Vol 34 No 1 February 2022

TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

ISSN 1177-620X (Online)

YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **taxtechnical.ird.govt.nz** (search keywords: public consultation).

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Public Consultation
Tax Counsel Office
Inland Revenue PO Box 2198
Wellington 6140

You can also subscribe at **taxtechnical.ird.govt.nz/subscribe** to receive regular email updates when we publish new draft items for comment.

Your opportunity to comment

Ref	Draft type	Title	Comment deadline
ED0238	Operational statement	Charities and donee organisations	28 February 2022
ED0239	Operational statement	Available Subscribed Capital record keeping requirements	11 February 2022
PUB00414	Question we've been asked	Can a payment that compensates for the time value of money be taxable income if it is outside the statutory definition of "interest"?	11 February 2022

IN SUMMARY

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NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

The COVID-19 Resurgence Support Payments Scheme (August 2021) Amendment Order (No 6) 2021

The COVID-19 Resurgence Support Payments Scheme (August 2021) Amendment Order (No 6) 2021 which amended the COVID-19 Resurgence Support Payments Scheme (August 2021) Order 2021 (the August Order) has now come into force. The new Order in Council:

- allows a sixth grant to be made available from 26 November (in force 26 November), and
- amends the end of the affected revenue periods for the fourth and fifth grants (in force 23 November).

Background

The August Order came into force on 24 August 2021 and activated the COVID-19 Resurgence Payments Support (RSP) scheme to provide grants to support businesses affected by the 17 August 2021 escalation in COVID-19 alert levels.

Refer to *Tax Information Bulletin Vol 33 No 9 October 2021, Tax Information Bulletin Vol 33 No 10 November 2021, and Tax Information Bulletin Vol 33 No 11 November 2021* for further information on the August Order and subsequent amending Orders.

Amendment

This amending Order made a sixth grant available under the RSP scheme.

Affected revenue periods

A person is eligible for a grant under the RSP scheme if the person experienced a minimum 30% decline in revenue in relation to a business or organisation during a nominated 7-day period. A person must nominate a 7-day period within the affected revenue period for each payment. The nominated 7-day period for each payment may overlap with the nominated periods for other payments.

The affected revenue period for the sixth grant started on 19 November 2021 and ended on the close of the day before any area of New Zealand moved to the COVID-19 Protection Framework.

Amount of grant

The amount of the sixth grant is double the amount of earlier grants under the August scheme. The amount is calculated as the lesser of:

- $3,000 plus an additional amount of $800 for each full-time equivalent worker (FTE) employed by the person (up to a maximum 50 FTE); or
- 8 times the actual revenue decline measured by the applicant's nominated 7-day period

Amending the affected revenue period for the fourth and fifth grants

The amending Order also changed the criteria to determine the end of the affected revenue period for the fourth and fifth grants to align with the sixth grant. This ensured that the settings for these grants are clear once New Zealand moved to the COVID-19 Protection Framework.

Applications

Applications for the sixth grant opened on 26 November 2021 and closed on 13 January 2022.

The full eligibility requirements have been set out by the Commissioner under section 7AAB(3) of the Tax Administration Act 1994 and are published on the Inland Revenue website **ird.govt.nz/covid-19/business-and-organisations/resurgence-support-payment/eligibility**.

The COVID-19 Resurgence Support Payments Scheme (August 2021) Amendment Order (No 7) 2021

The COVID-19 Resurgence Support Payments Scheme (August 2021) Amendment Order (No 7) 2021 came into force on 10 December 2021. This Order amended the COVID-19 Resurgence Support Payments Scheme (August 2021) Order 2021 (the August Order) to:

- allow a seventh grant to be made available from 10 December
- amend the rules for newly acquired businesses, and
- set an end date for the scheme.

Background

The August Order came into force on 24 August 2021 and activated the COVID-19 Resurgence Payments Support (RSP) scheme to provide grants to support business affected by the 17 August 2021 escalation in COVID-19 alert levels.

Refer to *Tax Information Bulletin Vol 33 No 9 October 2021, Tax Information Bulletin Vol 33 No 10 November 2021, Tax Information Bulletin Vol 33 No 11 November 2021 and the TIB item above* for further information on the August Order and subsequent amending Orders.

Amendment

This amending Order provided for a seventh grant (also referred to as the Transition Payment) to be made available under the RSP scheme.

Affected revenue periods

A person is eligible for a grant under the RSP scheme if the person experienced a minimum 30% decline in revenue in relation to a business or organisation during a nominated 7-day period. A person must nominate a 7-day period within the affected revenue period for each payment. The nominated 7-day period for each payment may overlap with the nominated periods for other payments.

The affected revenue period for the seventh grant started on 3 October 2021 and ended 9 November 2021.

Amount of grant

The base amount of the seventh grant is larger than any previous grants under the August scheme. The amount is calculated as the lesser of:

- $4,000 plus an additional amount of $400 for each full-time equivalent worker (FTE) employed by the person (up to a maximum 50 FTE); or
- 8 times the actual revenue decline measured by the applicant's nominated 7-day period.

Businesses acquired after 17 July 2021

To be eligible for a grant under the RSP scheme, applicants must have been in business for at least one month before 17 August 2021. This Order amended this requirement and extended eligibility under the RSP scheme to include businesses acquired after 17 July 2021.

To be eligible, the business must have been in operation for at least one month prior to 17 August 2021 and must be carrying on similar activity as before the change in ownership. For example, if the person acquired a café and kept running it as a café.

The applicant may use the revenue that the business earned (under the current or previous ownership) during a typical 7-day period in the six weeks before 17 August 2021 for the purposes of measuring a decline in revenue.

This change came into effect on 10 December, with eligible persons able to apply for the fourth to seventh grants.

Further guidance for businesses acquired after 17 July 2021 is available on the Inland Revenue website: **ird.govt.nz/covid-19/business-and-organisations/resurgence-support-payment/eligibility/recently-acquired-businesses**.

Applications

Applications for the seventh grant opened on 10 December 2021 and closed 13 January 2022.

The full eligibility requirements have been set out by the Commissioner under section 7AAB(3) of the Tax Administration Act 1994 and are published on the Inland Revenue website **ird.govt.nz/covid-19/business-and-organisations/resurgence-support-payment/eligibility**.

Ending the scheme

The amending Order also brought an end to the August RSP scheme, providing that the scheme will end six weeks after the first day on which any area of New Zealand moves to the COVID-19 Protection Framework.

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

FDR 2021/04: FIF Determination – Dimensional Trusts – Global Bond Sustainability Trust NZD Class

A type of interest in a foreign investment fund for which a person may not use the fair dividend rate method (Dimensional Trusts - Global Bond Sustainability Trust NZD Class).

Any investment by a New Zealand resident investor in the NZD class of units of the Dimensional Trusts Global Bond Sustainability Trust, to which none of the exemptions in section EX 29 to 43 of the Income Tax Act 2007 apply, is a type of attributing interest for which the investor may not use the fair dividend rate method to calculate foreign investment fund income for the interest.

Reference

This determination is made under section 91AAO(1)(b) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Team Lead - Legal Services under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Investment in the NZD Class of units of the Dimensional Trusts - Global Bond Sustainability Trust ("the Fund"), an Australian Unit Trust and regulated managed investment scheme, are an attributing interest in a foreign investment fund ("FIF") for New Zealand resident investors when none of the exemptions in section EX 29 to EX 43 of the Income Tax Act 2007 apply.

Under EX 32 of the Income Tax Act 2007 an exemption may arise for an Australian Unit Trust and a New Zealand resident investor so that a person's rights in the unit trust in an income year are not an attributing interest. The determination will only apply when an attributing interest arises.

New Zealand resident investors are required to apply the FIF rules to determine their tax liability in respect of their Global Bond Sustainability Trust NZD Class investments each income year.

The Fund invests in a broadly diversified portfolio of eligible intermediate term domestic and global fixed interest and money market securities. The Fund has AUD and NZD unit classes that provide holders of those classes of units with an interest in the pool of investments held by the Fund. The NZD class of units of the Fund are denominated in New Zealand dollars. The Fund has foreign currency hedging arrangements in place which effectively provide investors in the NZD class of the Fund with a New Zealand dollar denominated return on the financial arrangements held by the Fund.

The policy intention is that the FDR method of calculating FIF income should not be applied to investments that provide a New Zealand resident investor with a return similar to a New Zealand dollar denominated debt investment. It is appropriate for the Commissioner to take into account the whole of the arrangement in ascertaining whether an investment in a FIF provides the New Zealand-resident investor with a return akin to a New Zealand dollar denominated debt investment.

On this basis, where a New Zealand resident invests in the NZD Unit Class of the Fund, and holds an attributing interest in the FIF, I consider that it is appropriate for the investor holding that investment to be excluded from using the FDR method.

Scope of determination

This determination is issued on the basis of information provided to the Commissioner before the date of this determination and applies to an attributing interest in a FIF held by New Zealand resident investors in a non-resident issuer where:

1. The non-resident issuer:
    - Is an Australian Registered Managed Investment Scheme;
    - Is known at the date of this determination as the Dimensional Trusts - Global Bond Sustainability Trust;
    - Invests in financial arrangements including domestic and global fixed interest and money market securities; and
    - Is operated with separate classes of units.
2. The attributing interest consists of the New Zealand dollar denominated class of units issued in the Dimensional Trusts - Global Bond Sustainability Trust, a class of units that provides an interest in the underlying assets of the fund that predominantly (i.e. 80% or more by value at a time in the income year) consist of financial arrangements such as international fixed interest securities; and
3. The investment interest attributable to the New Zealand dollar denominated class of units are subject to currency hedging arrangements undertaken by the non-resident issuer for the purpose of eliminating exchange rate risk for New Zealand investors on a highly effective basis.

Interpretation

"Fair dividend rate method" means the fair dividend rate method under section YA 1 of the Income Tax Act 2007;

"Financial arrangement" means financial arrangement under section EW 3 of the Income Tax Act 2007;

"Foreign investment fund" means foreign investment fund under section YA 1 of the Income Tax Act 2007;

"New Zealand resident" means a person that is resident in New Zealand for the purposes of the Income Tax Act 2007; and

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Income Tax Act 2007.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may not use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2022 income year and subsequent income years.

However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination does not apply for a person and an income year beginning before the date of the determination unless the person chooses that the determination applies for the income year.

Dated on this 15th day of December 2021.

Nathan Wallis
Team Leader, Legal Services

COV 21/06: Variation in relation to the definition of "finance lease" in s YA 1 of the Income Tax Act 2007

Determination

The Commissioner of Inland Revenue has, under the discretion provided under section 6I of the Tax Administration Act 1994, made the following statutory variation:

> The time period of "more than 75% of the asset's estimated useful life" referred to in paragraph (b) of the definition of "finance lease" in s YA 1 of the Income Tax Act 2007 is extended to "more than 75% of the asset's estimated useful life plus an additional 18 months" where the term of the lease is extended between 17 August 2021 and 31 March 2022.

This variation is subject to the conditions that:

- The lease was entered into before 14 February 2020.
- The lease term was not more than 75% of the estimated useful life when the lease was entered into.
- The lease term is not extended more than 18 months beyond the end of its term as at 14 February 2020.
- The lease was extended because, in the period between 17 August 2021 and 31 March 2022, the lessee's business has experienced a significant decline in actual or predicted revenue due to COVID-19, and the lessee has been able to extend the lease term in return for reduced or deferred lease payments.

Application date

This variation applies from 14 December 2021 to 31 March 2022

Dated at Wellington on 14 December 2021

Jonathan Rodgers
Group Leader – Tax Counsel Office
Inland Revenue

Background (material under this heading does not form part of the variation)

Summary of effect

1. An operating lease of an asset has a maximum term of 75% of the asset's estimated useful life before it is treated for tax purposes as a finance lease (with different tax treatment) under the Income Tax Act 2007. Lessors and lessees may have agreed to extend lease terms (or intend to do so) due to the financial impacts of COVID-19. The time period in the definition of "finance lease" has been extended using s 6I of the Tax Administration Act 1994 to allow certain extended leases to continue to be treated as operating leases.

Provisions affected

2. Paragraph (b) of the definition of "finance lease" in s YA 1 of the Income Tax Act 2007.

Application of variation:

3. This variation applies to a person who has entered into an operating lease of an asset, but the lease term has been extended beyond 75% of the estimated useful life of the asset, and so in the absence of this variation it would be reclassified as a finance lease for tax purposes, with associated complexity and compliance costs.
4. The variation is subject to the conditions that the lease was entered into before 14 February 2020; that the lease term was not more than 75% of the estimated useful life when the lease was entered into; that the lease term is not extended by more than 18 months; and that the lessee has experienced a significant decline in actual or predicted revenue due to COVID-19 and has been able to extend their lease term in return for reduced or deferred lease payments.

5. Customers who may wish to apply this variation should note:
   - A lessor and lessee are not required to adopt the same treatment of the lease asset as both parties can make their own decision about whether they rely on the variation;
   - Customers do not need to take the same approach to all leases they have entered into for the same class of lease asset;
   - The variation applies to leases that are extended between 17 August 2021 and 31 March 2022 and is not limited to leases where the lease term would otherwise have ended during that period.

Associated variations:

6. This variation has the same effect as the earlier COV 20/08 "Variation in relation to the definition of "finance lease" in s YA 1 of the Income Tax Act 2007" which expired on 30 November 2020, and COV 20/12 which expired on 31 March 2021. This and the earlier two variations provide additional time for a person to decide whether to extend their operating leases without them becoming finance leases for tax purposes.

Legislative References

Tax Administration Act 1994: ss 6H and 6I

Income Tax Act 2007: s YA 1, paragraph (b) of the definition of finance lease

FX 21/01: Foreign exchange rates

Summary

1. The Act requires foreign currency amounts to be converted to NZD to calculate a taxpayer's New Zealand income tax liability.
2. In some cases, the Act prescribes a currency conversion method or a foreign exchange rate source to use, but in most cases it does not. Where the Act does not prescribe a currency conversion method or a foreign exchange rate source, the default method is to use the "close of trading spot exchange rate" on the date the amount is required to be measured or calculated (s YF 1(2)).[1] However, the Commissioner can also approve other rates and methods to help minimise compliance costs (s YF 1(5)).[2]
3. The Commissioner publishes foreign currency exchange rates for certain currencies on the Inland Revenue website at **https://www.ird.govt.nz/managing-my-tax/overseas-currency-conversion-to-nz-dollars**. The Commissioner publishes mid-month, end-of-month and rolling average rates for each currency. From 1 May 2021, the Commissioner changed the source from which she obtains the rates to the Reserve Bank of New Zealand. As a result, the number of rates published has decreased.
4. This Approval approves three foreign currency exchange rate sources.
   - Rates published by the Commissioner.
   - Rates published by the Reserve Bank of New Zealand.
   - Rates published by another country's central bank.
5. This Approval also approves three currency conversion methods.
   - The mid-month rate.
   - The end-of-month rate.
   - The rolling average rate.
6. The currency conversion methods listed at [5] must use the rates published in, or calculated from, the sources listed at [4].
7. This Approval does not apply where the Act or the Commissioner prescribe a source, method or rate for a particular transaction or arrangement.
8. You are not required to use the foreign exchange rates from the sources approved in this Approval. However, if you use a rate that is not from one of these sources (and you are not required to use a prescribed method or rate), you will need to ensure that the exchange rate you use is appropriate given the nature of your transaction. You must also keep sufficient records in case you later need to verify the exchange rates used.
9. Finally, this Approval provides guidance on cryptoassets and GST, and examples on how a foreign currency exchange rate should be used to convert foreign currency amounts to NZD.

Conditions for using this Approval

When the Approval applies

10. This Approval applies where a person is required to convert a foreign currency amount into NZD for the purpose of calculating their income tax liability.
11. This Approval **does not apply** where the Act or the Commissioner prescribe a source, currency conversion method or rate for a particular transaction or arrangement. For example, you must use the specified currency conversion methods and exchange rate sources for the financial arrangement rules, the foreign investment fund rules, and the controlled foreign company rules. Similarly, the Goods and Services Tax Act 1985 (the GST Act) generally prescribes that the consideration for a supply should be converted to NZD at the time of supply.

[1] "Close of trading spot exchange rate" is defined in s YA 1 and adopts some of the foreign exchange rate sources and currency conversion methods set out in Determination G6D. Determination G6D provides foreign exchange rate sources and methods for the financial arrangement rules.

[2] See for example, FX 20/01 Approval - foreign residential rental property amounts - currency conversion, *Tax Information Bulletin* Vol 32, No 7 (August 2020): 28. The Commissioner can also approve specific foreign exchange rate sources and currency conversion methods for use by a particular person (s YF 1(6)).

Obtaining a daily rate

12. If you need a rate for a particular day, but a rate is not quoted for that day in the foreign exchange rate source you are using (for example, because it is a weekend or a holiday), you may use the daily rate for the preceding day on which a daily rate was quoted.
13. Similarly, the Commissioner will take a practical approach where the foreign exchange rate source is situated in a different time zone from New Zealand. A daily rate quoted in the source time zone could arise on a different date based on New Zealand time. These timing mismatches can be disregarded, and a practical approach taken, when selecting a rate.

Level of accuracy required

14. Exchange rates are typically quoted to four decimal places. This level of accuracy is required for rates you have sourced and for your mid-rate, cross rate, or rolling average rate calculations. If you need to round your figures, round to the nearest 4th decimal place.

Records you must keep

15. You must keep sufficient records of the exchange rates you use including source, type and date of rate. You must also keep a record of any calculations you undertake (for example, if you calculate a rolling average or a cross rate). As noted at [18], if you change your foreign exchange rate source you should record the reasons for the change.

Choosing your own rate sources and methods

16. Subject to [11], you are free to choose your own rates and methods when converting foreign amounts to NZD. You may continue to use exchange rates from other sources for reasons such as established practices, integration with accounting software or to reduce compliance costs.
17. However, if you use a different foreign exchange rate source you must ensure that the rate you use is appropriate given the nature of your transaction. For example, it is not appropriate to use cash or foreign cheque rates.
18. Further, you should use exchange rates consistently, both in terms of using the same source of rates for converting all your foreign currency amounts, and in doing this consistently over time. If this is not possible (for example, if you change your exchange rate source provider or you change accounting software with in-built exchange rates), you can use a different source without notifying the Commissioner. However, you must keep a record of the change and the reasons for it.

Approval of foreign exchange rate sources

19. The Commissioner approves all the following foreign exchange rate sources under s YF 1(5) for converting foreign currency amounts to NZD, subject to the conditions at [11].
    - Foreign exchange rates published on the Inland Revenue website at **https://www.ird.govt.nz/managing-my-tax/overseas-currency-conversion-to-nz-dollars**.
    - Foreign exchange rates published by the Reserve Bank of New Zealand
    - Foreign exchange rates published by another country's central bank.[3]

Approval of mid-month, end-of-month and rolling average rates

20. Daily rates published by Inland Revenue, the Reserve Bank of New Zealand or another country's central bank (as approved at [19]) can be used where you need a rate for a particular day.
21. The Commissioner also approves the following currency conversion methods under s YF 1(5) for converting foreign currency amounts to NZD, subject to the conditions at [11].
    - The mid-month rate.
    - The end-of-month rate.
    - The rolling average rate.

[3] Although central bank rates are approved, for some countries the central bank rates might not accurately reflect the actual value of the foreign currency or might only be relevant for transactions with the government of that country. In those situations, a more appropriate rate should be used.

22. These currency conversion methods are approved where their use would be appropriate for the transactions being converted to NZD. The Commissioner considers that where there is a large volume of repeated transactions, it will generally be appropriate to use a rolling average rate to reduce the compliance costs of making daily conversions. Where foreign income is derived and foreign expenditure is incurred regularly throughout a period, using mid-month, end-of-month or rolling average rates is likely to be appropriate. However, significant and one-off transactions should be converted at a daily rate, as shown in *Example 1*.

Example 1: Appropriate rates

Villem, a New Zealand tax resident, has an export/import business to and from Estonia. Estonia uses the Euro currency.

In the 2021 income year, Villem purchased a warehouse property in Estonia to use in his business. Settlement of the purchase was on 2 February 2021.

In preparing Villem's income tax return for the year, Villem's accountant determines that because of the volume of regular income and expenditure amounts arising from the business each month, it is appropriate to use the end-of-month rates published by Inland Revenue to convert the foreign currency amounts to NZD. This reduces the compliance costs of converting each transaction at the daily rate.

However, Villem's accountant considers that as the purchase price of the warehouse sets the capital cost of the warehouse for ongoing depreciation purposes, it should be converted to NZD using the exchange rate published by the Reserve Bank for 2 February 2021.

Villem pays tax in Estonia twice a year and is eligible to claim foreign tax credits. Villem's accountant considers that because of the low volume of this type of transaction, it is also appropriate to convert these amounts using a daily rate (on the date that the tax was paid).

If your foreign exchange rate source does not publish the monthly and rolling average rates, these can be obtained as follows:

- **Mid-month rate:** This is the exchange rate on the 15th day of the month, or if no exchange rates were quoted on that day, on the preceding working day on which they were quoted.
- **End-of-month rate:** This is the exchange rate for the last day of the month, or if no exchange rates were quoted on that day, on the preceding working day on which they were quoted.
- **Rolling average rate:** This is the average of the mid-month exchange rate for the relevant month and the previous months in the relevant period. For example, a rolling 12-month average would be the mid-month exchange rate for the relevant month and the previous 11 months. The rolling average rate is calculated by adding together the mid-month rates for all the months in the period, and then dividing by the total number of months in the period. This calculation is illustrated in *Example 2*.

Example 2: Rolling average rates

Jamie needs to find the rolling 12-month average rate for the Samoan tala (SAT[4]) for April 2021 because Inland Revenue no longer publishes it.

She goes to the Central Bank of Samoa website and downloads the Historical Daily Rates schedule. From that schedule she identifies the mid-month SAT/NZD exchange rate for April 2021 and the preceding 11 months, as follows:

Month	Rate (for 1SAT)
April 2021	0.5533
March 2021	0.5516
February 2021	0.5502
January 2021	0.5492
December 2020	0.5532
November 2020	0.5619
October 2020	0.5718
September 2020	0.5709
August 2020	0.5786
July 2020	0.5770
June 2020	0.5802
May 2020	0.6034
Total	6.8013

To calculate the rolling average rate for April 2021, Jamie adds together the rates for April 2021 and the preceding 11 months and then divides the total by 12 (6.8013 ÷ 12).

This gives a rolling 12-month average rate for April 2021 of 1SAT = 0.5668NZD. (Note this exchange rate is expressed with the Samoan Tala as the base currency. See from [27] about the two different ways exchange rates can be expressed.)

Currency conversion calculations

24. The following discussion explains how foreign exchange rates should be used to convert foreign currency amounts to NZD.

Finding the mid-rate

25. The Inland Revenue website quotes only one rate per currency, but other foreign exchange rate sources may quote two rates. These rates are:
    - a **Bid Rate** or **Buy Rate**, which is the exchange rate at which the service provider is willing to purchase the foreign currency; and
    - an **Offer Rate** or **Sell Rate**, which is the exchange rate at which the service provider is willing to sell the foreign currency.
26. Where a source quotes two rates, you need to calculate the mid-rate by adding the two rates together and then dividing that number by two. You then use the mid-rate in your currency conversion calculations.

Base currency

27. Foreign exchange rates are expressed with one currency as the base currency. The way the foreign exchange rate is expressed affects how you convert the foreign currency amount to NZD.

[4] Some publications use the abbreviation WST, which reflects the country's earlier name of Western Samoa (used up to 1997).

New Zealand Dollar as the base currency

28. Exchange rates can be quoted with the NZD as the base currency. This is the way Inland Revenue expresses its rates. It means the exchange rate is expressed based on the amount of foreign currency that it would take to purchase one NZD. For example, on 31 March 2021, the Reserve Bank of New Zealand was quoting:
    - NZD/USD (United States Dollar) foreign exchange rate as 1NZD = 0.6989USD.
    - NZD/AUD (Australian Dollar) foreign exchange rate as 1NZD = 0.9182AUD.
29. Where the exchange rate is quoted in this way with NZD as the base currency, you need to divide the foreign currency amount by the exchange rate to calculate the NZD equivalent of the foreign currency amount. This is illustrated in *Example 3*.

Example 3: Converting a United States dollar amount with the New Zealand dollar as the base currency

On 1 April 2021, Madison enters into an USD100,000 term investment for one year with a United States bank. Madison needs to calculate the NZD opening balance amount of her investment.

Madison goes to the Reserve Bank of New Zealand's website **www.rbnz.govt.nz**, selects "Statistics", "B1 Exchange rates and TWI" and downloads the spreadsheet "Exchange rates and TWI – B1 Daily (2018-current)". In column C of that spreadsheet, Madison identifies the NZD/USD exchange rate of 0.6981 for 1 April 2021.

The exchange rate is quoted with the NZD as the base currency (that is, it will take 1NZD to purchase 0.6981USD). Therefore, Madison must divide the opening balance by the exchange rate. Madison's opening balance in NZD is calculated as:

Opening balance = USD100,000/0.6981

= NZD143,245.95

Foreign currency as the base currency

30. Alternatively, exchange rates can be quoted with the foreign currency as the base currency. This means the exchange rates are expressed based on the amount of NZD it takes to purchase one unit of a foreign currency. This is likely to be the case on other central bank webpages where the local currency is expressed as the base currency. For example, on 31 March 2021 the Reserve Bank of Australia quoted the AUD/NZD exchange rate as 1AUD = 1.0893NZD.
31. Where the exchange rate is quoted in this way with the foreign currency as the base currency, you need to multiply the foreign currency amount by the relevant exchange rate to calculate the NZD equivalent of the foreign currency amount. This is illustrated in *Example 4*.

Example 4: Converting an Australian dollar amount with the Australian dollar as the base currency

On 1 April 2021, Jarli enters into an AUD100,000 term investment for one year with an Australian bank. Jarli needs to calculate the NZD opening balance amount of his investment.

Because Jarli has previously used rates from the Reserve Bank of Australia for amounts he has needed to convert to NZD, he continues to use that bank's website: www.rba.gov.au. He selects "Statistics", then "Exchange Rates", and then scrolls down to "Historical Data" and downloads the spreadsheet "Exchange rates – Daily – 2018 to Current". He identifies in column L of that spreadsheet an AUD/NZD exchange rate of 1.0849 for 1 April 2021.

Jarli notes that the AUD/NZD exchange rate is quoted with the AUD as the base currency. Therefore, Jarli must multiply the opening balance by the exchange rate. Jarli's opening balance in NZD is calculated as follows:

Opening balance = AUD100,000 x 1.0849

= NZD108,490

Finding a rate where the New Zealand dollar is not quoted

32. For some currencies, a rate may not be quoted where the foreign currency is expressed against the NZD. In that case, you need to manually calculate the exchange rate for that currency against the NZD by using a third currency. The USD is usually used for this purpose. This is referred to as a cross-rate. The method for calculating the NZD exchange rate is as follows:
    - **Step 1:** Determine the NZD/USD exchange rate.
    - **Step 2:** Determine the exchange rate for the foreign currency against the USD.

- **Step 3:** Use the two rates expressed against the USD to calculate the NZD rate against the foreign currency. The method for doing this will depend on whether the USD/foreign currency rate is expressed with the USD or the foreign currency as the base currency.

33. You should use this method only when no rate is quoted for the foreign currency in NZD. Most of New Zealand's main trading partners quote a NZD exchange rate. Where that is not the case, the USD is usually expressed as the base currency.
34. Where the foreign currency is expressed against the USD with the USD as the base currency, you need to multiply this rate by the NZD/USD exchange rate on the same day (expressed with the NZD as the base currency) to determine the exchange rate against the NZD for that currency. *Example 5* and *Example 6* show how to calculate the exchange rate in these circumstances.

Example 5: Calculating a New Zealand dollar cross rate with USD as the base currency

On 31 May 2021, Yasmin needed to calculate the NZD amount of income she had received in Nigerian naira (NGN). She went to the Central Bank of Nigeria website, but could not find an NGN exchange rate expressed against the NZD. However, the NGN was expressed against the USD as 409.50NGN=1USD as at 31 May 2021.

As the NGN/USD rate was expressed with the USD as the base currency, Yasmin multiplied this rate against the NZD/USD foreign exchange rate of 0.7252 as at 31 May 2021 (note this rate is expressed with the NZD as the base currency). This calculation gave her a NZD/NGN exchange rate as at 31 May 2021 of 1NZD=296.97NGN (409.50/0.7252).

Example 6: Calculating a New Zealand dollar cross rate with USD as the base currency

On 30 June 2021, Claudio needed to calculate the NZD equivalent amount of expenditure he had incurred on a business transaction in Chile. Claudio went to the website of a US bank that he deals with, but he could not find an exchange rate showing the Chilean Peso (CLP) expressed against the NZD. However, he found the exchange rate of the Chilean Peso against the USD and the exchange rate of the USD against the NZD on that date. The rates were 735.28CLP=1USD and 1USD=1.4323NZD.

As both the CLP/USD and the USD/NZD rates were expressed with the USD as the base currency, Claudio divided the CLP/USD rate by the USD/NZ rate. This calculation gave him a CLP/NZ cross rate of 513.3561CLP=1NZD (735.28/1.4323).

Foreign exchange transactions involving cryptoassets

35. Cryptoassets are considered a form of property, rather than money. Therefore, foreign exchange transactions involving cryptoassets may require a two-step calculation. First, you may need to obtain a market value for the cryptoasset. On many exchanges, the market value is expressed in USD. Second, if the market value you have obtained is in USD or another foreign currency, you need to calculate the value in NZD. You may use the foreign exchange rate sources and methods in this Approval unless [11] applies to your transaction.
36. Some cryptoasset exchanges publish the value of cryptoassets in a choice of different currencies. To rely on these built-in currency conversions, you need to ensure the rates used by the exchange are appropriate for your transaction.

GST and currency conversions

37. You may need to convert foreign currency amounts to NZD for GST purposes. Section 77 of the Goods and Services Tax Act 1985 (the GST Act) requires that all amounts of money must be expressed in NZD. Where an amount is consideration in money for a supply, the conversion to NZD must generally be performed at the time of supply (s 77(1)). This means the foreign currency amounts must be converted using daily rates. Monthly and rolling average rates cannot be used.
38. Specific rules in s 77(2) to (5) of the GST Act apply to non-resident suppliers of distantly taxable goods or remote services. These suppliers can elect to express foreign currency amounts in NZD at a choice of dates set out in s 77(3). For example, a non-resident supplier of distantly taxable goods can choose to convert foreign currency amounts into NZD on the last day of the relevant GST taxable period.
39. While the monthly and rolling average rates cannot be used for GST purposes, the daily rates from the foreign exchange rate sources approved at [19] may be appropriate for GST purposes.

References

Legislative references

Income Tax Act 2007, ss YA 1, YF 1(2), YF 1(5), YF 1(6)

Goods and Services Tax Act 1985, s 77

Other references

Determination G6D: Foreign currency rates (Inland Revenue, 1991).
www.taxtechnical.ird.govt.nz/determinations/financial-arrangements/general/det-g6d

FX 20/01: Approval – foreign residential rental property amounts – currency conversion, *Tax Information Bulletin* Vol 32, No 7 (August 2020): 28.
www.taxtechnical.ird.govt.nz/determinations/foreign-currency/foreign-residential-rental-properties/fx-20-01

Inland Revenue, Overseas currency – conversion to NZ dollars (webpage, last updated 20 July 2021).
www.ird.govt.nz/managing-my-tax/overseas-currency-conversion-to-nz-dollars

CFC 2021/01: Non-attributing active insurance CFC status (Tower Limited)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(a) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). Pursuant to section 91AAQ(1)(a) and (7), Tower Limited has made an application to extend an earlier determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	Jurisdiction
Tower Insurance (Cook Islands) Limited	Cook Islands

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 2nd day of December 2021.

Sonya Duncan
Group Lead – Customer Compliance

CFC 2021/02: Non-attributing active insurance CFC status (Tower Limited)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(a) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). Pursuant to section 91AAQ(1)(a) and (7), Tower Limited has made an application to extend an earlier determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	Jurisdiction
Tower Insurance (PNG) Limited	Papua New Guinea

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 2nd day of December 2021.

Sonya Duncan
Group Lead – Customer Compliance

CFC 2021/03: Non-attributing active insurance CFC status (Tower Limited)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of the members of a group of CFCs, if the members satisfy subsection (3). Pursuant to section 91AAQ(1)(b) and (7), Tower Limited has made an application to extend an earlier determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the members of the group of CFCs satisfy the requirements set out in section 91AAQ(3) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	Jurisdiction
National Insurance Company (Holdings) Limited	Fiji
Tower Insurance (Fiji) Limited	Fiji
Southern Pacific Insurance Company (Fiji)) Limited	Fiji

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 2nd day of December 2021.

Sonya Duncan
Group Lead – Customer Compliance

CFC 2021/04: Non-attributing active insurance CFC status (Tower Limited)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(a) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). Pursuant to section 91AAQ(1)(a) and (7), Tower Limited has made an application to extend an earlier determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	Jurisdiction
National Pacific Insurance (Tonga) Limited	Tonga

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 2nd day of December 2021.

Sonya Duncan
Group Lead – Customer Compliance

CFC 2021/05: Non-attributing active insurance CFC status (Tower Limited)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

A person has no attributed CFC income or loss from a CFC under sections CQ 2 and DN 2 of the Income Tax Act 2007 if the CFC is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007 because the requirements of sections CQ 2(1)(h) and DN 2(1)(h) are not satisfied.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC is a non-attributing active CFC if it is an insurer that meets the requirements of section 91AAQ of the Tax Administration Act 1994 and the Commissioner makes a determination under that section. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because an attributable CFC amount includes the CFC's income from an insurance business or from being an insurer under s EX 20B(3)(f) of the Income Tax Act 2007.

Section 91AAQ(1)(a) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). Pursuant to section 91AAQ(1)(a) and (7), Tower Limited has made an application to extend an earlier determination in respect of the CFC set out below. Tower Limited has a 30 September balance date.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of the determination

The CFC to which this determination applies is:

Name	Jurisdiction
Tower Insurance (Vanuatu) Limited	Vanuatu

Interpretation

In this document, unless the context otherwise requires –

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a "controlled foreign company" as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2022 and 2023 income years.

This determination is signed by me this 2nd day of December 2021.

Sonya Duncan
Group Lead – Customer Compliance

OPERATIONAL STATEMENT

Operational statements set out the Commissioner of Inland Revenue's view of the law in respect of the matter discussed and deal with practical issues arising out of the administration of the Inland Revenue Acts.

OS 21/04: Non-resident employers' obligations to deduct PAYE, FBT and ESCT in cross-border employment situations

Introduction

Operational statements set out the Commissioner's view of the law in respect of the matter discussed and deal with the practical issues arising out of the administration of the Inland Revenue Acts.

This Statement discusses and provides guidance on the approach to take with regards to a non-resident employers' obligations to deduct PAYE, FBT and ESCT in certain cross-border employment situations.

All legislative references are to the Income Tax Act 2007 (the Act) unless specified otherwise.

Summary of approach

1. A non-resident employer has an obligation to withhold PAYE from a PAYE income payment made to an employee if:
   - The employer has made themselves subject to New Zealand tax law by having a sufficient presence in New Zealand; and
   - The services performed by the employee are properly attributable to the employer's presence in New Zealand.
2. A non-resident employer may have a Fringe Benefit Tax (FBT) or Employer Superannuation Contribution Tax (ESCT) liability for a benefit provided to, or a contribution made for an employee if:
   - The employer has made themselves subject to New Zealand tax law by having a sufficient presence in New Zealand; and
   - The services performed by the employee are properly attributable to the employer's presence in New Zealand.
3. There is no PAYE withholding obligation if a PAYE income payment is "non-residents' foreign sourced income" for the employee.
4. There is also no PAYE withholding obligation for a PAYE income payment made to a non-resident employee working in New Zealand if the domestic exemption in s CW 19 applies, or a Double Taxation Agreement (DTA) gives relief from source taxation such as where the employee is in New Zealand 183 days or less in a twelve-month period.

Application of the statement

5. This statement provides general guidance to assist non-resident employers' in meeting their tax obligations regarding when to deduct PAYE, FBT and ESCT in cross-border situations. The Statement will apply from the date it is issued. However, the Commissioner will not be applying resources to examine positions taken by taxpayers prior to that date.
6. If you have any concerns about compliance with the tax obligations discussed in this statement, you should discuss the matter with a tax professional or Inland Revenue.

Discussion

7. This Statement provides guidance on whether employers have PAYE, FBT and ESCT obligations in various cross-border employment situations.
8. The different situations involve different combinations of; the residence of the employer, the residence of the employee, and the country in which the employment services are performed.

Non-resident employers

Territorial limitation - Presence

9. The PAYE rules[1] are intended to apply to New Zealand residents or matters over which New Zealand has jurisdiction. A non-resident may make themselves subject to New Zealand law (including the PAYE rules) by having a sufficient presence in New Zealand (*Alcan*[2] and *Clark*[3]). The nature and extent of the required presence may vary depending on the facts in each case. For example, a sufficient presence could range from a non-resident employer having a permanent office or site in New Zealand where trading operations are performed, or a non-resident employer having a single employee in New Zealand working from home and performing contracts in New Zealand on their behalf utilising labour and resources in New Zealand to perform that contract.

10. If a non-resident employer has a trading presence in New Zealand, such as carrying on operations and employing a workforce for the purpose of trade, this would normally be sufficient for the employer to have a PAYE withholding obligation for employees they pay PAYE income payments to.

11. A sufficient presence for a non-resident employer would also include having a permanent establishment, a branch, contracts that have been entered into in New Zealand and performing those contracts in New Zealand with employees based there for the purposes of carrying on trading operations as mentioned in [10]. An address for service (in New Zealand) may also indicate that the non-resident employer has made themselves subject to New Zealand law, even though this may be for reasons other than tax purposes.

12. A sufficient presence would **not** include a situation where an employee chooses (as a matter of personal preference) to undertake their employment activities in New Zealand where those activities have no necessary connection to New Zealand, and where this was the non-resident employers' **only** connection with New Zealand.

13. It is considered that merely having employees in New Zealand would not, of itself, constitute a presence of the employer sufficient to subject the employer to New Zealand's jurisdiction. Therefore, the degree to which an employee "represents" the employer in activities mentioned in [9], [10] and [11] will be one of the things to take into account to decide whether the presence is sufficient to mean that the employer has submitted themselves to New Zealand's jurisdiction.

14. It is also considered that having a parent, subsidiary or associate would not be enough in itself to have a presence in New Zealand without something more, such as any of the factors mentioned in paragraphs [9], [10] and [11].

Example 1:

Boston Architects (BA) is an architect firm bases in the USA. BA employs George who lives in Wellington. George participates in virtual meetings and completes all of his work in Wellington but as BA does not have any New Zealand clients, all the work is sent back to the US electronically.

Would BA have an obligation to deduct PAYE?

No. There would be no obligation to deduct PAYE as George's employment activities have no necessary connection to New Zealand, and the only connection to New Zealand is that George lives there. George would have to account for his own tax through the New Zealand tax system (see paragraphs 15-18).

[1] Section RD 2 of the Income Tax Act 2007.

[2] *Alcan New Zealand Ltd v CIR* (1993) 15 NZTC 10,125 (HC).

[3] *Clark (Inspector of Taxes) v Oceanic Contractors Inc* [1983] 1 All ER 133 (HL).

Example 2:

George's work is highly respected and quite specialised, as he only designs schools. When there is a project to build a new school in Wellington, George is asked by BA to provide his expertise and advice.

Would BA have an obligation to deduct PAYE?

No. George's expertise and advice does not require him to be in New Zealand to give it. He is not carrying on operations or employing a workforce (on behalf on BA) in New Zealand to give this advice. Although there is a connection to New Zealand while undertaking his employment activities for this project, this is not enough to impose a PAYE obligation on BA as there is no indication of a trading presence or the utilisation on behalf of BA of resources and labour to subject BA to New Zealand tax law. George would have to account for his own tax through the New Zealand tax system (see paragraphs 15-18).

Example 3:

George's work on the school went well. When a new school project comes up, BA puts George in charge of dealing with the client and running the project. While some work is also done in the US, 3 more staff are hired in Wellington to help George out. It is hoped that this might be the start of more New Zealand work for BA.

Would BA have an obligation to deduct PAYE?

Yes. In this situation there is a sufficient presence in New Zealand for BA to have an obligation to deduct PAYE. George (on behalf of BA) is carrying on operations for the purpose of its business, he is entering into and performing contracts in New Zealand (on behalf of BA), and additional staff have been employed on behalf of BA in connection with the project being undertaken in Wellington.

Paying PAYE in New Zealand

15. An employee (in New Zealand) will have an obligation to account for and pay their own tax if their employer has no obligation, or does not for any reason, deduct PAYE.
16. As in example one and two, BA does not have an obligation to deduct PAYE from George, therefore George will be required to register as an IR 56 taxpayer, file an Employment Information form and pay any taxes to Inland Revenue.
17. Due to the nature of their work circumstances, IR56 taxpayers are required to account for their own tax. Guidance can be found on the IR website under **https://www.ird.govt.nz/roles/ir56-taxpayers** to help employees manage this process.
18. A non-resident employer can also register voluntarily to be an employer and therefore make the deductions and payments for their employees in New Zealand. The process for doing this can be followed on the IR website under **https://www.ird.govt.nz/employing-staff/register-as-an-employer**.

Services performed

19. Where a non-resident employer has made themselves subject to New Zealand law by having a sufficient presence in New Zealand, the extent of the non-resident employer's obligations will be limited to matters that are properly attributable to their New Zealand presence.
20. This means that if, for example, a non-resident employer carries on a business in New Zealand and pays wages to an employee who performs services that are properly attributable to the New Zealand business, the employer will have an obligation to withhold PAYE from those wages.
21. Most of the time the PAYE withholding obligations will arise where the employee is based in New Zealand.
22. However, it is possible that a New Zealand resident employee could perform services overseas that are properly attributable to the non-resident employers' New Zealand presence.
23. For example, a New Zealand resident employee may be temporarily based overseas investigating the purchase of new equipment to be used in the employers' New Zealand operations. The services of the employee would be properly attributable to the New Zealand operations and, therefore, the non-resident employer would be required to withhold PAYE from PAYE income payments made to the employee.

Section CW 19 - Amounts derived during short-term visits

24. Under s CW 19, income that a non-resident person derives in a tax year from performing personal or professional services in New Zealand during a visit is exempt income if:
    - The visit is for 92 or fewer days (counting the day of arrival and departure as whole days);
    - The person is present in New Zealand for 92 days or fewer in total in each 12-month period that includes the period of the visit;
    - The services are performed for or on behalf of a person (which could include an employer) who is not resident in New Zealand;
    - The income is chargeable with income tax in the country in which the person is resident.
25. Exempt income is excluded from the definition of "salary or wages" and, therefore a "PAYE income payment[4]" is also exempt under this provision. No PAYE withholding obligation will arise for any payments described in s CW 19.

Relief given by a DTA

26. No PAYE withholding obligation will arise for PAYE income payments where a DTA provides the employee with relief from New Zealand taxation.
27. A DTA may have the effect of denying New Zealand any taxing rights for an amount of employment income derived by a non-resident employee for employment services performed in New Zealand. This may occur if the non-resident employee is in New Zealand for in total, 183 days or less in a twelve-month period, the remuneration is paid by a non-resident employer, and the remuneration is neither borne by nor deductible in determining the profits attributable to a permanent establishment which the employer has in New Zealand.
28. Please note, the example above assumes the wording of the DTA as described, although this wording may vary slightly within different DTA's with regards to the taxing rights for employment income.

New Zealand resident employers

29. An issue with regards to payments by a New Zealand resident employer is whether there is an obligation to withhold PAYE where the PAYE income payment is paid to a non-resident employee for work performed overseas.
30. It is considered that a New Zealand resident employer does not have any obligation to withhold PAYE from a PAYE income payment that is "non-residents' foreign-sourced income"[5] for the employee. This is because:
    - The Core Provisions indicate that the purpose of the Act is to tax assessable income. Income tax is generally not intended to apply to non-residents' foreign-sourced income; certainly not in the case of employment income.
    - It would be inconsistent with the purpose of the Act to impose a PAYE withholding obligation on the employer in relation to such income.

Example 4:

Sarah is a UK resident and lives in London. She has never been to New Zealand. She is employed by a New Zealand Company that resides in New Zealand and does all her work remotely in the UK for this company.

The income she receives as an employee is considered to be "non-resident foreign sourced income" and is therefore not assessable income in New Zealand.

Sarah is not required to file a tax return in New Zealand. As this income is not assessable to Sarah in New Zealand, the New Zealand Company does not have an obligation to deduct PAYE or any employment related taxes.

The New Zealand Company would need to account for Sarah's income as an expense in their accounts and will not be required to add Sarah to their Employment Information Schedule.

[4] "PAYE income payment" is principally defined by reference to "salary or wages" which excludes an amount of exempt income (s RD 5(1)(c)(i)).

[5] As defined in s BD 1(4).

Employer superannuation contribution tax (ESCT)

31. A non-resident employer who has made themselves subject to New Zealand's law by having a sufficient presence in New Zealand, and who pays PAYE income payments, may have a liability for ESCT. Like the situation for PAYE on a PAYE income payment, the employer's superannuation contribution would have to relate to employment services that are properly attributable to the employer's presence in New Zealand.
32. This means that, for a non-resident employer, an ESCT liability will normally only arise when the employee is performing services in New Zealand. However, a non-resident employer could have an ESCT liability for a contribution made for the benefit of an employee working overseas, if the services provided by the employee overseas are properly attributable to the employer's New Zealand presence.
33. A non-resident employer who has **not** made themselves subject to New Zealand's jurisdiction has no liability for ESCT. This is so whether or not the employee is a New Zealand resident and whether or not the employment services are performed in New Zealand or overseas.

Fringe benefit tax (FBT)

34. A non-resident employer who has made themselves subject to New Zealand's jurisdiction by having a sufficient presence in New Zealand, and who pays PAYE income payments, will have a liability for FBT (subject to the discussion below). Like the situation for PAYE on a PAYE income payment, for an FBT liability to arise the provision of a fringe benefit to an employee would have to be a benefit provided to an employee in connection with the employer's presence in New Zealand.
35. This means that, for a non-resident employer, an FBT liability will normally only arise where the employee is performing services in New Zealand. However, a non-resident employer could have an FBT liability for a benefit provided to an employee working overseas, if the services provided by the employee overseas are properly attributable to the employer's New Zealand operations.
36. An FBT liability will also depend on other factors, including whether the employee has received a PAYE income payment in the period. Additionally, s CX 26 provides that a benefit is not a fringe benefit to the extent to which it is received in a quarter or an income year in which they derive one or more PAYE income payments, all of which are not liable for income tax.
37. A non-resident employer who has not made themselves subject to New Zealand's jurisdiction has no liability for FBT.

This Statement was signed on 1 December 2021.

Rob Falk
National Advisor, Technical Standards, Legal Services

INTERPRETATION STATEMENT

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 21/09: Income tax - foreign tax credits - how to calculate a foreign tax credit

Summary

1. New Zealand residents are taxed on their worldwide income. A New Zealand resident who derives assessable income from a foreign source may be entitled to a foreign tax credit for foreign income tax paid on that income. The process for calculating a foreign tax credit is set out in subpart LJ of the Income Tax Act 2007 (the Act). The purpose of subpart LJ is to prevent the double taxation of foreign-sourced income.
2. The Commissioner has previously published guidance on the foreign tax credit rules (see IS 14/02: Income tax – foreign tax credits – what is a tax of substantially the same nature as income tax imposed under s BB 1?[1] and IS 16/05: Income tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement[2]). These statements explain how to determine whether a person is entitled to claim a foreign tax credit. Different rules apply depending on whether the foreign tax is covered by a double tax agreement (DTA).
3. Once a person with a New Zealand income tax liability has determined they are entitled to claim a foreign tax credit, the amount of that credit is calculated under subpart LJ. An important part of this calculation is to divide the foreign-sourced income into segments. To do this, the foreign-sourced income must first be divided by country and then further divided by source or by nature (s LJ 4).[3] Based on the purpose of subpart LJ (that foreign tax paid on one segment of income cannot be credited against New Zealand tax payable on another segment of income), the Commissioner considers the words "source" and "nature" in s LJ 4 mean "type". Therefore, the foreign-sourced income should be divided by country and then by type of income.
4. After the foreign-sourced income has been segmented, the person's notional New Zealand income tax liability must be calculated. A formula is then applied to find the amount of New Zealand tax payable on each segment of foreign-sourced income. Any expenditure incurred must be attributed to each segment, and some adjustments may be required. The person is then entitled to a foreign tax credit for the foreign tax paid on the segment, up to a maximum of the amount of New Zealand tax payable on that segment.
5. This Interpretation Statement is in three parts. Part 1 explains how to calculate a foreign tax credit. It also outlines relevant compliance obligations. Part 2 explains the law on segmenting foreign-sourced income in greater detail. Part 3 illustrates how the foreign tax credit calculation applies in some specific scenarios.
6. Examples are included throughout the statement to illustrate the concepts discussed and relevant legislative provisions are attached in the Appendix.

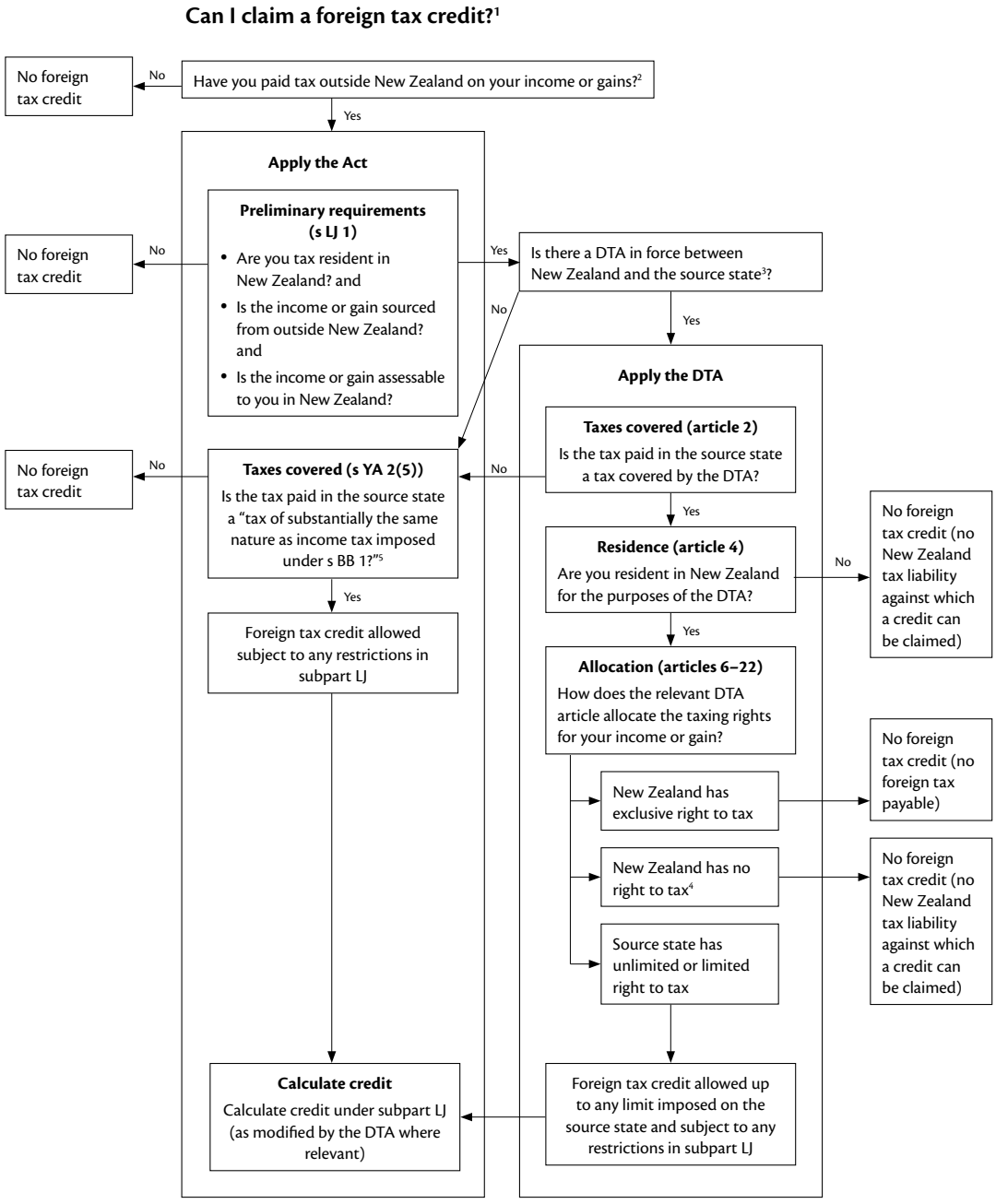
[1] *Tax Information Bulletin* Vol 26, No 5 (June 2014): 3.

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

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

Introduction

7. The Commissioner has previously published guidance on the foreign tax credit rules. The guidance explains how to determine whether a person is entitled to claim a foreign tax credit.
   - IS 14/02 interprets the phrase "a tax of substantially the same nature as income tax imposed under section BB 1" in s YA 2(5). This item applies where a foreign tax is not covered by a DTA. If the foreign tax is not covered by a DTA, a person may still be entitled to a foreign tax credit provided the tax is of substantially the same nature as income tax imposed under s BB 1.
   - IS 16/05 clarifies how the foreign tax credit rules work where the foreign tax paid is covered by a DTA.
8. IS 16/05 contains a useful flowchart that explains how to claim a foreign tax credit. This is reproduced below.



[1] All legislative references are to the Income Tax Act 2007.

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

[3] "Source state" refers to a country or a territory.

[4] This only occurs when article 20 (students) applies.

[5] See IS 14/02: "What is a tax of substantially the same nature as income tax imposed under s BB 1?" cited above.

9. Part 1 of this Interpretation Statement explains how to calculate a foreign tax credit under subpart LJ. This is the box in the bottom left-hand corner of the flowchart. For the purpose of this Interpretation Statement, it is assumed that a person has already determined they are entitled to claim a foreign tax credit. IS 14/02 and IS 16/05 provide further details on this.
10. Part 2 of this Interpretation Statement explains in greater detail how to segment foreign-sourced income. Part 3 then considers how the foreign tax credit calculation applies in some specific scenarios.
11. All foreign-sourced amounts referred to in the Interpretation Statement have been converted to New Zealand dollars.

PART 1: How to calculate a foreign tax credit

12. The rules for calculating a foreign tax credit are in subpart LJ of the Act. They can be summarised in three steps.
    - STEP 1: Establish the person's tax position
      - A person must have a New Zealand income tax liability for the relevant tax year. This is discussed from [13].
    - STEP 2: Calculate the amount of the foreign tax credit
      - This process is set out from [17].
    - STEP 3: Ensure the person's compliance obligations are met
      - This is discussed from [43].

Step 1: Establish the person's tax position

13. A person must have a New Zealand income tax liability before they can claim a foreign tax credit.
14. If a person has a net loss for the tax year, they will not have a New Zealand income tax liability (s BC 4(3)). Similarly, if a person's losses are equal to or greater than their net income for the tax year, they will not have a New Zealand income tax liability (s BC 6(2)). In both cases, no foreign tax credit will be available as there is no New Zealand income tax liability for the credit to offset (s LJ 2(2)).
15. Similarly, if a company receives a tax loss from another company in the same group of companies and the loss reduces its taxable income to nil, it will be unable claim a foreign tax credit as there is no New Zealand income tax liability for the credit to offset (*Charity Finance Ltd v CIR* (1998) 18 NZTC 13,565 (HC)).
16. This outcome is consistent with the policy intent of subpart LJ, which is to avoid the double taxation of income. If there is no New Zealand income tax liability, there will be no double taxation of income. *Example 1* and *Example 2* illustrate this principle:

Example 1: Net loss tax position

Facts

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

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

Application

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

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

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

Example 2: Net loss tax position

Facts

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

Application

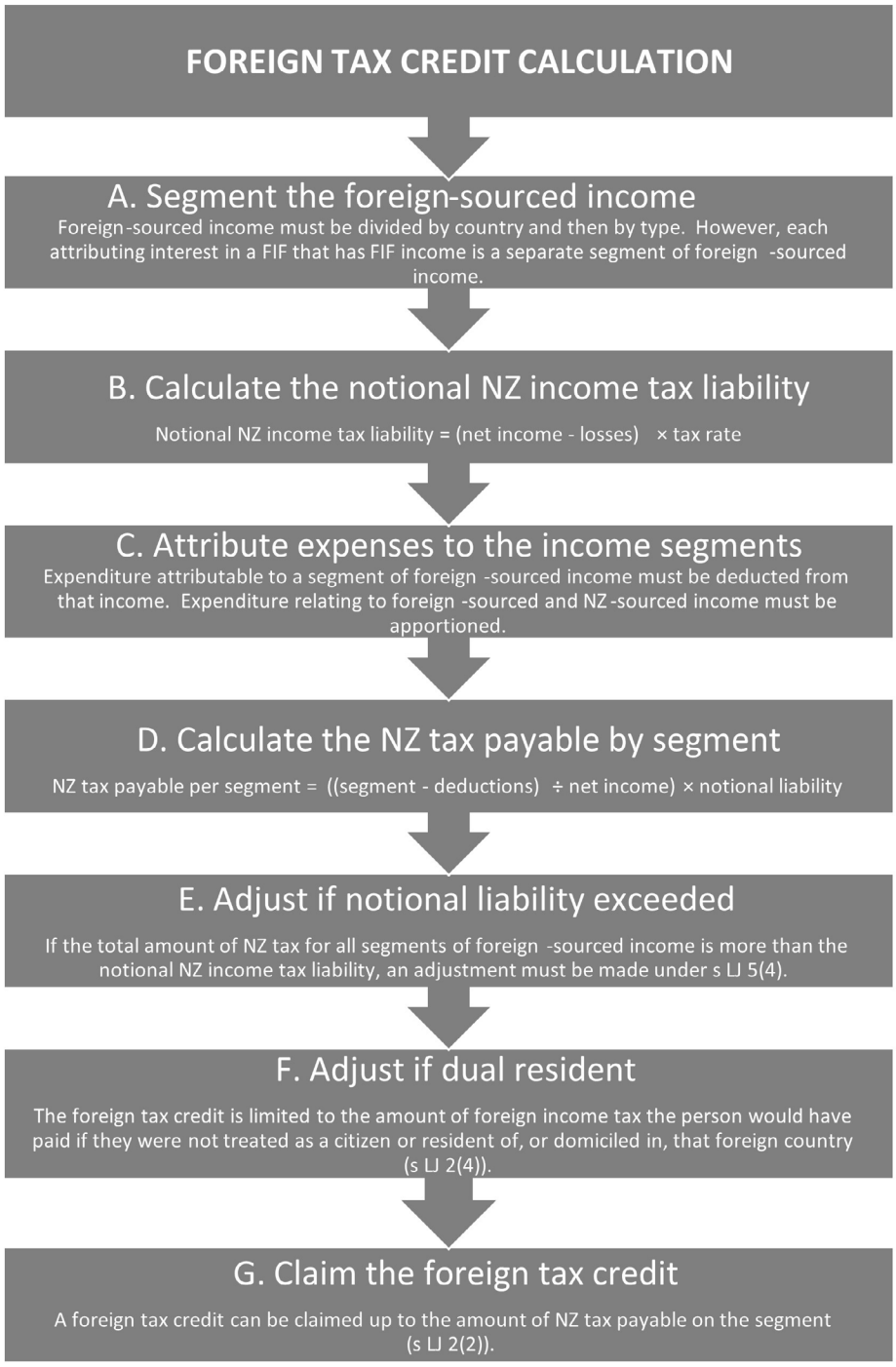
With the addition of the 2020 tax losses, Rebecca now has a net loss of $25,000.

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

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

Step 2: Calculate the amount of the foreign tax credit

17. Subpart LJ explains how to calculate a foreign tax credit. It applies to New Zealand tax residents who have derived foreign-sourced income that is assessable in New Zealand. They must also have paid foreign income tax[4] on that foreign-sourced income (ss LJ 1(2) and LJ 2(1)) and have a New Zealand income tax liability (see Step 1).
18. A person who satisfies these requirements will have a foreign tax credit for foreign income tax paid on a segment of foreign-sourced income. The foreign tax credit cannot exceed the amount of New Zealand tax payable on that segment (s LJ 2(2)).
19. The foreign tax credit calculation is summarised in the flowchart below.



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

A. Segment the foreign-sourced income

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

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

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

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

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

B. Calculate the notional New Zealand income tax liability

25. Before a person can calculate the New Zealand tax payable on each segment of foreign-sourced income, they must first calculate their notional New Zealand income tax liability under s LJ 5(5). This is done by multiplying the person's net income minus losses[5] by the appropriate tax rate.

$$(\text{person's net income} - \text{losses}) \times \text{tax rate}$$

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

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

Example 3: Notional New Zealand income tax liability

Facts

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

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

Application

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

C. Attribute expenses to the income segments

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

Example 4: Attribute expenses

Facts

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

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

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

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

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

Application

Segmentation

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

Calculation of notional New Zealand income tax liability

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

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

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

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

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

Attribute expenses

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

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

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

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

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

D. Calculate the New Zealand tax payable by segment

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

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

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

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

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

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

Example 5: New Zealand tax payable by segment – Rebecca

Facts

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

Application

Calculation of New Zealand tax payable on each segment

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

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

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

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

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

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

Foreign tax credits

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

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

Example 6: New Zealand tax payable by segment – Edna

Facts

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

Application

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

Edna has one segment of foreign-sourced Australian dividend income. The deductions attributable to the Australian dividend income segment are $3,250. Edna must now calculate the amount of New Zealand tax payable on that segment of foreign-sourced income by applying the formula in s LJ 5(2).

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

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

Foreign tax credits

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

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

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

Facts

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

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

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

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

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

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

Foreign tax credit calculation

Segmentation

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

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

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

	((segment – deductions)	÷ net income)	× notional liability	=	NZ tax payable
Australian dividends	(($30,000 – $0)	÷ $90,000)	× $20,620	=	**$6,873.33**
Australian royalties	(($20,000 – $0)	÷ $90,000)	× $20,620	=	**$4,582.22**
UK royalties	(($10,000 – $0)	÷ $90,000)	× $20,620	=	**$2,291.11**

Foreign tax credits

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

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

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

E. Adjust if notional liability exceeded

32. A person's foreign tax credit must be adjusted down if the combined total of New Zealand tax payable under s LJ 5(2) for each segment of foreign-sourced income exceeds the person's notional New Zealand income tax liability (s LJ 5(4B)).
33. These rules ensure that in calculating the New Zealand tax payable for a segment of foreign-sourced income, the foreign tax credit cannot exceed the notional income tax liability. They also ensure that excess deductions incurred in deriving income are spread across all income segments, foreign-sourced and New Zealand-sourced.
34. If an adjustment is required, it must be made to the amount of New Zealand tax payable on each of the segments of foreign-sourced income by multiplying them by the following ratio.

person's notional income tax liability ÷ NZ tax

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

Example 8: Adjustments

Facts

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

Application

Segmentation

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

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

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

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

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

Adjustment

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

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

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

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

*NZ tax payable cannot be less than $0.

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

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

Foreign tax credits

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

F. Adjust if dual resident

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

37. Section LJ 2(4) applies to a person who has paid tax on foreign-sourced income because they are "a citizen or resident of, or domiciled in, that foreign country". Section LJ 2(4) limits the person's foreign tax credit to the amount of foreign income tax they would have paid if they were treated as "not a citizen or resident of, or domiciled in, that foreign country".

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

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

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

Example 9: Dual resident adjustment 1

Facts

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

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

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

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

Application

Segmentation

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

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

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

Dual resident adjustment

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

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

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

Example 10: Dual resident adjustment 2

Facts

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

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

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

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

Application

Segmentation

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

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

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

Dual resident adjustment

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

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

G. Claim the foreign tax credit

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

Step 3: Ensure compliance obligations are met

42. Several compliance issues may have implications for the foreign tax credit calculation in subpart LJ. The following issues are discussed below.
    - Foreign income tax refunds
    - Excess foreign tax credits
    - Time limits for claiming a foreign tax credit
    - Timing of foreign tax credits

- Currency conversions
- Information required to support a foreign tax credit claim

Foreign income tax refunds

43. If a person receives a refund of foreign income tax[7], they must make an adjustment under s LJ 7. If the refund is received before the person has self-assessed their tax liability for the tax year, the amount of the foreign tax credit is reduced by the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(2)).
44. If the refund is received after the person has self-assessed their tax liability and used the foreign tax credit to satisfy it, they must pay the Commissioner the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(3)). The date for payment is 30 days after the later of:
    - the date the person receives the refund, or
    - the date of the notice of assessment in which the credit was used (s LJ 7(4)).
45. Section LJ 7 only applies to refunds of "foreign income tax". For example, this may occur where a DTA allocates taxing rights to the other state, but subsequent adjustments are made to the calculation of the foreign income tax, resulting in a refund to the person. This can be distinguished from the situation where foreign tax has been incorrectly withheld or deducted. Any refund of incorrectly withheld or deducted foreign tax is not a refund of "foreign income tax". In these circumstances, s LJ 7 does not apply. (See [26] and [27] of QB 14/12: Income tax – foreign tax credits for amounts withheld from United Kingdom pensions[8].) *Example 11* illustrates this position.

Example 11: Tax incorrectly withheld in country of source

Facts

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

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

Application

Segmentation

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

Calculation of Isaac's notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

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

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

Foreign tax credits

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

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

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

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

Excess foreign tax credits

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

Time limit for claiming a foreign tax credit

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

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

Timing of foreign tax credits

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

How to adjust for timing differences

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

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

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

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

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

Information required to support a foreign tax credit claim

54. A person who has a foreign tax credit under s LJ 2 must provide the Commissioner with information necessary to verify the amount of the credit (s 78B(2) of the TAA). This includes information about the:
    - type and amount of each segment of foreign-sourced income the person has (including the country of origin); and
    - amount of foreign income tax paid on each of the segments.

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

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

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

PART 2: Segmenting income under subpart LJ

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

Segments determined by type of income

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

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

> **LJ 4 Meaning of segment of foreign-sourced income**
>
> For the purposes of this Part, a person has a **segment of foreign-sourced income** equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

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

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

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

Case law on source and nature

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

Source rules

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

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

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

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

65. The courts also look to the statutory context for guidance. In *CIR v N V Philips Gloeilampenfabrieken* [1955] NZLR 868

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

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

(CA) at 883, Gresson J observed that the ordinary meaning of "source" is the starting point, but it has a flexible meaning depending on the statutory context.

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

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

Time bar

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

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

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

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

Summary of the case law

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

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

The purpose of subpart LJ

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

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

74. Subpart LJ does not calculate a person's foreign tax credit on a global basis. This means it does not require the person to combine all their foreign-sourced income and to calculate their credit by reference to the New Zealand tax payable on that combined amount. Instead, it divides the person's foreign-sourced income into segments. It then determines the New Zealand tax payable on each segment and limits the person's foreign tax credit to the New Zealand tax payable on

that segment. This is known as the schedular approach. A schedular approach is usually adopted when Parliament wants to apply different tax treatments to different types of income. The effect of the schedular approach in subpart LJ is that foreign tax paid on one segment of foreign-sourced income will not be creditable against New Zealand tax payable on another segment of foreign-sourced income.

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

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

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

Conclusion

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

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

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

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

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

Example 12: Straightforward segmentation

Facts

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

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

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

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

Application

Segmentation

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

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

Calculation of notional New Zealand income tax liability

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

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

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

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

Foreign tax credit

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

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

Summary

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

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

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

PART 3: Specific scenarios

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

Foreign investment funds

83. A person with an attributing interest in a foreign investment fund (FIF) must calculate their foreign tax credit slightly differently. The different treatment is required because FIF income is deemed income rather than actual income. Foreign jurisdictions tend to impose tax on actual income and not on the deemed amount recognised as FIF income under the Act. As a result, a person with FIF income would be unable to claim a foreign tax credit without special rules. These rules are explained in more detail below.
84. Under s EX 28, the following entities are defined as a FIF:
    - A foreign company
    - A foreign superannuation scheme
    - An insurer under a life insurance policy (but not if the policy is offered or entered into in New Zealand)
85. A person has an attributing interest in a FIF if they hold a direct income interest in a foreign company. A person has a direct income interest in a foreign company if they hold:
    - shares;
    - shareholder decision-making rights;
    - the right to receive or control the income of the FIF; or
    - the right to receive or control the net assets of the FIF (ss EX 29(2) and EX 30).
86. A person also has an attributing interest in a FIF if they hold a superannuation interest (s EX 29(3)) or a foreign life insurance policy entitlement (s EX 29(4)).
87. If a person has an attributing interest in a FIF (and none of the exemptions in ss EX 31 to EX 43 apply), they must calculate their income or loss from the FIF by applying one of the five calculation methods set out in s EX 44:
    - the attributable FIF income method
    - the comparative value method (CV method)
    - the deemed rate of return method
    - the fair dividend rate method (FDR method)
    - the cost method
88. A person will have FIF income if they have income under one of the five calculation methods (s CQ 4 – CQ 6). Certain exclusions may apply.
89. Because FIF income is deemed income, if actual income is received from the FIF, it is excluded income (s CX 57B). Special rules exist for tax credit purposes, as the foreign tax credit is likely to arise on the actual income but will be sought to be used against the deemed income. For example, a person with an attributing interest in a FIF receives a dividend payment. Foreign income tax is withheld from the dividend. However, under the FIF rules, the dividend payment is effectively ignored, and the person is taxed in New Zealand on their FIF income, calculated under one of the five calculation methods. The FIF income is generally based on the value of the attributing interest.
90. To ensure that double taxation does not occur, the Act prescribes different foreign tax credit rules for FIF income. Which rule applies depends on the FIF calculation method adopted.

Attributable FIF income method

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

Application of CFC rules tax credit rules

(8) The rules in sections LK 1 to LK 7 (which relate to tax credits for attributed CFC income) apply to allow the person to claim foreign tax credits but on the basis of the assumptions made in subsection (9). The rules in those sections allow foreign tax credits relating to attributed CFC income but apply a jurisdictional ring-fencing approach to the use of tax credits.

Assumptions in reading tax credit rules

(1) Sections LK 1 to LK 7 are applied as if—

(a) the FIF were a CFC; and

(b) the FIF income of the person from the FIF were attributed CFC income; and

(c) the person's income interest, calculated under subsection (4) were their relevant income interest for the purposes of those sections; and

(d) any relevant person's FIF income calculated under the attributable FIF income method from a FIF that is resident in the relevant country were attributed CFC income.

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

All other FIF calculation methods

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

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

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

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

When subsection (7) applies

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

Tax credit: attributing interest in FIF

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

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

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

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

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

Example 13: FIF rules

Facts

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

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

Can Co 1

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

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

FIF income

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

Can Co 2

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

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

FIF income

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

Can Co 3

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

Application

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

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

Segmentation

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

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

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

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

Foreign tax credits

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

Can Co 1

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

Can Co 2

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

Can Co 3

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

Foreign-sourced attributed personal services income

100. The attribution rule for income from personal services is an anti-avoidance rule that prevents an individual avoiding the top personal tax rate by diverting income to an associated entity (ss GB 27–GB 29). The rule applies when an individual (the working person) who performs personal services is associated with an entity (the associated entity) that provides personal services to a third person (the buyer). The income derived by the associated entity (after deductions for allowable expenditure) is attributed to the working person.
101. The attribution rule only applies where various threshold tests are met and no exemptions apply. The Commissioner's Interpretation Statements IS 19/02: Income tax – attribution rule for income from personal services[16] and IS 21/02 Income tax – calculating income from personal services to be attributed to the working person[17] explain in more detail when the attribution rule applies and how it is calculated.
102. If a person has attributed income under the attribution rule and the income has a foreign source, the person may be entitled to a foreign tax credit for any foreign income tax paid on that income by the associated entity.
103. The person's entitlement to a foreign tax credit is determined under ss LJ 2(8)–(10). Under ss LJ 2(9) and (10) the working person (and not the associated entity) has a foreign tax credit for foreign income tax paid on the attributed amount. Section LJ 2(9) provides that the attributed amount is one segment of foreign-sourced income.
104. Sections LJ 2(9) and (10) apply when:
    - the associated entity is tax resident in New Zealand;

[16] *Tax Information Bulletin* Vol 31, No 5 (June 2019): 23.

[17] *Tax Information Bulletin* Vol 33, No 4 (May 2021): 8.

- the associated entity derives assessable income sourced from outside New Zealand;
- the amount of foreign-sourced income is attributable to the working person; and
- the working person was tax resident in New Zealand when the associated entity derived the attributed amount (s LJ 2(8)).

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

Example 14: Foreign-sourced attributed personal services income

Facts

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

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

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

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

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

Application

Personal services income attribution rule

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

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

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

Segmentation

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

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

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

Foreign tax credit

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

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

Distributions of foreign income to trust beneficiaries

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

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

Facts

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

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

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

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

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

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

Application

Trust distribution

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

Bene Co

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

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

Emma

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

Katarina

Segmentation

Katarina has one segment of foreign-sourced dividend income.

Calculation of notional New Zealand income tax liability

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

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

The calculation is shown in the table below.

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

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

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

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

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

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

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

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

Foreign tax credits

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

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

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Appendix – Legislation

1. Subpart LJ states:

LJ 1 What this subpart does

When tax credits allowed

(1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for foreign income tax paid in relation to a segment of that income.

Limited application of rules

(2) The rules in this subpart apply only when—

(a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and

(b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.

When treated as assessable income [Repealed]

(3) *[Repealed]*

Source of dividends

(4) If a company is not resident in New Zealand, and is resident in another territory or is resident in another territory for the purposes of a double tax agreement between New Zealand and the territory, and foreign income tax is imposed by the territory on a dividend paid by the company, a dividend paid by the company has a source in the territory.

Double tax agreements [Repealed]

(5) *[Repealed]*

Relationship with section YD 5

(6) Section YD 5 (Apportionment of income derived partly in New Zealand) applies to determine how an amount is apportioned to sources outside New Zealand.

LJ 2 Tax credits for foreign income tax

Amount of credit

(1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.

Limitation on amount of credit

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

Amount adjusted

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

When person both resident in New Zealand and another country

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

Multi-rate PIEs and their investors

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

When subsection (7) applies

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

Tax credit: attributing interest in FIF

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

When subsections (9) and (10) apply

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

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

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

Tax credit: attributed income from personal services

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

No tax credit for associated entity

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

LJ 3 Meaning of foreign income tax

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

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

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

LJ 4 Meaning of segment of foreign-sourced income

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

LJ 5 Calculation of New Zealand tax

What this section does

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

Calculation for single segment

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

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

Definition of items in formula

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

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

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

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

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

When subsection (4B) applies

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

Modification to results of formula for single segment

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

person's notional income tax liability ÷ NZ tax.

Definition of item in formula

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

Person's notional income tax liability

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

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

Definition of items in formula

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

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

(b) **losses**—

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

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

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

LJ 6 Taxable distributions and NRWT rules

When this section applies

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

When credit not allowed

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

Amount of credit

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

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

Definition of items in formula

(4) In the formula,—

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

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

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

LJ 7 Repaid foreign tax: effect on income tax liability

Who this section applies to

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

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

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

When refund received before assessment

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

(a) the amount of the refund:

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

When refund received after assessment

(3) If the person receives the refund after they have assessed their income tax liability for a tax year, have used an amount of foreign tax credit in satisfying that liability, and have not taken the refund into account in that assessment, the person is liable to pay the Commissioner the lesser of—

(a) the amount of the refund:

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

Date for payment

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

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

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

Associated persons

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

QUESTION WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 21/11: Elections not to depreciate commercial buildings

Question

The depreciation rate for buildings with a useful life of at least 50 years was reduced to 0% from 1 April 2011, the start of the 2012 tax year. With effect from the 2021 income year, the ability of taxpayers to claim a depreciation loss on the commercial buildings they own was reinstated, at a rate of 2% (using the diminishing value (DV) method) or 1.5% (using the straight-line (SL) method).

Given this change, what are the consequences for taxpayers who elected, before the 2012 income year, to treat their commercial building as not being depreciable property and so not claim the relevant depreciation loss?

Answer

Where a taxpayer makes an election to treat their commercial building as not being depreciable property, that election is irrevocable, and the taxpayer is bound by that election until the building is disposed of. For the election to be effective, the taxpayer must make it "in writing".

A taxpayer who does not make an election and who claims a depreciation loss for their commercial building must continue to depreciate that building at the rate the Commissioner has set.

A taxpayer who does not make a written election and has never claimed a deduction for a depreciation loss on their commercial building may make a retrospective election not to depreciate that building. The retrospective election will apply from the date the taxpayer acquired the building.

Key terms

Commercial building means (for the purpose of this item) a building that is not a "residential building".

Election means notice given to the Commissioner in a taxpayer's return of income.[1]

Residential building means a dwelling. It includes a building intended to ordinarily provide accommodation for periods of fewer than 28 days at a time, if the building, together with other buildings on the same land, has fewer than four units for separate accommodation.[2]

Explanation

Background

The depreciation regime

1. Taxpayers are allowed a deduction for a depreciation loss on items of depreciable property[3] that a business uses to gain assessable income.[4]

[1] s EE 8(4) of the Act.

[2] s YA 1 of the Act.

[3] **Depreciable property** is defined in s EE 6 of the Act.

[4] ss DA 1, DA 4, and EE 1(2) of the Act.

2. It is mandatory for a taxpayer to claim a deduction for a depreciation loss where one is allowed. The deduction is calculated by using the most appropriate rate of depreciation for that asset as set out in the Commissioner's table of depreciation rates[5] and applying it to the cost of the asset.[6]
3. When they dispose of the asset, the taxpayer is generally considered to have claimed the applicable depreciation loss, even in circumstances where they have chosen not to claim the loss. For the purposes of calculating the depreciation recovery income or loss on sale, taxpayers are considered to have claimed the allowable depreciation loss. The quantum of income or loss on disposal is calculated accordingly.
4. A taxpayer may have valid commercial reasons for not wishing to claim a deduction for a depreciation loss. It was with this in mind that, in 1997, Parliament introduced s EE 8 of the Act[7] to allow taxpayers to elect to treat certain assets as not being depreciable property. The effect of making such an election is that a taxpayer cannot claim a deduction for the depreciation loss on the elected asset(s) that they otherwise would have been entitled to.
5. An election to treat an asset as not being an item of depreciable property must be made in the year that the taxpayer acquired the asset, or the year in which the use of that asset in the taxpayer's business changed. A change in use can occur when, for instance, a private asset is introduced into a business and is able to be depreciated. Once made, an election is irrevocable.
6. After making an election, a taxpayer is unable to "pick and choose" which years they claim a deduction for a depreciation loss on those assets. An election can only be made:
   - prospectively at the time that the taxpayer acquires the asset, or its use changes, or
   - retrospectively, but only if the taxpayer has not claimed a deduction for a depreciation loss in any year since they acquired the asset (or its use changed).
7. Once a taxpayer has claimed a deduction for an amount of depreciation loss on their asset or made an election to treat that asset as not being depreciable property, they are bound to follow that treatment until they dispose of the asset. The taxpayer therefore chooses "once and for all" whether to claim a deduction for a depreciation loss on that asset.
8. A taxpayer can only make an election to treat an asset as not being depreciable property by giving "notice" to the Commissioner of their intention to do so in their return of income. The Commissioner must be "notified".
9. Given the election requirements stated at [6], a taxpayer needs to provide the Commissioner with the following information:
   - Where the taxpayer is making a prospective election, the notice needs to advise the Commissioner of the asset(s) they are making the election for and of that asset's acquisition date (or the date that its use in the business changed and how it changed).
   - Where the taxpayer is making a retrospective election, the notice will need to advise the Commissioner of the asset(s) they are making the election for, and the asset's acquisition date or the date that its use changed.

     The notice must also include a statement that the taxpayer has not made a claim for a depreciation loss for the asset(s) since that date. A taxpayer can make a retrospective election in any income year after the year they acquired the asset, including the year that they dispose of the asset and the years following its disposal.
10. Although the taxpayer must make the election in their return of income, the election also needs to provide notice to the Commissioner of the election. Given that a taxpayer's return does not provide the Commissioner with any of the required information, the Commissioner does not expect taxpayers to literally attempt to provide notice "in" their return of income. It is the Commissioner's view that an election under s EE 8 must be in writing; it may take the form of a letter, email or webmail and be either attached to the return or provided separately to the Commissioner at or close to the time when the taxpayer provides the return.
11. Simply choosing not to depreciate an asset in a taxpayer's tax accounts does not notify or provide notice to the Commissioner that the taxpayer wishes to elect to treat that asset as not being an item of depreciable property. This is because tax accounts are not supplied to the Commissioner with a taxpayer's return of income. In addition, per [2], unless taxpayers make an election, they must claim an amount of depreciation loss where one is allowed and (per [3]) incorrectly not claiming an amount of depreciation loss will have consequences when the taxpayer disposes of the asset.

[5] See Inland Revenue's booklet *General depreciation rates* IR 265 (July 2021), available at **ird.govt.nz**

[6] s EE 16(3) of the Act.

[7] Previously s EG 16A of the Income Tax Act 1994.

The depreciation of commercial buildings

12. Before the 2012 income year, it was possible to depreciate buildings with an estimated useful life of at least 50 years for tax purposes. This included commercial buildings. However, the budget of 20 May 2010 introduced several changes to the depreciation regime, including replacing the then applicable rates of depreciation for most buildings with a rate of 0%.
13. This change was included in the Taxation (Budget Measures) Act 2010[8] and was effective from the beginning of a taxpayer's 2011–2012 income year. It is important to note that the Act did not remove the ability for taxpayers to claim a depreciation loss. What changed was the rate at which the amount of any depreciation loss was calculated.
14. Commercial buildings remained depreciable at the rate of 0% until the beginning of the 2020–2021 income year.[9] The COVID-19 Response (Taxation and Social Assistance Urgent Measures) Act 2020 amended the rate at which commercial building owners were able to claim a depreciation loss. It provided for a depreciation rate for these buildings of 2% DV or 1.5% SL.[10]

The effect of making (or not making) an election to treat a commercial building as not being depreciable property

15. Before the depreciation rate for commercial buildings was reduced to 0%, most taxpayers claimed the depreciation loss on their commercial buildings. However, some taxpayers made a written election to treat their building as not being depreciable property and so did not claim a deduction for a depreciation loss on that commercial building.
16. Other taxpayers, while deciding not to depreciate their commercial building, did not give adequate notice to the Commissioner of their election (which they needed to do by notifying the Commissioner in writing, per [5] – [11]). Instead, they did not claim a deduction for the depreciation loss on their commercial building in their tax accounts in the mistaken belief that this was all that was required to make an "election".
17. The following sections summarise the effect of these previous decisions to depreciate (or not depreciate) commercial buildings now that taxpayers can depreciate their commercial buildings at a rate other than 0%.

Taxpayers who have previously claimed a deduction for an amount of depreciation loss on their commercial buildings

18. Unless a taxpayer first elects to treat an asset as not being depreciable property, they must claim a deduction for an allowable depreciation loss (per [2]). Once a taxpayer has made a claim for an amount of depreciation loss for that commercial building in any income year, they are no longer able to elect to treat that asset as not being depreciable property until a "disposal event" occurs (per [20]). As stated, (at [6]), a taxpayer can only make a retrospective election where they have never made a claim for a depreciation loss on that asset.
19. A taxpayer in those circumstances must therefore continue to claim a deduction for the depreciation loss on their commercial building in each income year. If a taxpayer does not claim a deduction for the depreciation loss on their commercial building in an income year, they will be considered to have made a claim for the applicable amount of depreciation loss (per [2] and [3]).

Taxpayers who have previously made a written election to treat their commercial building as not being an item of depreciable property

20. When a taxpayer makes an election to treat their commercial building as not being an item of depreciable property, that election is irrevocable. It has effect for the income year in which the taxpayer acquired the building (irrespective of when the election is made) and in all future income years until a disposal event occurs. A disposal event is an event where:
    - the commercial building is disposed of,[11] or
    - the use of the building changes and, as a result, the taxpayer is denied a deduction for a depreciation loss on the building,[12] or
    - the nature of the taxpayer's activities changes to one of gaining exempt income, or

[8] See *Tax Information Bulletin* Vol 22, No 7 (August 2010) for more information.

[9] For more information on the application date for this change, see *QB 21/05: The application date for the depreciation of commercial buildings*.

[10] See *Tax Information Bulletin* Vol 32, No 5 (June 2020) for more information.

[11] s EE 8(5) of the Act.

[12] s EE 47 of the Act.

- the building suffers irreparable damage or damage that makes it useless, or
- the building is subject to acquisition by a person acting under statutory authority.

21. Until a disposal event occurs, a taxpayer who has previously made an election to treat their commercial building as not being an item of depreciable property cannot claim a depreciation loss on that building. This condition applies despite the possibility that the rate of depreciation may change for the elected asset (which, for commercial buildings it has; to 0% from the 2012 tax year, and then to 2% DV or 1.5% SL from the 2021 tax year).

Taxpayers who have not previously claimed a depreciation loss on their commercial building, but have not made a written election to treat their commercial building as not being an item of depreciable property

22. This circumstance may arise because the taxpayer acquired their commercial building:
    - before 1 April 2011 and mistakenly believed that they could make an election by simply not claiming a deduction in their tax accounts for the depreciation loss that was allowed on their building, or
    - before 1 April 2011 and was unaware that claiming an amount of depreciation loss that is allowable is mandatory, or
    - between 1 April 2011 and 31 March 2020, at a time when the depreciation rate was 0%. Because the rate of depreciation was 0%, it is highly unlikely that a taxpayer in this circumstance would have made an election to treat that building as not being an item of depreciable property.

Taxpayers acquiring a commercial building prior to 1 April 2011

23. If either of the first two bullet points above applies, the effect is that the taxpayer has failed to claim a mandatory deduction.

24. Given this, the taxpayer in either of these categories has two options. Either:
    - (if they wish to claim the allowable depreciation loss) the taxpayer starts to claim the relevant depreciation loss on their commercial building and request that the Commissioner reassess the relevant back year returns to claim the appropriate amount of depreciation loss in those years[13] (as far as they are able before the time-bar rules contained in s RM 2 of the Act take effect), or
    - (if they do not wish to claim the allowable depreciation loss) as the taxpayer has not claimed a deduction for any amount of depreciation loss for the commercial building, they can now provide the Commissioner with a written election to retrospectively treat the commercial building as not being an item of depreciable property.[14]

Taxpayers acquiring a commercial building between 1 April 2011 and 31 March 2020

25. In the final circumstance set out at [22], where a taxpayer has acquired their commercial building during the time that the depreciation rate for their building was 0% (between 1 April 2011 and 31 March 2020), they have not failed to claim a depreciation loss (as none was available). The reassessment of prior returns of income is therefore not required. If the taxpayer wishes to claim the allowable depreciation loss on their commercial building they can simply commence to do so.

26. Because the taxpayer has not claimed a deduction for any amount of depreciation loss for the commercial building, if they do not wish to claim the amount of allowable depreciation loss on their commercial building, they can provide the Commissioner with a written election to retrospectively treat the commercial building as not being an item of depreciable property.

Effect of retrospective elections

27. Retrospective elections are effective for all years from the year that the taxpayer acquired the commercial building. Making a retrospective election therefore rectifies the errors made in the taxpayer's past returns of income.

28. As stated at [9], a taxpayer can make a retrospective election in any income year after the year they acquired the asset. This includes the year that they disposed of the asset and the years following its disposal.

[13] Such a request can be made in terms of s 113 of the Tax Administration Act 1994. See also standard practice statement *SPS 20/03: Requests to amend assessments.*

[14] s EE 8(3) of the Act.

References

Legislative references

Income Tax Act 1994 – s 16A

Tax Administration Act 1994 – s 113

Income Tax Act 2007 – s DA 1, s DA 4, s EE 1(2), ss EE 8(3), (4), (5) and (6), s EE 16(3), s EE 47, s RM 2, and s YA 1

Other references

"Changes to building depreciation" *Tax Information Bulletin* Vol 22, No 7 (August 2010): 12
taxtechnical.ird.govt.nz/tib/volume-22---2010/tib-vol22-no7

"Depreciation deductions for non-residential buildings" *Tax Information Bulletin* Vol 32, No 5 (June 2020): 2
taxtechnical.ird.govt.nz/tib/volume-32---2020/tib-vol32-no5

TECHNICAL DECISION SUMMARIES

Technical decision summaries (TDS) are summaries of technical decisions made by the Tax Counsel Office. As this is a summary of the original technical decision, it may not contain all the facts or assumptions relevant to that decision. A TDS is made available for information only and is not advice, guidance or a "Commissioner's official opinion" (as defined in s 3(1) of the Tax Administration Act 1994). **You cannot rely on this document as setting out the Commissioner's position more generally or in relation to your own circumstances or tax affairs**. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest.

TDS 21/05: GST - Input tax deductions, penalties

Technical decision summary - Adjudication

Decision date: 30 June 2021

Issue date: 18 November 2021

Subjects | Ngā kaupapa

GST: input tax deductions, taxable activity; TAA: shortfall penalties

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer & Compliance Services of Inland Revenue
Commissioner	Commissioner of Inland Revenue
Customs	New Zealand Customs Service
GST	Goods and services tax
GST Act	Goods and Services Tax Act 1985
TAA	Tax Administration Act 1994

Taxation laws | Ngā ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GST Act) unless otherwise stated.

Facts | Ngā meka

1. The Taxpayer is an incorporated company registered for GST. Its stated taxable activity is the importation and distribution of goods.
2. The Taxpayer filed GST returns over four taxable periods during 2017 (the relevant periods). All the returns gave rise to refunds, which were paid out to the Taxpayer, except for one that was withheld pending investigation.
3. Despite repeated requests for information by the Customer and Compliance Services group of Inland Revenue (CCS), the Taxpayer failed to provide any documentation to support the refunds. CCS was able to obtain some bank statements from a bank during their audit activities. The bank statements covered part of the relevant periods, but no further information or explanation was provided regarding the nature of the transactions in the bank statements.
4. During the disputes process, the Taxpayer provided two invoices addressed to the Taxpayer that showed GST and duty paid to Customs. Both invoices were dated in 2021.

Issues | Ngā take

5. The main issues considered in this dispute were:
   - whether the Taxpayer was carrying on a taxable activity;
   - if not, whether the Taxpayer's GST registration should be cancelled from the date of its registration;
   - whether the Taxpayer was entitled to claim the input tax deductions;
   - whether the Taxpayer is liable for a shortfall penalty for evasion or similar act;
   - alternatively, whether the Taxpayer is liable for a shortfall penalty for gross carelessness.
6. A preliminary issue on the onus and standard of proof was also considered.

Decisions | Ngā whakatau

7. The Tax Counsel Office decided that:
   - the Taxpayer was not carrying on a taxable activity during the relevant periods;
   - the Taxpayer's GST registration should be cancelled from the date of registration;
   - the Taxpayer was not entitled to the input tax deductions claimed;
   - the Taxpayer was not liable for a shortfall penalty for evasion or a similar act; and
   - the Taxpayer was liable for a shortfall penalty for gross carelessness.

Reasons for decisions | Ngā take mō ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

8. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
9. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer has discharged the onus of proof is considered in the relevant issues.

Issue 1 | Take tuatahi: Taxable activity

10. GST is imposed on taxable supplies of goods and services made by a registered person in the course or furtherance of a taxable activity carried on by the registered person (s 8(1)). There are four requirements that must be satisfied to show there is a taxable activity (s 6(1)(a)):[5]
    - There must be an activity.[6]
    - The activity must be carried on continuously or regularly by a person.[7]
    - The activity must involve, or be intended to involve, the supply of goods and services to another person.[8]
    - The supply or intended supply of goods and services must be made for a consideration.[9]

[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

[2] Section 149A(2) of the Tax Administration Act 1994 (TAA).

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[5] *Case 14/2016* [2016] NZTRA 14, (2016) 27 NZTC 3-036 at [63]-[70].

[6] *Newman v CIR* (1994) 16 NZTC 11,229 (HC) at 11,233; *CIR v Bayly* (1998) 18 NZTC 14,073 (CA) at 14,078; *CIR v Newman* (1995) 17 NZTC 12,097 (CA) at [32]; *Case 14/2016* at [63].

[7] *Newman* (CA) at 12,100; *Smith v Anderson* (1880) 15 Ch D 247 at 277, 278; *Premier Automatic Ticket Issues Ltd v FCT* (1933) 50 CLR 268 (HCA) at 298; *Case 14/2016* at [67]-[68]; *Wakelin v CIR* (1997) 18 NZTC 13,182 (HC) at 13,185-13,186; *Case N27* (1991) 13 NZTC 3,229 at 3,238-3,239; *Allen Yacht Charters Ltd v CIR* (1994) 16 NZTC 11,270 (HC) at 11,274.

[8] Definition of "supply" in s 5(1); *Databank Systems Ltd v CIR* (1987) 9 NZTC 6,213 (HC) at 6,223; *Pacific Trawling Ltd v Chief Executive of the Ministry of Fisheries* (2005) 22 NZTC 19,204 (HC); *Case S77* (1996) 17 NZTC 7,483; *Case L67* (1989) 11 NZTC 1,391; *Case N27* at 3,238-3,239; *Case 14/2016* at [69].

[9] Definition of "consideration" in s 2(1); *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 (CA) at 12,314.

11. Section 6(2) provides that anything done in the beginning or ending of a taxable activity is treated as carried out in the course or furtherance of that taxable activity.
12. The Taxpayer did not show on the balance of probabilities that it was carrying on a taxable activity for these reasons:
    - The bank statements obtained by CCS contained a number of deposits and withdrawals that are mostly made in a period after the relevant periods. These transactions provide some evidence that an activity of importing and distributing goods may have commenced at some point during or before the relevant periods.
    - The later transactions could point to a broader pattern indicating the existence of a continuous or regular activity, or that there may have been an intention to involve the making of supplies for consideration. Further, preliminary actions undertaken during the relevant periods could form part of a later taxable activity.
    - However, the nature of these bank transactions is merely speculative, and the taxpayer had not provided any evidence to substantiate these transactions as business transactions.
    - The invoices that showed GST and Customs duties and levies paid in relation to goods do provide support for the Taxpayer's view that it was carrying on an activity of importing goods. However, these invoices are dated in 2021 and, while they may support the existence of an activity three years later, they do not support the existence of an activity during the relevant periods.

Issue 2 | Take tuarua: Cancellation of GST registration

13. The Commissioner may cancel a person's GST registration if the Commissioner is satisfied that the person is not carrying on a taxable activity (s 52(5)). The cancellation may be retrospective to a date not earlier than the date of registration if the Commissioner is satisfied that the person did not carry on any taxable activity from that date (s 52(5A)).
14. The Taxpayer has not satisfied the onus of proving on the balance of probabilities that it was carrying on a taxable activity during the relevant periods, or at any point after that. Therefore, the Commissioner can cancel the Taxpayer's GST registration from a date not earlier than the date it was registered for GST.

Issue 3 | Take tuatoru: Input tax deductions

15. The Taxpayer cannot claim input tax deductions for the amounts claimed if it is not a registered person. The Taxpayer will not be registered during the relevant periods if the Commissioner deregisters it from the date of registration.
16. However, in the event the Taxpayer remains registered during some or all of the relevant periods, the issue of whether the Taxpayer was entitled to the input tax deductions claimed was considered.
17. The calculation of GST payable by a registered person is set out in s 20. Broadly, the input tax that a registered person has paid for acquiring goods and services for making taxable supplies can be offset against the GST output tax payable on taxable supplies made by the person in the same period.
18. For a taxpayer to be eligible for GST input tax deductions under s 20(2):
    - The goods or services acquired by the taxpayer must be used for, or available for use in, making taxable supplies (s 20(3C)).
    - The taxpayer must have held the relevant tax invoices when the input tax deductions were claimed (s 20(2)(a)).
    - The tax invoice must generally satisfy the requirements for a "tax invoice" (ss 24(3) or 24(4)).
    - The Commissioner may determine that no input tax deduction is available if sufficient records are not kept in accordance with s 75.
    - It is not enough that the taxpayer merely shows there was a supply made to them. It must go further and provide sufficient particulars of the supply, generally in a tax invoice.[10]
    - The requirement for a tax invoice is an evidential requirement of the GST Act to ensure real supplies are being made which are within the GST base.[11]
19. The Taxpayer was not entitled to the input tax deductions claimed for these reasons:
    - The Taxpayer did not show that it paid input tax for goods or services used or available for use in making taxable supplies. The only evidence to support the existence of any input tax paid are the bank transactions, which were largely outside the relevant periods and have not been substantiated with any further documentation.

[10] *Case 1/2012* (2012) 25 NZTC 1-013 at [147].

[11] *Case Z12* (2009) 24 NZTC 14,142 at [27].

- The Taxpayer also failed to show it was provided with tax invoices for the input tax deductions claimed. Even if the tax invoices exist, the Taxpayer has not complied with its record-keeping obligations in s 75.
- The invoices presented by the Taxpayer, being two invoices dated three years after the relevant periods, did not provide sufficient evidence of the existence of input tax paid during the relevant periods.

Issue 4 | Take tuawhā: Shortfall penalty for evasion

20. Section 141E(1) of TAA imposes a shortfall penalty for evasion or a similar act on a taxpayer if the following requirements are satisfied:[12]
    - The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[13]
    - Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[14]
    - The taxpayer has done any of the acts set out in s 141E(1) of the TAA. In this dispute, the relevant provisions were ss 141E(1)(d) and 141E(1)(da) of the TAA.
    - Under these provisions, a person must obtain or attempt to obtain a refund or payment of tax, and this includes a refund of excess input tax. The person must obtain or attempt to obtain the refund knowing that they are not lawfully entitled to the refund:
        - The "knowing" element requires actual knowledge on the part of the person or a responsible officer that they were not allowed the refund obtained or that they attempted to obtain. The required knowledge can be inferred from surrounding circumstances and conduct.[15]
        - Recklessness can amount to knowing in this context and involves the conscious taking of risk. Recklessness will be proven where:[16]
            - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that they were not allowed the refund they obtained or attempted to obtain.
            - The taxpayer made a conscious decision to ignore the facts without making further inquiry.
21. The penalty payable for evasion or a similar act is 150% of the resulting tax shortfall.
22. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E of the TAA.[17] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[18]
23. The Taxpayer took a tax position that resulted in a tax shortfall. However, CCS did not prove on the balance of probabilities that the Taxpayer obtained or attempted to obtain refunds knowing that it was not lawfully entitled to the refunds for these reasons:
    - The Taxpayer's director's failure to substantiate the input tax deductions claimed and engage with CCS is evidence that the Taxpayer has not met its record-keeping requirements. However, it is not necessarily evidence of intent or knowledge that the Taxpayer was not entitled to the amounts claimed.
    - The evidence provided by CCS did not demonstrate that the Taxpayer's director knew facts which would have put them on inquiry that the Taxpayer was not entitled to the amounts claimed.
    - The evident language barrier and the failure to meaningfully address CCS's arguments, showed a lack of understanding by the Taxpayer's director. This made it less likely that the Taxpayer had the necessary mental element for evasion.

[12] The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: *Shortfall Penalty—Evasion* as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

[13] Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

[14] Definition of "tax shortfall" in s 3 of the TAA.

[15] *Meulen's Hair Stylists Ltd v CIR* [1963] NZLR 797 at 798 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388.

[16] *Case W3* (2003) 21 NZTC 11,014; *Case R31* (1994) 16 NZTC 6,171; *Godfrey Allan Ltd v CIR* (1980) 4 NZTC 61,548 (HC); *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626.

[17] Section 149A(2) of the TAA.

[18] Section 149A(1) of the TAA.

Issue 5 | Take tuarima: Shortfall penalty for gross carelessness

24. Section 141C of the TAA imposes a shortfall penalty for gross carelessness on a taxpayer if the following requirements are satisfied:[19]
    - The taxpayer has taken a tax position.
    - Taking the tax position has resulted in a tax shortfall.
    - The taxpayer has been grossly careless in taking the taxpayer's tax position. Gross carelessness means doing or not doing something in a way that, in all of the circumstances, suggests or implies a complete or high level of disregard for the consequences (s 141C(3)):
        - Gross carelessness is characterised by conduct which creates a high risk of a tax shortfall occurring where that risk and its consequences would have been foreseen by a reasonable person in the circumstances.[20]
        - The test for gross carelessness is not whether the taxpayer actually foresaw the probability that their act or omission would cause a tax shortfall but whether a reasonable person would have foreseen that probability.[21] Whether the taxpayer has acted intentionally is not a consideration.[22]
        - A person who takes reasonable care is not grossly careless. Taking reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records, and generally making a reasonable attempt to comply with tax law.[23]
        - A taxpayer who adequately informs and follows the advice of a qualified tax agent takes reasonable care and is not careless.[24]
25. The following factors may be relevant in determining whether a reasonable person would have foreseen that their conduct created a high risk of a tax shortfall occurring:[25]
    - the significance of the transaction leading to the tax shortfall;
    - the taxpayer's level of experience in the relevant tax laws;
    - previous warnings given by Inland Revenue or advisors in relation to the risk of the tax shortfall.
26. The penalty payable for gross carelessness is 40% of the resulting tax shortfall.
27. As noted above, the Taxpayer took a tax position that resulted in a tax shortfall. Further, the Taxpayer did not prove that it was not grossly careless in taking a tax position for these reasons:
    - The Taxpayer's apparent failure to retain tax invoices or any records substantiating the input tax deductions claimed indicates a level of negligence that supports the view that the Taxpayer was grossly careless in filing the returns.
    - The director's English-language ability and lack of engagement with CCS indicates they may have limited knowledge or understanding of the GST system. However, having considered all the circumstances, even having regard to the Taxpayer's director's personal circumstances, it is considered the director had a high level of disregard for the consequences of their actions.
    - A reasonable person in the circumstances would be aware of a general requirement to retain tax invoices or other evidence substantiating amounts claimed in a return, even with a language barrier.
    - It is noted that the director of the Taxpayer has referred to the existence of an unnamed accountant, whose services were apparently required for gathering tax invoices in relation to the amounts claimed. This is relevant as a person who relies on the advice of a qualified tax advisor will not be careless. However, the Taxpayer has not provided any information about the accountant or any advice or involvement the accountant had in the Taxpayer's tax affairs. Therefore, this does not support the view that the Taxpayer was not grossly careless.

[19] The shortfall penalty for gross carelessness is considered in the Interpretation Statement: *Shortfall Penalty for Gross Carelessness* as published in *Tax Information Bulletin* Vol 16, No 8 (September 2004).

[20] *Case W4* (2003) 21 NZTC 11,034 at [44].

[21] *Case 9/2014* (2014) 26 NZTC 2-019 at [88].

[22] *Case W4* at [60].

[23] *Case W4* at [60].

[24] *Re Carlaw and FCT* 95 ATC 2166 (AAT); *Re Sparks and FCT* [2000] AATA 28 and see also *Pech v Tilgals* [1994] ATC 4206.

[25] *Case W4*.

TECHNICAL DECISION SUMMARIES

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TDS 21/06: Exempt income and R&D credits

Technical decision summary - Adjudication

Decision date: 22 July 2021

Issue date: 2 December 2021

Subjects | Ngā kaupapa

ITA 2007: CW 42, exempt income; Subpart MX, R&D credits

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
ITA 2007	Income Tax Act 2007
TAA	Tax Administration Act 1994
R&D	Research and Development
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ngā ture take

All legislative references are to the Income Tax Act 2007 (**ITA 2007**) unless otherwise specified.

Facts | Ngā meka

1. Company Z (**Z**) is registered under the Companies Act 1993 with its two shareholders being Entity A (**A**) and Entity B (**B**), both being registered charities.
2. In the 2017 tax year Z treated its income as taxable, and as its deductible expenditure exceeded its assessable income it had a net tax loss.
3. As a consequence of the loss, Z claimed a research and development (**R&D**) loss tax credit.
4. Customer and Compliance Services, Inland Revenue **(CCS**) proposed to disallow the R&D loss tax credit on the basis that Z's income is exempt under s CW 42.

Issues | Ngā take

5. The main issues considered in this dispute were:
   - whether Z's income was exempt under s CW 42. To establish this, the following two sub-issues were relevant:
     - whether Z's business was being carried on by, for, or for the benefit of, A and B.
     - if so, whether a person with some control over Z's business was able to direct or divert an amount derived from the business to the benefit or advantage of a person other than A and B.
   - whether Z had a R&D loss tax credit under subpart MX.
6. There was also a preliminary issue on the onus and standard of proof.

Decisions | Ngā whakatau

7. The Tax Counsel Office (**TCO**) decided that:
   - Z 's income was **not** exempt under s CW 42(1). Z's business was not being carried on by, for, or for the benefit of, A and B. As a result, the second sub-issue did not need to be considered.
   - Z had a R&D loss tax credit under subpart MX.

Reasons for decisions | Ngā take mō ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

8. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
9. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether Z has discharged the onus of proof is considered in the other issues.

Issue 1 | Take tuatahi: Whether Z's income was exempt

10. The issue is whether the Taxpayer's income from the business was exempt from tax under s CW 42(1). At the relevant time, s CW 42(1) exempted income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society or institution of a kind referred to in s CW 41(1).[5]
11. The trust, society, or institution must:
    - carry out its charitable purposes in New Zealand, and
    - be a tax charity when the income is derived.
12. The trust, society, or institution must be a trust for charitable purposes, or a society or institution established and maintained exclusively for charitable purposes and not carried on for the profit of any individual (s CW 41(1)) and no person with some control over the business is able to direct or divert an amount derived from the business to the benefit or advantage of another person or entity.

Whether Z's business was being carried on by, for, or for the benefit of, A and B

13. TCO considered the following in analysing this issue:
    - Natural and intended meaning of the phrase "by, for, or for the benefit of".
    - Determining the purpose of an entity.
    - Relationship between a company and its shareholders.
    - Case law specific to s CW 42 and its predecessor sections.

[1] Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to a Taxation Review Authority or a court) are civil proceedings.

[2] Section 149A(2) of the TAA.

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[5] Section CW 42 was amended with effect for the 2020-21 and later income years to require that the entity carrying on the business was registered as a charitable entity under the Charities Act 2005 when the income was derived. This dispute would not have arisen under the amended legislation as Z was not registered as a charity under the Charities Act 2005.

14. It was not asserted by Z or CCS that Z's business was carried on by either A or B so the word "by" was not considered any further.
15. The terms "for" and "for the benefit of" are not defined in the ITA 2007. Where the legislation does not define a term, it should be interpreted according to its natural and intended meaning.[6]
16. For guidance as to the natural and intended meaning of "for" and "for the benefit of", TCO considered the dictionary definitions of the terms[7] and case law. This indicated that in s CW 42 both "for" and "for the benefit of" suggest that the business deriving the income does so in order to give it to another person who is ultimately entitled to that income.[8]
17. Determining the purpose of an entity was considered by reference to relevant case law (as discussed below in [19] to [23]).
18. In considering the relationship between a company and its shareholders, reference was made to an Inland Revenue publication referred to by Z and the case law cited within.[9] The proposition put forward in the bulletin is that the income of a business carried on by a company will not be treated as exempt merely because all the shares in the company are transferred to charitable entities. The Companies Act 1993 was also considered.

Summary of principles derived from case law

19. The case law is not entirely consistent, but some principles can be extracted.
20. A mere shareholding relationship is not sufficient to satisfy the phrase "for, or for the benefit of " in s CW 42. Without more, a company cannot be said to be acting "for" its shareholders, that term being apt to the relationship of principal and agent, but hardly that of a company and its shareholders.[10]
21. The founding documents, such as a deed of trust or company constitution, can establish that the entity derives income from a business carried on for a trustee in trust for charitable purposes under s CW 42.[11]
22. When a body's founding documents are clear as to what its purpose is, then its purposes must be ascertained from those documents.[12]
23. For s CW 42 to apply the only permitted application of the profits of the business must be for charitable purposes, although the profits do not need to be paid immediately for charitable purposes. Funds derived from the business can be used for business development or the creation of reserves instead of being immediately distributed to the charity but any resulting assets from the business must ultimately be required to be applied for charitable purposes.[13]

Application

24. TCO concluded that Z was not within s CW 42(1). This was because:
    - Z's only shareholders were charities. Having tax charities as the only shareholders in a company is not (by itself) sufficient to establish that the company is carrying on a business for, or for the benefit of, a charitable entity.
    - Z's directors were required to act in the best interests of Z rather than considering the interests of the shareholders. This is required by s 131 of the Companies Act 1993 and by the provisions of Z's constitution.
    - Z's constitution did not require that all the profits and assets of Z's business could only be applied for the benefit of A and B. The constitution was silent on the matter.
    - The constitution is clear with no ambiguity and did not make any provision that required that all the profits and assets of Z's business could only be applied for the benefit of A and B.
25. This conclusion made it unnecessary to consider whether a person with some control over Z's business was able to direct or divert an amount derived from the business to the benefit or advantage of a person other than A and B (s CW 42(1)(c)).

[6] *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175 (CA).

[7] *Concise Oxford English Dictionary* (12th ed, 2011, Oxford University Press).

[8] *Gillespie v City of Glasgow Bank* (1879) 4 App Cas 632 at 642.

[9] *Technical Bulletin* No 15 September 1959: "Charitable Purposes – Company with all shares held by charities".

[10] *CIR v NTN Bearing-Saeco (New Zealand) Ltd* (1986) 8 NZTC 5,039.

[11] *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC). See also *Bearing-Saeco.*

[12] *Institution of Professional Engineers v CIR* (1991) 13 NZTC 8,162 (HC). See also *Calder Construction.*

[13] Refer *Calder Construction.*

Issue 2 | Take tuarua: Whether Z had a R&D loss tax credit under Subpart MX

26. Subpart MX provides for a R&D loss tax credit if certain criteria are met. It was accepted by both parties that Z satisfied all the criteria for a R&D loss tax credit except in relation to two particular requirements:
    - That the company has a net loss for the year (s MX 1(c));
    - If the company is a member of a R&D group of entities, the group in aggregate has a net loss for the year (s MX 1(d)).
27. CCS argued that Z derived exempt income and therefore did not have a net loss for the year and was part of a group of entities that derived exempt income and did not have a net loss for the year.
28. TCO concluded that Z's income was not exempt under s CW 42. Therefore, the loss that Z incurred was a net loss for tax purposes (s BC 4). Consequently, the requirements in s MX 1(1)(c) and (d) were met. Z, and the R&D group of which it was a member, had a net loss.
29. Therefore, since Z, and the R&D group of which it was a member, had a net loss for the year and it was agreed that all the other requirements for Subpart MX applied, Z had a R&D loss tax credit.

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