Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT: 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

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

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Scope of this statement

1. Double taxation occurs when two or more countries or territories (referred to as "states" for the purposes of this Interpretation Statement) tax the same taxpayer on the same income or gains. Many states tax residents on their worldwide income, including income sourced in a foreign state. States also tax non-residents on income sourced in that state. This can result in the same income being taxable under the tax laws of both states, based on residence and source respectively.

2. To relieve double taxation, a New Zealand tax resident taxpayer may be entitled to claim a foreign tax credit against their New Zealand income tax liability for any foreign income tax paid. There are two circumstances where a taxpayer may be entitled to claim a foreign tax credit:

   - if the foreign tax is covered by a Double Tax Agreement (DTA), a credit may be allowed under, and in accordance with, the terms of that DTA; or
   - if the foreign tax is not covered by a DTA, a foreign tax credit may be allowed directly under subpart LJ.

3. This Interpretation Statement explains how to claim a foreign tax credit where a foreign tax **is** covered by a DTA. A foreign tax **is** covered by a DTA if it is:

   - expressly listed in the "Taxes covered" article of the DTA (typically art 2); or
   - a tax on income or capital as defined in art 2(1) and (2) of the DTA; or
   - a subsequently enacted tax that is "identical or substantially similar" to one of the taxes covered by the DTA (typically art 2(4)).

4. If a tax **is** covered by a DTA, then the DTA will determine whether a foreign tax credit is available. If a foreign tax credit is available, the amount of that credit will be calculated under subpart LJ. If a foreign tax credit is not available, then there will be no foreign tax credit relief.

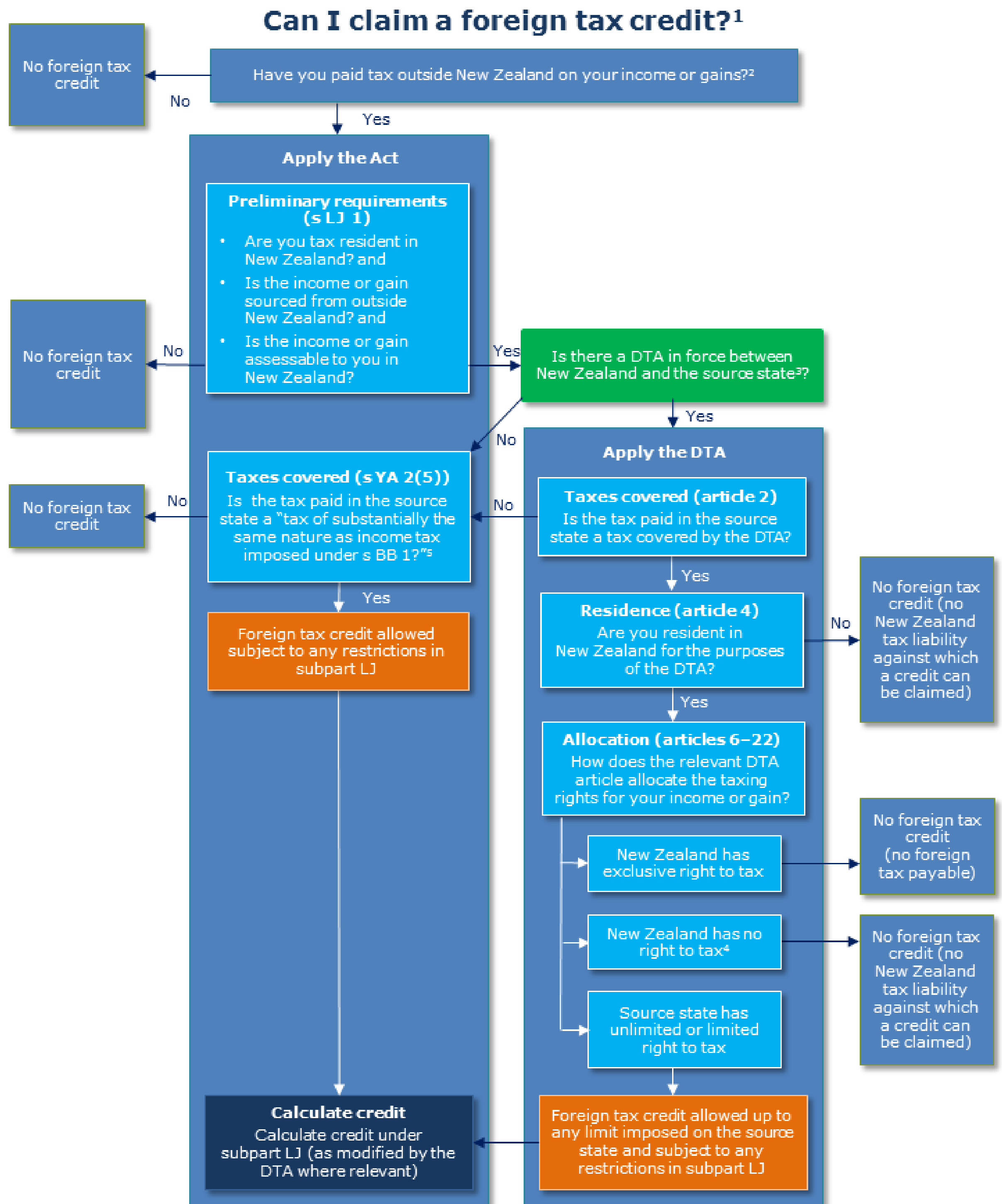
5. A foreign tax is **not** covered by a DTA if:

   - New Zealand does not have a DTA with the state imposing the foreign tax; or
   - there is a DTA between New Zealand and the state imposing the foreign tax, but the foreign tax is not a tax that the DTA applies to.

6. Where a tax is **not** covered by a DTA, a taxpayer may still be entitled to a foreign tax credit under subpart LJ. Taxpayers should refer to Interpretation Statement 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?" in *Tax Information Bulletin* Vol 26, No 5 (June 2014): 3, for further guidance.

Introduction

7. The following flowchart is intended as a useful framework for analysing a foreign tax credit issue. However, the flowchart is not meant to be a replacement for carefully reading and applying the relevant legislation.



[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.

8. After confirming that a taxpayer has paid tax outside New Zealand on their income or gains, the flowchart then looks at the domestic law preliminary requirements for foreign tax credits (ss LJ 1 and LJ 2) before considering the potential application of the DTA. In the Commissioner's opinion, this is the most logical place to start. If you do not apply domestic law first, then you will not know if you have a New Zealand income tax liability. Without this knowledge you will not be able to determine if you are subject to double taxation.

9. This approach is consistent with most international tax law commentary. However, the Commissioner accepts there may be other approaches to analysing foreign tax credit issues.

10. This Interpretation Statement does not attempt to explain every element of the flowchart. Instead, it focuses on how the foreign tax credit rules work where a foreign tax is covered by a DTA. If a taxpayer has paid foreign tax that is not covered by a DTA, they should refer to IS 14/02 for further guidance.

11. This Interpretation Statement does not consider how the foreign tax credit rules apply to trusts, controlled foreign companies, foreign investment funds, partnerships or fiscally transparent (look-through) entities.

Analysis

12. This Interpretation Statement is set out in two parts. The first part explains how the foreign tax credit rules work when a foreign tax is covered by a DTA and follows the structure set out in the flowchart. The second part contains worked examples that illustrate some of the issues discussed.

Have you paid tax outside New Zealand on your income or gains?

13. The first step in the flowchart asks: have you paid tax outside New Zealand on your income or gains? This is a question of fact. If tax has not been paid outside New Zealand on income or a gain, there will be no double taxation requiring foreign tax credit relief. Different rules exist if a tax sparing article applies.

Apply the Act - preliminary requirements – subpart LJ

14. Section LJ 2(1) provides that a person is entitled to a foreign tax credit for an amount of foreign income tax paid on a segment of foreign-sourced income:

> **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.

15. A person described in s LJ 1(2)(a) is a person who is resident in New Zealand and derives assessable income that is sourced from outside New Zealand.

16. Section LJ 1(2)(b) provides that a foreign tax credit will not be allowed for any unrecognised taxes listed in sch 27 (there are currently none listed).

17. Based on ss LJ 1(2) and LJ 2(1), to be eligible for a foreign tax credit a taxpayer must:

- be tax resident in New Zealand, and
- have derived foreign-sourced income, and
- have that foreign-sourced income assessable under the Act, and
- have paid foreign income tax on that foreign-sourced income.

18. Each requirement must be satisfied positively. Failure to satisfy any one of the requirements will mean that a taxpayer will not be eligible for foreign tax credit relief, as there will be no New Zealand tax liability against which a credit can be claimed. These requirements are domestic law requirements and should first be determined without reference to the DTA.

19. The first three preliminary requirements are considered below. The fourth requirement is considered separately at [167].

Are you tax resident in New Zealand?

20. The rules for determining tax residence status for individuals (including transitional residents) and companies are summarised below. Interpretation Statement IS 16/03: "Tax residence" *Tax Information Bulletin* Vol 28, No 10 (October 2016) comprehensively explains these rules. Taxpayers should refer to this Interpretation Statement for further guidance.

Individuals

21. Section YD 1 determines the residence of natural persons (individuals). An individual is a New Zealand resident if they are personally present in New Zealand for more than 183 days in total in a 12-month period (s YD 1(3). The person will then be treated as resident from the first of those 183 days (s YD 1(4)). A person is also resident if they have a permanent place of abode in New Zealand, even if they also have a permanent place of abode elsewhere (s YD 1(2)). A person who is resident by virtue only of the 183-day rule will stop being a New Zealand resident if they are personally absent from New Zealand for more than 325 days in total in a 12-month period (s YD 1(5)). The person will then be treated as not resident from the first of those 325 days (s YD 1(6)).

22. However, the permanent place of abode test is the overriding residence rule for individuals. This means that a person who is absent from New Zealand for more than 325 days in a 12-month period will remain a New Zealand resident if they continue to have a permanent place of abode in New Zealand. Equally, a person who is present in New Zealand for less than 183 days in a 12-month period is still a New Zealand resident if they have a permanent place of abode in New Zealand. A person who is absent for more than 325 days in a 12-month period, but who has a permanent place of abode in New Zealand at any time during that period, cannot cease to be resident any earlier than the day they lose their permanent place of abode in New Zealand.

23. There are also special residence rules for government servants and seasonal workers (s YD 1(7) and (11)).

Transitional residents

24. Transitional residents are resident in New Zealand for tax purposes but are eligible for tax exemptions on certain income.

25. New migrants and returning New Zealanders may be transitional residents under s HR 8(2) if they meet the necessary requirements. If a person is a transitional resident they are temporarily entitled to tax exemptions (s CW 27) for all foreign-sourced income except for:

- employment income in connection with employment or service performed while the person is a transitional resident; and
- income from a supply of services.

26. IS 16/03 explains in more detail the requirements for transitional resident status and when this special status starts (on the date a person becomes a New Zealand tax resident under s YD 1 – either by acquiring a permanent place of abode or by

meeting the requirements of the 183-day rule) and ends (usually at the end of the 48th month after the month in which the person acquired a permanent place of abode in New Zealand or satisfied the 183-day rule, (ignoring the back-dating rule in s YD 1(4)) whichever is earlier. Transitional resident status may also end on the day before the date where a person stops being a New Zealand resident or on the date on which they stop being a transitional resident because they elect not to be one under s HR 8(4) or (5).

27. Transitional residents will satisfy this preliminary requirement because they are tax resident in New Zealand. However, [43] below explains why transitional residents may ultimately be ineligible for foreign tax credit relief on their exempt income.

Companies

28. "Company" is defined in s YA 1. The definition is broad and extends to any entity with a legal existence separate from that of its members.

29. Section YD 2 sets out the tax residence tests for companies:

> **YD 2 Residence of companies**
>
> *Four bases for residence*
>
> (1) A company is a New Zealand resident for the purposes of this Act if—
>
> (a) it is incorporated in New Zealand:
>
> (b) its head office is in New Zealand:
>
> (c) its centre of management is in New Zealand:
>
> (d) its directors, in their capacity as directors, exercise control of the company in New Zealand, even if the directors' decision-making also occurs outside New Zealand.
>
> *International tax rules*
>
> (2) Despite subsection (1), for the purpose of the international tax rules, a company is treated as remaining resident in New Zealand if it becomes a foreign company but is resident in New Zealand again within 183 days afterwards.
>
> …

30. IS 16/03 considers the test for company tax residence in detail. Taxpayers should refer to that Interpretation Statement for further details.

Conclusion

31. Whether an individual or a company is tax resident in New Zealand will be a question of fact. If they are not tax resident in New Zealand, there will be no foreign tax credit relief available in New Zealand.

Is the income or gain sourced from outside New Zealand?

Source rules

32. To be eligible for a foreign tax credit, a taxpayer must have derived income sourced from outside New Zealand. "Income sourced from outside New Zealand" is not defined in the Act. However, s YA 1 does define "foreign-sourced amount" (which is a comparable term also used in s LJ 1(1)):

> **foreign-sourced amount** means an amount of income that is not treated as having a source in New Zealand under sections YD 4 (Classes of income treated as having New Zealand source) and YZ 1 (Source rule for interest)

33. Section YA 1 defines "foreign-sourced amount" by what it is not. If it is not one of the classes of income treated as having a source in New Zealand[1] under ss YD 4 or YZ 1, it will be a foreign-sourced amount.

34. Section YD 4 lists the classes of income that are treated as having a source in New Zealand. The list includes income derived from a business wholly carried on in New Zealand, income derived from a contract made in New Zealand, income earned in New Zealand, and pensions payable in New Zealand, to name a few. Section YD 4(18) is the catch-all provision that includes income derived directly or indirectly from any other source in New Zealand.

35. Section YZ 1 supplements the rules in s YD 4(11), which relate to income from debt instruments.

36. Income not treated as sourced in New Zealand under ss YD 4 and YZ 1 will be sourced from outside New Zealand. For ease of reference, this Interpretation Statement refers to this income as "foreign-sourced income".

Section LJ 1(4) – an additional source rule for dividends

37. Section LJ 1(4) is an additional source rule for dividends. It ensures that a New Zealand resident can claim a foreign tax credit for foreign withholding tax paid on a dividend received from a non-resident company. Section LJ 1(4) treats the dividend as being derived in that foreign territory.

Apportionment

38. Foreign-sourced income may also have a source in New Zealand. Section YD 5 permits certain classes of foreign-sourced income to be apportioned. Under s YD 5, if a business is partly carried on outside New Zealand, then the income derived outside New Zealand will be foreign-sourced income (to the extent it is apportioned to that source). Apportionment is also permitted under s YD 5 where income is derived under a contract made in New Zealand and performed in whole or in part by a person outside New Zealand (or alternatively, where a contract is made outside New Zealand and performed in whole or in part by a person in New Zealand). The apportionment is to be undertaken on an arm's length basis.

Conclusion

39. Income that is not deemed to have a source in New Zealand under ss YD 4, YD 5, YZ 1 or LJ 1(4), will be foreign-sourced income. If the income is not foreign-sourced income, foreign tax credit relief will be unavailable.

Is the income or gain assessable in New Zealand?

40. To be eligible for a foreign tax credit, the foreign-sourced income or gain (on which foreign income tax is paid) must also be assessable income in New Zealand. If the foreign-sourced income or gain is not assessable income in New Zealand, there will be no double taxation to relieve.

41. Section BD 1(1) provides that an amount is income of a person if it is their income under Part C of the Act. This amount will be assessable income under s BD 1(5) if it is not exempt income, excluded income or non-residents' foreign-sourced income. All relevant definitions are at s BD 1.

42. Taxpayers must work through Part C and the definitions in s BD 1 to determine whether the foreign-sourced income or gain is assessable income in New Zealand.

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[1] "New Zealand" is defined in s YA 1 and includes the continental shelf and the water and air space above any part of the continental shelf that is beyond New Zealand's territorial sea, as defined in s 3 of the Territorial Sea, Contiguous Zone, and Exclusive Economic Zone Act 1977.

Transitional residents

43. A transitional resident will not be eligible for a foreign tax credit for any foreign-sourced income that is subject to the s CW 27 tax exemption. This is because the foreign-sourced income will not be assessable income in New Zealand.

44. However, not all of a transitional resident's income is exempt. Section CW 27(a) and (b) exclude from the tax exemption foreign-sourced employment income in connection with employment or services performed while the person is a transitional resident, and foreign-sourced income from a supply of services. Such income will be assessable income of the transitional resident and therefore potentially eligible for foreign tax credit relief. This is illustrated in the example at [47].

Conclusion

45. If the income or gain is not assessable in New Zealand, there will be no foreign tax credit relief because there will be no New Zealand income tax liability against which a credit can be claimed.

46. A taxpayer must satisfy all of the above preliminary requirements to be eligible for a foreign tax credit.

Example illustrating the application of the preliminary requirements for a transitional resident

47. The following example illustrates the application of the preliminary requirements for a transitional resident.

Example 1 – preliminary requirements and transitional residents

Lucy recently migrated to New Zealand and is a transitional resident under s HR 8(2). Lucy is therefore a New Zealand tax resident but is exempt from income tax on certain items of foreign-sourced income. Prior to migrating, Lucy had been tax resident in the United Kingdom for 10 years.

During her first tax year as a transitional resident, Lucy derives investment income from the United Kingdom. Lucy wants to know if she is entitled to claim a foreign tax credit for the United Kingdom income tax that she has paid on that investment.

Under s CW 27, Lucy's investment income is exempt from income tax in New Zealand. The investment income therefore fails the third preliminary requirement because the income is not assessable to Lucy in New Zealand. This means Lucy is not eligible for a foreign tax credit, as there is no New Zealand income tax liability against which a credit can be claimed.

During her first tax year as a transitional resident, Lucy returns to the United Kingdom and derives employment income while there. This income is taxed at source in the United Kingdom. Section CW 27(a) states that this income is not subject to the transitional resident exemption, so the income is also assessable to Lucy in New Zealand. Lucy will therefore suffer double taxation, although she may be entitled to a foreign tax credit under the New Zealand/United Kingdom DTA. Example 9 of this Interpretation Statement considers whether Lucy would be entitled to a foreign tax credit under the DTA.

Is there a DTA in force between New Zealand and the source state?

48. The next step in the flowchart is to determine whether there is a DTA in force between New Zealand and the source state. This will decide whether any potential foreign tax credit arises under the DTA or under domestic law.

What is a DTA?

49. A DTA (also known as a double tax convention or tax treaty) is an international agreement entered into between the Government of New Zealand and the government of any state outside New Zealand (s BH 1(1)).

50. One of the main purposes of a DTA is to eliminate double taxation. Double taxation occurs when two or more states tax the same taxpayer on the same income or gains. Many states tax residents on their worldwide income, including income sourced in a foreign state. States also tax non-residents on income sourced in that state. This can result in the same income being taxable under the tax laws of both states, based on residence and source respectively.

51. A DTA may eliminate double taxation by allocating the right to tax in one of three ways. It could give New Zealand an exclusive right to tax the income, so that the source state must give up the right to tax that income. It could give the source state the exclusive right to tax the income, so that New Zealand must give up the right to tax that income. Thirdly, it could give the source state an unlimited or limited right to tax while preserving New Zealand's right to tax. In the third scenario, New Zealand will provide a foreign tax credit up to any limit imposed on the source state. (The allocation articles are discussed in greater detail below from [139].)

52. Where double taxation arises, and it is not relieved by the application of an allocation article, a DTA will identify a method for relieving that double taxation. In New Zealand's DTAs, this is usually by way of a foreign tax credit.

53. Many of New Zealand's DTAs have one or more protocols that must be read alongside the DTA. A protocol is a treaty that clarifies, implements or modifies the provisions of the DTA. When reading a DTA, it is important to check for any protocols, as they may change the meaning of the DTA.

54. Most of New Zealand's DTAs follow a similar format, based on the OECD Model Tax Convention on Income and Capital[2] (the Model Convention). The Model Convention is accompanied by the OECD Model Tax Convention Commentary (the Model Commentary), which provides commentary on the articles of the Model Convention[3].

55. It is important to remember, however, that each DTA is negotiated separately and consequently no two DTAs are exactly the same. Care needs to be taken when applying a DTA to ensure that the actual words of the relevant article have been considered.

Does New Zealand have a DTA with the source state? Has that DTA entered into force and taken effect? Has the DTA been replaced or terminated?

56. Inland Revenue's website has a list of states that New Zealand has entered into DTAs with: www.ird.govt.nz/international/residency/dta/. Inland Revenue's Tax Policy website has more detailed DTA information, including the text of the DTAs

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[2] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (OECD Publishing, Paris, 2014).

[3] The relevance of the Model Convention and the Model Commentary for interpreting DTAs is considered at [70].

and the related protocols: www.taxpolicy.ird.govt.nz/tax-treaties. This site also includes information such as:

- when the DTA was signed;
- the status of the DTA (ie, whether in force or not); and
- when the DTA became effective.

57. The site also lists DTAs that have been signed but are not yet in force, and includes a list of states that New Zealand is currently negotiating DTAs or protocols with.

58. All of New Zealand's DTAs contain an article that explains when the DTA will enter into force and when it has effect from (see art 30 of the Model Convention). A DTA typically enters into force once it has been incorporated into the domestic law of both states and each state has notified the other that this process has been completed.

59. Once a DTA has been signed, it needs to be incorporated into New Zealand law. This is done by an Order in Council. The Order in Council incorporates the text of the DTA and any protocols to the DTA into New Zealand's domestic law. For example, the New Zealand/United Kingdom DTA is part of New Zealand's domestic law by Order in Council: Double Taxation Relief (United Kingdom) Order 1984.

60. The DTA will also explain when it takes effect from. Once entered into force, a DTA usually takes effect from the next income year. For example, the New Zealand/United Kingdom DTA notes at art 27(1)(b) that the DTA shall have effect "in New Zealand: for any income year beginning on or after 1 April in the calendar year next following the date on which the Convention enters into force." Some DTAs may come into effect at different times for different taxes. It is therefore important to ensure not just that the DTA is in force, but that it has also taken effect.

61. Finally, taxpayers need to ensure that the DTA has not been replaced or terminated.

62. If there is no DTA between New Zealand and the source state, a taxpayer may still be eligible for foreign tax credit relief under subpart LJ, provided the foreign tax paid is of substantially the same nature as income tax imposed under s BB 1 (s YA 2(5)). IS 14/02 contains further guidance.

How to interpret a DTA

The Vienna Convention

63. A DTA is both an international treaty and part of New Zealand's domestic law. This unique dual nature means that it is interpreted differently from domestic legislation.

64. Because it is an international treaty, a DTA is subject to the Vienna Convention on the Law of Treaties 1969[4], to which New Zealand is a signatory. Articles 31 and 32 of the Vienna Convention describe how a treaty shall be interpreted. Article 31(1) sets out the general rule of interpretation. It requires a holistic and integrated approach[5] that considers the ordinary meaning of the text in its context and in light of the object and purpose of the treaty. The ordinary meaning of the terms of the treaty is necessarily the starting point, but it is also

[4] Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, ratified by New Zealand on 4 August 1971) entered into force on 27 January 1980.

[5] See ***CT v Lamesa Holdings BV*** 97 ATC 4752 (FCA), ***McDermott Industries Pty Ltd v FCT*** 2005 ATC 4398 (FCAFC) and ***R v Crown Forest Industries Ltd*** 95 DTC 5389 (SCC).

mandatory to consider the context, object and purpose of the treaty[6]. It is from the combined effect of these elements that the legally relevant interpretation must be taken.

65. Article 31(2) and (3) describe the context that can be taken into account for the purposes of the general rule.

66. Despite the interpretation reached under the general rule, art 31(4) provides that a special meaning can be given to a term if it is established that the parties to the treaty so intended.

67. Article 32 relates to supplementary means of interpretation. Recourse to supplementary means of interpretation is restricted. It can only be had to confirm the meaning reached under art 31 or to determine the meaning when the interpretation under art 31 is ambiguous, manifestly absurd or unreasonable.

68. The courts have interpreted New Zealand's DTAs in a manner consistent with these international obligations, adopting a broad and purposive approach. McCarthy P, in ***CIR v United Dominions Trust Ltd*** [1973] 2 NZLR 555 (CA) at 558, held that when interpreting a DTA the starting point is "not to adopt a narrow interpretation but to interpret having regard to the broad intentions of the framers as they emerge from the text."

69. The Commissioner considers that a DTA must be interpreted in a holistic and integrated manner. A DTA must not be interpreted solely by reference to the ordinary meaning of the words used or, at the other extreme, solely by reference to the purpose of the DTA. What is required is that the terms are given their ordinary meaning taking into account their context and the object and purpose of the DTA.

Relevance of the Model Commentary

70. In ***CIR v JFP Energy Inc*** (1990) 12 NZTC 7,176 (CA), Richardson J stated that appropriate regard should be given to the Model Commentary. While the Model Commentary is not binding, the Commissioner considers it extremely influential and an important tool for interpreting DTAs.

71. The Commissioner considers the Model Commentary can form part of the legal context of a DTA under art 31(1) of the Vienna Convention, provided the DTA article is the same or similar to the Model Convention and the Model Commentary was in existence at the time the DTA was signed. The Model Commentary may still be relevant if it was written after the DTA was signed, provided the changes to the Model Commentary are for clarification only. Similarly, the Model Convention can be a relevant supplementary means of interpretation under art 32 of the Vienna Convention.[7]

Article 3 – definitions

Defined terms

72. When interpreting a DTA, it is important to consider the general definitions article (typically art 3). Article 3(1) lists definitions that apply for the purposes of the DTA, unless the context requires otherwise. The list of defined terms will vary between DTAs. The list is not exhaustive and definitions can also be found elsewhere in a DTA. For example, art 4 (the Resident article) defines "resident of a Contracting State".

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[6] See ***TD Securities (USA) LLC v R*** 2010 TCC 186, 2010 DTC 1137 (Tax Court of Canada), ***Crown Forest, Coblentz v R*** (1996) 96 DTC 6,531 (Fed CA), ***Weiser v HMRC*** [2012] UKFTT 501 (TC), ***Bayfine UK v Revenue and Customs Commissioners*** [2011] EWCA Civ 304, [2011] STC 717, ***CIR v JFP Energy Inc*** (1990) 12 NZTC 7,176 (CA).

[7] See ***Thiel v FCT*** 90 ATC 4717 (HCA) and ***Crown Forest***.

Undefined terms

73. If a DTA does not define a term, that term is to be defined under the domestic law of that state, unless the context requires otherwise. Article 3(2) of the Model Convention provides:

> 2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

74. Article 3(2) confirms that the domestic law meaning to be used is the meaning at the time the DTA is applied, not the meaning that existed at the time the DTA was signed. The Model Commentary also explains that when trying to find a domestic law definition, a tax law definition will take precedence over a non-tax law definition. Furthermore, a tax law definition from a law that imposes the relevant DTA tax will take precedence over any other definitions, including other tax law definitions.[8]

75. Article 3(2) applies "unless the context requires otherwise". The Model Commentary explains how "context" should be determined[9]:

> 12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

76. The context might otherwise require an interpretation that is different from the domestic law meaning where, for example, the application of a domestic law meaning would render part of the treaty inoperable or if the domestic law would give the taxpayer unjustified treaty benefits or would lead to double taxation or non-taxation.[10]

Apply the DTA - Is the tax paid in the source state a tax covered by the DTA?

Introduction

77. If a DTA is in force and has taken effect between New Zealand and the source state, the next step is to work out whether the tax paid in the source state is a tax covered by the DTA. The "Taxes covered" article of a DTA is typically art 2.

78. Depending on how the DTA has been drafted, a tax is covered by a DTA if it is:

- expressly listed in art 2 as one of the taxes covered; or
- a tax on income or capital as defined in art 2(1) and (2) of the DTA; or
- a subsequently enacted tax that is "identical or substantially similar" to one of the taxes expressly covered (art 2(4)).

79. If a tax is covered by a DTA, the DTA will determine whether a foreign tax credit is available (the amount of the credit will be calculated under subpart LJ). However, if a tax is not covered by a DTA, relief may still be available under the domestic law foreign tax credit provisions.

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[8] Model Commentary, [13.1] at 84.
[9] Model Commentary, [12] at 83.
[10] E Reimer and A Rust (eds), *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015) at 213.

Taxes covered under art 2(1), (2) and (3)

80. In most cases, it will be easy to determine whether a tax is covered by a DTA because art 2 of the DTA will expressly list those taxes covered. For example, art 2(1) of the New Zealand/Australia DTA[11] expressly lists the taxes covered by the DTA:

> 1. The taxes to which this Convention shall apply are:
>
> a) in the case of Australia:
>
> (i) the income tax, including the resource rent tax in respect of offshore projects relating to exploration for or exploitation of petroleum resources; and
>
> (ii) the fringe benefits tax
>
> imposed under the federal law of Australia (hereinafter referred to as "Australian tax");
>
> b) in the case of New Zealand: the income tax, including the fringe benefit tax (hereinafter referred to as "New Zealand tax").

81. Most of New Zealand's DTAs adopt this prescriptive approach to defining the taxes covered by the DTA. However, some DTAs follow the Model Convention structure. Article 2(1)-(3) of the Model Convention state:

> 1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
>
> 2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
>
> 3. The existing taxes to which the Convention shall apply are in particular:
>
> a) (in State A):……….
>
> b) (in State B):……….

82. Under the Model Convention structure, the list of taxes in art 2(3) is not considered to be an exhaustive list. Instead, the taxes listed in art 2(3) are illustrative of the types of taxes on income and capital described in arts 2(1) and 2(2). In these circumstances, a tax may be covered by a DTA even if it is not specifically listed in art 2(3), provided it is a tax on income or capital as defined by arts 2(1) and 2(2). This was the outcome in the Irish case ***Kinsella v The Revenue Commissioners*** [2007] IEHC 250. The Irish High Court held that Irish capital gains tax (introduced after the DTA had been entered into) was covered by art 2(2) of the Ireland/Italy DTA. Article 2(2) of the Ireland/Italy DTA did not follow the Model Convention article exactly. It applied the DTA to "all taxes imposed on total income or on elements of income, including taxes on gains from the alienation of moveable or immovable property."

83. The "Taxes covered" article can be drafted in a number of different ways, so it is important to check the exact wording used. For example, art 2(1) of the Model Convention states that the DTA "shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities…". However, art 2(1) of the New Zealand/United States DTA[12] omits the reference to political subdivisions or local authorities. This is because the

[11] Double Taxation Relief (Australia) Order 2010.
[12] Double Taxation Relief (United States of America) Order 1983.

United States has reserved its position on this part of art 2(1) of the Model Convention[13].

"Identical or substantially similar" taxes under art 2(4)

Introduction

84. A tax is also covered by a DTA if it is imposed after the DTA is signed and it is identical or substantially similar to one of the taxes covered. It may be imposed in addition to, or in place of, the existing taxes. Article 2(4) of the Model Convention provides:

> 4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

85. The Model Convention and the Model Commentary do not provide any guidance on how to apply the test of "substantially similar". The Commissioner's view on how to apply this test is therefore set out below.

Ordinary meaning

86. Article 3 of the Model Convention lists general definitions for the purpose of the DTA. Article 3 does not define "substantially similar". Article 3(2) notes that where a term is not defined in the DTA, it should be given the meaning it has at that time under the domestic law of that state, unless the context otherwise requires (see from [73] to [76] above).

87. As "substantially similar" is not defined under New Zealand domestic law, the ordinary meaning of the term should be considered. *The Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) defines "substantially" to mean:

> ▸adv. **1** to a great or significant extent. **2** for the most part; essentially.

88. "Similar" is defined as:

> ▸adj. **1** of the same kind in appearance, character, or quantity, without being identical: *a soft cheese similar to brie.*

89. Combining these definitions, the ordinary meaning of "substantially similar" suggests that the relevant tax need not be identical, as long as it is, for the most part, the same kind of tax as a tax covered by art 2 of the relevant DTA.

90. The definition of the phrase "substantially the same" was considered by the Employment Court in *National Distribution Union Inc v General Distributors Ltd* [2007] ERNZ 120 (EmpC). While the context was different, the court noted that "substantially the same" must mean more than "substantially similar". It was a higher and more precise standard. This suggests that "substantially similar" is a lesser standard than "substantially the same".

Case law on meaning of "substantially similar"

91. The meaning of "substantially similar" in a DTA context has not been considered by the courts in New Zealand. However, it has been considered in other jurisdictions. The main cases are discussed below.

92. The issue before the Federal Court of Australia in *Virgin Holdings SA v FC of T* [2008] FCA 1503, 2008 ATC 20-051 was whether the Australian Government

[13] "Reservations" are recorded in the Model Commentary by article and indicate that a state disagrees with the text (or part of the text) of an article. "Observations" are also recorded in the Model Commentary and indicate where a state disagrees with an aspect of the Model Commentary (but not the article itself). See [31] and [32], Introduction, OECD Model Commentary, at 15.

could tax a capital gain made by a Swiss resident company (Virgin) on the sale of shares in Australia.

93. Under the Australia/Switzerland DTA (entered into in 1980, before Australia had a capital gains tax), Australia was prevented from taxing **Virgin's** business profits. The Australian Government argued that the DTA did not apply to Australian capital gains tax, meaning Australia could tax the capital gains made by Virgin on the share sale.

94. In addition to the argument that the "Australian income tax" incorporated capital gains tax (discussed below at [116]), the taxpayer argued, in the alternative, that **the capital gains tax was "substantially similar" to Australian income tax.**

95. **Edmonds J held that the term "Australian income tax"** extended to the capital gains from the sale of shares. He noted that if he was wrong on this point, the capital gains tax would still **be "substantially similar" to** Australian income tax. He noted at [55] **–** [56]:

> 55. Where a tax on capital gains is effected, as it has been in this country, by the inclusion of the capital gains, or some figure computed therefrom, in the tax base upon which income tax is imposed on an annual basis, I have great difficulty in comprehending why the tax on the capital gain is not substantially similar, if not identical, to the income tax on the tax base not including the capital gain or the figure computed therefrom. In saying this, I am mindful that one should not be blinded by the mechanisms used to impose the tax in characterising the nature of the tax for a specific purpose: see ***South Australia v Commonwealth*** 174 CLR at 261 per Dawson J extracted in [46] above. But that does not mean that in deciding whether a tax is substantially similar to another tax the mechanisms of imposition are irrelevant.
>
> 56. Second, if the tax with respect to which the tax on capital gains is being compared for similarity, also taxes capital gains, albeit depending on circumstances (s 25A) and time (s 26AAA) of acquisition, the more readily will a conclusion of substantial similarity be **reached. This harks back to Dixon J's observ**ation in ***Resch*** 66 CLR that the distinction between profits of a capital nature and profits in the nature of income in the strict sense is not one which the 1930 Act maintained; nor, according to the majority joint judgment in ***South Australia*** v ***Commonwealth*** 174 CLR, does the ITAA 36.

96. In deciding that Australian capital gains tax is **"substantially similar"** to Australian income tax, Edmonds J considered it was significant that the income tax taxed the same tax base as the capital gains tax.

97. Edmonds J also observed that, prior to the introduction of the Australian capital gains tax, the Australian income tax taxed capital gains in certain situations. He **noted that a finding of "substantially similar" is more likely to be reached where** the new tax and the tax covered by the DTA both tax capital gains. He also considered that the mechanism used to impose the tax is relevant.

98. The same issue came before the Irish High Court in ***Kinsella***. In this case, the taxpayer sold shares in an Irish company to a third party while tax resident in Italy. The taxpayer argued that, under the Ireland/Italy DTA, she was tax resident in Italy and the sale of shares was subject to Italian tax only. The Revenue Commissioners argued that the DTA did not apply to Irish capital gains tax (the DTA pre-dated the introduction of Irish capital gains tax), so the sale of shares was subject to Irish capital gains tax.

99. Kelly J held that the DTA did apply to Irish capital gains tax as it was a covered tax under art 2(2). However, he acknowledged that if he was wrong in that, the capital gains tax would fall **within art 2(4) as a "substantially similar tax":**

> As I have already pointed out CGT is a tax on gains or profits rather than a tax on capital wealth. Although introduced in 1975 it is now dealt with by the 1997 Act. That Act contains all of the provisions related to other direct taxes such as corporation tax and income tax. The rules for computing CGT are included in that legislation. True it is that the capital gains are taxed in a different way from other forms of income but the tax legislation regards the two as being very closely related. Section 4 of the Income Tax Act, 1967 which is now contained in S. 12 of the 1997 Act provides that income tax is to be charged in respect of all property, profits or gains respectively described in the schedules contained in the sections which are

> enumerated. Thus, although it is calculated in a different way from income tax, CGT is substantially similar.

100. Kelly J also specifically endorsed Vogel's approach to this exercise (discussed in more detail below at [107]):

> My view appears to be in keeping with that of Klaus Vogel in his book on Double Taxation Conventions (3rd edition 1998). He opines that new capital gains taxes will normally be considered as substantially similar to income tax. He says:
>
> > "What is necessary is a comprehensive comparison of the tax laws' constituent elements. In such a comparison, the new tax under review, rather than being compared merely with a solitary older one (to which it will always be similar in some respects and different in others), should be considered with reference to all types of taxes historically developed within the State in question – and of States with related legal systems – in order to determine which of such traditional taxes comes closest to the new tax law….Whether a tax is "substantially similar" to another can, consequently, not be decided otherwise than against the background of the entire tax system…"
>
> Later he says:
>
> > "Taxation of capital gains is normally dealt with in income tax laws, though in some instances separate legislation is devoted to that subject (see the National Reports of LX1BCDF 1129FF [1976]. Consequently, any new capital gains tax will, for Treaty purposes normally have to be considered as being at least similar to income taxes; the Danish Landskattereten (Danish Tax Court) 26 ET114 [1986]: DTC Denmark/France, differs, however."
>
> I have briefly carried out the exercise which he suggests, namely to consider all types of taxes historically developed within the State and I have reached a conclusion similar to his namely, that for the purposes of this Convention, CGT falls within the wording of Article 2.4.

101. In ***Case 8/2014*** [2014] AATA 961, 2014 ATC 1-070, the Australian Administrative Appeals Tribunal (AAT) considered whether Irish pay-related social insurance (PRSI) was identical or substantially similar to the Irish income tax for the purposes of art 2 of the Australia/Ireland DTA.

102. The taxpayer was an Australian tax resident who had been employed in Ireland. Income tax and PRSI had been deducted from his salary. PRSI is a compulsory contribution to the Social Insurance Fund used to pay social welfare benefits and pensions. The taxpayer argued that because he would not be entitled to receive any of the PRSI benefits, PRSI was substantially similar to Irish income tax and therefore he should be entitled to a foreign income tax offset (the Australian tax credit equivalent).

103. The AAT held that the PRSI was not an identical or substantially similar tax. The AAT referred to the Model Commentary and Vogel and concluded that social security charges, such as the PRSI, where there is a direct connection between the levy and the individual benefits, are not intended to fall within the ambit of taxes covered by a DTA. It was not relevant that the taxpayer did not actually receive any benefits. The AAT held that the characterisation of the PRSI could not be different for the taxpayer because of his particular circumstances.

104. In comparing the PRSI with the existing taxes covered by the DTA, how the PRSI was reflected in tax legislation was relevant. The PRSI was not imposed by the main income tax assessment legislation in Ireland and was not referred to as a "tax" in the Social Welfare Development Act 2005 (Ireland). It was calculated on a different basis from income tax and arose because of a contributor's employment status. It was not paid into the general revenue, but into the Social Insurance Fund.

105. The AAT also endorsed the decisions in ***Virgin*** and ***Kinsella*** by confirming that the mechanisms of imposition used are relevant but not determinative, as are the methods of calculation.

International tax commentary

106. As "substantially similar" is a term used in an international treaty, it is useful to look to international tax law experts for guidance.

107. In the recently published 4th edition of ***Klaus Vogel on Double Taxation Conventions,*** the text identifies "two potential and equally valid approaches" to undertaking this comparison – the "micro-approach" and "macro-approach"[14]. Under a micro-approach, a new tax is compared to a single tax or even a component of that tax. The approach requires a comprehensive comparison of the respective taxes' constituent elements. Under a macro-approach, the new tax is compared to a combination of several taxes. This approach requires an overall assessment of the place of the new tax in the tax system as a whole. The Commissioner considers that the two approaches reflect aspects of the earlier approach outlined in the 3rd edition[15] of Vogel set out at [100].

Test of "substantially similar"

108. Under art 2(4), a tax is covered by a DTA if it is imposed after the DTA is signed and it is identical or substantially similar to the taxes covered by the DTA. The case law and commentary have identified a number of factors that should be considered when determining whether a tax is substantially similar to a tax specifically covered by a DTA. Based on these factors, the Commissioner has formulated the following test.

109. When approaching this exercise, the Commissioner considers that the starting point should be to compare the new tax with a single covered tax (or component of that tax). If the taxes are "substantially similar", taking into account the essential elements of that tax, the tax will be covered under art 2(4). If the tax is not "substantially similar" under this approach, the macro-approach should also be considered. The new tax is then compared to a combination of covered taxes. Under this approach, the question of whether a tax is substantially similar has to be considered against the background of the entire tax system.

110. The Commissioner considers that, when undertaking the comparison, it may be useful to consider the following:

- The formal arrangement of the tax should first be considered (Vogel).
- The essential elements of the taxes should be comprehensively compared (Vogel).
- The new tax should be compared with all types of taxes historically developed within the overseas jurisdiction and jurisdictions with related legal systems to determine which traditional taxes come closest to the new law (Vogel).
- If the new tax taxes the same tax base as the DTA tax, it is likely to be "substantially similar" (*Virgin*).
- If the new tax taxes the same items of income/gains as the DTA tax (albeit in different circumstances – ie, a capital gains tax compared to an income tax that also taxes some capital gains), the new tax is likely to be "substantially similar" (*Virgin*).
- Even if the new tax is calculated in a different way from the DTA tax, it may still be "substantially similar" (*Kinsella*).

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[14] E Reimer and A Rust (eds), ***Klaus Vogel on Double Taxation Conventions*** (4th ed, Kluwer Law International, The Netherlands, 2015) at 167.
[15] Klaus Vogel, ***Klaus Vogel on Double Taxation Conventions,*** (3rd ed, Kluwer Law International, The Netherlands, 1997).

- How the tax is imposed is relevant, but not determinative (***Virgin***).
- How the tax is reflected in the legislation is relevant. For example, does the legislation regard the two taxes as being closely related? (***Kinsella***).
- The name of the tax, the rate and who it is imposed on is of little significance (Vogel).
- Taxes or charges paid where a direct connection exists between the levy and the individual benefits to be received are not intended to be covered by a DTA (***Case 8/2014,*** Vogel, Model Convention).

Capital gains taxes

111. While the previous section discussed the creditability of capital gains taxes in the context of art 2(4) of the Model Convention, this section discusses the creditability of capital gains taxes more broadly. A capital gains tax may be covered by a DTA in one of three ways:

- It may be one of the taxes covered by the DTA (either a specifically listed tax, or a tax that satisfies the definitions in art 2(1) and (2)).
- It may be integrated into a specifically covered tax (for example, the inclusion of capital gains in the Australian Income Tax Assessment Act 1997).
- It may be enacted subsequent to the signing of the DTA and be considered an identical or substantially similar tax to one of the taxes specifically covered by a DTA.

Capital gains taxes covered by DTA

112. In some cases, a DTA may specifically cover taxes on capital gains. For example, art 2(1) of the New Zealand/United Kingdom DTA[16] states that the DTA covers the United Kingdom capital gains tax:

> (1) The taxes which are the subject of this Convention are:
>
> (a) in the United Kingdom:
>
> (i) the income tax;
>
> (ii) the corporation tax;
>
> (iii) the capital gains tax; and
>
> (iv) the petroleum revenue tax;
>
> (hereinafter referred to as "United Kingdom tax");
>
> (b) in New Zealand:
>
> (i) the income tax; and
>
> (ii) the excess retention tax;
>
> (hereinafter referred to as "New Zealand tax").

113. A capital gains tax may also be included under art 2(1) or (2). In ***Kinsella,*** the Irish High Court held that Irish capital gains tax fell within the terms of art 2(2) of the Ireland/Italy DTA.

114. **In the Commissioner's view, if a capital gains tax is specifically covered by a DTA**, then, depending on how the taxing right is allocated, New Zealand will give a foreign tax credit for capital gains tax paid, provided the same income is also taxable in New Zealand. This might be the case, for example, where a gain on a foreign property disposal is subject to capital gains tax in the foreign jurisdiction and is also treated as taxable income in New Zealand under s CB 6.

[16] Double Taxation Relief (United Kingdom) Order 1984.

Capital gains taxes integrated into an income tax

115. The position is the same for capital gains taxes that are integrated into an income tax. For example, art 2(1)(a)(i) of the New Zealand/Australia DTA lists Australian income tax as a tax covered by the DTA. Australian capital gains tax is not a separate tax, but a component of Australian income tax. Because the DTA covers Australian income tax, New Zealand would (if required) allow a credit for Australian income tax imposed on capital gains, provided those same gains are also taxable in New Zealand.

116. The Commissioner's view is consistent with the conclusion reached by the Federal Court of Australia in ***Virgin Holdings SA*** and ***Undershaft No 1 Ltd v FC of T; Undershaft No 2 BV v FC of T*** 2009 ATC 20-091. In ***Virgin***, Edmonds J considered the structure of the Australian Income Tax Assessment Act 1997 and did not accept that there was a separate Australian capital gains tax. He held that capital gains fell into, and formed part of, income subject to income tax under the Act.

117. It is therefore important to determine whether a tax (although not specifically listed as a covered tax) is included within the ambit of a specifically listed DTA tax.

Capital gains taxes as "substantially similar" taxes

118. Vogel also argues that if a country introduces a capital gains tax, it would most likely come within the DTA's scope as a result of art 2(4). Consequently, any new capital gains tax would normally have to be considered as being at least similar to income tax[17]:

> Taxation of capital gains is normally dealt with in income tax laws, though in some instances separate legislation is devoted to that subject (see National Reports of LX1BCDF 1129FF [1976]. Consequently, any new capital gains tax will, for Treaty purposes normally have to be considered as being at least similar to income taxes; the Danish Landskattereten (Danish Tax Court) 26 ET114 [1986]: DTC Denmark/France, differs, however.

119. While any such comparison will depend on the actual taxes covered by a DTA, if an income tax (as traditionally understood) is covered by a DTA, the Commissioner considers that any subsequently enacted capital gains tax that taxes realised capital gains, rather than increases in wealth, would likely be considered "substantially similar" to that income tax.

Does a DTA tax also need to satisfy the domestic law test in s YA 2(5)?

120. A tax covered by a DTA does not also need to satisfy the s YA 2(5) test by being "of substantially the same nature as income tax imposed under s BB 1". The s YA 2(5) test applies only to foreign taxes that are not covered by a DTA.

Does the test of "substantially similar" (art 2(4)) need to be interpreted consistently with the s YA 2(5) test of "substantially the same nature"?

121. As mentioned above, a tax that is covered by a DTA does not need to satisfy the s YA 2(5) test. However, it is worth noting that the two tests - "a tax of substantially the same nature" and "substantially similar" - are different tests. The s YA 2(5) test compares the foreign tax paid with New Zealand income tax to determine whether the foreign tax is "of substantially the same nature" as New Zealand income tax. The art 2(4) test compares the foreign tax paid to the taxes covered under the DTA to determine whether the foreign tax is "substantially similar" to the DTA taxes. The tests are different and the Commissioner's view is that there is no reason why the tests should be interpreted consistently.

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[17] Klaus Vogel, ***Klaus Vogel on Double Taxation Conventions,*** (3rd ed, Kluwer Law International, The Netherlands, 1997) at 157.

Apply the DTA - are you resident in New Zealand for the purposes of the DTA?

Introduction

122. The "Persons covered" article of a DTA (typically art 1) explains that the DTA applies to persons who are "residents of one or both of the Contracting States". Article 4(1) of the Model Convention defines "resident of a Contracting State":

> 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

123. This means that, for a DTA to apply, a person needs to be a resident of a contracting state under the domestic laws of that state. As the flowchart has already determined domestic law residence (under preliminary requirements), this condition will have been satisfied.

124. However, an issue may arise if a person is a tax resident under the domestic laws of both New Zealand and the source state. This is known as dual residence. Dual residence issues are resolved by the DTA, typically under art 4. Article 4 contains a series of tie-breaker tests that are applied to allocate resident status to one of the two states for the purposes of the DTA. The tie-breaker tests for individuals and non-individuals (ie, companies) are summarised below. Taxpayers should refer to IS 16/03 for more information.

Dual resident tie-breaker tests

125. Article 4 of the Model Convention sets out the tie-breaker test for individuals and for persons other than individuals (ie, companies).

Tie-breaker tests - Individuals

126. Article 4(2) contains the tie-breaker tests for individuals. The tie-breaker tests are applied in order until residence can be determined under one of them. The main tie-breaker tests are outlined below. It is important to note that the tie-breaker tests may vary between DTAs. The order in which the tie-breaker tests apply may also vary. Taxpayers must ensure that they apply the correct tie-breaker tests in the order that they appear in the relevant DTA.

<u>Permanent home test</u>

127. The first test gives preference to the state in which the person "has a permanent home available to [them]". There are three elements to the test: there must be a home, it must be permanent, and it must be available for use (art 4(2)(a)).

128. If a person has a permanent home available in one state, they will be resident in that state, unless the person can establish that they also have a permanent home available in the other state.

129. Where a person has a permanent home available in both states, the next test will generally be the personal and economic relations test. Where a person does not have a permanent home available to them in either state, the next test for consideration will usually be the habitual abode test.

<u>Personal and economic relations (centre of vital interests) test</u>

130. The next test gives preference to the state "with which [the person's] personal and economic relations are closer (centre of vital interests)".

131. If a person's economic and personal relations are evenly balanced between New Zealand and another state (even if personal relations are stronger with one

state and economic relations with the other), the person will have no centre of vital interests, as the factors are regarded as being of equal weight. In this situation, the habitual abode test will need to be considered.

Habitual abode test

132. A person will have a habitual abode in a state if they live there habitually or normally. A person may habitually live in more than one state; the enquiry is not about assessing the state in which the person's abode is more habitual, but about whether they have a habitual abode in New Zealand and/or the other state.

Nationality and mutual agreement

133. When a person has a habitual abode in both states or in neither of them, residence is generally determined on the basis of nationality or citizenship. In cases where nationality is the test, the concept of nationality (for individuals) is generally defined as a person who is a New Zealand citizen. A New Zealand citizen is someone who has citizenship here under the Citizenship Act 1977.

134. If residence cannot be resolved under the tie-breaker tests, it will need to be resolved by mutual agreement between the competent authorities of the two states.

Tie-breaker test - Companies

135. Article 4(3) of the Model Convention contains the residence tie-breaker test for dual-resident non-individuals. It allocates residence, for DTA purposes, to the state in which the person's "place of effective management" is situated.

136. However, New Zealand's DTAs contain a number of different rules for allocating company residence for DTA purposes. Under these rules, residence may be allocated according to the company's "place of effective management", its "day-to-day management", the "centre of its administrative or practical management" or the location of its "head office".

Conclusion

137. If a New Zealand resident is deemed to be a non-resident under the tie-breaker rules in the DTA (for the purposes of the DTA), there will be no basis for the DTA to allocate taxing rights to New Zealand (as the income is not sourced in New Zealand[18]). It follows that there will be no foreign tax credit available, as the person will not have a New Zealand tax liability for that segment of foreign-sourced income against which a foreign tax credit can be claimed.

138. A New Zealand tax resident who is deemed to be a non-resident under the DTA will only have that status for the purposes of the DTA. They will remain a New Zealand tax resident under the Act and for other tax purposes, for example, in relation to any New Zealand-sourced income.

Apply the DTA - allocation articles – how does the relevant DTA article allocate the taxing rights for your income or gain?

Introduction

139. Once residence status (for the purposes of the DTA) has been established, the next step is to determine which allocation article applies to the foreign-sourced income. The application of the relevant allocation article will decide which state or states have the right to tax that foreign-sourced income.

[18] See from para [32] above, and subpart LJ, which requires the income to be sourced from outside New Zealand.

Which allocation article applies?

140. It is important to correctly identify which allocation article applies to the foreign-sourced income. Articles 6 to 21 of the Model Convention contain the allocation articles for income. Article 22 is the allocation article for capital.

141. Income not covered under any of the specific allocation articles is usually dealt with under art 21 (Other income) of the Model Convention. Article 21 also covers income that would normally be covered by another allocation article, but that article does not apply because the conditions for application are not met (for example, the income arises in a third state).

142. A DTA also contains specific priority rules that apply where the income satisfies more than one allocation article. For example, art 7 (Business profits) only applies to the extent that the business profits are not subject to any other allocation article (see art 7(4)). So, if a person's business profits include interest income, that interest income must be dealt with under art 11 (Interest) not art 7.

How does the allocation article allocate the right to tax?

143. Once the correct allocation article has been identified, it can be applied to the foreign-sourced income. There are three potential outcomes:

- New Zealand has the exclusive right to tax.
- The source state has either an unlimited or a limited right to tax.
- New Zealand has no right to tax.

These outcomes are discussed below.

New Zealand has the exclusive right to tax

144. Some allocation articles will prevent the source state from taxing the foreign-sourced income, giving New Zealand (as the state of residence) exclusive taxing rights. For example, art 19 of the New Zealand/United Kingdom DTA gives New Zealand (as the state of residence) the exclusive right to tax pension income:

> **Article 19 Pension and annuities**
>
> (1) Pensions (including pensions paid under the social security legislation of a Contracting State), and similar remuneration in consideration of past employment or services, paid to a resident of a Contracting State, and any annuity paid to a resident of a Contracting State, **shall be taxable only in that State**.
>
> [Emphasis added]

145. The phrase "shall be taxable only in that State" allocates an exclusive taxing right to the state of residence. This can be compared with the phrase "may be taxed", which allocates a shared right to tax (see [147] below).

146. If this type of allocation article applies, New Zealand (as the state of residence) will have the exclusive right to tax the foreign-sourced income and the source state will agree not to tax that income. Because of this exclusive right to tax, New Zealand does not have to provide a foreign tax credit for any foreign tax that may be incorrectly paid or withheld in the source state.[19]

[19] For example, see 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.

Source state has an unlimited or limited right to tax

Unlimited right to tax in source state

147. Under this type of allocation article, both states have a shared right to tax the foreign-sourced income. The source state's taxing rights are not limited in any way. New Zealand's taxing rights (as the state of residence) are also unaffected, but under art 23 it will have to provide a foreign tax credit for the tax imposed by the source state (subject to the calculation provisions in subpart LJ – see from [165] below). An example of this type of allocation article is art 6 (Income from immovable property) of the New Zealand/Spain DTA[20]. Use of the words "may be taxed" in art 6(1) means that the taxing rights are shared:

Article 6 Income from immovable property

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

Limited right to tax in source state

148. Under this type of allocation article, both states have a shared right to tax the foreign-sourced income, but the source state's taxing right is limited. This type of allocation article is often applied to dividend income, interest income and royalty income. New Zealand's taxing rights (as the state of residence) are unaffected, but it will have to provide a foreign tax credit under art 23 for the tax imposed by the source state (subject to subpart LJ). Article 12 of the New Zealand/Australia DTA contains an example of this type of allocation rule:

Article 12 Royalties

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but the tax so charged shall not exceed 5 per cent of the gross amount of the royalties.

…

149. Use of the words "may be taxed" in art 12(1) mean that the taxing rights are shared. However, art 12(2) limits Australia's taxing rights (as the source state) to no more than 5% of the gross amount of the royalties. New Zealand also has the right to tax the royalty income. However, it will be required to provide relief by way of a foreign tax credit under art 23 for the amount of tax imposed by Australia (subject to subpart LJ).

150. New Zealand will not provide a foreign tax credit for any amounts incorrectly imposed by a foreign state. The taxpayer will only receive a foreign tax credit for the amount of foreign tax that was entitled to be paid or withheld under the DTA, which in this case is 5%.[21]

[20] Double Taxation Relief (Spain) Order 2006.

[21] See 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.

Example illustrating a limited right to tax

Example 2 – limited right to tax

Scenario 1

In the 2015 income year, Toby derived NZD$100 of royalty income from Australia. Toby is a foreign resident under Australian tax law and resident in New Zealand for the purposes of the Act and the New Zealand/Australia DTA.

As Toby is defined as a "foreign resident" under Australian tax law, the royalty income is subject to withholding tax of 30%, or NZD$30. New Zealand is also entitled to tax that income at Toby's marginal tax rate of 30% as he is resident here. If there was no DTA between New Zealand and Australia, Toby would have to try and obtain a foreign tax credit under the domestic law foreign tax credit provisions for the tax withheld in Australia.

However, New Zealand and Australia have entered into a DTA. Under art 12(2) of the New Zealand/Australia DTA, Australia's right to tax royalty income is limited to 5% of the gross amount of the royalty, or NZD$5, which is what the Australian payer of the royalty withholds. New Zealand is also entitled to tax the royalty income, but under art 23 of the DTA it will need to provide a foreign tax credit for the Australian tax that has been withheld. In this scenario, the total notional New Zealand income tax liability for that segment of foreign-sourced income is NZD$30 (as calculated under s LJ 5(2)) and a credit of NZD$5 would be allowed to reduce that liability by reference to the Australian tax paid, giving an end result of NZD$25 for that royalty income.

Scenario 2

The facts are the same as in scenario 1, however in this scenario the Australian payer of the royalties is unaware of the New Zealand/Australia DTA. The Australian payer withholds NZD$30, rather than the NZD$5 permitted under the DTA. Toby tries to claim a foreign tax credit in New Zealand for the NZD$30 incorrectly withheld by the Australian payer.

New Zealand will not provide Toby with a foreign tax credit for the NZD$30 incorrectly withheld by the Australian payer. Under the DTA, the Australian payer should only have withheld NZD$5. New Zealand will therefore only give a credit for this amount. In this scenario, Toby has paid the $30 incorrectly withheld plus NZD$30 of New Zealand income tax, less the NZD$5 credit permitted under the DTA. Toby must go back to the Australian payer or the Australian Tax Office and seek a refund of the incorrectly withheld amount. This will ensure Toby is in the same position as in scenario 1.

New Zealand has no right to tax

151. Article 20 of the Model Convention is different from the other allocation articles under a DTA. It simply exempts the relevant income from tax in New Zealand:

> **Article 20 Students**
>
> Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

152. Where all of the conditions of this article are met, the DTA exempts from tax all foreign-sourced payments received by the student in New Zealand for his/her maintenance, education or training. However, a payment received by way of a

scholarship or bursary for attendance at an educational institution will likely be exempt income under s CW 36 in any event. The student will remain subject to New Zealand tax on all other income.

153. This article also applies where a New Zealand student is studying overseas and satisfies the conditions of this article. Any payments for the purpose of the student's maintenance, education or training received by the New Zealand student will be exempt from tax in that foreign jurisdiction.

Apply the DTA - elimination of double taxation (art 23)

154. Where double taxation arises, and it is not relieved by the application of an allocation article[22], a DTA will identify a method for relieving that double taxation.

155. New Zealand's DTAs all include an elimination of double taxation article (typically art 23) that explains when New Zealand (and the other contracting state) will give a foreign tax credit. The details of how to calculate the foreign tax credit are contained in subpart LJ of the Act.

156. New Zealand's DTAs do not follow the structure of art 23 of the Model Convention (see para [10] of the Appendix to this Interpretation Statement). New Zealand takes the following approach, as illustrated by art 22(2)(a) of the New Zealand/United Kingdom DTA:

> (a) Subject to the provisions of the law of New Zealand from time to time in force relating to the allowance as a credit against New Zealand tax of tax paid in any country other than New Zealand (which shall not affect the general principle hereof), United Kingdom tax computed by reference to income from sources in the United Kingdom and paid under the law of the United Kingdom and in accordance with this Convention, whether directly or by deduction, in respect of income derived by a resident of New Zealand from sources in the United Kingdom (excluding in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid), shall be allowed as a credit against the New Zealand tax computed by reference to the same income and payable in respect of that income.

157. This article is important because it explains how the DTA and the domestic law will work together to relieve double taxation. In the context of the New Zealand/United Kingdom DTA, it has the following effect:

- A foreign tax credit is allowed against New Zealand tax for United Kingdom tax paid on the same income.
- The allowance of the foreign tax credit is subject to New Zealand's domestic laws (that is, as to the timing and the amount of the credit). However, New Zealand's domestic legislation must be interpreted so as to uphold the general principle that a foreign tax credit should be available to eliminate double taxation.
- Any foreign tax credit allowed under art 22 must be for United Kingdom tax that is paid not only under the law of the United Kingdom but also in accordance with the DTA. For example, if New Zealand has the exclusive right to tax that income and the United Kingdom withholds an amount on that income in error, United Kingdom tax has not been paid in accordance with the DTA. Therefore, art 22 will not give rise to any foreign tax credit entitlements. (See, for example, 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.)

158. Where a DTA determines that New Zealand should provide a foreign tax credit, subpart LJ (as modified by the DTA where relevant) will determine how that foreign tax credit should be calculated.

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[22] For example, where an allocation article gives New Zealand an exclusive right to tax, meaning the other contracting state must not tax that income.

Apply the Act and the DTA - how to calculate a foreign tax credit

Introduction

159. If New Zealand is required by the DTA to provide a foreign tax credit, that credit will be calculated under subpart LJ of the Act. However, the credit will not be calculated solely by reference to domestic law. The DTA must also be considered. This is because s BH 1 provides that the DTA is to have overriding effect. Where there is any inconsistency between the DTA and domestic law, the domestic law must be read subject to the DTA. The overriding effect of the DTA is discussed below from [161].

160. Subpart LJ explains how to calculate a foreign tax credit where "foreign income tax" has been paid. It does this in two steps. First, it requires the foreign-sourced income to be divided into segments (s LJ 4). It then allows a foreign tax credit for foreign income tax paid on each segment of that foreign-sourced income (s LJ 2(1)) up to the amount of New Zealand income tax payable on that same segment (as calculated under s LJ 5).

The overriding effect of a DTA

161. Section BH 1 provides that a DTA "has effect in relation to income tax", despite anything in the Act. The heading to s BH 1(4) explains that the DTA has an overriding effect. Richardson J in *CIR v E R Squibb & Sons (New Zealand) Ltd* (1992) 14 NZTC 9,146 (CA) explained the overriding effect at 9,154: "…wherever and to the extent that there is any difference between the domestic legislation and the double tax agreement provision, the agreement has overriding effect."

162. This means that the DTA has an overriding effect as to income tax imposed under the Act, including the income part of the Act (part C) and the foreign tax credit part of the Act (subpart LJ). Therefore, the income and foreign tax credit parts of the Act must always be read together with the relevant articles of a DTA. Where there is any inconsistency between the two, the domestic law must be read subject to the DTA.

163. However, when it comes to calculating the amount of the foreign tax credit and the timing of that credit, the DTA does not provide any guidance. These issues are determined solely under domestic law. A credit may arise under a DTA, but it will be calculated under subpart LJ. Subpart LJ provides that the amount of the foreign tax credit will not be able to exceed the amount of New Zealand tax payable on that segment of foreign-sourced income. As the DTA provides no guidance on how to calculate a foreign tax credit, there can be no inconsistency between the DTA and domestic law.

164. Likewise, the timing of the allowance of the foreign tax credit arising under the DTA will be subject to the rules in s 78B of the Tax Administration Act 1994. (See para [184] below.)

Subpart LJ – "foreign income tax"

165. As discussed at [17] above, to be entitled to a foreign tax credit, a taxpayer must:

- be tax resident in New Zealand;
- have derived foreign-sourced income;
- have that foreign-sourced income assessable under the Act; and
- have paid foreign income tax on that foreign-sourced income.

166. The first three bullet points have already been considered at [14] to [46]. The fourth bullet point is considered below.

Meaning of "foreign income tax"

167. Section LJ 2(1) requires that a taxpayer must have paid foreign income tax to be entitled to a foreign tax credit[23]. "Foreign income tax" is defined in s LJ 3 for the purposes of the foreign tax credit rules (subpart LJ).

168. Where a DTA applies, s BH 1(4) gives the DTA an overriding effect on the foreign tax credit rules. This means that the definition of "foreign income tax" in s LJ 3 (which is only used for the purpose of the foreign tax credit rules) must be read together with the DTA. Where there is any inconsistency between the two, the term "foreign income tax" in s LJ 3 must be read subject to the relevant articles in the DTA.

169. When a DTA applies, the definition in s LJ 3 must be interpreted as referring to those taxes that are covered by art 2 of the DTA and are paid in accordance with the DTA.

Proof of payment of foreign tax

170. The Commissioner will also require proof that the foreign income tax has been paid. Because of timing mismatches between jurisdictions, it may not always be possible for taxpayers 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.

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

171. Foreign income and foreign tax must be converted to New Zealand dollars. Taxpayers must convert the amounts using the close of trading spot exchange rate (s YF 1(2)) or an alternative method approved by the Commissioner.

Dividing foreign-sourced income into segments

172. Once the preliminary requirements have been satisfied, the next step in the calculation process is to divide the foreign-sourced income into segments (s LJ 2(1)).

173. Section LJ 4 defines "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.

174. To divide the foreign-sourced income into segments, the income must first be split up by country. After this, the foreign-sourced income is further split up by source or nature.

Calculating the credit – s LJ 5

175. Once the foreign-sourced income has been segmented under s LJ 4, the New Zealand income tax payable on that segment must be calculated. This is required because under s LJ 2(2) the amount of the foreign tax credit must not be more than the amount of New Zealand income tax payable on that segment (as calculated under s LJ 5(2) and modified, if necessary, under s LJ 5(4B)). A separate calculation is required for each segment of foreign-sourced income. The first step is to calculate the taxpayer's notional New Zealand income tax liability

[23] Different rules exist if a tax sparing article applies.

under s LJ 5(5). This is done by multiplying **the taxpayer's** net income (minus losses[24]) by the appropriate tax rate.

176. The second step is to insert this information into the equation in s LJ 5(2). Under s LJ 5(2), the segment of foreign-sourced income (less any deductions) is divided by **the taxpayer's** total net income for the year and then multiplied by their notional New Zealand income tax liability (as calculated under s LJ 5(5)). The result of this equation is **the taxpayer's** notional New Zealand income tax liability for that segment of foreign-sourced income.

177. The foreign tax credit for that segment cannot, therefore, be more than the notional New Zealand income tax liability for that segment.

[24] 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 which a taxpayer company may use under the loss offset or subvention provisions are not brought into this calculation.

Example showing how to calculate a foreign tax credit under s LJ 5

Example 3 – how to calculate a foreign tax credit under s LJ 5

Jo is a New Zealand tax resident. She owns a rental property in the Canadian Rockies, which she rents out.

For the 2017 income year, Jo receives $20,000 of rental income and has deductions of $5,000. Jo has paid Canadian income tax of $3,750. Jo's net income for the 2017 income year is $50,000 (including the rental income). Under art 6(1) of the New Zealand/Canada DTA (Double Tax Agreements (Canada) Order 2015), Canada has an unlimited right to tax the rental income and New Zealand is obliged to provide a foreign tax credit under art 21.

Step 1: Calculate Jo's notional New Zealand income tax liability – s LJ 5(5)

Jo needs to calculate her notional New Zealand income tax liability:

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

Jo therefore has a notional New Zealand income tax liability of $8,020.

Step 2: Calculate Jo's notional New Zealand income tax liability on the segment of foreign-sourced income - s LJ 5(2)

Jo now needs to calculate her notional New Zealand income tax liability on the segment of foreign-sourced income (the Canadian rental income):

((segment – deductions) ÷ net income) x notional liability

(($20,000 - $5,000) ÷ $50,000) x $8,020 = $2,406

$2,406 is Jo's notional New Zealand income tax liability for the Canadian rental income. This means that the total amount of the foreign tax credit available under subpart LJ for this segment of foreign-sourced income cannot exceed $2,406 (s LJ 2(2)).

Jo has paid $3,750 of Canadian income tax. New Zealand will only grant Jo a foreign tax credit for $2,406, as that is the New Zealand income tax payable on that segment of foreign-sourced income.

**All amounts have been converted to New Zealand dollars.*

Adjustment under s LJ 5(4), (4B) and (4C)

178. Section LJ 5(4), (4B) and (4C) will adjust the amount of a taxpayer's foreign tax credit if the combined total of New Zealand tax payable under s LJ 5(2) for each segment of foreign-sourced income exceeds their notional New Zealand income tax liability.

179. These rules ensure that in calculating the notional income tax liability for a segment of foreign-sourced income, expenses and losses that are not attributable to a particular segment are spread across all sources of income, both domestic and foreign-sourced.

Example illustrating how to make an adjustment under s LJ 5(4), (4B) and (4C)

Example 4 – how to make an adjustment under s LJ 5(4), (4B) and (4C)

New Co has foreign interest income of $1,000, foreign royalty income of $800, New Zealand sales of $1,000 and $1,500 of deductible expenses attributable to those sales.

Step 1: Calculate New Co's notional New Zealand income tax liability – s LJ 5(5)
New Co needs to calculate its notional New Zealand income tax liability:

(net income – losses) x tax rate
(($1,000 + $800 + $1,000 - $1,500) - $0) x 0.28
$1,300 x 0.28 = $364

Step 2: Calculate New Co's notional New Zealand income tax liability on the different segments of foreign-sourced income - s LJ 5(2)
New Co now needs to separately calculate the notional New Zealand income tax liability on the segments of foreign interest and royalty income.

((interest – deductions) ÷ net income) x notional liability
(($1,000 - $0) ÷ $1,300) x $364 = $280

$280 is the notional New Zealand income tax liability for the foreign interest income.

((royalty – deductions) ÷ net income) x notional liability
(($800 - $0) ÷ $1,300) x $364 = $224

$224 is the notional New Zealand income tax liability for the foreign royalty income.

The total amount of New Zealand tax for all segments of foreign-sourced income is $504 (being $280 + $224). An adjustment needs to be made under s LJ 5(4B) because the total amount of New Zealand tax for all segments of foreign-sourced income ($504) is more than New Co's notional New Zealand income tax liability ($364).

Step 3: Adjustment under s LJ 5(4B)
Under s LJ 5(4B), each amount of New Zealand tax calculated under s LJ 5(2) is multiplied by New Co's notional income tax liability and divided by NZ tax. NZ tax is defined in s LJ 5(4C) to mean the total of all calculations made under s LJ 5(2), including a calculation on New Zealand sourced income. This means:

NZ tax = foreign interest and royalty calculations + NZ income calculation
NZ tax = $280 + $224 + $0*
NZ tax = $504

(*In this instance, the calculation on the New Zealand sourced income is -$140 but it is reduced to zero as it cannot be less than zero).

So for the foreign interest, the amount is $280 x $364 ÷ $504. This gives a figure of $202.22. This means that under s LJ 5(2) the amount of New Zealand tax payable on that foreign-sourced income is $202.22. New Zealand will therefore only grant a foreign tax credit for any foreign tax paid on that segment up to the amount of New Zealand income tax payable on that segment. Similarly, for the foreign royalty income, the amount is $224 x $364 ÷ $504, being $161.78. New Zealand will only grant a foreign tax credit on the royalty income up to an amount of $161.78.

**All amounts have been converted to New Zealand dollars.*

Foreign tax refund – s LJ 7

180. If a taxpayer receives a refund of foreign income tax, they must make an adjustment under s LJ 7. If the refund is received before the taxpayer has self-assessed, the amount of the foreign tax credit will be 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)).

181. If the refund is received after the taxpayer has self-assessed (and used the foreign tax credit), they must pay to 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)). In these circumstances, the date for payment is 30 days after the later of:

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

182. Section LJ 7 only applies to refunds of "foreign income tax". For example, this is 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 refund to the taxpayer. 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 will not be 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" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.)

Foreign tax credits are non-refundable

183. A foreign tax credit is defined in s YA 1 as a non-refundable credit. 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 back or forward and used to offset a previous or future year's income tax liabilities.

Time limit for claiming a foreign tax credit

184. Under s 78B of the Tax Administration Act 1994 (TAA), the time limit for claiming a foreign tax credit is "four years after the end of the tax year in which the taxpayer has the foreign tax credit". The Commissioner considers that 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. There are three arguments that support this interpretation:

- Section 78B links to the foreign tax credit provisions in the Act. Subpart LJ of the Act and s LJ 2(1) in particular, make it clear that a taxpayer "has a tax credit for a tax year". Therefore, to be entitled to a foreign tax credit a taxpayer must have foreign-sourced income (which is assessable income in New Zealand) and have paid foreign income tax on that income. If these requirements are met then the taxpayer will have a foreign tax credit for that tax year. Under s 78B, the time for applying for that credit starts from the tax year in which the taxpayer is eligible to claim (or "has") a foreign tax credit under subpart LJ. This is the tax year in which the taxpayer is liable to pay New Zealand income tax on the foreign-sourced income.
- The predecessor section to s 78B was s LC 13 of the Income Tax Act 2004. This section started the four-year time period from the end of the tax year in which the income tax liability arose. It was not intended that s 78B would change the previous policy of s LJ 3.

- This view is also consistent with s 93C of the TAA. Section 93C requires the Commissioner to amend an assessment where a person is entitled to a foreign tax credit under s LK 1 of the Act (foreign tax credits for CFC income) and where the amount of the credit cannot be determined before the person must file a return. The time period in this case runs from the end of the income year in which the person was entitled to the credit.

185. The Commissioner may extend the four-year period for claiming a foreign tax credit by up to two years (s 78B of the TAA).

186. The time limit for claiming foreign tax credits under s 78B applies to foreign tax credits arising under domestic law and foreign tax credits arising under a DTA.

Timing of foreign tax credits

Does foreign tax have to be paid in the same year in which the income is derived?

187. Foreign tax does not have to be paid in the same year in which the income is derived for New Zealand tax purposes.

188. 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. The reasons supporting this view are:

- The ordinary meanings of ss LJ 1, LJ 2 and LJ 3 do not indicate that the foreign income tax needs to be paid in the same tax period as the foreign tax credit is claimed.
- The segmentation approach under s LJ 5 only requires the foreign income to be allocated to a tax year and not the foreign income tax paid.
- It is possible that a direct correlation may not exist between most foreign tax periods and the relevant tax year in New Zealand, so Parliament must not have intended a strict correlation between the relevant foreign tax period and the tax year in which the foreign tax credit is claimed.

How to adjust for timing differences

189. 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 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 income years or where the income is treated as derived in a later year in the foreign state.

190. It is not possible to claim a foreign tax credit in year two, because s LJ 5 restricts 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.

191. Applications to re-open an assessment must be made to the Commissioner in writing. Applications are made under s 113 of the TAA and must contain proof that the foreign tax has been paid (see para [170] above). Further details can be found in Standard Practice Statement SPS 16/01: "Requests to amend assessments" in *Tax Information Bulletin* Vol 28, No 4 (May 2016): 12.

Example illustrating how to adjust for timing differences

Example 5 – foreign tax credits and timing differences

Sven is a New Zealand tax resident who owns a commercial rental property in Australia. The rent is paid annually on 12th March directly into Sven's New Zealand bank account. As Sven is a New Zealand tax resident he is taxed in New Zealand on his worldwide income, including his Australian rental income. Sven files his New Zealand IR3 tax return on 12 June 2016 (before the 7 July deadline for filing). He declares his Australian rental income and pays New Zealand income tax on that income under s CC 1 of the Act. At this time, Sven has not filed his Australian tax return and has not paid any Australian income tax on the rental income. He therefore cannot claim a foreign tax credit for Australian income tax because he has not yet paid this tax, as is required under s LJ 2(1).

In October, Sven prepares his Australian tax return. The Australian tax year runs from 1 July to 30 June and returns are due on 31 October. Sven understands that he must also pay tax in Australia on the rental income. Sven files his Australian tax return and pays Australian income tax on the rental income on 31 October 2016. Sven has now paid tax twice on this rental income.

Under art 6 of the New Zealand/Australia DTA both states (Australia and New Zealand) have a shared right to tax the rental income. However, under art 23 of the DTA, New Zealand (as the state of residence), must provide a foreign tax credit for the tax imposed by and paid in Australia on the rental income (subject to the calculation provisions in subpart LJ).

Sven understands that he is entitled to claim a foreign tax credit for the Australian tax paid on the rental income. He understands that he must match this foreign tax credit with the income in the year the income was derived. Sven therefore applies to the Commissioner in writing under s 113 of the Tax Administration Act 1994 (TAA) to amend his 2016 return to claim a foreign tax credit for the foreign tax paid in Australia. Sven must make his application within the time limits prescribed by s 78B of the TAA and he must provide proof that he has paid Australian income tax on the rental income.

Further examples

192. The examples set out below are included to assist in explaining the application of the law. Examples 6 to 8 consider whether a taxpayer may be able to claim a foreign tax credit for certain foreign taxes. Examples 9 and 10 consider more complex foreign tax credit issues. These examples have been included because they are current issues that the Commissioner has been asked to consider.

193. Where not otherwise stated, foreign amounts have been converted to New Zealand dollars.

Example 6 – Australian Temporary Budget Repair Levy – integrated into a tax covered under art 2

194. Kai is a New Zealand tax resident. He owns two commercial properties in Sydney. During the 2016 New Zealand tax year, he derives rental income from those properties that results in taxable income of AUS$200,000. This is Kai's only income for the 2016 tax year.

195. In addition to Australian income tax, Kai's taxable income is subject to the Australian Temporary Budget Repair Levy (TBRL) at a rate of 2% on taxable income above AUS$180,000:

> Taxable income: AUS$200,000
>
> Australian income tax: AUS$72,000
>
> Australian Temporary Budget Repair Levy: AUS$400

196. Kai understands that he can claim a foreign tax credit under the New Zealand/Australia DTA for Australian income tax paid. Australian income tax is specifically covered by the DTA under art 2(1)(a)(i). Article 6 (Income from real property) allocates an unlimited right to tax the rental income to Australia (as the state of source). New Zealand may also tax the income, but will have to provide a foreign tax credit under art 23 (Elimination of double taxation) for foreign tax paid.

197. Kai wants to know whether his foreign tax credit for Australian income tax would include credit for the TBRL.

198. As the list of taxes covered in art 2 of the New Zealand/Australia DTA is an exhaustive list, the TBRL will only be creditable if it is integrated into one of the taxes covered or if it is an identical or substantially similar tax under art 2(2).

199. The TBRL was introduced as part of the 2014-2015 Federal Budget of Australia. It was enacted as a short-term measure to try and reduce the Australian Federal budget deficit. The TBRL is imposed at a rate of 2% on individual taxpayers with a taxable income of more than AUS$180,000 per year[25]. It applies to residents and non-residents from 1 July 2014 until 30 June 2017. The TBRL is applied after a taxpayer's basic income tax liability has been calculated (taxable income – tax offsets) because it cannot be reduced by non-refundable tax offsets.

200. The TBRL is reflected in s 4-10(3) of the Income Tax Assessment Act 1997 (Australia's main tax Act). Section 4-10(3) contains the rules for calculating Australian income tax. Note 2 states:

> Section 4-11 of the *Income Tax (Transitional Provisions) Act 1997* (which is about the temporary budget repair levy) may increase the amount of income tax worked out under this section.

201. Section 4-11 of the Income Tax (Transitional Provisions) Act 1997 sets out the rules for calculating the TBRL (as relevant):

> **4-11 Temporary budget repair levy**
>
> *Temporary budget repair levy*
>
> (1) You must pay extra income tax (***temporary budget repair levy***) for a financial year if:
>
> (a) you are an individual; and
>
> (b) your taxable income for the corresponding income year exceeds $180,000; and
>
> (c) the financial year is a temporary budget repair levy year.
>
> Note: This section will also affect the income tax payable by some trustees who are taxed as if certain trust income were income of individuals. See sections 98 and 99 of the *Income Tax Assessment Act 1936*.
>
> *Amount of temporary budget repair levy*
>
> (2) Your temporary budget repair levy is worked out by reference to your taxable income for the corresponding income year using the rate or rates that apply to you.

---

[25] Individuals with a taxable income of less than AUS$180,000 will not pay the levy, except where their income is subject to some other tax rate based on the top personal marginal tax rate or based on a calculation comprising the top personal tax rate.

Note: See Part IV of the *Income Tax Rates Act 1986*.

…

202. The relevant legislation is clear that the TBRL is not a separate tax, but an increase in the rate of income tax, or extra income tax. The effect of applying the TBRL is that a taxpayer's Australian income tax liability will increase. On this basis, the Commissioner considers that the TBRL is included in the Australian income tax and is not a separate tax. It will therefore be creditable under the DTA as Australian income tax.

203. The TBRL is similar to the Australian Temporary Flood and Cyclone Reconstruction Levy introduced for the 2011-2012 income year to help rebuild infrastructure damaged as a result of the 2010-2011 Queensland floods. Like the TBRL, the levy was simply an increase in the rate of Australian income tax and would be creditable under the DTA as Australian income tax.

204. New Zealand will therefore provide Kai with a foreign tax credit for Australian TBRL. The credit will be calculated under subpart LJ and the foreign tax credit will be limited to the amount of New Zealand income tax payable on that foreign-sourced income.

Example 7 – Australian income tax on capital gains – covered by a DTA

205. Anna is a New Zealand tax resident who owns an investment property on the Gold Coast. In the 2017 income year Anna sells the property for a profit and makes a capital gain. She is taxed on that capital gain in Australia. Anna is also required to account for the capital gain in New Zealand under s CB 6A, as she purchased and sold the property within two years. Anna wants to know if she can claim a foreign tax credit for the tax paid in Australia.

206. Article 2(1)(i) of the New Zealand/Australia DTA explains that Australian income tax is covered by the DTA.

207. Australian capital gains tax is not a separate tax, but a component of Australian income tax. Because the DTA covers Australian income tax (art 2(1)(i)), New Zealand would (if required by the DTA) allow a credit for Australian income tax imposed on capital gains.

208. Article 13(1) of the New Zealand/Australia DTA concerns gains derived by a resident of a contracting state from the alienation of real property. It gives the source state (Australia) an unlimited right to tax that income. New Zealand may also tax that income, but must also provide a foreign tax credit under art 23.

209. New Zealand will therefore provide Anna with a foreign tax credit for Australian income tax (which includes the taxation of capital gains). The credit will be calculated under subpart LJ and the foreign tax credit will be limited to the amount of New Zealand income tax payable on that foreign-sourced income.

Example 8 – Brazilian Income Tax – No DTA in force

210. During the 2016 New Zealand tax year, Elsa derives interest income from investments in Brazil. Brazilian income tax (Imposto de Renda Retido na Fonte (IRRF)) is withheld from the interest income at source.

211. As Elsa is tax resident in New Zealand, she must also pay New Zealand income tax on the Brazilian-sourced interest income. Elsa wants to know if she can claim a foreign tax credit in her 2016 income tax return for the Brazilian income tax paid.

212. There is currently no DTA between New Zealand and Brazil. This means that Elsa cannot claim a foreign tax credit under a DTA. However, Elsa may be entitled to

claim a foreign tax credit under the domestic law foreign tax credit rules. The rules will allow a foreign tax credit for foreign income tax paid if the foreign income tax is of "substantially the same nature as income tax imposed under s BB 1". (See IS 14/02 for details on how to apply this test.)

213. Brazilian IRRF is compulsory, enforceable by law and paid to the Federal Government of Brazil. It is imposed on taxable income and calculated as a proportion of a taxpayer's income. It is not a penalty, service charge or licence fee, and there is no connection between the payment of the tax and any specific benefit.

214. The Commissioner therefore considers that Brazilian IRRF would satisfy the s YA 2(5) test. Specifically, Brazilian IRRF would satisfy s YA 2(5)(b) – as it is imposed as a collection mechanism for Brazilian income tax and is of substantially the same nature as New Zealand NRWT.

215. Elsa's foreign tax credit is calculated under subpart LJ. The amount of the credit will be limited to the amount of New Zealand income tax also payable on that foreign-sourced income.

Example 9 – United Kingdom employment income incurred when a transitional resident

This example follows on from example 1 at para [47] of this Interpretation Statement

216. Lucy recently migrated to New Zealand and is a transitional resident under s HR 8(2). Lucy is therefore a New Zealand tax resident but is exempt from income tax on certain items of foreign-sourced income. Prior to migrating, Lucy had been tax resident in the United Kingdom for 10 years.

217. During her first year as a transitional resident, Lucy returns to the United Kingdom and derives employment income while there. United Kingdom income tax and national insurance (NI) contributions are deducted from this income by Lucy's United Kingdom employer (the employer is resident in the United Kingdom and the employment income was borne by a permanent establishment or fixed base in the United Kingdom). Under s CW 27(a) employment income is not subject to the transitional resident exemption, so the income is also assessable to Lucy in New Zealand. Lucy wants to know if she can claim a foreign tax credit for the United Kingdom income tax and NI contributions.

218. NI contributions are not a tax covered by art 2 of the New Zealand/ United Kingdom DTA. This means Lucy will need to look to the domestic law foreign tax credit rules to determine if she is eligible for a foreign tax credit. One of the requirements of eligibility is that the foreign tax paid must satisfy the test in s YA 2(5). This means it must be a "tax of substantially the same nature as income tax imposed under s BB 1". The Commissioner considered the creditability of NI contributions in IS 14/02. The Commissioner determined that United Kingdom NI Contributions did not satisfy the test in s YA 2(5) (see paras [223] to [225] of IS 14/02). This means that Lucy is not entitled to a foreign tax credit for NI contributions.

219. However, under art 2(1)(a) of the New Zealand/United Kingdom DTA, United Kingdom income tax is a tax covered by the DTA. (It is assumed for the purposes of this example, that under art 4 of the DTA, Lucy tie-breaks to New Zealand and is therefore deemed to be resident in New Zealand for the purposes of the DTA.)

220. Employment income is considered under art 16 of the DTA:

Article 16 – Dependent personal services

(1) Subject to the provisions of Articles 17, 19 and 20, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

(2) Notwithstanding the provisions of paragraph (1) of this Article, remuneration derived by a resident of a Contracting State in respect of employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any consecutive period of 12 months; and

(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

(3) Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that State.

221. Under this article, the residence state (New Zealand) has the exclusive right to tax the employment income, unless the employment is exercised in the other state (United Kingdom). If the employment is exercised in the United Kingdom, then the income may be taxed there.

222. In this case, Lucy's employment is exercised in the United Kingdom. The Model Commentary notes that "[e]mployment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid". Lucy was physically present in the United Kingdom when performing her employment duties.

223. Article 16 states that where the employment is exercised in the other contracting state, then it may be taxed there. As noted at para [147] above, use of the words "may be taxed" indicates that taxing rights to that income are to be shared. This means New Zealand, as the state of residence must provide a foreign tax credit for the tax imposed in the United Kingdom, subject to the calculation provisions in s LJ 5.

224. Article 16 is subject to arts 17 (Directors' fees), 19 (Pensions and annuities), and 20 (Government service). As Lucy's employment income cannot be characterised as directors' fees, a pension or income from government service, these articles do not apply.

225. Paragraph 2 of art 16 must also be considered. This paragraph limits the taxing rights of the United Kingdom (as the state where the employment is exercised), where the employment is short-term in nature. It essentially prevents the United Kingdom from taxing the employment income and gives New Zealand back the sole right to tax the income, where all three conditions are met:

- Lucy is present in the United Kingdom for a period or periods not exceeding in the aggregate 183 days in any consecutive period of 12 months; and
- The income is paid by, or on behalf of, an employer who is not a resident of the United Kingdom; and
- The income is not borne by a permanent establishment or a fixed base which the employer has in the United Kingdom.

226. In Lucy's case these three conditions are not met. Lucy had previously lived in the United Kingdom for 10 years before moving to New Zealand, so she had been present in the United Kingdom for a period exceeding 183 days in the consecutive period of 12 months. Lucy's employer was resident in the United Kingdom and

the employment income was borne by a permanent establishment or fixed base which the employer had, as the employer was already resident in the United Kingdom. Failure to satisfy one of these conditions means that the paragraph does not apply. In this case, all three conditions are not met. This means that the outcome under art 16(1) prevails and the United Kingdom has an unlimited right to tax the employment income, with New Zealand providing a foreign tax credit for the tax paid in the United Kingdom, subject to the calculating provisions in s LJ 5.

Example 10 – New Zealand/United States DTA and the application of art 1(3)

227. The New Zealand/United States DTA is different from other DTAs that New Zealand has entered into. This is because the United States taxes individuals on the basis of citizenship, rather than residency.

228. This position is reflected in the Reservation to art 1 of the Model Convention, which notes:

> 28. The United States reserves the right, with certain exceptions, to tax its citizens and residents, including certain former citizens and long-term residents, without regard to the convention.

229. The United States taxes its citizens (wherever they reside) and resident aliens on their worldwide income. This means that United States citizens residing in New Zealand will be taxable here on the basis of residency, and taxable in the United States on the basis of citizenship. (Citizenship is determined under United States domestic law and is not a DTA concept.) In these circumstances, the DTA applies differently to relieve double taxation, as the following example illustrates.

230. Olaf is a New Zealand tax resident and a self-employed business consultant. He is also a United States citizen. During the 2016 tax year, Olaf worked as an independent contractor in the United States for three months. He provided consultancy services to Widget Co (and its clients) in the United States. Olaf was paid for his services, and United States Federal income tax was withheld from this payment.

231. As Olaf is a New Zealand tax resident he is taxed in New Zealand on his worldwide income. Additionally, Olaf is a United States citizen and is therefore taxable in the United States on his worldwide income. Olaf wants to know if he is entitled to any foreign tax credit relief.

232. In these circumstances, the New Zealand/United States DTA applies. Article 7 (business profits) applies to "business profits of an enterprise". Article 3(1)(m) of the DTA explains that "enterprise" applies to the "carrying on of any business", and art 3(1)(n) notes that the term "business" includes "the performance of professional services and other activities of an independent character". Therefore, art 7 applies to Olaf's professional services income.

233. Article 7 (business profits) is the appropriate article because art 14 (independent personal services) of the New Zealand/United States DTA was revoked from 12 November 2010. The revocation is consistent with the Model Convention, which has also deleted this article. The Model Commentary on arts 5 and 14 states that income derived from professional services or other activities of an independent character should be considered under art 7, as business profits.

234. Article 7(1) of the New Zealand/United States DTA provides:

> 1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

235. Under art 7, Olaf's business profits are taxable only in New Zealand, unless he carries on business in the United States through a permanent establishment. Article 5 (permanent establishment), defines "permanent establishment":

> 1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

236. Olaf and his business are based in New Zealand. He provided advice in the United States on a short-term basis. He worked at various times at the office of Widget Co and at their clients' offices. He therefore does not have a "fixed place of business" in the United States through which his business is wholly or partly carried on and so does not have a "permanent establishment". Therefore, under art 7, Olaf should only be subject to tax in New Zealand on the income earned in the United States.

237. However, as mentioned above, the New Zealand/United States DTA operates differently to other DTAs. In these circumstances reference must be made to art 1(3) of the DTA, known as the "savings clause". Article 1(3) states:

> 3. Except to the extent provided in paragraph 4, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Residence)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that Contracting State.

238. The effect of art 1(3) is that the United States maintains its right to tax its United States citizens, regardless of the DTA. So, while New Zealand has been allocated the exclusive right to tax Olaf's personal services income under art 7, the United States also continues to tax that income under art 1(3).

239. However, there is an exception to the application of art 1(3), set out in art 1(4), which helps to resolve this double taxation outcome:

> 4. The provisions of paragraph 3 shall not effect (sic):
>
> (a) the benefits conferred in a Contracting State under the Convention in accordance with paragraph 2 of Article 9 (Associated Enterprises), paragraph 1(b) of Article 18 (Pensions and Annuities), and Articles 22 (Relief from Double Taxation), 23 (Non-Discrimination), and 24 (Mutual Agreement Procedure); and
>
> (b) the benefits conferred in a Contracting State under the Convention in accordance with Articles 19 (Government Service), 20 (Students), and 26 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

240. Under art 1(4)(a), art 22 (relief from double taxation) is listed as an exception to the rule in art 1(3). Put another way, the "savings clause" in art 1(3) is not to affect the application of art 22. Article 22(1) provides:

> 1. Subject to paragraph 4, and in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), in the case of the United States double taxation shall be avoided as follows:
>
> (a) the United States shall allow to a resident or citizen of the United States or a United States company as a credit against United States tax the income tax paid to New Zealand by or on behalf of such resident, citizen or company; and
>
> (b) the United States shall also allow to a United States company owning at least 10 percent of the voting stock of a company (other than a United States company) which is a resident of New Zealand and from which the United States company receives dividends, as a credit against United States tax, the income tax paid to New Zealand by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.
>
> For the purposes of this paragraph, the taxes referred to in paragraphs 3(a) and 4 of Article 2 (Taxes Covered) shall be considered income taxes.

241. Under art 22(1) the United States agrees to provide Olaf with a foreign tax credit for the New Zealand income tax imposed on the income earned in the United States. That credit will be calculated under the domestic law of the United States. (As Olaf is a United States citizen, the United States will also want to tax Olaf on his worldwide income, including income earned in New Zealand. Olaf will need to determine which article or articles apply to his New Zealand income and how those articles will relieve double taxation.)

242. The United States Internal Revenue Code contains the foreign tax credit calculation provisions. Section 904 IRC 26 USC restricts the amount of the foreign tax credit to the amount of United States tax payable on that income from sources outside the United States. This section could potentially deny Olaf a credit, as his income has a United States source. The problem is resolved by referring back to the DTA. Article 22(4)(c) of the New Zealand/United States DTA applies to deem the income to have a New Zealand source, therefore allowing the credit under United States domestic law:

> 4. For the purpose of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:
>
> …
>
> (c) For purposes of paragraph 3, income beneficially owned by a resident of New Zealand who is a citizen of the United States or a United States company shall be deemed to arise in New Zealand to the extent necessary to give effect to the provisions of this paragraph.

243. Olaf must apply to the United States Inland Revenue Service for a foreign tax credit. He cannot seek a foreign tax credit from New Zealand, because under the New Zealand/United States DTA, New Zealand has been allocated the sole right to tax this income.

References

Related rulings/statements

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?" *Tax Information Bulletin* Vol 26, No 5 (June 2014): 3
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
SPS 16/01: "Requests to amend assessments" in *Tax Information Bulletin* Vol 28, No 4 (May 2016): 12
IS 16/03: "Tax residence" *Tax Information Bulletin* Vol 28, No 10 (October 2016)

Subject references

Double tax agreements
Foreign income tax
Foreign tax credit
Income tax
Residence
Source
Substantially similar
Transitional residents

Legislative references

Income Tax Act 2007 – ss BB 1, BD 1, BH 1, CB 6, CB 6A, CC 1, CW 27, HR 8, LA 5, LJ 1, LJ 2, LJ 3, LJ 4, LJ 5, LJ 7, LK 1, YA 2(5), YD 1, YD 2, YD 4, YD 5, YF 1, and YZ 1, subparts LJ and LK, sch 27, and the definitions of "company", "foreign-sourced amount", "New Zealand" and "non-refundable credit" in s YA 1
Tax Administration Act 1994 –ss 78B, 93C and 113
Double Taxation Relief (Australia) Order 2010
Double Tax Agreements (Canada) Order 2015
Double Taxation Relief (United Kingdom) Order 1984
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Appendix – Legislation

Income Tax Act 2007

1. Section BD 1 provides:

BD 1 Income, exempt income, excluded income, non-residents' foreign-sourced income, and assessable income

Amounts of income

(1) An amount is income of a person if it is their income under a provision in Part C (Income).

Exempt income

(2) An amount of income of a person is **exempt income** if it is their exempt income under a provision in subpart CW (Exempt income) or CZ (Terminating provisions).

Excluded income

(3) An amount of income of a person is **excluded income** if—

(a) it is their excluded income under a provision in subpart CX (Excluded income) or CZ; and

(b) it is not their non-residents' foreign-sourced income.

Non-residents' foreign-sourced income

(4) An amount of income of a person is **non-residents' foreign-sourced income** if—

(a) the amount is a foreign-sourced amount; and

(b) the person is a non-resident when it is derived; and

(c) the amount is not income of a trustee to which section HC 25(2) (Foreign-sourced amounts: non-resident trustees) applies.

Assessable income

(5) An amount of income of a person is **assessable income** in the calculation of their annual gross income if it is not income of any of the following kinds:

(a) their exempt income:

(b) their excluded income:

(c) their non-residents' foreign-sourced income.

2. Section BH 1(4) provides:

BH 1 Double tax agreements

…

Overriding effect

(4) Despite anything in this Act, except subsection (5) or (5B), or in any other Inland Revenue Act or the Official Information Act 1982 or the Privacy Act 1993, a double tax agreement has effect in relation to—

(a) income tax:

(b) any other tax imposed by this Act:

(c) the exchange of information that relates to a tax, as defined in paragraphs (a)(i) to (v) of the definition of **tax** in section 3 of the Tax Administration Act 1994.

3. Section LJ 5 provides:

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) x 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).

4. Section YD 1 provides:

YD 1 Residence of natural persons

What this section does

(1) This section contains the rules for determining when a person who is not a company is a New Zealand resident for the purposes of this Act.

Permanent place of abode in New Zealand

(2) Despite anything else in this section, a person is a New Zealand resident if they have a permanent place of abode in New Zealand, even if they also have a permanent place of abode elsewhere.

183 days in New Zealand

(3) A person is a New Zealand resident if they are personally present in New Zealand for more than 183 days in total in a 12-month period.

Person treated as resident from first of 183 days

(4) If subsection (3) applies, the person is treated as resident from the first of the 183 days until the person is treated under subsection (5) as ceasing to be a New Zealand resident.

Ending residence: 325 days outside New Zealand

(5) A person treated as a New Zealand resident only under subsection (3) stops being a New Zealand resident if they are personally absent from New Zealand for more than 325 days in total in a 12-month period.

Person treated as non-resident from first of 325 days

(6) The person is treated as not resident from the first of the 325 days until they are treated again as resident under this section.

Government servants

(7) Despite subsection (5), a person who is personally absent from New Zealand in the service, in any capacity, of the New Zealand Government is treated as a New Zealand resident during the absence.

Presence for part-days

(8) For the purposes of this section, a person personally present in New Zealand for part of a day is treated as—

(a) present in New Zealand for the whole day; and

(b) not absent from New Zealand for any part of the day.

[subss (9) and (10) have been repealed]

Treatment of non-resident seasonal workers

(11) Despite subsection (3), a non-resident seasonal worker is treated for the duration of their employment under the recognised seasonal employer (RSE) instructions as a non-resident.

5. Section YD 4 provides:

YD 4 Classes of income treated as having New Zealand source

What this section does

(1) This section lists the types of income that are treated as having a source in New Zealand for the purposes of this Act.

Business in New Zealand

(2) Income derived from a business has a source in New Zealand if—

(a) the business is wholly carried on in New Zealand:

(b) the business is partly carried on in New Zealand, to the extent to which the income is apportioned to a New Zealand source under section YD 5.

Contracts made or performed in New Zealand

(3) Income derived by a person from a contract has a source in New Zealand if the contract is—

(a) made in New Zealand, except to the extent to which the person wholly or partly performs the contract outside New Zealand, and the income is apportioned to a source outside New Zealand under section YD 5:

(b) made outside New Zealand but the person wholly or partly performs the contract here, to the extent to which the income is apportioned to a New Zealand source under section YD 5.

Personal services in New Zealand

(4) An amount that is income under section CE 1 (Amounts derived in connection with employment) has a source in New Zealand if the amount is earned in New Zealand, even if the employer is not a New Zealand resident.

Accident compensation payments

(5) An accident compensation payment as defined in section CF 1(2) (Benefits, pensions, compensation, and government grants) has a source in New Zealand.

Pensions

(6) The following amounts have a source in New Zealand:

(a) a pension or annuity payable by the government of New Zealand:

(b) a pension or annuity payable out of a superannuation scheme established in New Zealand:

(c) a gratuitous payment, within the definition of **pension** in section CF 1(2), if the services are provided in New Zealand.

Income from land owned in New Zealand

(7) Income derived by a person as the owner of land in New Zealand has a source in New Zealand.

Income from use in New Zealand of personal property

(8) Income, other than a royalty, derived as consideration for the use of, or right to use, personal property in New Zealand has a source in New Zealand if the income is—

(a) paid by a New Zealand resident:

(b) paid by a non-resident, and for which the non-resident is allowed a deduction.

Royalties

(9) A royalty has a source in New Zealand if it is—

(a) paid by a New Zealand resident and not made in connection with a business they carry on outside New Zealand through a fixed establishment outside New Zealand:

(b) paid by a non-resident, and for which the non-resident is allowed a deduction.

Dividends

(10) Income derived from shares in, or membership of, a company resident in New Zealand has a source in New Zealand.

Income from debt instruments

(11) The following amounts have a source in New Zealand—

(a) interest or a redemption payment derived from money lent in New Zealand:

(b) interest or a redemption payment derived from money lent outside New Zealand—

(i) to a New Zealand resident, unless the money is used by them for the purposes of a business they carry on outside New Zealand through a fixed establishment outside New Zealand:

(ii) to a non-resident, if the money is used by them for the purposes of a business they carry on in New Zealand through a fixed establishment in New Zealand:

(c) income from securities issued by the government of New Zealand:

(d) income derived from debentures issued by a local authority or public authority:

(e) income derived from a mortgage of land in New Zealand.

Income from disposal of New Zealand property

(12) Income derived from the disposal of property situated in New Zealand has a source in New Zealand.

Beneficiary income

(13) Income derived by a beneficiary from a trust has a source in New Zealand to the extent to which the income of the trust fund has a source in New Zealand.

Income from air transport

(14) Income derived from transporting people or property by air has a source in New Zealand if the transportation leaves from New Zealand.

Income from sea transport

(15) Income derived from transporting people or property by sea has a source in New Zealand if the transportation leaves from New Zealand to the extent to which the income is apportioned to a New Zealand source under section YD 6.

Non-resident general insurers

(16) A premium for general insurance paid to a non-resident general insurer of the type described in section YD 8 has a source in New Zealand to the extent set out in section YD 8(2).

Non-resident life insurers: policies in New Zealand

(17) Income of a non-resident life insurer calculated under section EY 48 (Non-resident life insurers with life insurance policies in New Zealand) has a source in New Zealand.

Income from New Zealand partnerships

(17B) Income has a source in New Zealand if, treating all of the partners of a New Zealand partnership as resident in New Zealand, the income is treated as having a source in New Zealand under another provision of this section. The application of the other provisions of this section is unaffected if this subsection does not apply.

Any other source in New Zealand

(18) Income derived directly or indirectly from any other source in New Zealand has a source in New Zealand.

6. Section YD 5 provides:

YD 5 Apportionment of income derived partly in New Zealand

When this section applies

(1) This section applies when—

(a) a person carries on business partly in New Zealand and partly outside New Zealand; or

(b) a contract is made in New Zealand and is performed, in whole or in part, by a person outside New Zealand; or

(c) a contract is made outside New Zealand and is performed, in whole or in part, by a person in New Zealand.

Relationship with source rules

(1B) This section does not apply to limit the effect of—

(a) any of the source rules in section YD 4 other than those in section YD 4(2) and (3); or

(b) the source rules in section YD 4(2) and (3) to the extent to which the income referred to is also income referred to in any source rule other than those in section YD 4(2) and (3).

Apportionment

(2) The amount of income derived from the business or under the contract, and the amount of expenditure incurred in deriving the income, must be apportioned between New Zealand and sources outside New Zealand to the extent necessary to achieve the result in subsection (3).

Necessary effect of apportionment

(3) The result of the apportionment, to the extent consistent with subsection (2), must be that the person's net income or net loss, in relation to the business or contract, is the same as a separate and independent person would have if they were carrying out only the person's activities in New Zealand and dealing at arm's length.

7. Section YZ 1 states:

YZ 1 Source rule for interest

Application from 29 July 1983

(1) Section YD 4(11)(a) and (b) (Classes of income treated as having New Zealand source) applies to—

(a) interest derived from money lent under a binding contract entered into on or after 29 July 1983:

(b) a redemption payment made on a commercial bill if—

(i) it was issued on or after 29 July 1983; and

(ii) it was not issued under a binding contract entered into before that date.

Meaning of issue

(2) In this section, **issue** has the meaning given in section 2 of the Bills of Exchange Act 1908.

Vienna Convention

8. Articles 31 and 32 of the Vienna Convention provide:

Article 31

General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) Any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32

Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) Leaves the meaning ambiguous or obscure; or

(b) Leads to a result which is manifestly absurd or unreasonable.

Model Convention

9. Article 4(2) and (3) of the Model Convention state:

Article 4 Resident

...

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

10. Article 23B of the Model Convention states:

Article 23B Credit method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.