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Inland Revenue Department
New Zealand

By email: **Public.Consultation@ird.govt.nz**

Your reference: PUB00370

Dear Sir/Madam,

PUB000370 Income tax - foreign tax credits - how to calculate a foreign tax credit

CPA Australia represents the diverse interests of more than 168,000 members, including over 2,700 members in New Zealand, working in over 100 countries and regions supported by 19 offices around the world. With the assistance of our New Zealand Tax Committee, we make this submission on behalf of our members and in the broader public interest.

The Inland Revenue's (**IRD**) Exposure Draft **PUB00370 Income tax- foreign tax credits- how to calculate a foreign tax credit** (**the Exposure Draft**) seeks comments on proposed guidance on how to calculate a foreign tax credit.

The Commissioner has previously issued two very helpful interpretation statements[1] which focus on whether a New Zealand tax resident is entitled to claim a foreign tax credit. The current exposure draft is a welcome addition as it will guide New Zealand tax residents when calculating the amount of foreign tax credit that is claimable when assessing their New Zealand income tax liability.

Overall, we find this proposed Interpretation Statement, outlined in the Exposure Draft, to be practical and clear. We raise the following for your consideration.

1. The Exposure Draft should consider the impacts of **Determination G9A *Financial arrangements that are denominated in a currency or commodity other than New Zealand Dollars*** (**Determination G9A**) and the availability of the secondary approach under section LJ 5 of the Income Tax Act 2007 (**ITA 2007**) to address distorted results
2. Earlier consideration of section LJ 2(7) under "A. Segment foreign-sourced income" in the Exposure Draft
3. Clarification of Example 3 – Attribute expenses and Example 13 – Foreign-sourced attributed personal service income
4. Review of Example 12: FIF rules for correctness.

Further details are contained in the Attachment.

If you have any queries about this submission, contact Rick Jones, Country Head, New Zealand on +64 21 190 1039 or **rick.jones@cpaaustralia.com.au** or Elinor Kasapidis, Senior Manager Tax Policy on +61 3 9606 9666 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

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[1] **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?** 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.** Additional guidance is available in ***IR461 Guide to foreign investment funds and the fair dividend rate***. However, this guidance only covers the impact of foreign tax credit calculations for New Zealand tax residents who derive income from foreign investment funds as defined in section EX28 of the *Income Tax Act 2007* (**ITA 2007**).

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Step 1

We generally agree with the Commissioner's technical conclusions in ***Step 1****: Establishing the person's tax position.* A New Zealand tax resident is only able to claim a foreign tax credit when they have a New Zealand income tax liability for the relevant income tax year.

Step 2 and the distorted outcomes arising from Determination G9A

Determination G9A of the financial arrangement rules may affect whether a person will be able to claim a foreign tax credit for a segment of foreign-sourced income. Because the thresholds in section EX57 of the *Income Tax Act 2007* (**ITA 2007**) have not been amended for a significant amount of time, New Zealand tax residents are generally required to apply the accrual rules when determining the income or expenditure of financial arrangements.

Determination G9A requires that currency movements are taken into account when determining the income of a segment of foreign-sourced income (e.g., interest income). This can result in distorted outcomes as the value of financial arrangements (e.g., account balances denominated in foreign currency) fluctuates from year to year and taxpayers may be unable to apply unused foreign tax credits to future years under the general approach. The following example illustrates the issue that arises.

CPA Australia example: New Zealand tax resident with net interest income from an Australian account

A person (with New Zealand tax payable overall) has net interest income from Australia of NZ$10,000 for an account with a value of AU$500,000. The person has paid Australian withholding tax of 10 per cent under Article 11 of the Double Tax Agreement (**DTA**) between New Zealand and Australia, which equates to an amount of NZ$1,000. The person is required to apply Determination G9A to the financial arrangement which means including the changes in the market value of the account.

Table 1: Income, foreign tax credits and value of opening and closing account balances in Australian (AU$) and New Zealand (NZ$) dollars

Date	Net interest income (NZ$)	Foreign tax credits (NZ$)	Account value (AU$)	Account value (NZ$)	Change in account value (NZ$)
1 April 202X			500,000	531,914	
31 March 202Y	10,000	1,000	500,000	522,315	(9,599)
31 March 202Z	10,000	1,000	500,000	543,478	21,163

The interest income of the person for the year ending 31 March 202Y equals the amount received of $10,000 plus/minus the amount calculated under Determination G9A. Therefore, the person has interest income of $401 (see Table 2) with foreign tax credits of $1,000. Subpart LJ of the ITA 2007 limits the amount of foreign tax credit claimable to the amount of New Zealand tax on $401.

In the following income year, the person again has NZ$10,000 of interest income. The application of Determination G9A results in the interest income of the person being the NZ$10,000 of net interest income received plus NZ$21,163 for change in value, totalling NZ$31,163 (see Table 2).

Table 2: Net interest income, change in account value and adjusted interest income in NZ$

Income year ended	Net interest income	Change in account value	Interest income adjusted as per Determination G9A
31 March 202Y	10,000	(9,599)	401
31 March 202Z	10,000	21,163	31,163

We note that in paragraph 46 of the Exposure Draft, the Commissioner makes a statement that any excess foreign tax credits are not able to be carried forward. However, in the IRD's 1996 Tax Information Bulletin **TIB Volume Eight No. 9,** the Commissioner issued the following guidance:

> *"The new section LC 14 [of the Income Tax Act 1994] provides a prescriptive approach to determining the maximum amount of tax credit that may be credited against the NZ income tax liability. It also incorporates a policy change which ensures that group tax losses do not reduce a taxpayer's entitlement to a foreign tax credit. The general approach in section LC 14 to determining the maximum foreign tax credit examines the ratio of foreign sourced "net" income (foreign sourced gross income less applicable allowable deductions) to the net income of the taxpayer. However, where the taxpayer has losses, this general approach can give rise to distorted results and a secondary approach is necessary.*

The secondary approach fixes the maximum amount of credit by reference to the ratio of the tax credits for any single type or class of foreign sourced gross income calculated under the general approach to the sum of those tax credits for all types and classes." [emphasis added]

The corresponding provision is now **section LJ 5** of the ITA 2007 and, given that it remains consistent with section LC 14 of the now repealed 1994 and 2004 Income Tax Acts, it is our understanding that the secondary approach remains available. If so, in our example, the distorted foreign tax credits for the year ending 31 March 202Y could be used in the following income year.

We note that this issue has been raised with the IRD previously and strongly believe that this proposed Interpretation Statement provides the opportunity to clarify the application of the secondary approach in these circumstances.

Segment foreign-sourced income

The Exposure Draft elaborates on segmentation using a broad approach and does not consider the impact of **section LJ 2(7)** of the ITA 2007 in paragraphs 19 to 22 of the Exposure Draft titled, "A. Segment foreign-sourced income". A specific scenario in relation to these paragraphs is also included at Part 3 of the Exposure Draft.

We are of the opinion that this proposed Interpretation Statement should include the impact of section LJ 2(7) under the heading "A. Segment foreign sourced income" and that a reference should be included in the flowchart at paragraph 18. As an alternative, as a caveat, the reader needs to be alerted to the impact of the section in the specific scenario in Part 3.

This is an important issue as it demonstrates that a person can have an allowable foreign tax credit claim even if the overall income under the portfolio approach of all non-exempted foreign investment funds is nil. While this is illustrated in Part 3, a link should be included.

We acknowledge that the "straightforward segmentation" in Example 11 stipulates that Margaret's investments are exempt from the application of the foreign investment fund (**FIF**) rules. However, we believe it would be beneficial if the impact of section LJ 2(7) is included earlier in the guidance.

Example 3: Attribute expenses

Edna borrowed funds to finance her Australian share investments. We would appreciate if the Commissioner could clarify that either Edna borrowed the money from a New Zealand lender and the loan agreement is in NZ dollars, or that Edna borrowed the money form an Australian bank with a branch in New Zealand and the loan is in NZ dollars. Edna might be required to apply accrual rules and would need to calculate her interest expenditure by using Determination G9A. This could mean that her expenditure is greater, or she could have additional interest income.

The example should also highlight that an offshore lending arrangement might impose an obligation on Edna to account for non-resident withholding tax (**NRWT**) or Approved Issuer Levy if none of the exemption (i.e., Australian bank with New Zealand branch) applies.

The example also broadly states that she does not have an attributing interest in a FIF. It may be of benefit to change this to a conclusion that all her Australian investments are exempt from the FIF rules.

Example 12: FIF Rules

The FIF rules are portfolio rules meaning that Walter needs to apply the same calculation method for all non-ordinary FIFs. The example suggests that Walter applies the fair dividend rate method (**FDR**) to Can Co 1 and the comparative value method (**CV**) to Can Co 2. However, this is not possible.

Sections EX 51(7) and (8) of the ITA 2007 are portfolio rules which mean that the overall losses are reduced to nil and a tax credit would still be allowable for the segment which derived taxable income. The example does not appear to work due to the distinction between offshore equities which are in substance debt and those which are pure equity arrangements. The example suggests that all FIFs which are *not listed on a recognised exchange* are non-ordinary shares, which is not necessarily correct.

We suggest that an example be provided which correctly illustrates how the portfolio approach is applied and the impact of section LJ 2(7) to the segmentation. The inclusion of investments which are in substance debt instruments illustrates that there are FIFs for which different calculation methods need to be applied, regardless of the portfolio approach. Where a "debt versus equity" example is included in this proposed Interpretation Statement, we recommend the application and explanation of s EX 46(10) is better articulated.

Example 13: Foreign-sourced attributed personal services income and deduction under section DC 8

We suggest that this example should be clarified to ensure that the net income and the tax credits are attributed to Seamus, and that both are a deduction under section DC 8 of the ITA 2007.

Due to the recent developments arising from COVID (e.g., returning New Zealand citizens who maintain their offshore employment while in New Zealand), we also suggest that the Commissioner includes an employment income example to illustrate what is foreign-sourced income (with tax credits) and what is New Zealand sourced income. An example of this kind

can link back to the **IR56 taxpayer's handbook** and the guidance material on what constitutes a presence of the foreign employer in New Zealand.

Other points

It would be helpful if this proposed Interpretation Statement included an example where FIF income is calculated under the CV method and the taxpayer, due to citizenship (e.g., United States), is taxed on capital gains offshore (e.g., gains sourced in the United States).

The guidance on the time limit for claiming a foreign tax credit at paragraphs 47 and 48 focuses on domestic law. We suggest including reference to whether a Double Tax Agreement would require the Commissioner to amend the time limit.

At the operational level, we also highlight that there remain software calculation issues when claiming foreign tax credits for segments of foreign-sourced income. Our members report that the new software (Start) does not yet appear able to conduct a foreign tax credit calculation as suggested in this Exposure Draft. The current software incorrectly assumes that offshore income is derived from one segment/source when verifying the amount of claimable tax credits[2]. This fault results in returns having to be manually processed which comes at a significant cost for our members and their clients.

[2] This was also a problem in the previous software.