INTERPRETATION STATEMENT

Income tax – foreign tax credits – how to calculate a foreign tax credit

Issued: 22 December 2021

IS 21/09

This Interpretation Statement explains how to calculate a foreign tax credit under subpart LJ of the Income Tax Act 2007. It also explains how to segment foreign-sourced income by country and by type. Examples are included to illustrate the concepts discussed.

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

RELATED ITEMS

- **IS 14/02:** Income tax – foreign tax credits – what is a tax of substantially the same nature as income tax imposed under s BB 1?
- **IS 16/05:** Income tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement

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Summary

1. New Zealand residents are taxed on their worldwide income. A New Zealand resident who derives assessable income from a foreign source may be entitled to a foreign tax credit for foreign income tax paid on that income. The process for calculating a foreign tax credit is set out in subpart LJ of the Income Tax Act 2007 (the Act). The purpose of subpart LJ is to prevent the double taxation of foreign-sourced income.

2. The Commissioner has previously published guidance on the foreign tax credit rules (see IS 14/02: Income tax – foreign tax credits – what is a tax of substantially the same

nature as income tax imposed under s BB 1?[1] and IS 16/05: Income tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement[2]). These statements explain how to determine whether a person is entitled to claim a foreign tax credit. Different rules apply depending on whether the foreign tax is covered by a double tax agreement (DTA).

3. Once a person with a New Zealand income tax liability has determined they are entitled to claim a foreign tax credit, the amount of that credit is calculated under subpart LJ. An important part of this calculation is to divide the foreign-sourced income into segments. To do this, the foreign-sourced income must first be divided by country and then further divided by source or by nature (s LJ 4).[3] Based on the purpose of subpart LJ (that foreign tax paid on one segment of income cannot be credited against New Zealand tax payable on another segment of income), the Commissioner considers the words "source" and "nature" in s LJ 4 mean "type". Therefore, the foreign-sourced income should be divided by country and then by type of income.

4. After the foreign-sourced income has been segmented, the person's notional New Zealand income tax liability must be calculated. A formula is then applied to find the amount of New Zealand tax payable on each segment of foreign-sourced income. Any expenditure incurred must be attributed to each segment, and some adjustments may be required. The person is then entitled to a foreign tax credit for the foreign tax paid on the segment, up to a maximum of the amount of New Zealand tax payable on that segment.

5. This Interpretation Statement is in three parts. Part 1 explains how to calculate a foreign tax credit. It also outlines relevant compliance obligations. Part 2 explains the law on segmenting foreign-sourced income in greater detail. Part 3 illustrates how the foreign tax credit calculation applies in some specific scenarios.

6. Examples are included throughout the statement to illustrate the concepts discussed and relevant legislative provisions are attached in the Appendix.

[1] *Tax Information Bulletin* Vol 26, No 5 (June 2014): 3.

[2] *Tax Information Bulletin* Vol 28, No 12 (December 2016): 41.

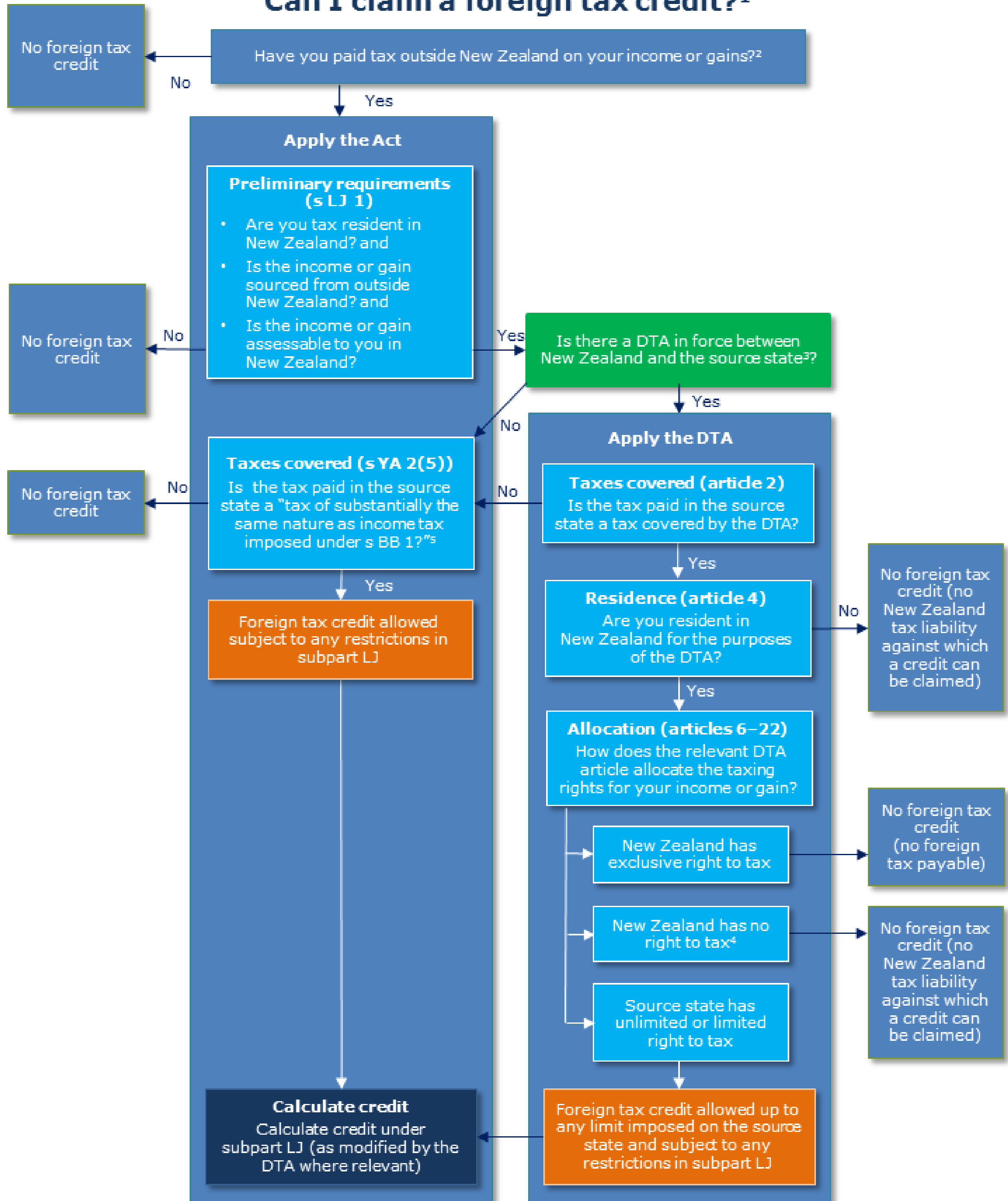
[3] Different segmentation rules apply where a person has foreign-sourced income that is FIF income from an attributing interest in a FIF.

Introduction

7. The Commissioner has previously published guidance on the foreign tax credit rules. The guidance explains how to determine whether a person is entitled to claim a foreign tax credit.

   - IS 14/02 interprets the phrase "a tax of substantially the same nature as income tax imposed under section BB 1" in s YA 2(5). This item applies where a foreign tax is not covered by a DTA. If the foreign tax is not covered by a DTA, a person may still be entitled to a foreign tax credit provided the tax is of substantially the same nature as income tax imposed under s BB 1.
   - IS 16/05 clarifies how the foreign tax credit rules work where the foreign tax paid is covered by a DTA.

8. IS 16/05 contains a useful flowchart that explains how to claim a foreign tax credit. This is reproduced below.



[1] All legislative references are to the Income Tax Act 2007.
[2] Different rules exist if a tax-sparing article applies.
[3] "Source state" refers to a country or a territory.
[4] This only occurs when article 20 (students) applies.
[5] See IS 14/02: "What is a tax of substantially the same nature as income tax imposed under s BB 1?" cited above.

9. Part 1 of this Interpretation Statement explains how to calculate a foreign tax credit under subpart LJ. This is the box in the bottom left-hand corner of the flowchart. For the purpose of this Interpretation Statement, it is assumed that a person has already determined they are entitled to claim a foreign tax credit. IS 14/02 and IS 16/05 provide further details on this.

10. Part 2 of this Interpretation Statement explains in greater detail how to segment foreign-sourced income. Part 3 then considers how the foreign tax credit calculation applies in some specific scenarios.

11. All foreign-sourced amounts referred to in the Interpretation Statement have been converted to New Zealand dollars.

PART 1: How to calculate a foreign tax credit

12. The rules for calculating a foreign tax credit are in subpart LJ of the Act. They can be summarised in three steps.

    - STEP 1: Establish the person's tax position
        - A person must have a New Zealand income tax liability for the relevant tax year. This is discussed from [13].
    - STEP 2: Calculate the amount of the foreign tax credit
        - This process is set out from [17].
    - STEP 3: Ensure the person's compliance obligations are met
        - This is discussed from [43].

Step 1: Establish the person's tax position

13. A person must have a New Zealand income tax liability before they can claim a foreign tax credit.

14. If a person has a net loss for the tax year, they will not have a New Zealand income tax liability (s BC 4(3)). Similarly, if a person's losses are equal to or greater than their net income for the tax year, they will not have a New Zealand income tax liability (s BC 6(2)). In both cases, no foreign tax credit will be available as there is no New Zealand income tax liability for the credit to offset (s LJ 2(2)).

15. Similarly, if a company receives a tax loss from another company in the same group of companies and the loss reduces its taxable income to nil, it will be unable claim a foreign tax credit as there is no New Zealand income tax liability for the credit to offset (*Charity Finance Ltd v CIR* (1998) 18 NZTC 13,565 (HC)).

16. This outcome is consistent with the policy intent of subpart LJ, which is to avoid the double taxation of income. If there is no New Zealand income tax liability, there will be no double taxation of income. *Example 1* and *Example 2* illustrate this principle:

Example 1: Net loss tax position

Facts

Rebecca is a New Zealand tax resident who carries on a business in New Zealand. For the 2021 tax year, she derived $200,000 of assessable income from the business. She also has $250,000 of allowable deductions incurred in deriving that income.

In addition, Rebecca derived $25,000 of interest income from Australia. Australian income tax at the rate of 10% ($2,500) has been deducted from the Australian interest payment under art 11 of the Double Taxation Relief (Australia) Order 2010 (the New Zealand/Australia DTA).

Application

Rebecca has a net loss for the 2021 tax year. This is shown in the table below.

Annual gross income		
New Zealand business income	$200,000	
Australian interest	$25,000	
		$225,000
Annual total deductions		
Business expenses		$250,000
Net loss		**–$25,000**

Rebecca's New Zealand business expenses mean she has no New Zealand income tax liability, and therefore no New Zealand tax is payable on the Australian interest income. Consequently, a foreign tax credit is not available as the Australian interest income is not subject to double taxation.

Example 2: Net loss tax position

Facts

The facts are the same as in *Example 1*, but Rebecca only has $150,000 of allowable deductions. This would give her a net income of $75,000, however she also has $100,000 of tax losses carried forward from the 2020 tax year (s IA 3(4)).

Application

With the addition of the 2020 tax losses, Rebecca now has a net loss of $25,000.

Annual gross income		
New Zealand business income	$200,000	
Australian interest	$25,000	
		$225,000
Annual total deductions		
Business expenses	$150.000	
Losses carried forward	$100,000	
		$250,000
Net loss		**–$25,000**

Rebecca's New Zealand business expenses and losses carried forward means she has no New Zealand income tax liability, and therefore no New Zealand tax is payable on the Australian interest income. Consequently, a foreign tax credit is not available as the Australian interest income is not subject to double taxation.

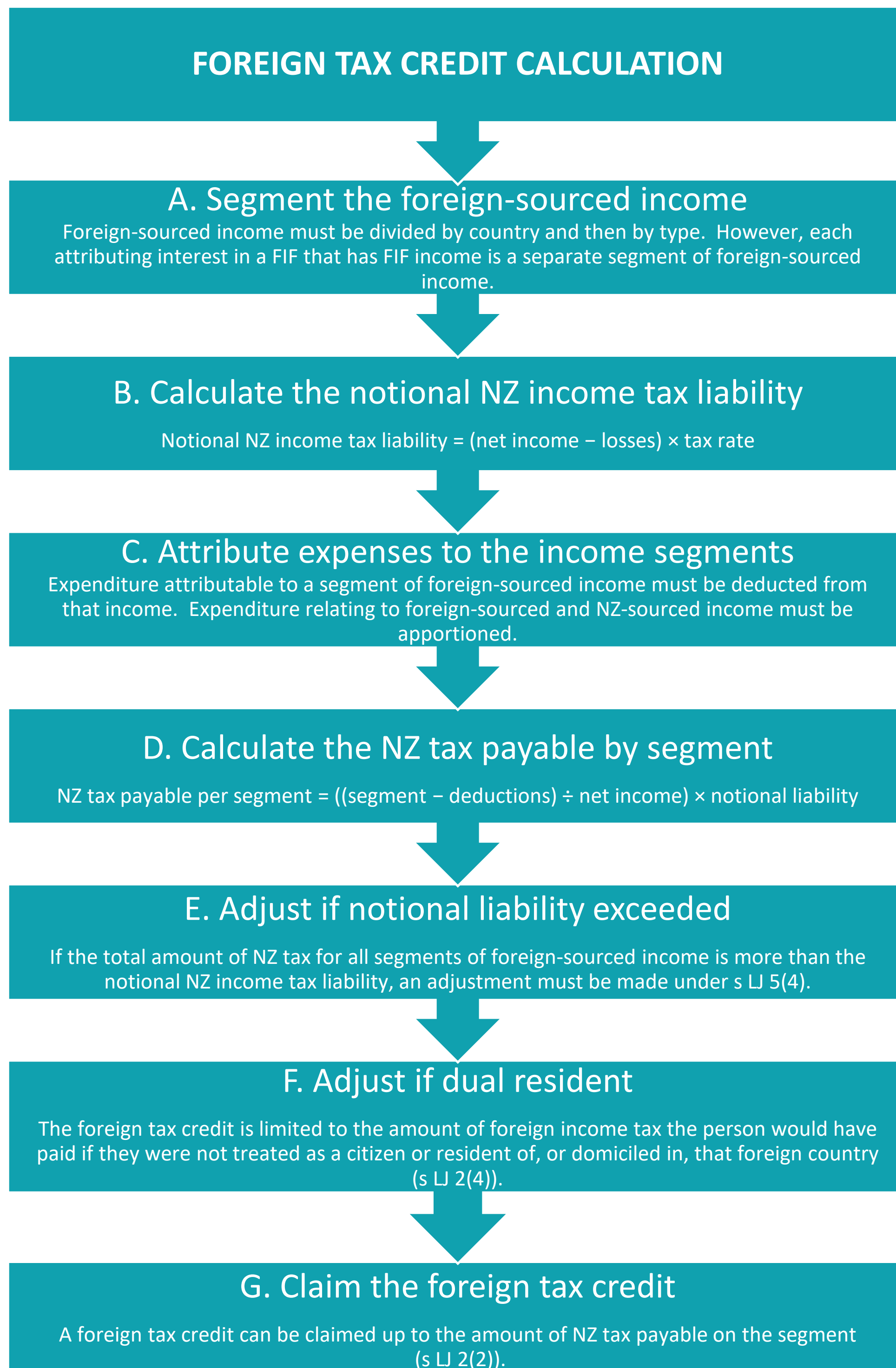
Step 2: Calculate the amount of the foreign tax credit

17. Subpart LJ explains how to calculate a foreign tax credit. It applies to New Zealand tax residents who have derived foreign-sourced income that is assessable in New Zealand. They must also have paid foreign income tax[4] on that foreign-sourced income (ss LJ 1(2) and LJ 2(1)) and have a New Zealand income tax liability (see Step 1).

[4] Only foreign income tax that has been correctly withheld or deducted will qualify for a foreign tax credit (See Example 2 of IS 16/05: Income tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement *Tax Information Bulletin* Vol 28, No 12 (December 2016): 41, and QB 14/12: Income tax – foreign tax credits for amounts withheld from United Kingdom pensions *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.

18. A person who satisfies these requirements will have a foreign tax credit for foreign income tax paid on a segment of foreign-sourced income. The foreign tax credit cannot exceed the amount of New Zealand tax payable on that segment (s LJ 2(2)).

19. The foreign tax credit calculation is summarised in the flowchart below.



A. Segment the foreign-sourced income

20. A person's foreign-sourced income must be segmented (or divided) by country and then divided further by source or by nature. "Segment of foreign-sourced income" is defined in s LJ 4 to refer to "an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature".

21. In most cases, it will be simple to segment foreign-sourced income as part of a foreign tax credit calculation. For example, a person who has royalty income from Australia and employment income from the United Kingdom clearly has two segments of foreign-sourced income.

22. However, the process becomes more complicated if, for example, the person has royalty income and employment income from Company A in Australia and royalty income from Company B, also in Australia. Is the royalty income from both Company A and Company B one segment of foreign-sourced income? Alternatively, is the royalty income from Company A and the employment income from Company A one segment of foreign-sourced income because both types of income originate from the same company?

23. The answers to these questions depend on how "source" and "nature" in s LJ 4 are interpreted. The interpretation of s LJ 4 and the meaning of "source" and "nature" are considered in greater detail in Part 2 of this statement (from [57]). In summary, the Commissioner considers that, based on the purpose of subpart LJ, "source" and "nature" mean the type of income. Therefore, foreign-sourced income must be segmented by the type of income. In the example above, all Australian royalty income (from both Company A and Company B) would be one segment, and the Australian employment income from Company A would be another segment.

24. Where a person has foreign-sourced income that is foreign investment fund (FIF) income from an attributing interest in a FIF, that amount is treated as a separate segment of foreign-sourced income (s LJ 2(7)). The specific rules for segmenting FIF income are discussed in detail from [84].

B. Calculate the notional New Zealand income tax liability

25. Before a person can calculate the New Zealand tax payable on each segment of foreign-sourced income, they must first calculate their notional New Zealand income

tax liability under s LJ 5(5). This is done by multiplying the person's net income minus losses[5] by the appropriate tax rate.

(person's net income − losses) × tax rate

26. This calculation is illustrated in *Example 3*.

Example 3: Notional New Zealand income tax liability

Facts

The facts are the same as in *Example 1*, but for the 2021 tax year Rebecca has only $135,000 of expenses, resulting in net income of $90,000 and no available losses:

Annual gross income		
New Zealand business income	$200,000	
Australian interest	$25,000	
		$225,000
Annual total deductions		
Business expenses		$135,000
Net income		**$90,000**

Application

Calculation of notional New Zealand income tax liability

Rebecca must calculate her notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($90,000	–	$0)	x	($14,000 x .105)	=	$1,470
			x	($34,000 x .175)	=	$5,950
			x	($22,000 x .30)	=	$6,600
			x	($20,000 x .33)	=	$6,600
						$20,620

[5] "Losses" are defined in s LJ 5(6)(b) for the purpose of s LJ 5(5) and refer to the taxpayer's own losses. Group company losses that a taxpayer company may use under the loss offset or subvention provisions are not brought into this calculation.

Therefore, Rebecca's notional New Zealand income tax liability for the 2021 tax year is $20,620.

C. Attribute expenses to the income segments

27. Deductible expenditure that is attributable to a segment of foreign-sourced income must be deducted from that income (s LJ 5(2)). Expenditure that relates to both a segment of foreign-sourced income and a segment of New Zealand-sourced income must be apportioned. Subpart LJ does not specify a method of apportionment. Therefore, the Commissioner considers a person should use a method that is fair and reasonable in the circumstances. *Example 4* illustrates how to attribute and apportion deductible expenses.

Example 4: Attribute expenses

Facts

In the 2021 tax year, Edna uses a mix of borrowed funds (from a New Zealand lender in New Zealand dollars) and her own savings to invest in New Zealand and Australian shares. She gets advice from a financial advisor and invests $200,000 in New Zealand shares and $100,000 in Australian shares. Edna also incurs several items of deductible expenditure. She pays $1,500 of monitoring fees to the financial advisor to monitor her two investment and $750 of bank charges on the Australian share investment. Edna also incurs $7,500 of interest on the borrowed money she used to fund the share purchases.

Edna derives dividends of $10,000 from the New Zealand shares and $7,500 from the Australian shares. Australian income tax at the New Zealand/Australia DTA rate of 15% ($1,125) is withheld from the Australian dividends (art 10(2)(b)).

Edna also derives a $50,000 salary from New Zealand.

All of Edna's Australian investments are exempt from the FIF rules.

Edna must calculate her foreign tax credit entitlement under ss LJ 5(2) and 5(5).

Application

Segmentation

Edna has one segment of foreign-sourced Australian dividend income.

Calculation of notional New Zealand income tax liability

Edna must calculate her notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5):

(person's net income – losses) × tax rate

Edna's net income is $57,750 – the difference between her total income of $67,500 and her total deductions of $9,750. Her notional liability is calculated in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($57,750.00	–	$0)	x	($14,000 x .105)	=	$1,470
			x	($34,000 x .175)	=	$5,950
			x	($9,750 x .30)	=	$2,925
						$10,345

Therefore, Edna's notional New Zealand income tax liability for the 2021 tax year is $10,345.

Attribute expenses

The $750 of bank charges paid on the Australian shares are attributable to the Australian shares and so must be deducted from the Australian dividend income.

The interest on the borrowed money and the monitoring fees are attributable to both the Australian and New Zealand dividends. Subpart LJ does not specify a method of apportionment to be applied when expenditure relates to foreign-sourced income and New Zealand income. Edna may adopt a method of apportionment that produces a fair and reasonable result in the circumstances. This is consistent with the approach the courts have adopted on mixed-use expenditure.[6]

On these facts, a fair and reasonable method of apportionment for this tax year is one that apportions the expenditure incurred on investing in the shares between the New Zealand and Australian dividends in the same proportions as the amounts invested by Edna in the New Zealand and Australian shares. As one-third of Edna's total investment was incurred acquiring the Australian shares, she attributes one-third of her mixed expenses ($2,500 of the interest and $500 of the monitoring fees) to the Australian dividends. When these amounts are added to the $750 of bank charges that relate to the Australian dividends, Edna's allowable deductions attributable to the Australian dividends total $3,750.

[6] See for instance, *CIR v Banks* (1978) 3 NZTC 61,236 (CA); *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *New Zealand Co-Operative Dairy Co Ltd v CIR* (1988) 10 NZTC 5,215 (HC).

The following tables show Edna's income and expenditure divided between the New Zealand and Australian components:

NZ income			Australian income		
NZ dividends	$10,000		Australian dividends		$7,500
Salary	$50,000				
Income before expenses		$60,000			$7,500
NZ expenditure			**Australian expenditure**		
Monitoring fees (67.67%)	$1,000		Monitoring fees (33.33%)	$500	
			Bank charges	$750	
Interest (67.67%)	$5,000		Interest (33.33%)	$2,500	
		$6,000			$3,750
Net NZ income		**$54,000**	**Net Australian income**		**$3,750**

D. Calculate the New Zealand tax payable by segment

28. The person must now calculate the amount of New Zealand tax payable on each segment. The amount of the foreign tax credit cannot exceed this amount (s LJ 2(2)).

29. A separate calculation must be undertaken for each segment of foreign-sourced income. Section LJ 5(2) sets out the formula:

((segment − person's deductions) ÷ person's net income) × notional liability

30. Under the formula, any allowable deductions are subtracted from the segment of foreign-sourced income, and the amount is divided by the person's total net income for the year. This sum is then multiplied by the person's notional New Zealand income tax liability (calculated earlier from [25]).

31. The result of this equation is the amount of New Zealand tax payable by the person on that segment of foreign-sourced income. The foreign tax credit for that segment cannot be more than this amount. *Example 5*, *Example 6* and *Example 7* explain how this calculation works:

Example 5: New Zealand tax payable by segment – Rebecca

Facts

The facts are the same as in *Example 3*.

Application

Calculation of New Zealand tax payable on each segment

Rebecca has one segment of foreign-sourced income – $25,000 of Australian interest income. None of the $135,000 of business expenses are attributable to the Australian interest income.

Rebecca must calculate the amount of New Zealand tax payable on that segment for the 2021 tax year by applying the formula in s LJ 5(2):

((segment − person's deductions) ÷ person's net income) × notional liability

The calculation for the Australian interest income is shown in the table below.

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($25,000	–	$0)	÷	$90,000)	x	$20,620	=	**$5,727.78**

Therefore, the New Zealand tax payable on the segment of Australian interest income is $5,727.78.

Foreign tax credits

Rebecca is entitled to a foreign tax credit for the foreign tax paid on the segment of foreign-sourced income, up to the amount of New Zealand tax payable on that segment.

As the New Zealand tax payable on the segment of foreign-sourced Australian interest income ($5,727.78) is more than the Australian income tax on the segment ($2,500), Rebecca is entitled to a foreign tax credit of $2,500 for all the foreign tax paid.

Example 6: New Zealand tax payable by segment – Edna

Facts

The facts are the same as in *Example 4*.

Application

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Edna has one segment of foreign-sourced Australian dividend income. The deductions attributable to the Australian dividend income segment are $3,250. Edna must now

calculate the amount of New Zealand tax payable on that segment of foreign-sourced income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($7,500	–	$3,250)	÷	$57,750)	x	$10,345	=	**$761.32**

Foreign tax credits

Edna is entitled to a foreign tax credit for the foreign tax paid on the segment of foreign-sourced income, up to the amount of New Zealand tax payable on that segment.

As the New Zealand tax payable of $761.32 for the segment of foreign-sourced Australian dividend income is less than the $1,125 of Australian income tax withheld from the dividends, Edna is only entitled to a foreign tax credit of $761.32 for the Australian tax paid.

Example 7: Foreign tax credit calculation with three segments of foreign-sourced income

Facts

Natana is a New Zealand tax resident. For the 2021 tax year, he derives dividends of $30,000 from AUS Co 1 (an Australian company) and royalties of $20,000 from AUS Co 2 (another Australian company). He also derives royalties of $10,000 from UK Co (a United Kingdom company).

Australian income tax is withheld from each payment made by AUS Co 1 and AUS Co 2 at the rates allowable under art 10(2) of the New Zealand/Australia DTA: 15% for dividends and 5% for royalties.

United Kingdom income tax is withheld from the royalty payment from UK Co at the rate allowable under art 13(2) of the Double Taxation Relief (United Kingdom) Order 1984 (the New Zealand/United Kingdom DTA): 10% for royalties.

Natana also has $30,000 of New Zealand-sourced income. He does not have any allowable deductions.

Natana does not have an attributing interest under the FIF rules in any of the overseas companies.

Natana must calculate his foreign tax credit entitlement under ss LJ 5(2) and (5).

Foreign tax credit calculation

Segmentation

Natana must divide his foreign-sourced income into segments. He takes his foreign-sourced income and divides it by country. He then further divides the income by type. Consequently, Natana has three segments of foreign-sourced income.

- $30,000 of dividend income from Australia
- $20,000 of royalty income from Australia
- $10,000 of royalty income from the United Kingdom

Calculation of notional New Zealand income tax liability

Natana must calculate his notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($90,000	–	$0)	x	($14,000 x .105)	=	$1,470
			x	($34,000 x .175)	=	$5,950
			x	($22,000 x .30)	=	$6,600
			x	($20,000 x .33)	=	$6,600
						$20,620

Therefore, Natana's notional New Zealand income tax liability for the 2021 tax year is $20,620.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Natana must now calculate the amount of New Zealand tax payable on each segment of foreign-sourced income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Natana's foreign-sourced income as follows:

	((segment – deductions)	÷ net income)	× notional liability	=	NZ tax payable
Australian dividends	(($30,000 – $0)	÷ $90,000)	× $20,620	=	**$6,873.33**

Australian royalties	(($20,000 – $0)	÷ $90,000)	× $20,620	=	**$4,582.22**
UK royalties	(($10,000 – $0)	÷ $90,000)	× $20,620	=	**$2,291.11**

Foreign tax credits

Natana is entitled to a foreign tax credit for the foreign tax paid on each segment of foreign-sourced income, up to the amount of New Zealand tax payable on that segment.

As the New Zealand tax payable for each segment of foreign-sourced income is more than the foreign tax paid on each segment, Natana is entitled to a foreign tax credit for all the foreign tax paid ($6,500). This is illustrated in the table below.

Segment	foreign tax paid	NZ tax payable on segment	foreign tax credit allowed
Australian dividends	$4,500	$6,873.33	$4,500
Australian royalties	$1,000	$4,582.22	$1,000
UK royalties	$1,000	$2,291.11	$1,000
TOTAL	**$6,500**	**$13,746.66**	**$6,500**

E. Adjust if notional liability exceeded

32. A person’s foreign tax credit must be adjusted down if the combined total of New Zealand tax payable under s LJ 5(2) for each segment of foreign-sourced income exceeds the person’s notional New Zealand income tax liability (s LJ 5(4B)).

33. These rules ensure that in calculating the New Zealand tax payable for a segment of foreign-sourced income, the foreign tax credit cannot exceed the notional income tax liability. They also ensure that excess deductions incurred in deriving income are spread across all income segments, foreign-sourced and New Zealand-sourced.

34. If an adjustment is required, it must be made to the amount of New Zealand tax payable on each of the segments of foreign-sourced income by multiplying them by the following ratio.

person’s notional income tax liability ÷ NZ tax

35. “NZ tax” is defined in s LJ 5(4C) (for the purpose of s LJ 5(4B), to mean the total of all amounts calculated under s LJ 5(2), including New Zealand-sourced assessable income. This adjustment is illustrated in *Example 8*.

Example 8: Adjustments

Facts

For the 2021 tax year, New Co derives New Zealand interest income of $200, Australian interest income of $1,000, New Zealand sales of $1,000 and $1,500 of deductible expenses attributable to those sales. This means New Co has net income of $700.

Application

Segmentation

New Co has one segment of foreign-sourced Australian interest income.

Calculation of New Co's notional New Zealand income tax liability

New Co must calculate its notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($700	–	$0)	x	.28	=	**$196**

New Co has net income of $700 and a notional income tax liability of $196.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

New Co must now calculate the amount of New Zealand tax payable for each segment of foreign-sourced income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to New Co's foreign-sourced Australian interest income as follows.

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($1,000	–	$0)	÷	$700)	x	$196	=	**$280**

New Co's New Zealand tax payable on the segment of Australian interest income is $280.

In these circumstances, an adjustment must be made under s LJ 5(4B). This is because the total amount of New Co's New Zealand tax for all segments of foreign-sourced income ($280) is more than its notional New Zealand income tax liability ($196).

Adjustment

New Co must adjust the amount of New Zealand tax payable on the Australian interest income using the formula in s LJ 5(4B).

tax payable on segment x notional income tax liability ÷ NZ tax

"NZ tax" means the total amount of all segments, including New Zealand-sourced assessable income. This is shown in the following table.

Segment	((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
Australian interest income	(($1,000	–	$0)	÷	$700)	x	$196	=	$280
NZ interest income	(($200	–	$0)	÷	$700)	x	$196	=	$56
NZ business income	(($1,000	–	$1,500)	÷	$700)	x	$196	=	$0*
									$336

*NZ tax payable cannot be less than $0.

Tax payable on the segment of Australian interest income is then adjusted.

tax payable on segment	x	notional income tax liability	÷	NZ tax	=	adjusted NZ tax payable on segment
$280	x	$196	÷	$336	=	**$163.33**

Foreign tax credits

The adjustment formula gives a figure of $163.33. This means that under s LJ 5(2) the amount of New Zealand tax payable on the segment of foreign-sourced income is reduced from $280 to $163.33. New Zealand will only grant a foreign tax credit for any foreign tax paid on that segment up to the adjusted amount of New Zealand tax payable.

F. Adjust if dual resident

36. A person's foreign tax credit may be restricted if they are a tax resident in New Zealand and the foreign country where they derived the foreign-sourced income.

37. Section LJ 2(4) applies to a person who has paid tax on foreign-sourced income because they are "a citizen or resident of, or domiciled in, that foreign country". Section LJ 2(4) limits the person's foreign tax credit to the amount of foreign income

tax they would have paid if they were treated as "not a citizen or resident of, or domiciled in, that foreign country".

38. This might occur where a person earns income in a foreign country that taxes residents at a higher rate than non-residents. For example, a person is a tax resident of New Zealand and Country A. Country A taxes interest income derived by residents at 30% and interest income derived by non-residents at 15%. The person earns $30,000 of interest income from Country A and must pay Country A's tax at the resident rate of 30% ($9,000), rather than the lower non-resident rate of 15% ($4,500). In these circumstances, s LJ 2(4) would apply to limit the person's foreign tax credit to the lower non-resident rate of 15% ($4,500).

39. Section LJ 2(4) only applies where the foreign tax is not covered by a DTA. If a DTA applies, the tie-breaker rules in the DTA will deem the taxpayer to be a tax resident of one country only. Article 22(2) of the Double Taxation Relief (United States of America) Order 1983 contains a similar rule to s LJ 2(4). If the segment of United States-sourced income is subject to a higher rate of tax because the person is a United States citizen, New Zealand will only give a foreign tax credit up to the amount that would have been imposed if the person were not a United States citizen.

40. *Example 9* and *Example 10* illustrate the adjustment for dual residents.

Example 9: Dual resident adjustment 1

Facts

Clara is a tax resident of New Zealand and Brazil under each country's domestic law.

For the 2021 tax year, Clara's only income is rent of $65,000 from a property situated in Brazil. Clara has $5,000 of allowable deductions (under New Zealand tax law) against this income, and therefore Clara's net income for New Zealand tax purposes is $60,000.

As Clara is a tax resident of Brazil, she is taxed in Brazil on her worldwide income. Clara pays $14,500 of tax in Brazil on the rental income. As Clara is a tax resident of New Zealand, the rent is also taxable in New Zealand.

New Zealand does not have a DTA with Brazil, so Clara does not qualify for any DTA relief. However, she understands from the Commissioner's statement in IS 16/05 that Brazilian income tax is a tax that New Zealand will provide a foreign tax credit for under subpart LJ, as it is a tax of substantially the same nature as income tax imposed under s BB 1 (s YA 2(5)).

Application

Segmentation

Clara has one segment of foreign-sourced Brazilian rental income – $60,000.

Calculation of notional New Zealand income tax liability

Clara must calculate her notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($60,000	–	$0)	x	($14,000 x .105)	=	$1,470
				($34,000 x .175)	=	$5,950
				($12,000 x .30)	=	$3,600
						$11,020

Therefore, Clara has a notional New Zealand income tax liability of $11,020.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Clara now calculates the amount of New Zealand tax payable on each segment of foreign-sourced income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Clara's foreign-sourced Brazilian rental income as follows.

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($65,000	–	$5,000)	÷	$60,000)	x	$11,020	=	**$11,020**

Therefore, New Zealand tax payable on the segment of Brazilian rental income is $11,020.

Dual resident adjustment

Because Clara is a dual resident, her foreign tax credit is limited to the amount of foreign tax she would have paid if she was not a tax resident of Brazil (s LJ 2(4)).

If Clara was not a tax resident of Brazil, the rental income would have remained taxable in Brazil because it was derived from a source in Brazil. However, a lower non-resident tax rate of 15% would have applied to the gross amount of the rent.

Therefore, although Clara paid Brazilian income tax of $14,500 on the rental income, her foreign tax credit is limited to the tax she would have paid if she were a non-resident, which would have been $9,750. As that amount is less than the amount of New Zealand tax payable on the foreign-sourced rental income ($11,020), Clara's foreign tax credit is reduced to $9,750.

Example 10: Dual resident adjustment 2

Facts

Sunil is a tax resident of New Zealand and Brazil under each country's domestic law.

For the 2021 tax year, Sunil derives $20,000 of interest income from Canada. Sunil does not have any allowable deductions against this income.

New Zealand does not have a DTA with Brazil, but it does have a DTA with Canada – the Double Tax Agreements (Canada) Order 2015 (New Zealand/Canada DTA). Under the New Zealand/Canada DTA, Sunil is treated as a resident of New Zealand.

As Sunil is a tax resident of Brazil, he is taxable in Brazil on his worldwide income. Sunil pays income tax on the Canadian interest income in Brazil at a flat rate of 25%. As Sunil is a tax resident of New Zealand, the interest is also taxable in New Zealand. Further, the New Zealand/Canada DTA provides that Canada has the right to tax the gross amount of the interest at the rate of 10%.

Application

Segmentation

Sunil has one segment of foreign-sourced Canadian interest income – $20,000.

Calculation of notional New Zealand income tax liability

Sunil must calculate his notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($20,000	–	$0)	x	($14,000 x .105)	=	$1,470
				($6,000 x .175)	=	$1,050
						$2,520

As Sunil has no deductions against his income, his net income is $20,000 and his notional New Zealand income tax liability for the 2021 tax year is $2,520.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Sunil now calculates the amount of New Zealand tax payable on the segment of Canadian interest income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Sunil's foreign-sourced Canadian interest income as follows.

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($20,000	–	$0)	÷	$20,000)	x	$2,520	=	**$2,520**

Sunil's notional New Zealand tax liability is $2,520, and the New Zealand tax payable on the Canadian interest income is $2,520.

Dual resident adjustment

Sunil has paid two amounts of foreign tax on the Canadian interest income – $5,000 in Brazil and $2,000 in Canada. Section LJ 2(4) provides that Sunil's foreign tax credit for the tax paid in Brazil is limited to the amount of Brazilian tax he would have paid if he were not a tax resident of Brazil. However, if Sunil were not a tax resident of Brazil, the interest would not have been taxable in Brazil because it was sourced from Canada. This means, although Sunil paid Brazilian tax of $5,000, his foreign tax credit is reduced to zero, as he would have paid nil tax in Brazil if he were not a tax resident of Brazil.

However, Sunil is entitled to a foreign tax credit for the $2,000 of Canadian tax he paid on the Canadian interest income up to the amount of New Zealand tax payable on the interest income. As the amount of New Zealand tax payable on the interest income ($2,520) is more than the Canadian tax paid ($2,000), Sunil is entitled to a credit for the full amount of Canadian tax paid ($2,000).

G. Claim the foreign tax credit

41. A foreign tax credit may be claimed for foreign tax paid on a segment of foreign-sourced income, up to the amount of New Zealand tax payable on that segment (s LJ 2(2)).

Step 3: Ensure compliance obligations are met

42. Several compliance issues may have implications for the foreign tax credit calculation in subpart LJ. The following issues are discussed below.

- Foreign income tax refunds
- Excess foreign tax credits
- Time limits for claiming a foreign tax credit
- Timing of foreign tax credits
- Currency conversions
- Information required to support a foreign tax credit claim

Foreign income tax refunds

43. If a person receives a refund of foreign income tax[7], they must make an adjustment under s LJ 7. If the refund is received before the person has self-assessed their tax liability for the tax year, the amount of the foreign tax credit is reduced by the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(2)).

44. If the refund is received after the person has self-assessed their tax liability and used the foreign tax credit to satisfy it, they must pay the Commissioner the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(3)). The date for payment is 30 days after the later of:

- the date the person receives the refund, or
- the date of the notice of assessment in which the credit was used (s LJ 7(4)).

45. Section LJ 7 only applies to refunds of "foreign income tax". For example, this may occur where a DTA allocates taxing rights to the other state, but subsequent adjustments are made to the calculation of the foreign income tax, resulting in a

[7] "Foreign income tax" is defined in s LJ 3 to mean a tax of substantially the same nature as income tax imposed under s BB 1, or a tax covered by a DTA.

refund to the person. This can be distinguished from the situation where foreign tax has been incorrectly withheld or deducted. Any refund of incorrectly withheld or deducted foreign tax is not a refund of "foreign income tax". In these circumstances, s LJ 7 does not apply. (See [26] and [27] of QB 14/12: Income tax – foreign tax credits for amounts withheld from United Kingdom pensions[8].) *Example 11* illustrates this position.

Example 11: Tax incorrectly withheld in country of source

Facts

For the 2021 tax year, Isaac derives interest income of $20,000 from Australia. Article 11(2) of the New Zealand/Australia DTA gives Australia the right to tax the gross amount of the interest at 10%, ie $2,000. However, the payer of the interest incorrectly deducts $4,000 from the interest when paying it to Isaac.

Isaac does not have any other foreign-sourced or New Zealand-sourced income.

Application

Segmentation

The interest income is Isaac's only segment of foreign-sourced income.

Calculation of Isaac's notional New Zealand income tax liability

Isaac must calculate his notional New Zealand income tax liability for the 2021 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($20,000	–	$0)	x	($14,000 x .105)	=	$1,470
			x	($6,000 x .175)	=	$1,050
						$2,520

Isaac therefore has a notional New Zealand income tax liability of $2,520.

[8] *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.

Calculation of Isaac's New Zealand tax payable on the segment of foreign-sourced income

Isaac then calculates the amount of New Zealand tax payable on the segment of Australian interest income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Isaac's foreign-sourced Australian interest income as follows.

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($20,000	–	$0)	÷	$20,000)	x	$2,520	=	**$2,520**

Foreign tax credits

Under art 23(2) of the New Zealand/Australia DTA, New Zealand must give Isaac a foreign tax credit for the Australian tax paid. However, the $4,000 withheld from the interest exceeded the amount of tax Australia was entitled to withhold under art 11(2) of the New Zealand/Australia DTA by $2,000. The excess $2,000 is not "foreign income tax" under s LJ 3 because it was not deducted according to the New Zealand/Australia DTA.

Therefore, although the amount of New Zealand tax payable on the interest ($2,520) is less than the amount deducted in Australia ($4,000), Isaac is only entitled to a foreign tax credit of $2,000 as that is the amount of tax Australia was entitled to deduct under the New Zealand/Australia DTA.

	foreign tax paid	NZ tax payable for segment	tax credit allowed
Australian interest	$2,000	$2,520	$2,000

Isaac needs to contact the Australian Taxation Office if he wants a refund of the $2,000 incorrectly withheld.

Excess foreign tax credits

46. A foreign tax credit is a non-refundable credit (s YA 1). This means it must be used to offset an income tax liability or it will be extinguished (s LA 5(2)). It cannot be carried backwards or forwards and used to offset a previous or future year's income tax liability.

Time limit for claiming a foreign tax credit

47. Under s 78B of the Tax Administration Act 1994 (the TAA), the time limit for claiming a foreign tax credit is "4 years after the end of the tax year in which the taxpayer would have the credit in the absence of this section". The Commissioner considers this means four years from the end of the tax year in which the taxpayer is liable to pay New Zealand income tax on the foreign-sourced income.

48. The Commissioner may extend the four-year period for claiming a foreign tax credit by up to two years.

Timing of foreign tax credits

49. Foreign tax does not have to be paid in the same year in which the income is derived for New Zealand tax purposes. In the Commissioner's view, s LJ 2 does not require the foreign tax (for which a credit is available) to have been paid in the year in which the income being taxed is derived for New Zealand tax purposes.

How to adjust for timing differences

50. If New Zealand income tax is paid in year one and foreign tax on that same income is paid in year two, the Commissioner will re-open an assessment for year one to give a credit for the foreign tax paid on that income. The focus is on matching the foreign tax credit to the New Zealand income year of derivation. This might occur where New Zealand and the foreign state have different tax years or where the income is treated as derived in a later year in the foreign state.

51. In this scenario, it is not possible to claim a foreign tax credit in year two. This is because ss LJ 2 and LJ 5 restrict any foreign tax credit to the amount of New Zealand tax payable on each segment of foreign-sourced income that is allocated to the income year (ie year two). As the income has already been returned in year one (and New Zealand tax paid), there will be no income in year two against which to claim a credit.

52. Applications to re-open an assessment must be made to the Commissioner by telephone or in writing.[9] Applications are made under s 113 of the TAA and must contain proof that the foreign tax has been paid. Further details can be found in Standard Practice Statement SPS 20/03: Requests to amend assessments.[10]

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[9] Where the tax effect of the amendment requested is greater than $10,000, the request to amend a return must be made in writing. "In writing" includes a taxpayer modifying their tax return using myIR, as well as other communication with the Commissioner by electronic means.

[10] *Tax Information Bulletin* Vol 32, No 6 (July 2020): 11.

Foreign income and foreign tax to be converted to New Zealand dollars

53. Foreign income and foreign tax must be converted to New Zealand dollars. FX 21/01: Foreign exchange rates, provides guidance on currency conversion rates and methods.

Information required to support a foreign tax credit claim

54. A person who has a foreign tax credit under s LJ 2 must provide the Commissioner with information necessary to verify the amount of the credit (s 78B(2) of the TAA). This includes information about the:

- type and amount of each segment of foreign-sourced income the person has (including the country of origin); and
- amount of foreign income tax paid on each of the segments.

55. The Commissioner also requires proof that the foreign income tax has been paid. Because of timing mismatches between jurisdictions, it may not always be possible for a person to obtain a notice of assessment in time for filing their New Zealand tax return. A statement of account or a tax deduction certificate from a foreign revenue authority confirming that foreign tax has been paid will satisfy this proof requirement in the absence of a notice of assessment.

PART 2: Segmenting income under subpart LJ

56. This part of the Interpretation Statement explains the law on segmenting foreign-sourced income in greater detail.

Segments determined by type of income

57. Subpart LJ requires a person to divide their foreign-sourced income into segments and to calculate the New Zealand tax payable on each segment. The person is then entitled to a foreign tax credit for the foreign tax paid on each segment, up to the amount of New Zealand tax payable on that segment. Segmentation is therefore an important step in the foreign tax credit calculation.

58. Section LJ 4 defines "segment of foreign-sourced income".

> **LJ 4 Meaning of segment of foreign-sourced income**

> For the purposes of this Part, a person has a **segment of foreign-sourced income** equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

59. "Source" and "nature" are not defined in the Act so should be given their ordinary meanings. The *Oxford English Dictionary*[11] has several definitions of "source" and "nature". The following definitions are the most relevant.

> **Source, n.**
>
> 4a. The chief or prime cause *of* something of a non-material or abstract character; the quarter whence something of this kind originates.
>
> **Nature, n.**
>
> 8a. The inherent or essential quality or constitution of a thing; the inherent and inseparable combination of properties giving any object, event, quality, emotion, etc., its fundamental character.

60. The ordinary meanings suggest that "source" focuses on the origin of the income and "nature" means the inherent or essential qualities of a thing.

Case law on source and nature

61. The Commissioner is not aware of any cases that consider the meaning of "source" or "nature" in the context of subpart LJ. However, these words have been considered by the courts in the context of the source rules (s YD 4) and the time bar (s 108 of the TAA). While these sections have a different purpose to subpart LJ, the cases provide helpful guidance on the meaning of "source" and "nature" in an income tax context.

Source rules

62. Section YD 4 lists the types of income that are treated as having a source in New Zealand. Several cases have considered the word "source" in this context.

63. The New Zealand courts[12] have adopted the "practical person" test when interpreting the word "source". From *Nathan v FCT* (1918) 25 CLR 183 (HCA) at 189–190.

[11] *Oxford English Dictionary* (online ed, 3rd ed, Oxford University Press, June 2003, OED Online Version June 2021, www.oed.com, accessed15 June 2021)

[12] See *CIR v N V Philips Gloeilampenfabrieken* [1955] NZLR 868 (CA).

> The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income . . . But the ascertainment of the actual source of a given income is a practical, hard matter of fact.

64. The test asks – as a matter of fact, what would a practical person regard as the real source of the income? Under this test, the source of income will often be linked with the activities or property that produced the income. For example, the courts have held that the source of a payment of dividends was the activities that produced the profits from which the dividends were paid (*Nathan v FCT*; *Parke Davis & Co v FCT* (1959) 101 CLR 521 (HCA); *Esquire Nominees Limited v FCT* 73 ATC 4,114 (HCA)). Similarly, the courts have held that the source of remuneration for personal services was the work carried out in the performance of the services (*FCT v French* (1957) 98 CLR 398 (HCA)).

65. The courts also look to the statutory context for guidance. In *CIR v N V Philips Gloeilampenfabrieken* [1955] NZLR 868 (CA) at 883, Gresson J observed that the ordinary meaning of "source" is the starting point, but it has a flexible meaning depending on the statutory context.

> The ordinary meaning of source is the starting point which, when used in relation to physical things, e.g., a river, is a matter of location. But it is a word of flexible meaning, especially when used of something non-material or abstract. It can, and often does, mean the chief or prime cause of something. What has to be determined is the sense in which the Legislature used the word in s 87 (n). …

66. The issue in this case was whether interest on a loan paid by a New Zealand company to a Dutch company was income derived from New Zealand by the Dutch company. The court held that the source of the interest was the provision of credit by the Dutch company to the New Zealand company, and therefore the income was not derived from a source in New Zealand. North J explained that a practical person of business would conclude that all income had its origin in "work" or in the ownership of "property".

Time bar

67. Section 108(2) of the TAA states the time bar does not apply if a taxpayer provides a tax return that fails to mention "… income which is of a particular nature or was derived from a particular source…".

68. The meaning of "particular nature" and "particular source" in s 108(2) of the TAA was considered in *Sleeman v CIR* [1965] NZLR 647 (SC). The taxpayer purchased several properties and sold them at a profit. He included rent from the properties in his returns but not the sales profits. The Commissioner amended the taxpayer's assessments outside the four-year period. The taxpayer appealed, arguing that the

rents and profits shared the same nature and therefore the Commissioner was time-barred under s 108(2). The issue was whether the profits were income of a particular nature or from a particular source that had not been mentioned in the taxpayer's returns.

69. Wilson J explained that "particular nature" and "particular source" must bear their ordinary meaning. Consequently, the "nature" of a thing, including income, means its essential qualities, and its "particular nature" means "those essential qualities which distinguish it amongst others of its kind".

70. Wilson J concluded that income from buying and selling property was of a different nature to rental income from that property. The particular nature of the income was income from dealing in property. This could be distinguished from other types of income from property, such as rents from letting and royalties from permitting others to remove minerals or timber.

Summary of the case law

71. Based on the above case law (in the context of the source rules and the time bar).

- The words "source" and "nature" bear their ordinary meanings. (*Philips, Sleeman*)
- When determining the source of income, the approach is to ask what would a practical person regard as the real source of the income? (*Nathan, Philips)*
- "Source" can mean the chief or prime cause of something, but this meaning is flexible depending on statutory context. (*Philips)*
- The nature of an item of income is determined by reference to the essential qualities that distinguish it from other types of income of the same kind. (*Sleeman*)

The purpose of subpart LJ

72. As the dictionary definitions and case law have illustrated, "source" and "nature" are capable of more than one meaning. Where a word is capable of more than one meaning, the preferred meaning is the one that aligns with the purpose of the provision in which it appears (see *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36, [2007] 3 NZLR 767; *Mangin v CIR* [1971] NZLR 591 (PC); *CIR v Alcan New Zealand Ltd v CIR* [(1994) 16 NZTC 11,175 (CA)). It is therefore necessary to consider the purpose of subpart LJ.

73. The purpose of subpart LJ is to avoid double taxation by allowing a person a credit for foreign tax paid, up to the amount of New Zealand tax payable on the foreign-sourced income.

74. Subpart LJ does not calculate a person's foreign tax credit on a global basis. This means it does not require the person to combine all their foreign-sourced income and to calculate their credit by reference to the New Zealand tax payable on that combined amount. Instead, it divides the person's foreign-sourced income into segments. It then determines the New Zealand tax payable on each segment and limits the person's foreign tax credit to the New Zealand tax payable on that segment. This is known as the schedular approach. A schedular approach is usually adopted when Parliament wants to apply different tax treatments to different types of income. The effect of the schedular approach in subpart LJ is that foreign tax paid on one segment of foreign-sourced income will not be creditable against New Zealand tax payable on another segment of foreign-sourced income.

75. It is likely that Parliament's rationale for prohibiting the cross-crediting of foreign tax paid on one segment against another segment of foreign-sourced income is because tax may have been imposed on each segment at different rates in the relevant foreign jurisdictions. For example, the New Zealand/Australia DTA permits Australia to deduct income tax at the rate of 15% for dividends and 5% for royalties.

76. However, Parliament did not adopt a pure schedular approach to foreign tax credits. A pure schedular approach would have required every item of foreign income to be considered separately. This would likely involve significant compliance costs. Instead, Parliament defined a "segment of foreign-sourced income" to mean amounts of assessable income derived from one foreign country that comes from one source or is of one nature. This approach allows some level of income aggregation. It is a middle ground that balances the undesirable cross-crediting of foreign tax credits against increased compliance costs.

77. Based on the purpose of subpart LJ, the Commissioner considers that "source" and "nature" are meant to capture the various types of income that a taxpayer derives from a foreign country. They are treated as a composite concept and used in a schedular and generic sense. Under this interpretation, dividends and interest paid by a single company would not constitute a single segment of income. This is because dividends and interest are different types of income that are often taxed at different rates. However, a person who derives two streams of dividends from two different companies in a single country would have a single segment of foreign-sourced income, because dividends are a single type of income taxed at the same rate.

Conclusion

78. A person who calculates their foreign tax credit under subpart LJ must divide their foreign-sourced income into segments and determine the New Zealand tax payable on each segment.

79. Foreign-sourced income must first be segmented by country. This means all foreign-sourced income must be grouped by the source[13] country. For example, all Australian income is grouped together, and all United Kingdom income is grouped together.

80. The income is then further divided by type. Based on the purpose of subpart LJ (that foreign tax paid on one segment of income cannot be credited against New Zealand tax payable on another segment of income), the Commissioner considers that the reference in s LJ 4 to "income that comes from 1 source or is of 1 nature" means income that is of the same type. For example, all Australian royalty income can be grouped together, and all Australian interest income can be grouped together. However, Australian interest income and Australian royalty income from the same company cannot be grouped together as a segment because they are different types of income.

81. *Example 12* explains how segmentation works in a straightforward case.

Example 12: Straightforward segmentation

Facts

Margaret is a New Zealand tax resident. For the 2022 tax year, she derives $25,000 of dividend income and $25,000 of royalty income from an Australian company, Oz Co. Tax is deducted from these payments in Australia at the rates prescribed by the New Zealand/Australia DTA: 15% ($3,750) and 5% ($1,250) respectively.

Margaret also derives $10,000 of interest income from a United Kingdom company, UK Co, and gross rents of $250,000 from a United Kingdom property. Tax is paid on the interest income in the United Kingdom at the rate set out in the New Zealand/United Kingdom DTA: 10% ($1,000). The rental income (net of United Kingdom deductions) is taxed at the applicable United Kingdom graduated rates for an individual ($55,000). Margaret incurred $50,000 of expenditure deriving the rents, which is an allowable deduction under s DA 1.

Margaret also derives $40,000 of employment income from New Zealand.

Oz Co and UK Co do not create attributing interests for Margaret under the FIF rules.

[13] "Source" as defined in s YD 4, not s LJ 4.

Application

Segmentation

Margaret must divide her foreign-sourced income into segments by country and then by the type of income. Therefore, Margaret has the following segments of foreign-sourced income.

- Dividend income from Australia
- Royalty income from Australia
- Interest income from the United Kingdom
- Rental income from the United Kingdom

Calculation of notional New Zealand income tax liability

Margaret must first calculate her net income for the 2022 tax year.

income	gross income	deductions	net income
AUS dividends	$25,000	$0	$25,000
AUS royalties	$25,000	$0	$25,000
UK interest	$10,000	$0	$10,000
UK rents	$250,000	$50,000	$200,000
NZ salary	$40,000	$0	$40,000
Total	**350,000**	**$50,000**	**$300,000**

Margaret's annual gross income of $350,000 is more than her annual gross deductions of $50,000. This means her net income is $300,000.

Margaret must now calculate her notional New Zealand income tax liability for the 2022 tax year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(Net income	–	losses)	x	tax rate	=	notional liability
($300,000	–	$0)	x	($14,000 x .105)	=	$1,470
				($34,000 x .175)	=	$5,950
				($22,000 x .30)	=	$6,600
				($110,000 x .33)	=	$36,300
				($120,000 x .39)	=	$46,800
						$97,120

Therefore, Margaret's notional New Zealand income tax liability for the 2022 tax year is $97,120.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Margaret must now calculate the amount of New Zealand tax payable on each segment of foreign-sourced income by applying the formula in s LJ 5(2):

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Margaret's foreign-sourced income as follows.

	((segment – deductions)	÷ net income)	× notional liability	=	NZ tax payable
AUS dividends	(($25,000 – 0)	÷ $300,000)	× $97,120	=	**$8,093.33**
AUS royalties	(($25,000 – 0)	÷ $300,000)	× $97,120	=	**$8,093.33**
UK interest	(($10,000 – 0)	÷ $300,000)	× $97,120	=	**$3,237.33**
UK rents	(($250,000 – $50,000)	÷ $300,000)	× $97,120	=	**$64,746.66**

Foreign tax credit

Margaret is entitled to a foreign tax credit for the foreign tax paid on each segment of foreign income up to the amount of New Zealand tax payable on the segment. This is shown in the table below.

income	foreign tax paid	NZ tax payable on segment	tax credit allowed	difference
AUS dividends	$3,750.00	$8,093.33	$3,750.00	$0.00
AUS royalties	$1,250.00	$8,093.33	$1,250.00	$0.00
UK interest	$1,000.00	$3,237.33	$1,000.00	$0.00
UK rents	$55,000.00	$64,746.66	$55,000.00	$0.00
Total	**$61,000.00**	**$84,170.65**	**$61,000.00**	**$0.00**

Summary

In summary, for the 2022 tax year, Margaret has taxable income of $300,000 and a New Zealand tax liability of $97,120. Margaret's taxable income includes foreign-sourced income on which Margaret paid foreign tax of $61,000. Margaret is entitled to tax credits of $61,000 for the foreign tax she paid.

Margaret claims the foreign tax credits in her income tax return. She provides the following information in support of her claim:

- A list of the segments of foreign-sourced income.
- The amounts of foreign income tax paid on each of the segments.
- Evidence of the foreign tax paid, such as an overseas tax deduction certificate.

PART 3: Specific scenarios

82. Part 3 of this Interpretation Statement considers how the foreign tax credit calculation applies in the following scenarios where:
    - a person has an attributing interest in a FIF (from [84]);
    - a person has attributed income under the personal services attribution rules (from [101]); and
    - a discretionary complying trust makes a distribution of foreign-sourced income to trust beneficiaries (from [107]).

Foreign investment funds

83. A person with an attributing interest in a foreign investment fund (FIF) must calculate their foreign tax credit slightly differently. The different treatment is required because FIF income is deemed income rather than actual income. Foreign jurisdictions tend to impose tax on actual income and not on the deemed amount recognised as FIF income under the Act. As a result, a person with FIF income would be unable to claim a foreign tax credit without special rules. These rules are explained in more detail below.
84. Under s EX 28, the following entities are defined as a FIF:
    - A foreign company
    - A foreign superannuation scheme
    - An insurer under a life insurance policy (but not if the policy is offered or entered into in New Zealand)
85. A person has an attributing interest in a FIF if they hold a direct income interest in a foreign company. A person has a direct income interest in a foreign company if they hold:
    - shares;
    - shareholder decision-making rights;

- the right to receive or control the income of the FIF; or
- the right to receive or control the net assets of the FIF (ss EX 29(2) and EX 30).

86. A person also has an attributing interest in a FIF if they hold a superannuation interest (s EX 29(3)) or a foreign life insurance policy entitlement (s EX 29(4)).

87. If a person has an attributing interest in a FIF (and none of the exemptions in ss EX 31 to EX 43 apply), they must calculate their income or loss from the FIF by applying one of the five calculation methods set out in s EX 44:

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

88. A person will have FIF income if they have income under one of the five calculation methods (s CQ 4 – CQ 6). Certain exclusions may apply.

89. Because FIF income is deemed income, if actual income is received from the FIF, it is excluded income (s CX 57B). Special rules exist for tax credit purposes, as the foreign tax credit is likely to arise on the actual income but will be sought to be used against the deemed income. For example, a person with an attributing interest in a FIF receives a dividend payment. Foreign income tax is withheld from the dividend. However, under the FIF rules, the dividend payment is effectively ignored, and the person is taxed in New Zealand on their FIF income, calculated under one of the five calculation methods. The FIF income is generally based on the value of the attributing interest.

90. To ensure that double taxation does not occur, the Act prescribes different foreign tax credit rules for FIF income. Which rule applies depends on the FIF calculation method adopted.

Attributable FIF income method

91. If a person applies the attributable FIF income method (s EX 50), they must calculate their foreign tax credit under subpart LK as though the FIF was a controlled foreign company (CFC). Section EX 50(8) and (9) provide:

> *Application of CFC rules tax credit rules*

> (8) The rules in sections LK 1 to LK 7 (which relate to tax credits for attributed CFC income) apply to allow the person to claim foreign tax credits but on the basis of the assumptions made in subsection (9). The rules in those sections allow foreign tax credits relating to attributed CFC income but apply a jurisdictional ring-fencing approach to the use of tax credits.
>
> *Assumptions in reading tax credit rules*
>
> (9) Sections LK 1 to LK 7 are applied as if—
>
> (a) the FIF were a CFC; and
>
> (b) the FIF income of the person from the FIF were attributed CFC income; and
>
> (c) the person's income interest, calculated under subsection (4) were their relevant income interest for the purposes of those sections; and
>
> (d) any relevant person's FIF income calculated under the attributable FIF income method from a FIF that is resident in the relevant country were attributed CFC income.

92. Under subpart LK, the amount of the foreign tax credit is calculated by multiplying the attributed CFC interest income by the tax paid (s LK 2). Unlike subpart LJ, any unused foreign tax credits may be carried forward and used to offset future FIF income (s LK 4).

All other FIF calculation methods

93. If a person applies any of the other four FIF calculation methods, their foreign tax credit will be calculated under subpart LJ.

94. Under s CX 57B,[14] if a person has an attributing interest in a FIF and they receive a dividend payment from the FIF, the payment is treated as excluded income (provided the person is not using the attributable FIF income method). This means the dividend payment is not assessable income of the person (s BD 1(3)). However, as the dividend payment is from a foreign source, foreign income tax will likely have been deducted or withheld on that payment in the foreign jurisdiction.

95. In New Zealand, the person must pay income tax based on their FIF income, calculated under the relevant FIF calculation method. This is usually a deemed amount based on the value of the attributing interest, which excludes the dividend payment.

96. For foreign tax credit purposes, it is necessary to synchronise the foreign tax paid on the dividend with the New Zealand income tax paid on the FIF income to ensure that double taxation does not occur. Sections LJ 2(6) and (7) explain how this happens:

[14] Subject to an exception for amounts derived from certain Australian companies that a person has a direct income interest in of 10% or more and the person applies the FDR method (s EX 59(1B)).

> *When subsection (7) applies*
>
> (6) Subsection (7) applies to a person who derives an amount from an attributing interest in a FIF when the amount is treated as not being income under section EX 59(2) (Codes: comparative value method, deemed rate of return method, fair dividend rate method, and cost method).
>
> *Tax credit: attributing interest in FIF*
>
> (7) The person has a tax credit under this subpart for foreign income tax paid on or withheld in relation to the amount. The calculation of the maximum amount of the tax credit is made under section LJ 5(2), modified so that the item **segment** in the formula is the amount of FIF income from the attributing interest that the person derives in the period referred to in section EX 59(2).

97. Section LJ 2(7) provides that a person will have a foreign tax credit for foreign income tax paid or withheld on the excluded income (the dividend payment on which the foreign income tax was withheld) to use against their FIF income. The credit is calculated under s LJ 5(2), and the maximum amount of the credit is determined by treating the FIF income as the "segment" in the formula in s LJ 5(2).

98. Therefore, the effect of s LJ 2(7) is that each FIF attributing interest is a separate segment of foreign-sourced income. This means FIF attributing interests from the same country are not aggregated and calculations must be done for each individual interest.

99. *Example 13* explains how the foreign tax credit rules apply to FIF income.

Example 13: FIF rules

Facts

Walter is a New Zealand tax resident who owns shares in two Canadian companies, Can Co 1 and Can Co 2. During the 2020 income year, Walter acquires shares in Can Co 3 (on 1 February 2020). The companies are FIFs and Walter's shareholdings in the companies are attributing interests under s EX 29. All three companies are listed on the Canadian stock exchange. No exemptions apply.

Walter also has $25,000 of employment income from New Zealand in the 2020 tax year.

Can Co 1

Walter receives $10,000 of dividend income from Can Co 1. Foreign income tax of $1,500 is deducted from the dividend at the New Zealand/Canada DTA rate of 15% (art 10).

At the start of the 2020 income year, the market value of Walter's interest in Can Co 1 was $300,000, based on the listed share price. Walter did not increase his attributing interest in Can Co 1 during the 2020 income year.

FIF income

Walter calculates his FIF income from Can Co 1 by applying the FDR method. Under the FDR method, Walter's FIF income from his attributing interest in Can Co 1 is 5% of the market value of his interest in Can Co 1 at the start of the income year (s EX 51). Walter's shares in Can Co 1 had a listed value of $300,000 at the start of the 2020 income year. Therefore, Walter has FIF income of $15,000 from Can Co 1.

Can Co 2

Walter also receives $10,000 of dividend income from Can Co 2. Foreign income tax of $15,00 is deducted from the dividend at the New Zealand/Canada DTA rate of 15% (art 10).

At the start of the 2020 income year, the market value of Walter's interest in Can Co 2 was $200,000, based on the listed share price. Walter did not increase his attributing interest in Can Co 2 during the 2020 income year.

FIF income

Walter must calculate his FIF income from Can Co 2 by applying the FDR method because he used that method for his FIF income from Can Co 1. Under the FDR method, Walter's FIF income from his attributing interest in Can Co 2 is 5% of the market value of his interest in Can Co 2 at the start of the income year (s EX 51). Walter's shares in Can Co 2 had a listed value of $200,000 at the start of the 2020 income year. Therefore, Walter has FIF income of $10,000 from Can Co 2.

Can Co 3

Walter receives $8,000 of dividend income from Can Co 3. Foreign income tax of $1,200 is deducted from the dividend at the New Zealand/Canada DTA rate of 15% (art 10). However, as no shares in Can Co 3 were held at the beginning of the income year, and no shares in Can Co 3 have been sold during the income year, the FIF income for that attributing interest is nil.

Application

Section EX 59 applies to a person who has an attributing interest in a FIF and who applies any of the calculation methods in s EX 44 other than the attributable FIF income method.[15] Section EX 59(2) provides that an amount derived by the person from their attributing interest, other than FIF income, is excluded income under s CX 57B. As Walter applies the FDR method to calculate his FIF income from Can Co 1, Can Co 2 and Can Co 3, the dividends he derived from those companies are excluded income under s CX 57B.

Segmentation

Walter has two segments of foreign-sourced income. The FIF income from Can Co 1 and the FIF income from Can Co 2. Walter does not have any FIF income from Can Co 3.

Section LJ 2(7) provides that a person who derives an amount from a FIF that is excluded income under s CX 57B has a foreign tax credit for tax paid or withheld on the amount. This means Walter may be able to claim a foreign tax credit for the tax deducted from the dividends by Can Co 1 and Can Co 2 to use against his FIF income from Can Co 1 and Can Co 2.

Section LJ 2(7) also provides that the maximum amount of the foreign tax credit must be calculated by treating the person's FIF income from the FIF as the "segment" in the formula in s LJ 5(2).

Calculation of notional New Zealand income tax liability

Walter must calculate his notional New Zealand income tax liability for the 2020 income year by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($50,000	–	$0)	x	($14,000 x .105)	=	$1,470
			x	($34,000 x .175)	=	$5,950
			x	($2,000 x .30)	=	$600
						$8,020

[15] A person who applies the attributable FIF income method to a FIF must calculate their foreign tax credit entitlement under subpart LK as though the FIF was a CFC.

Walter's net income includes FIF income of $15,000 from his interest in Can Co 1 and $10,000 of FIF income from his interest in Can Co 2. It also includes $25,000 of employment income. Walter has no FIF income from Can Co 3. This gives Walter net income of $50,000 and a notional New Zealand income tax liability for the 2020 income year of $8,020.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Water must now calculate the amount of New Zealand tax payable on each segment of foreign-sourced income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Walter's foreign-sourced income as follows.

	((segment	**–**	**deductions)**	**÷**	**net income)**	**x**	**notional liability**	**=**	**NZ tax payable**
Can Co 1	(($15,000	–	$0)	÷	$50,000)	x	$8,020	=	**$2,406**
Can Co 2	(($10,000	–	$0)	÷	$50,000)	x	$8,020	=	**$1,604**
Can Co 3	(($0	–	$0)	÷	$50,000)	x	$8,020	=	**$0**

Foreign tax credits

In summary, Walter has net income of $50,000 and a notional New Zealand tax liability of $8,020.

Can Co 1

As Walter paid foreign tax of $1,500 on the dividend he earned from Can Co 1, he is entitled to a foreign tax credit for that amount up to the amount of New Zealand tax payable on his FIF income from Can Co 1. As the New Zealand tax payable of $2,406 is more than the foreign tax paid, Walter is entitled to a foreign tax credit of $1,500.

Can Co 2

Walter also paid foreign tax of $1,500 on the dividend he earned from Can Co 2. He is therefore entitled to a foreign tax credit for that amount up the amount of New Zealand tax payable on his FIF income from Can Co 2. As the New Zealand tax payable of $1,604 is more than the foreign tax paid, Walter is entitled to a foreign tax credit of $1,500.

Can Co 3

Walter cannot claim a foreign tax credit for the $1200 of foreign tax paid on dividend income from Can Co 3. This is because his FIF income from Can Co 3 is nil. As there is no New Zealand tax payable on the FIF income, there is no double taxation to relieve.

Foreign-sourced attributed personal services income

100. The attribution rule for income from personal services is an anti-avoidance rule that prevents an individual avoiding the top personal tax rate by diverting income to an associated entity (ss GB 27–GB 29). The rule applies when an individual (the working person) who performs personal services is associated with an entity (the associated entity) that provides personal services to a third person (the buyer). The income derived by the associated entity (after deductions for allowable expenditure) is attributed to the working person.

101. The attribution rule only applies where various threshold tests are met and no exemptions apply. The Commissioner's Interpretation Statements IS 19/02: Income tax – attribution rule for income from personal services[16] and IS 21/02 Income tax – calculating income from personal services to be attributed to the working person[17] explain in more detail when the attribution rule applies and how it is calculated.

102. If a person has attributed income under the attribution rule and the income has a foreign source, the person may be entitled to a foreign tax credit for any foreign income tax paid on that income by the associated entity.

103. The person's entitlement to a foreign tax credit is determined under ss LJ 2(8)–(10). Under ss LJ 2(9) and (10) the working person (and not the associated entity) has a foreign tax credit for foreign income tax paid on the attributed amount. Section LJ 2(9) provides that the attributed amount is one segment of foreign-sourced income.

104. Sections LJ 2(9) and (10) apply when:

- the associated entity is tax resident in New Zealand;
- the associated entity derives assessable income sourced from outside New Zealand;
- the amount of foreign-sourced income is attributable to the working person; and

[16] *Tax Information Bulletin* Vol 31, No 5 (June 2019): 23.
[17] *Tax Information Bulletin* Vol 33, No 4 (May 2021): 8.

- the working person was tax resident in New Zealand when the associated entity derived the attributed amount (s LJ 2(8)).

105. The application of this rule is illustrated in *Example 14*.

Example 14: Foreign-sourced attributed personal services income

Facts

Service Co is a New Zealand–incorporated company that provides personal services. The services are performed by Service Co's sole shareholder and director, Seamus. Seamus is the working person and Service Co is the associated entity.

The only income that Service Co earned in the 2020 tax year was $110,000 from an Australian customer, Elle (the buyer). Seamus performed the services for Elle in Australia, although he remained a New Zealand tax resident at all times.

While in Australia, Seamus worked from an office that qualifies as a permanent establishment of Service Co under art 5 of the New Zealand/Australia DTA. For the 2020 tax year, Service Co has allowable deductions of $10,000, all of which are attributable to the income that Service Co earned from Australia.

Article 7 of the New Zealand/Australia DTA provides that Australia has the right to tax Service Co's business profits to the extent they are attributable to the permanent establishment. Service Co determines that its entire $100,000 net income is attributable to the permanent establishment. Service Co pays $27,500 of Australian tax on the net income.

Service Co also determines that the income attribution rule applies, and therefore the $100,000 of net income must be attributed to Seamus. Seamus did not earn any other income in the 2020 tax year.

Application

Personal services income attribution rule

The requirements of s LJ 2(8) are met. Service Co is resident in New Zealand and earned a $100,000 profit from outside New Zealand. The amount is attributed to Seamus under the personal services attribution rule, and Seamus is a New Zealand resident at the time Service Co derives the profits.

Under s LJ 2(10), Service Co is not entitled to a foreign tax credit for the Australian tax paid on the amount attributed to Seamus. However, Service Co is entitled to a deduction for the amount attributed to Seamus (s DC 8).

Under s LJ 2(9), Seamus is entitled to a foreign tax credit for the Australian income tax paid by Service Co.

Segmentation

The amount attributed to Seamus is a segment of foreign-sourced income (s LJ 2(9)).

Calculation of notional New Zealand income tax liability

For the 2020 tax year, Seamus has net income of $100,000 and must calculate his notional New Zealand income tax liability by applying the formula in s LJ 5(5).

(person's net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($100,000	–	$0)	x	($14,000 x .105)	=	$1,470
				($34,000 x .175)	=	$5,950
				($22,000 x .30)	=	$6,600
				($30,000 x .33)	=	$9,900
						$23,920

Therefore, Seamus has a notional New Zealand income tax liability of $23,920.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Seamus must now calculate the amount of New Zealand tax payable on the segment of foreign-sourced attributed personal services income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Seamus's foreign-sourced attributed personal services income as follows.

((segment	–	deductions)	÷	net income)	x	notional liability	=	NZ tax payable
(($100,000	–	0)	÷	$100,000)	x	$23,920	=	**$23,920**

The amount of New Zealand tax payable on Seamus's attributed personal services income is $23,920.

Foreign tax credit

Seamus is entitled to a foreign tax credit for the foreign tax paid on the segment of foreign-sourced income, up to the amount of New Zealand tax payable on that segment.

As the New Zealand tax payable on the segment of foreign-sourced attributed personal services income is $23,920, Seamus is entitled to a foreign tax credit of $23,920 of the $27,500 Australian tax paid by Service Co.

Distributions of foreign income to trust beneficiaries

106. A discretionary complying trust that distributes foreign-sourced income to its beneficiaries based on one ratio, cannot "stream" foreign tax credits to those beneficiaries based on a different ratio. For example, a trust receives a dividend from a foreign company. If it distributes the dividend income 50/50 between two beneficiaries, it cannot stream the foreign tax credit 80/20 between the same two beneficiaries. The foreign tax credit must be applied to the foreign income in the same proportions as the distributed dividend income. This is because the foreign tax credit is paid on and is attached to the segment of foreign-sourced income, as a proportion of the foreign-sourced income. A beneficiary cannot be allocated a foreign tax credit for foreign tax paid on foreign-sourced income they did not receive. This is illustrated in *Example* 15.

Example 15: Distributions of foreign-sourced income to trust beneficiaries

Facts

For the 2021 tax year, a New Zealand discretionary complying trust receives a $150,000 dividend from an Australian company, OZ Co.[18] Tax of $22,500 is withheld from the dividend at the New Zealand/Australia DTA rate of 15%.

The trustees of the trust distribute $50,000 of the dividend to a New Zealand corporate beneficiary, Bene Co. The dividend payment received by Bene Co is exempt income under s CW 9.[19]

[18] OZ Co is exempt from the FIF rules.

[19] Section CW 9 provides that dividends derived by a New Zealand resident company from a foreign company are exempt income of the New Zealand company. Section CW 9(2) sets out several exceptions that do not apply in this example .

The trustees also distribute $50,000 to Katarina, who has no other income, and $50,000 to Emma, who has a $75,000 loss from a trading activity. The distributions are beneficiary income to the beneficiaries under s CV 13(a).

The foreign tax is allocated equally among the three beneficiaries at $7,500 each.

Application

Trust distribution

The distributions received by the beneficiaries retain their character as dividends paid by OZ Co. Accordingly, each beneficiary derives a dividend from OZ Co, less the tax withheld in Australia from their share of the dividend.

Bene Co

The dividend received by Bene Co is exempt income under s CW 9. As subpart LJ only applies to assessable income and not exempt income (s BD 1(5)(a)), Bene Co is not entitled to a foreign tax credit.

This outcome is consistent with the policy intent of subpart LJ to avoid double taxation. As Bene Co is not subject to New Zealand income tax on the exempt income, no double taxation occurs and a foreign tax credit is not required.

Emma

Emma has a net loss for the 2021 tax year of $25,000. As discussed from [13], if a person has a net loss for the tax year, there is no New Zealand income tax liability for a credit to offset, and therefore a foreign tax credit is not available.

Katarina

Segmentation

Katarina has one segment of foreign-sourced dividend income.

Calculation of notional New Zealand income tax liability

For the 2021 tax year, Katarina has net income of $50,000 and must calculate her notional New Zealand income tax liability by applying the formula in s LJ 5(5).

(person’s net income − losses) × tax rate

The calculation is shown in the table below.

(net income	–	losses)	x	tax rate	=	notional liability
($50,000	–	0)	x	($14,000 x .105)	=	$1,470

x	($34,000 x .175)	=	$5,950
x	($2,000 x .30)	=	$600
			$8,020

Therefore, Katarina has a notional New Zealand income tax liability of $8,020.

Calculation of New Zealand tax payable on each segment of foreign-sourced income

Katarina must now calculate the amount of New Zealand tax payable on the segment of foreign-sourced income by applying the formula in s LJ 5(2).

((segment − person's deductions) ÷ person's net income) × notional liability

The formula applies to Katarina's foreign-sourced dividend income as follows.

((segment	**–**	**deductions)**	**÷**	**net income)**	**x**	**notional liability**	**=**	**NZ tax payable**
(($50,000	–	$0)	÷	$50,000)	x	$8,020	=	**$8,020**

The amount of New Zealand tax payable on Katarina's foreign-sourced dividend income is $8,020.

Foreign tax credits

As the amount of New Zealand tax payable on Katarina's foreign-sourced dividend income ($8,020) is greater than her share of the tax withheld from the dividend ($7,500), Katarina is entitled to a credit for all the foreign tax paid and attributed to her.

The $7,500 foreign tax credit Katarina receives is the maximum she is entitled to under subpart LJ. The trust cannot allocate to Katerina any of the foreign tax paid on the income distributed to Emma or Bene Co so Katerina can obtain a greater credit. Katarina has received her maximum entitlement, and she cannot claim foreign tax credits for foreign tax paid on income she did not receive.

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About this document

Interpretation Statements are issued by the Tax Counsel Office. They set out the Commissioner's views and guidance on how New Zealand's tax laws apply. They may address specific situations we have been asked to provide guidance on, or they may be about how legislative provisions apply more generally. While they set out the Commissioner's considered views, Interpretation Statements 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 an Interpretation Statement will not necessarily lead to the same tax result. Each case must be considered on its own facts.

Appendix – Legislation

1. Subpart LJ states:

> **LJ 1 What this subpart does**
>
> *When tax credits allowed*
>
> (1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for foreign income tax paid in relation to a segment of that income.
>
> *Limited application of rules*
>
> (2) The rules in this subpart apply only when—
>
> (a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and
>
> (b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.
>
> *When treated as assessable income [Repealed]*
>
> (3) *[Repealed]*
>
> *Source of dividends*
>
> (4) If a company is not resident in New Zealand, and is resident in another territory or is resident in another territory for the purposes of a double tax agreement between New Zealand and the territory, and foreign income tax is imposed by the territory on a dividend paid by the company, a dividend paid by the company has a source in the territory.
>
> *Double tax agreements [Repealed]*
>
> (5) *[Repealed]*
>
> *Relationship with section YD 5*
>
> (6) Section YD 5 (Apportionment of income derived partly in New Zealand) applies to determine how an amount is apportioned to sources outside New Zealand.
>
> **LJ 2 Tax credits for foreign income tax**
>
> *Amount of credit*
>
> (1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.

Limitation on amount of credit

(2) The amount of the person's credit in subsection (1) must not be more than the amount of New Zealand tax payable by the person in relation to the segment calculated under section LJ 5(2), modified as necessary under section LJ 5(4).

Amount adjusted

(3) The amount of the person's credit in subsection (1) may be reduced or increased if either section LJ 6 or LJ 7 applies.

When person both resident in New Zealand and another country

(4) A person described in section LJ 1(2)(a) who has, because they are a citizen or resident of, or are domiciled in, a foreign country, paid foreign income tax on their assessable income, has a credit under subsection (1). However, the amount of the credit is limited to the amount of foreign income tax that would have been paid in the foreign country if the person were treated as not a citizen or resident of, or domiciled in, that foreign country.

Multi-rate PIEs and their investors

(5) For a multi-rate PIE and an investor in a multi-rate PIE, the amount of a tax credit is limited to the extent allowed under subpart HM (Portfolio investment entities).

When subsection (7) applies

(6) Subsection (7) applies to a person who derives an amount from an attributing interest in a FIF when the amount is treated as not being income under section EX 59(2) (Codes: comparative value method, deemed rate of return method, fair dividend rate method, and cost method).

Tax credit: attributing interest in FIF

(7) The person has a tax credit under this subpart for foreign income tax paid on or withheld in relation to the amount. The calculation of the maximum amount of the tax credit is made under section LJ 5(2), modified so that the item **segment** in the formula is the amount of FIF income from the attributing interest that the person derives in the period referred to in section EX 59(2).

When subsections (9) and (10) apply

(8) Subsections (9) and (10) apply when a person (the **associated entity**) resident in New Zealand derives an amount (the **attributed amount**) that—

(a) is assessable income of the associated entity that is sourced from outside New Zealand; and

(b) is attributed under sections GB 27 to GB 29 (which relate to the attribution rule for income from personal services) in an income year to another person (the **working person**) who is resident in New Zealand when the associated entity derives the attributed amount.

Tax credit: attributed income from personal services

(9) Despite section LJ 1(2)(a), the working person has a tax credit under this subpart for foreign income tax paid on the attributed amount by the associated entity or withheld in relation to the attributed amount. The calculation of the maximum amount of the tax credit is made under section LJ 5(2), modified so that the item **segment** in the formula is the attributed amount for the income year.

No tax credit for associated entity

(10) The associated entity does not have a tax credit under this subpart for foreign income tax paid on or withheld in relation to the attributed amount.

LJ 3 Meaning of foreign income tax

For the purposes of this Part, **foreign income tax** means—

(a) an amount of a tax of another country meeting the requirements of section YA 2(5) (Meaning of income tax varied):

(b) in relation to a double tax agreement providing relief from tax or double taxation, an amount of tax to which the double tax agreement applies

LJ 4 Meaning of segment of foreign-sourced income

For the purposes of this Part, a person has a **segment of foreign-sourced income** equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

LJ 5 Calculation of New Zealand tax

What this section does

(1) This section provides the rules that a person must use to calculate the amount of New Zealand tax for an income year in relation to each segment of foreign-sourced income of the person that is allocated to the income year.

Calculation for single segment

(2) If the person has a notional income tax liability of more than zero, the amount of New Zealand tax for the income year relating to the allocated segment is calculated using the following formula, the result of which can not be less than zero:

((segment − person's deductions) ÷ person's net income) × notional liability.

Definition of items in formula

(3) In the formula in subsection (2),—

(a) **segment** is the amount of the segment of foreign-sourced income for the income year:

(b) **person's deductions** is the amount of the person's deduction for the tax year corresponding to the income year that is attributable to the segment of foreign-sourced income:

(c) **person's net income** is the person's net income for the tax year corresponding to the income year under section BC 4(1) to (3) (Net income and net loss):

(d) **notional liability** is the person's notional income tax liability for the income year under subsection (5).

When subsection (4B) applies

(4) Subsection (4B) applies for the income year when the total amount of New Zealand tax for all segments of foreign-sourced income of the person calculated under subsection (2) is more than the notional income tax liability.

Modification to results of formula for single segment

(4B) Each amount of New Zealand tax calculated under subsection (2) in relation to each segment of foreign-sourced income is adjusted by multiplying the amount by the following ratio:

person's notional income tax liability ÷ NZ tax.

Definition of item in formula

(4C) In the formula in subsection (4B), **NZ tax** is the amount given by adding together the result of the calculation under subsection (2), for each segment of assessable income from all sources, including assessable income sourced in New Zealand.

Person's notional income tax liability

(5) For the purposes of this section, a person's notional income tax liability for a tax year is calculated using the formula—

(person's net income − losses) × tax rate.

Definition of items in formula

(6) In the formula in subsection (5),—

(a) **person's net income** is the person's net income for the tax year:

(b) **losses**—

(i) is the amount of the loss balance carried forward to the tax year that the person must subtract from their net income under section IA 4(1)(a) (Using loss balances carried forward to tax year):

(ii) must be no more than the amount of the person's net income:

(c) **tax rate** is the basic rate of income tax set out in schedule 1, part A (Basic tax rates: income tax, ESCT, RSCT, RWT, and attributed fringe benefits).

LJ 6 Taxable distributions and NRWT rules

When this section applies

(1) This section applies when a person who is a beneficiary of a trust and resident in New Zealand derives a taxable distribution in their capacity as beneficiary of the trust.

When credit not allowed

(2) The person is not allowed a tax credit in relation to any foreign income tax paid on the taxable distribution unless the tax has substantially the same nature as non-resident withholding tax (NRWT).

Amount of credit

(3) The person's tax credit is equal to an amount calculated using the formula—

(person's taxable distribution ÷ total distribution) × foreign tax paid.

Definition of items in formula

(4) In the formula,—

(a) **person's taxable distribution** is the amount of the taxable distribution derived by the person in their capacity as beneficiary of the trust, including a payment of tax that meets the requirements of subsection (2):

(b) **total distribution** is the total amount of the distribution derived by the person in their capacity as beneficiary of the trust, including a payment of tax that meets the requirements of subsection (2):

(c) **foreign tax paid** is the payment of tax that meets the requirements of subsection (2).

LJ 7 Repaid foreign tax: effect on income tax liability

Who this section applies to

(1) This section applies to a person who has—

(a) paid an amount of foreign income tax, or in relation to whom an amount of foreign income tax has been paid, on a segment of foreign-sourced income in relation to which they are entitled to a tax credit under section LJ 2; and

(b) received a refund, amount, or benefit (the **refund**) determined directly or indirectly by reference to some or all of the payment of foreign income tax.

When refund received before assessment

(2) If the person receives the refund before they assess their income tax liability for a tax year, the amount of the tax credit for the foreign income tax paid is reduced by the lesser of—

(a) the amount of the refund:

(b) the amount of New Zealand tax payable on the foreign-sourced income calculated under section LJ 5.

When refund received after assessment

(3) If the person receives the refund after they have assessed their income tax liability for a tax year, have used an amount of foreign tax credit in satisfying that liability, and have not

taken the refund into account in that assessment, the person is liable to pay the Commissioner the lesser of—

(a) the amount of the refund:

(b) the amount of New Zealand tax payable on the foreign-sourced income calculated under section LJ 5.

Date for payment

(4) In subsection (3), the date for payment is 30 days after the later of—

(a) the date on which the person receives the refund:

(b) the date of the notice of assessment in relation to which the person has used the credit.

Associated persons

(5) For the purposes of this section, the refund is treated as received by the person, whether it is received by the person, a person who paid the foreign income tax, or a person associated with either of them.