tax affairs. This QWBA clarifies that they must use a default method – usually FDR. Inland Revenue will require taxpayers to use the default method for their investments for any voluntary disclosures they make and late returns filed from the date this QWBA is published in its final form.
3. The information is particularly relevant to natural persons and eligible trustees – see [12] – as they will not be able to choose a method and this may result in more tax to pay.

4. The law and reasoning supporting the answer is summarised in the body of this item with more detailed analysis set out in the appendix.

Overview of the FIF rules

5. The FIF rules apply to a person if they are a New Zealand tax resident who is not a transitional resident and they have certain kinds of investments overseas.

6. These investments are:

   - a direct income interest in a foreign company, including a foreign unit trust;
   - rights in a FIF superannuation scheme as a member or beneficiary; and
   - rights to benefit from a life insurance policy if it is not offered or entered into in New Zealand.

7. A person may have FIF income if they hold rights in these investments and they are not exempt. These rights are called attributing interests. If an exemption applies, other rules may tax any income from the investment.

8. If a person has an attributing interest in a FIF, they must calculate FIF income by choosing one of the following five methods:

   - the fair dividend rate (FDR) method;
   - the comparative value (CV) method;
   - the cost method;
   - the deemed rate of return method; and
   - the attributable FIF income method.

9. Restrictions apply as to which methods a person can choose, depending on several factors such as the nature of the person and their investment.

10. A wide range of investments can be an attributing interest in a FIF and several methods for calculating FIF income are possible. For these reasons, to make the explanation as clear as possible, we focus on a common attributing interest in a FIF where:

    - the taxpayer is a natural person or eligible trustee, and they own ordinary shares in a foreign company;
    - a market value is available for the shares;
    - the company is not in Australia;
    - the shareholding is under 10%; and

- the total cost of all FIF investments is over NZ$50,000.

11. Natural persons and eligible trustees can choose between FDR and CV from one year to the next in this situation. However, the general rule is that once a person uses a particular method, they must use it in the following years.

12. Eligible trustees are trustees where:

    - the settlor is a natural person or deceased, and
    - the trust is a complying trust for a distribution, and
    - the trust is mainly for the benefit of natural persons for whom the settlor has or had natural affection or for the benefit of a charity.

The FDR method

13. FIF income under FDR is 5% of the opening market value of the shares plus any quick sale adjustment[1]. Where a person acquires the shares during the year, the opening balance is zero and there is no FIF income under FDR provided no quick sales have occurred.

The CV method

14. By contrast, the CV method essentially calculates FIF income by comparing the closing market value of the shares with their opening value, adjusted for purchases and dividends. The result reflects the performance of the investment and foreign currency fluctuations. No losses are permitted unless the investment is a non-ordinary share.

Choosing a method

15. Choosing either the FDR or the CV method over the other may result in more or less income depending on the circumstances. A person makes their choice by reporting any resulting FIF income in their tax return by the due date. The due date is usually 7 July for a natural person with no agent. It will be a later date where a person has an extension of time arrangement.

16. Inland Revenue treats a person as if they have not chosen a method if they:

    - file their return by the due date but do not include the relevant FIF income; or

[1] A person needs to calculate a quick sale adjustment if they sell shares they have bought in the same year.

- do not file their return by the due date for filing (including the due date under any extension of time arrangement).

The default method

17. Where one of the above situations applies and a person later corrects their tax affairs by making a voluntary disclosure or by filing a tax return including FIF income, a choice of methods is unavailable. The person must apply the method that the legislation requires.

18. In the common situation described at [10], Inland Revenue treats the person as if they had chosen the FDR method. The CV method is not available.

Further information

19. For more information about the FIF rules, please refer to IR461 *Guide to foreign investment funds* (August 2022) at ird.govt.nz or seek advice from a tax advisor.

Examples

20. The following examples demonstrate how the rules apply in different scenarios.

Example 1 – Return includes FIF income correctly

James is a New Zealand resident who is not a transitional resident.

He has owned ordinary shares in a company listed on the London Stock Exchange for a number of years. The market value of these shares at the start of the current year is NZ$100,000. He receives no dividends during the year and the shares are worth NZ$103,000 on his balance date of 31 March. He has no agent and must file a tax return by 7 July.

James has an attributing interest in a FIF and must choose a calculation method. The available methods are FDR and CV. The amount of FIF income using FDR is 5% of the opening balance of NZ$100,000, or NZ$5,000. The amount using CV is NZ$103,000 less NZ$100,000, or NZ$3,000.

James is a natural person and can choose either method. He chooses CV and reports NZ$3,000 in his IR3 return, which he files on time.

Example 2 – Return leaves out FIF income and more tax is payable

The facts are the same as in Example 1, but here James forgets to include FIF income in his return.

He later decides to make a voluntary disclosure after hearing from a friend that Inland Revenue exchanges financial account information with the United Kingdom annually and if he makes a voluntary disclosure before an audit starts shortfall penalties can be reduced by 100%.

As James did not include the FIF income in his return, he cannot choose between FDR and CV. He must use the default method, which is FDR, and report NZ$5,000.

Example 3 – Return leaves out FIF income and the same tax is payable

Michael is a New Zealand resident who is not a transitional resident.

Michael acquires ordinary shares in a company on the Hong Kong Stock Exchange during the year at a cost of NZ$60,000. He receives no dividends and the market value of the shares is NZ$80,000 on 31 March. Michael is unaware of the FIF rules and does not report any FIF income from his investment in his tax return, which he files on time.

Michael learns about the FIF rules from a conversation with his friend James and decides to check his situation.

The default method requires him to use FDR. As Michael did not own the shares at the beginning of the year, his FIF income is zero and there is no shortfall.

21. There may be situations where the result of applying the CV method is zero and it is not clear whether the person chose a method at the time of filing their tax return. It will be a question of fact whether the person made a choice. The burden of proof will be on the person in such circumstances.

Example 4 – CV method used in voluntary disclosure

Kiri is a New Zealand resident who is not a transitional resident.

Through an oversight, Kiri does not report FIF income in her returns for four years. Inland Revenue learns that she may have investments overseas through its annual automatic exchange of information programme with other tax jurisdictions. It sends her a letter asking if her tax affairs are in order.

Kiri decides to make a voluntary disclosure. She declares income using the following methods:

- year 1 NZ$0 – CV
- year 2 NZ$5,000 - FDR
- year 3 NZ$3,000 – FDR
- year 4 NZ$5,000 – FDR.

She explains that her reason for not complying was that she did not know about the rules.

Inland Revenue will treat Kiri as if she chose FDR for the period when she did not choose a method. This is for years 1 to 4. The period includes year 1 as Jane did not know about the FIF rules and therefore did not choose a method that year.

Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

References

Legislative references

Income Tax Act 2007 – ss CQ 4-6, CX 57B, EX 28-72 (the FIF rules), LJ 2(6), LJ 2(7)

Tax Administration Act 1994 – ss 33, 37

Other references

IR461 *Guide to foreign investment funds* (August 2022) (Inland Revenue 2022), https://ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir400---ir499/ir461/ir461-2022.pdf?modified=20220921025937&modified=20220921025937

Interpretation Statement IS 21/09 Income tax – foreign tax credits – how to calculate a foreign tax credit (Inland Revenue 2022), https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/interpretation-statements/2021/is-21-09.pdf?modified=20211222005828

Standard Practice Statement *SPS 19/02 Voluntary disclosures* (Inland Revenue 2022), https://www.taxtechnical.ird.govt.nz/en/standard-practice-statements/shortfall-penalties/sps-1902-voluntary-disclosures

About this document

QWBAs are issued by the Tax Counsel Office. QWBAs answer specific tax questions we have been asked that may be of general interest to taxpayers. While they set out the Commissioner's considered views, QWBAs are not binding on the Commissioner. However, taxpayers can generally rely on them in determining their tax affairs. See further Status of Commissioner's advice (*December 2012*). It is important to note that a general similarity between a taxpayer's circumstances and an example in a QWBA will not necessarily lead to the same tax result. Each case must be considered on its own facts.

Appendix: Technical explanation of the answer in this QWBA

22. This appendix explains the answer to the question posed in this QWBA with the relevant legislative references from the Income Tax Act 2007 (ITA) and the Tax Administration Act 1994 (TAA). References are to the ITA unless otherwise stated. The focus is on natural persons who own shares in a foreign company in the circumstances described at [10].

FIF income taxable

23. FIF income is income under s BD 1(1) because it is income under s CQ 4. It is assessable income under s BD 1(5). Section CQ 5 describes when FIF income arises. Essentially, this is when a person who is a New Zealand tax resident has an attributing interest in a FIF that is not exempt. The two main exclusions are for transitional residents and attributing FIF interests with a total cost not exceeding $50,000. If the person does not need to apply the FIF rules, they may still have income under other sections in the ITA.

24. Under s CQ 6, FIF income is calculated using the relevant calculation method in ss EX 44 to EX 61.

Attributing interest in a FIF

25. FIF investments are listed in s EX 28, as follows:

    - a direct income interest in a foreign company, including a foreign unit trust
    - rights in a FIF superannuation scheme as a member or beneficiary
    - rights to benefit from a life insurance policy if it is not offered or entered into in New Zealand.

26. Section EX 29(1) provides that a person has an attributing interest in a FIF if:

    - the person holds rights in one of the listed categories, such as a direct income interest in a foreign company, and
    - none of the exemptions in ss EX 31 to EX 43 apply.

27. Section EX 30 describes how to determine a person's direct income interest in a foreign company. Basically, it is the percentage of the person's shareholding in the company. The examples in this QWBA assume the natural person has an investment in a listed company and the shareholding does not exceed 10%. If the shareholding is 10% or

more, different rules may apply and the person may have to apply the controlled foreign company rules.

28. A common exemption is for a shareholding in an ASX-listed Australian company under s EX 31. If the exemption applies, the person does not calculate FIF income but instead must return any dividend income on a cash basis. The person must also return any gains on sale if the shares are held on revenue account.

Calculation of FIF income

29. Section EX 44(1) provides five methods under which the amount of FIF income for an attributing interest can be calculated:

- the fair dividend rate (FDR) method
- the comparative value (CV) method
- the cost method
- the deemed rate of return (DRR) method
- the attributable FIF income method.

30. Section EX 44(2) explains the requirement to choose a calculation method and reads:

> *Choosing method*
>
> (2) The person must choose which calculation method applies by completing their return of income accordingly, but the choice is limited by sections EX 46, EX 47, EX 47B, EX 48, and EX 62.

31. The section requires a person to choose one of the calculation methods for each attributing interest. This choice is made by "completing a return of income accordingly" with the amount of FIF income resulting from the calculation. A "return of income" is defined in s YA 1 by reference to s 33 of the TAA. This section requires a person to file a return for each tax year. For persons with a 31 March balance date, the return must be filed by 7 July under s 37 of the TAA unless the person has an extension of time arrangement. Therefore, choosing a method and completing a return on time as a consequence of that choice are important elements of the FIF rules.

32. If a person uses the end-of-year automatic process and has more than $200 of income other than reportable income, such as FIF income, they must provide this information to the Commissioner by the same date as someone who files an IR3 return (s 37(1B) of the TAA).

33. Section EX 44(2) places restrictions on the choice a person can make. For example:

- s EX 46(6) limits who can use the CV method for an attributing interest in share in a foreign company.
- s EX 47 limits the methods that can be used to calculate FIF income from an attributing interest in a non-ordinary share to the CV method, or failing that, the DRR method.
- s EX 47B limits the method that a person can use for certain returning share transfers to the CV method.
- s EX 62 limits the ability of persons to change methods from year to year.

34. If a person calculates FIF income, s EX 59(2) provides that other amounts derived from the attributing interest for a period are excluded income under s CX 57B. This means that, for example, a person does not need to return dividends from an investment in ordinary shares in a US company if they are required to calculate and return FIF income from the attributing interest. The dividends are excluded income under s CX 57B and not assessable income under s BD 1(5).

35. Section EX 57 contains rules about how to convert foreign amounts into New Zealand dollars. Credits for foreign tax paid are calculated on the segment of FIF income under ss LJ 2(6) and LJ 2(7) unless the attributable FIF income method has been used. See "IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit", from page 83.

Default calculation method

36. The choice of calculation method is also limited by s EX 48. This section reads:

> **EX 48 Default calculation method**
>
> *When this section applies*
>
> (1) This section applies when—
>
> (a) a person does not choose a calculation method to calculate FIF income or loss from an attributing interest for a period; and
>
> (b) sections EX 46, EX 47, and EX 62 do not have the effect of requiring a particular calculation method to be used.
>
> *Default choice*
>
> (2) The person is treated as having chosen to use, for the period,—

(a) the fair dividend rate method if it is practical to use it; and

(b) the cost method if it is not practical to use the fair dividend rate method.

37. Two conditions must be met for the section to apply and limit the choice a person can make under s EX 44(2).

38. Firstly, the person must have failed to choose a calculation method to calculate FIF income from an attributing interest for a period. As noted at [31], in the Commissioner's view, failure to choose occurs when a person files a return by the due date but fails to declare FIF income, or when a person does not file a return by the due date. The reference to "for a period" in s EX 48(1)(a) means the time for which the person has not chosen a calculation method to calculate FIF income. This could be more than one tax year.

39. A person who files late – no matter whether it is a single day or two years – can no longer meet the requirements of s 44(2). If a person knows they are going to be late, they should request an extension of time **before** the due date. There is no discretion in the FIF rules for the Commissioner to accept a choice which is late.

40. A person who includes a dividend in their return but no FIF income has also not met the requirements of s 44(2). The FIF rules require a person to "calculate" FIF income. This means determining the amount of income mathematically. For example, the FDR method requires a person to calculate 5% of the opening market value of an attributing interest and add any income from quick sales taking into account the currency conversion rules. An amended assessment will involve eliminating the dividend and including FIF income calculated using a default method.

41. Secondly, the sections listed in s EX 48(1)(b) must not have the effect of requiring a particular method to be used. If a person must use a calculation method in a particular section, then that becomes the default method. For example, s EX 62(1) provides that a person must use the same method for the interests in a FIF for the next period unless they are allowed to change. As a natural person is able switch freely between the FDR method and the CV method under s 62(8), there is no requirement to use a particular method. However, a company will generally have to use the same method from one year to the next so the calculation method would be that used in the previous period.

42. If s EX 48(1) applies, the person is treated under s EX 48(2) as having chosen to use the FDR method for the period they did not make a choice if it is practical to use it. This means that if a person did not choose a method for, say three years, the FDR method would be used for that period to calculate FIF income in a late return, or a voluntary

disclosure submitted in accordance with SPS 19/02 *Voluntary disclosures*. If it is not practical to use the FDR method, the person must use the cost method.