Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

Source of income and foreign tax credits

Decision date | Rā o te Whakatau: 28 November 2024

Issue date | Rā Tuku: 1 May 2025

TDS 25/10

Subjects | Kaupapa

Source of income; entitlement to foreign tax credits

Taxation laws | Ture tāke

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

Summary of facts | Whakarāpopoto o Meka

1. This dispute concerned two individual taxpayers (Taxpayers) who were shareholder employees and directors of a New Zealand registered company (Company) that provided services in New Zealand.
2. The dispute related to an income year during which the Taxpayers resided overseas. There is no Double Tax Agreement between New Zealand and the country where the Taxpayers resided, so this did not prevent New Zealand from taxing the income.
3. Customer and Compliance Services, Inland Revenue (CCS) agreed that the Taxpayers were not New Zealand residents for tax purposes in that income year.
4. The dispute concerned whether, for that income year, the Taxpayers' PAYE income and shareholder salaries (Income) had a source in New Zealand under ss YD 4(18) (any other source in New Zealand) and YD 4(4) (Personal services in New Zealand). The Taxpayers raised an argument that the Income did not have a source in New Zealand under s YD 4(3) (Contracts made and performed in New Zealand). CCS did not dispute that. The Tax Counsel Office (TCO) briefly considered s YD 4(3).
5. If the Income had a New Zealand source, it was assessable for tax in New Zealand.
6. The dispute also concerned whether the Taxpayers had shown they were entitled to foreign tax credits for tax paid overseas (under s LJ 2 (Tax credits for foreign tax)).

Issues | Take

7. The issues considered in this dispute were:
    - Whether the Income had a New Zealand source under ss YD 4(18), YD 4(4) and YD 4(3).
    - If the Income had a New Zealand source, whether the Taxpayers were entitled to foreign tax credits under s LJ 2.

8. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

9. TCO decided that:

- The Income had a New Zealand source under:
  - s YD 4(18), as income derived directly or indirectly from any other source in New Zealand, and
  - s YD 4(4), as employment income earned in New Zealand.
- The Taxpayers were not entitled to foreign tax credits under s LJ 2.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

10. Except for proceedings relating to evasion or similar act or obstruction, the onus of proof is on the taxpayer to show that an assessment is wrong, why it is wrong, and by how much it is wrong.[1] However, if the taxpayer proves, on the balance of probabilities, that the amount of an assessment is excessive by a specific amount, the taxpayer's assessment must be reduced by the specific amount.[2]

11. The standard of proof required is the balance of probabilities.[3]

12. It is appropriate that the same onus and standard of proof be applied in the disputes process as in challenge proceedings. TCO considered whether the Taxpayers had discharged the onus of proof in the context of the issues raised by the parties to the dispute, based on the documentary evidence before it. If the dispute proceeds, the Taxation Review Authority or a court may reach a different conclusion after hearing the evidence of the Taxpayers and that of any other witnesses the Taxpayers may choose to call.

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[1] Section 149A(2) of the Tax Administration Act 1994 (the TAA). See also *Case V17* (2002) 20 NZTC 10,192, *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC), and *Vinelight Nominees Ltd v CIR (No 2)* (2005) 22 NZTC 19,519 (HC).

[2] Section 138P(1B) of the TAA.

[3] *Yew v CIR* (1984) 6 NZTC 61,710 (CA), *Case Y3* (2007) 23 NZTC 13,028, and *Case X16* (2005) 22 NZTC 12,216.

Issue 1 | Take tuatahi: Whether the Income had a source in New Zealand

13. Income may have a source in New Zealand under any one or more of ss YD 4(3), YD 4(4), and YD 4(18).[4]

14. TCO considered the issue first under s YD 4(18) and s YD 4(4). This approach was consistent with the cases analysed by TCO, where the courts considered the location of the "source" of income first (relevant to s YD 4(18)) and the place where the income was "earned" (relevant to s YD 4(4)) after that.

15. TCO considered s YD 4(3) last because the extent to which income has a source in New Zealand under s YD 4(3) may depend on whether the income also has a source in New Zealand under ss YD 4(4) and YD 4(18).

Section YD 4(18)

16. Under s YD 4(18), income derived directly or indirectly from any other source in New Zealand has a source in New Zealand.

17. The Taxpayers argued the Income did not have a New Zealand source under s YD 4(18) because it was not derived directly or indirectly from a source in New Zealand. CCS disagreed and referred to the Taxpayers being entitled to the Income under the Companies Act 1993 and the Employment Relations Act 2000.

18. The test for determining the source of employment income was not in dispute. Both the Taxpayers and CCS considered:

    - The relevant factors are where the employment was obtained, where the services were performed, and where the remuneration was paid.
    - In the absence of special circumstances, where the services were performed is the most important factor.

19. Nor was it disputed the Taxpayers obtained their employment in New Zealand, they performed the services overseas, and the Income was paid in New Zealand. What was disputed was whether there were special circumstances so that where the services were performed was not the most important factor in determining the source of the Income.

[4] *Tillard v C of T* [1938] NZLR 795 (SC), at 801 and 802, and see also *Case H6* (1986) 8 NZTC 147 and *Case H46* (1982) 5 NZTC 59,277. Further, s YD 5, which deals with apportionment of income derived partly in New Zealand, contemplates that income may come within more than one source rule in s YD 4.

20. After analysing relevant cases, TCO noted that:[5]

- The "source" of income is its originating cause. The test for determining the source of income is what a practical person would regard as the real source of the income. This is a matter of fact.
- Ordinarily, in the case of an employee earning their salary month by month by doing their work, the all-important factor will be where the work is done. In other cases, where the right to remuneration is not dependent on the performance of services, where the employment is obtained and where the remuneration is paid may be more significant.
- Cases where remuneration is not dependent on the performance of services may include where remuneration is paid independently of the services provided or an employee is engaged for their knowledge and experience rather than to perform a particular task.
- The terms of employment must be examined to determine whether the right to remuneration depends upon the performing of services.

21. TCO concluded that the Income had a source in New Zealand under s YD 4(18). This was because:

- The Taxpayers obtained the employment in New Zealand and their Income was paid in New Zealand. The Taxpayers performed the services overseas.
- The Taxpayers' circumstances were special, making the place where they performed the services less important in determining the source of the Income than the place where they obtained their employment and where their remuneration was paid.
- The Taxpayers were not ordinary employees earning their income month by month by doing their work. There was evidence they were employed for their knowledge and experience and that the services they provided to the Company were largely of a non-routine nature. The evidence supported that their services had contributed to the Company's unique intangibles and enabled the company to earn "super profits". Their shareholder salaries were determined and paid differently from remuneration paid to ordinary employees. The Taxpayers' association with the Company meant they would not have been accountable in the same way as ordinary employees for failing to provide services. The Taxpayers were not like overseas-based employees holding shares in their

[5] *C of T (NSW) v CAM and Sons Ltd* (1936) 4 ATD 32 (SC); *FCT v French* (1957) 11 ATD 288 (HCA); *FCT v Mitchum* (1965) 13 ATD 497 (HCA); *FCT v Efstathakis* 79 ATC 4,256 (FC); *Case E46* (1982) 5 NZTC 59,277; *Case H6* (1986) 8 NZTC 147; and *Robertson v FCT* (1937) 57 CLR 147 (HCA).

employer under employee share schemes. Nor were they like non-shareholder employees who had worked in New Zealand for their employer before transferring overseas.

- Having regard to all the circumstances, a practical person would regard New Zealand as the real source of the Taxpayers' Income.

Section YD 4(4)

22. Under s YD 4(4) employment income has a source in New Zealand if it is earned in New Zealand.

23. The Taxpayers argued the Income did not have a New Zealand source under s YD 4(4) because it was remuneration for services performed outside New Zealand. They argued there were no special circumstances making it inappropriate to rely on the place where the services were performed as the primary factor determining the source of the remuneration. CCS argued there were special circumstances making where the services were performed the most important factor.

24. After analysing relevant cases, TCO noted that:[6]

    - "Earn" means to obtain money in return for services.
    - Employment income, the entitlement to which arises in New Zealand, is earned in New Zealand.

25. TCO concluded the Income had a New Zealand source under s YD 4(4) as employment income earned in New Zealand because the Taxpayers' entitlement to the Income arose from New Zealand. Relevantly, the Taxpayers:

    - had established the Company and had control over its business, including their employment and remuneration. Under the Companies Act 1993, as the Taxpayers were directors of the Company, the board of the Company was required to authorise the amount of remuneration the Company paid them for services they provided in the capacity of employees. The Employment Relations Act 2000 seemed less relevant.
    - were employed for their knowledge and experience and that, fundamentally, contributed to the Company's profits which were earned in New Zealand. New Zealand was where the Company carried on its business and earned the profit from which the Taxpayers were paid. The services the Taxpayers provided were fundamental in the establishment and operation of the Company's business.

[6] *Case E46*, *Case* H6, and *Case P17* (1992) 14 NZTC 4,115.

Section YD 4(3)

26. The Taxpayers argued the Income did not have a New Zealand source under s YD 4(3) because they did not have written contracts with the Company.

27. CCS did not argue the Income had a New Zealand source under s YD 4(3).

28. TCO concluded that it was unnecessary to reach a conclusion on whether the Income was derived from a contract made in New Zealand with a source in New Zealand under s YD 4(3). This was because whether s YD 4(3) applied was not in dispute.

29. However, TCO made the following observations in case the dispute proceeded further:

- Under s YD 4(3), income derived by a person from a contract made in New Zealand has a source in New Zealand – except to the extent the person performs the contract outside New Zealand, and the income is apportioned to a source outside New Zealand under s YD 5.
- However, income derived from a contract made in New Zealand that also has a source in New Zealand under s YD 4(4) or under s YD 4(18) will not be apportioned to a source outside New Zealand under s YD 5. Section YD 5 does not apply to income derived by a person under a contract to the extent the income is also income referred to in ss YD 4(4) or YD 4(18).
- A contract need not be in writing and may be implied from the conduct of the parties.[7]

30. Relevantly, in TCO's view, the Taxpayers performed services for the Company, and both the Taxpayers and the Company treated payments the Company made to the Taxpayers as remuneration for those services. TCO concluded that it could be inferred from this conduct there were concluded bargains between the Taxpayers and the Company for the provision of services in return for payment.

Issue 2 | Take tuarua: Entitlement to foreign credits under s LJ 2

31. Subpart LJ allows a person a tax credit for foreign income tax paid on income that is also assessable for tax in New Zealand.[8] To be entitled to the tax credit, a person must

[7] *Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd* [2002] 2 NZLR 433 (CA) at [53]; *LSG Sky Chefs New Zealand Ltd v Prasad* [2018] NZCA 256; *Meates v Attorney-General* [1983] NZLR 308 (CA), at 377. See also Burrows, Finn and Todd, *Law of Contract in New Zealand* (7th ed, LexisNexis, Wellington, 2022), at [3.1] and [3.6]; and *Ayson v C of T* [1938] NZLR 282 (SC), at 286.

[8] Sections BC 2, BC 4, and BC 5, BD 1(4) and (5), and YA 1.

be tax resident in New Zealand when they derived the income, and the income must not have a source in New Zealand.

32. The Taxpayers argued that, if the Income had a New Zealand source, they should be entitled to foreign tax credits under s LJ 2. CCS argued the Taxpayers had not shown they paid any foreign income tax in the income year in question or that they were entitled to foreign tax credits under s LJ 2.

33. TCO concluded that the Taxpayers were not entitled to foreign tax credits as they were not resident in New Zealand when they derived the Income, and the Income had a New Zealand source. The Taxpayers had also not shown they paid any foreign income tax on the Income. Accordingly, the requirements under s LJ 2 were not met.