Inland Revenue
Te Tari Taake

QUESTIONS WE'VE BEEN ASKED

Foreign investment fund (FIF) calculation methods in cases of non-compliance

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QB 23/10

This QWBA explains that a person has a choice of methods to calculate FIF income even if they fail to declare the income in a tax return and later file a voluntary disclosure, or fail to file a tax return by the due date and later provide one including the income.

It also explains what happens if a person does not file a return and the Commissioner issues a default assessment.

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

Key provisions

Income Tax Act 2007 (ITA) – ss EX 44, EX 48

Tax Administration Act 1994 (TAA) – ss 33, 37, 113, Part 9

All section references are to the ITA unless otherwise stated.

Question

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

Answer

Yes. Normally, a person has a choice of up to five methods for calculating FIF income subject to certain restrictions. This choice is available even if the person:

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

If the Commissioner issues a default assessment due to a person not filing a return, it will usually be based on the default calculation method. A person will need to file a return to challenge the assessment but can choose from the available methods in calculating the amount of FIF income to include.

Penalties and use of money interest may be applicable in cases of non-compliance.

Explanation

Introduction

1. This QWBA primarily explains what happens under the FIF rules if a natural person or eligible trustee:
    - fails to declare FIF income in a tax return and later makes a voluntary disclosure; or
    - fails to file a tax return by the due date and later provides one with FIF income.
2. It also explains what happens if a person does not file a return and the Commissioner issues a default assessment.
3. Some people are unsure whether they have a choice of methods to calculate FIF income when they correct their tax affairs. This QWBA clarifies that they do have a choice subject to the usual restrictions. This is particularly relevant for natural persons and eligible trustees but where other taxpayers have a choice of methods the same principles apply when they correct their tax affairs.

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

Overview of the FIF rules

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

6. These investments are:

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

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

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

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

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

10. A general rule is that once a person uses a particular method, they must use it in the following years. However, natural persons and eligible trustees can choose between the FDR and CV methods from one year to the next. Eligible trustees are trustees where:

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

11. A wide range of investments can be an attributing interest in a FIF and several methods for calculating FIF income are possible. For these reasons, this item focuses on a common attributing interest in a FIF where:

- the taxpayer is a natural person or eligible trustee;
- they own ordinary shares in a foreign company;
- a market value is available for the shares;
- the company is not in Australia[1];
- the shareholding is under 10%;
- the total cost of all FIF investments is over NZ$50,000; and
- the choice of method is between FDR and CV.

The FDR method

12. FIF income under the FDR method is 5% of the opening market value of the shares plus any quick sale adjustment. A person needs to calculate a quick sale adjustment if they sell shares they have bought in the same year. Where a person acquires the shares during the year, the opening balance is zero and there is no FIF income under the FDR method provided no quick sales have occurred. Any dividends under this method are treated as excluded income and not taxed.

The CV method

13. By contrast, the CV method essentially calculates FIF income by comparing the closing market value of the shares with their opening value, adjusted for purchases and dividends. The result reflects the performance of the investment and foreign currency fluctuations. A positive result is FIF income. A special limitation rule may restrict losses to the amount of FIF income. Any dividends are part of the calculation and not taxed separately.

Choosing a method

14. A natural person or eligible trustee can choose the lower of the amount of FIF income calculated under the FDR or CV methods. A person makes their choice by reporting any resulting FIF income in their tax return.

[1] ASX-listed Australian companies are exempt from the FIF rules if the requirements of s EX 31 are met.

15. The due date for a return is usually 7 July for a natural person with no agent. It will be a later date where a person or their agent has an extension of time arrangement. If the return is late, the person may have to pay a late filing penalty but can still choose between the FDR or CV methods.

16. Similarly, if the person omits FIF income from a return and later makes a voluntary disclosure, they can choose between the FDR or CV methods. Shortfall penalties may apply but these can be reduced by up to 100% for a voluntary disclosure. Use of money interest will be payable on any shortfall.

The default calculation method

17. If a person does not file a return, the Commissioner may issue a default assessment. In the common situation described at [11], the legislation treats the person as if they had chosen the FDR method if it is practical to use it. If it is not practical, the person is treated as if they had chosen the cost method. The CV method is not available. This may result in FIF income in the default assessment being higher than if the person had chosen the CV method.

18. In order to object to the assessment by way of a notice of proposed adjustment (NOPA), the person must file the return in question. This process is described in **SPS 23/01** **Disputes Process** starting at paragraph 53. The person can choose between the FDR and CV methods when calculating FIF income to include in the return.

19. Alternatively, as set out in paragraph 87 of **SPS 20/03** **Requests to amend assessments**, if the person simply files the return in question without issuing a NOPA, the Commissioner will treat the tax return as a request to amend the default assessment. The assessment will generally be amended after confirming that the tax return contains the correct tax position. However, if the person is within the relevant disputes resolution response period, they should consider issuing a NOPA with the tax return to preserve their dispute rights where the Commissioner declines to amend the default assessment.

20. The person may be subject to penalties and use of money interest.

Further information

21. For more information about the FIF rules, refer to **Guide to foreign investment funds - IR461**.

22. For more information about making voluntary disclosures, refer to **SPS 19/02** **Voluntary disclosures**.

23. For more information about amending assessments, refer to **SPS 20/03** **Requests to amend assessments**.

24. For more information about the disputes process, refer to **SPS 23/01** **Disputes Process**.

25. These can be found on our website at ird.govt.nz. You may also decide to seek advice from a tax advisor.

Examples

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

Example 1 – Return includes FIF income correctly

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

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

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

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

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

The facts are the same as in Example 1, but James forgets to include the FIF income in his return. He later remembers and makes a voluntary disclosure.

James chooses the CV method and reports NZ$3,000 in his voluntary disclosure. He is eligible for a reduction in shortfall penalties of up to 100% but must pay use of money interest on the shortfall.

Example 3 – Return leaves out FIF income but returns dividend income

The facts are the same as in Example 1 except that James receives dividend income of NZ$1,000 and reports that instead of FIF income in his return.

He later learns that the dividends are excluded income and he should have reported FIF income instead. He makes a voluntary disclosure of the shortfall.

James chooses the CV method and pays additional tax on the difference between the FIF income of NZ$3,000 and the dividend income of NZ$1,000. James is eligible for a reduction in shortfall penalties but must pay use of money interest on the shortfall.

Example 4 – Late return

The facts are the same as in Example 1 except that James files his return late by six months.

FIF income remains at NZ$3,000 but James may have to pay a late filing penalty.

Example 5 – Default assessment

Oscar is a New Zealand resident. He is not a transitional resident.

Oscar previously filed tax returns and reported FIF income but he has not done so for the last two years. Inland Revenue (IR) learns that Oscar has investments overseas through its annual automatic exchange of information programme with other tax authorities. IR sends a letter asking Oscar to confirm that his tax affairs are in order but he ignores the request. IR then issues default assessments for each of the two years using the default method of FDR:

- year 1 NZ$5,000
- year 2 NZ$5,200.

Oscar decides to correct his tax affairs and files the returns with NOPAs.

In year 1, the market value of ordinary shares Oscar held on the London Stock Exchange were NZ$100,000. They were valued at NZ$104,000 at the end of the year. No dividends were received and there were no quick sales.

Oscar can choose between the FDR and CV methods:

- FDR 100,000 x 5% + 0 (quick sale adjustment) = NZ$5,000.
- CV (104,000 + 0) – (100,000 + 0) = NZ$4,000.

Oscar chooses the CV method and reports FIF income of NZ$4,000 in his IR3 return.

At the end of year 2, Oscar's shares have increased in value to NZ$107,000. No dividends were received and there were no quick sales.

Oscar can choose between the FDR and CV methods:

- FDR 104,000 x 5% + 0 (quick sale adjustment) = NZ$5,200.
- CV (107,000 + 0) – (104,000 + 0) = NZ$3,000.

Oscar chooses the CV method and reports FIF income of NZ$3,000 in his IR3 return.

The returns and NOPAs are accepted. Oscar has to pay use of money interest on the shortfalls and may have to pay penalties.

References

Legislative references

Income Tax Act 2007 – ss BD 1, CQ 4-6, CX 57B, DN 5-9, EX 28-72 (the FIF rules), LJ 2(6), LJ 2(7)

Tax Administration Act 1994 – ss 33, 37, 113, 89D, Part 9

Other references

Guide to foreign investment funds – IR461 (guide, Inland Revenue, 2022)

https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir400---ir499/ir461/ir461-2022.pdf?modified=20220921025937&modified=20220921025937

IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit (Inland Revenue, 2022)

https://www.taxtechnical.ird.govt.nz/interpretation-statements/2021/is-21-09

SPS 19/02: Voluntary disclosures (Inland Revenue 2022)

https://www.taxtechnical.ird.govt.nz/standard-practice-statements/shortfall-penalties/sps-1902-voluntary-disclosures

SPS 20/03: Requests to amend assessments (Inland Revenue, 2020)

https://www.taxtechnical.ird.govt.nz/standard-practice-statements/investigations/sps-20-03

SPS 23/01: Disputes Process (Inland Revenue, 2023)

https://www.taxtechnical.ird.govt.nz/standard-practice-statements/disputes/sps-23-01

About this document

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

Appendix: Technical explanation of the answer in this QWBA

1. This appendix explains the answer to the question posed in this QWBA with the relevant legislative references to the Income Tax Act 2007 (ITA) and the Tax Administration Act 1994 (TAA). References are to the ITA unless otherwise stated. The focus is on natural persons and eligible trustees who own shares in a foreign company in the circumstances described at [11]. Where other taxpayers have a choice of methods, the same principles apply when they correct their tax affairs.

FIF income taxable

2. FIF income is income under s BD 1(1) because it is income under s CQ 4. It is assessable income under s BD 1(5). Section CQ 5 describes when FIF income arises. Essentially, this is when a person who is a New Zealand tax resident has an attributing interest in a FIF that is not exempt. The two main exclusions are for transitional residents and attributing FIF interests if the total cost does not exceed $50,000 at any time during the year. If the person does not need to apply the FIF rules, they may still have income under other sections in the ITA.
3. Under s CQ 6, FIF income is calculated using the relevant calculation method in ss EX 44 to EX 61.

Attributing interest in a FIF

4. FIF investments are listed in s EX 28, as follows:
   - a direct income interest in a foreign company, including a foreign unit trust
   - rights in a FIF superannuation scheme as a member or beneficiary
   - rights to benefit from a life insurance policy if it is not offered or entered into in New Zealand.
5. Section EX 29(1) provides that a person has an attributing interest in a FIF if:
   - the person holds rights in one of the listed categories, such as a direct income interest in a foreign company, and
   - none of the exemptions in ss EX 31 to EX 43 apply.
6. Section EX 30 describes how to determine a person's direct income interest in a foreign company. Basically, it is the percentage of the person's shareholding in the company. Whether or not the shareholding is 10% or more can be relevant to the application of the rules.

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

Calculation of FIF income

8. If the FIF investment is an attributing interest, s EX 44(1) provides five methods under which the amount of FIF income can be calculated:

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

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

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

10. The section requires a person to choose one of the calculation methods for each attributing interest. This choice is made by "completing a return of income accordingly" with the amount of FIF income resulting from the calculation. A "return of income" is defined in s YA 1 by reference to s 33 of the TAA. This section requires a person to file a return for each tax year. There is no explicit requirement that the choice has to be made by the due date for the return.

11. However, penalties can be imposed for filing a return late. For persons with a year ending on 31 March, the return must be filed by 7 July under s 37 of the TAA unless the person has an extension of time arrangement or uses an agent.

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

13. Section EX 44(2) places restrictions on the choice a person can make. For example:
    - s EX 46(6) limits who can use the CV method for an attributing interest in shares in a foreign company.
    - s EX 47 limits the methods that can be used to calculate FIF income from an attributing interest in a non-ordinary share to the CV method, or failing that, the DRR method.
    - s EX 47B limits the method that a person can use for certain returning share transfers to the CV method.
    - s EX 62 limits the ability of persons to change methods from year to year.
14. If a person calculates FIF income using a method other than the attributable FIF income method, s EX 59(2) provides that other amounts derived from the attributing interest for a period are excluded income under s CX 57B. This means that, for example, a person does not need to return dividends from an investment in ordinary shares in a US company if they are required to calculate and return FIF income from the attributing interest and choose the FDR method. The dividends are excluded income under s CX 57B and not assessable income under s BD 1(5).
15. Section EX 57 contains rules about how to convert foreign amounts into New Zealand dollars. Credits for foreign tax paid are calculated on the segment of FIF income under ss LJ 2(6) and LJ 2(7) unless the attributable FIF income method has been used. See **IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit**, from page 83.

Default calculation method

16. Section EX 48 also limits the choice of calculation method. This section reads:

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

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

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

17. This section applies where a taxpayer does not file a return and the Commissioner issues a default assessment. If one of the restrictions in s EX 48(1)(b) do not apply, the person will be treated as though they chose the FDR method. If this is not possible, the person will be treated as if they chose the cost method. The CV method is not available. This could result in the person paying tax on a higher amount of FIF income. In order to challenge the assessment, the person needs to file a return. If the taxpayer is a natural person or eligible trustee, they can choose the CV method in that return if applicable.

18. In order to object to the assessment by way of a NOPA, s 89D(2) of the TAA requires the person to file the return in question. This process is described in **SPS 23/01 Disputes Process** starting at paragraph 53. The person can choose between the FDR and CV methods when calculating FIF income to include in the return.

19. Alternatively, as set out in paragraph 87 of **SPS 20/03 Requests to amend assessments**, if the person simply files the return in question without issuing a NOPA, the Commissioner will treat the tax return as a request under s 113 of the TAA to amend the default assessment. The assessment will generally be amended after confirming that the tax return contains the correct tax position. However, if the person is within the relevant disputes resolution response period, they should consider issuing a NOPA with the tax return to preserve their dispute rights where the Commissioner declines to amend the default assessment.

20. The person may be subject to penalties and use of money interest.

Dividends returned instead of FIF income

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

22. To correct the situation, the person should make a voluntary disclosure. A voluntary disclosure can result in shortfall penalties being reduced by up to 100%. The person can choose between the FDR or CV methods in the voluntary disclosure, subject to the usual restrictions on choice.

Other cases

23. This item focuses on the choice a natural person or eligible trustee may have between the FDR and CV methods when correcting their tax affairs. However, the same principle applies to any taxpayer who has a choice of methods available to them when correcting their tax affairs. For example, a company may meet the criteria to use the attributable FIF income method and be able to choose between that and the FDR method in the year of acquisition when making a voluntary disclosure, filing a late return or filing a return in response to a default assessment.

FIF losses may be restricted

24. FIF losses can be deductible without satisfying the general permission because of section DN 5. Section DN 6 describes when a FIF loss arises. Its provisions are similar to what has already been described above for section CQ 5.

25. However, a deduction for a loss amount calculated using the CV method can be subject to a special limitation rule. This applies where the person is allowed to use either the FDR or CV methods. If the CV method is used and the overall result for all of those investments is a loss (ie the total of the negative results is more than the total of the positive results), the effect of s EX 51(8) is that the amount of each negative result is reduced to the extent necessary so that the overall result for all of the investments is zero.

26. The positive results are still taxable income under section CQ 4 in the normal way. However, this special loss limitation rule can mean that the total deduction for the loss amounts under section DN 5 cannot exceed the total FIF income.