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WEEKLY COMMENT: FRIDAY 4 OCTOBER 2013

1. In May of this year Inland Revenue released a draft Interpretation Statement *Income tax – foreign tax credits – what is tax of substantially the same nature as income tax imposed under s BB 1?* ("the draft IS"). The *Public Rulings Work Programme* as at 20 September 2013 states that submissions are being considered, and at that stage a final version was expected to be issued in September, however, this had not happened by the time of writing. The draft IS raises some interesting questions about foreign nationals working in New Zealand who continue to receive some remuneration from their home country employer:

   (a) Whether they are New Zealand residents;

   (b) Whether they derive foreign-sourced income; and

   (c) Whether foreign social security levies in the form of insurance premiums can result in foreign tax credits that could be claimed in New Zealand.

New Zealand tax residence

2. Most, if not all, of the double tax agreements entered into by New Zealand contain a residence "tie-breaker" clause, which usually decide tax residence, in the first instance, in favour of the Contracting State in which a permanent home is available. If a permanent home is available in both Contracting States, the individual is deemed to be a resident only of the Contracting State with which their personal and economic relations are closer (centre of vital interests).

3. Inland Revenue released a draft Interpretation Statement in December 2012: *Income tax – residence* (discussed in *Weekly Comment* 11 January (individuals) and 18 January (companies) 2013). The "permanent home" test in double-tax agreements was discussed and the following example was provided:

   "**Facts:** Megan, who normally resides in Canada, is seconded to New Zealand by her Canadian employer for a period of 18 months. While in New Zealand, Megan works for the New Zealand subsidiary of her Canadian employer. Megan lets her Canadian house for a fixed term of 18 months while she is in New Zealand, and lives in rented accommodation here. Most of Megan's personal property remains in Canada, and most of her investments are in Canada. For the purposes of this example, it is assumed that Megan is resident for tax purposes in Canada under the relevant legislation.

Result: Megan is resident in both New Zealand and Canada under the tax legislation of each country. However, for the purposes of the DTA between New Zealand and Canada, Megan is deemed to be a resident only of New Zealand."

4. Based on the above, a number of foreign secondees would probably be regarded as tax residents of New Zealand for the duration of their secondment.

Foreign-sourced income

5. Most, if not all foreign secondees working in New Zealand will probably qualify for transitional resident status, which will mean that they will only be taxable in New Zealand on income that is sourced in New Zealand. However, there is an important qualification: the exemption in s. CW 27 does not apply to employment income or to income from the supply of services.

6. Whether income is foreign-sourced or New Zealand-sourced when New Zealand workers are paid by their foreign employers was the subject of the decision in *Dow Chemicals Overseas Management Company Limited v Commissioner of Inland Revenue* (1994) 16 NZTC 11,143. It was argued, based on Australian case law, that payments made to US expatriate workers after they had left New Zealand emanated from their US employment contracts and were, therefore, not taxable in New Zealand. While the judge accepted that the USA employment contracts were partly responsible for the income, he maintained that the payments were taxable in New Zealand in the year they were paid because they were earned in New Zealand, and the US employment contracts did not alter that conclusion.

7. Therefore, in a number of cases, the question of foreign tax credits relating to foreign social security and tax deductions will not arise, because the income will be regarded as sourced in New Zealand. However, it is conceivable that foreign income could be earned because of the exemption exclusions in s. CW 27. In that case, the discussion in the draft IS becomes relevant.

Entitlement to a tax credit for foreign income tax

8. A person resident in New Zealand who derives foreign-sourced income that is subject to tax in New Zealand may be entitled to a tax credit for *foreign income tax* paid on the income under s. LJ 1(2) and s. LJ 2(1). *Foreign income tax* is defined in s. LJ 3 as "an amount of income tax of a foreign country".

9. The meaning of "income tax" (a defined term in s. YA 1) is varied by s. YA 2 when the term is used in relation to tax of another country, whether imposed by a central, state or local government:

   (a) It means a tax of substantially the same nature as income tax imposed under s. BB 1; and

   (b) It includes a tax imposed as a collection mechanism for the foreign tax that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT.

10. Section BB 1 states that income tax is imposed on taxable income and is payable to the Crown. The inclusions referred to in paragraph 9(b) above are necessary because they are "ancillary tax" as defined in s. YA 1, and not income tax.

11. The discussion the draft IS commences by looking at the meaning of "tax". Based on Australian, Canadian and some New Zealand cases discussed, a tax is:

(a) A compulsory contribution or exaction - *Haliburton & Ors v Broadcasting Commission* (CA 14-99, 15 July 1999) in which the New Zealand Court of Appeal discussed what is a tax, *Matthews v Chicory Marketing Board* (VIC) (1938) 60 CLR 263 in which the Australian High Court referred to "a compulsory exaction of money by a public authority for public purposes, enforceable by law, and is not a payment for services rendered", and *Leake v C of T* (1934) 36 WALR 66 (WASC), in which a Hospital Fund contribution was held to be a tax because every person who earned income was required to pay it and the contributions were used to fund public hospitals.

(b) Imposed on and required from the general body of citizens – *Leake*;

(c) Levied to support government – *Haliburton*, *R v Barger* [1908] HCA 43, (1908) 6 CLR 41:

- But it need not be paid into the consolidated revenue fund for it to be a tax – *Leake*, the Canadian case *Eurig estate (Re)* [1998] 2 SCR 565, *Australian Tape Manufacturers Association v Commonwealth of Australia* [1993] HCA 10, (1993) 176 CLR 480, in which a royalty on blank tapes was paid to a collecting society to distribute to copyright owners;

(d) Levied for a public purpose – *Haliburton*, *Chicory*, *Lawson v Interior Tree Fruit and Vegetable Committee of Direction & The Attorney General of Canada* [1931] SCR 357:

- There is some overlap between public purpose and a State authority – *Australian Tape Manufacturers*;

- If an impost is paid into the consolidated revenue fund then this will establish a public purpose – *Roy Morgan Research Pty Ltd v FCT & Anor* [2011] HCA 35, [2011] ATC 20,282, in which it was held that a superannuation guarantee charge (SGC) was a tax because it was paid into the consolidated revenue fund;

(e) Levied under government/Crown authority – *Haliburton*, *Chicory*, *Leake*, *Lawson*):

- This might not be essential, as long as the body imposing the tax has been given the power to do so by Parliament – *Australian Tape Manufacturers*, *Lawson*;

- Includes being levied by a public body where that public body has been authorised by the government to levy the tax – *Lawson*; and

(f) Enforceable by law – *Chicory*, *Lawson*.

12. A charge may also be a tax even if it is:

(a) Imposed on a specified class of property or persons – *Morris Leventhal & Ors v David Jones Ltd* [1930] UKPC 10, (1930) AC 259, in which a "bridge tax" used to fund building the Sydney Harbour Bridge was a tax even though it was imposed on specific persons and for a specific purpose;

(b) Imposed for a specific purpose – *Morris Leventhal*; and

(c) Not called a tax – *Leake*.

13. A service charge or licence fee is not a tax – *Haliburton*, *Chicory*, and neither is a penalty – *Barger*, in which a dissenting judgment held that a penalty was not a tax.

Meaning of "income tax imposed under s. BB 1"

14. It is noted in the draft IS that s. BB 1 identifies the following characteristics of New Zealand income tax:

    (a) Income tax is compulsory – s. BB 1 refers to income tax "imposed" which means forced to be complied with;

    (b) Income tax is imposed on taxable income, no gross income – s. BB 1 refers to "taxable income";

    (c) Income tax only taxes "income" as defined in s. CA 1;

    (d) Income tax can be imposed at either a flat or graduated rate – s. BB 1 refers to "the rate or rates of tax" implying potentially different rates;

    (e) Income tax can be imposed at different rates depending on the person or entity being taxed – this again follows from the reference to "rate or rates" in s. BB 1, for example, authorising different rates for individuals and companies;

    (f) The rate of income tax is fixed by an Act on an annual basis – s. BB 1 refers to "fixed by an annual taxing Act";

    (g) Income tax is payable to the Crown – as stated in s. BB 1.

15. It is noted that in relation to foreign income tax, s. YA 2(5) allows it to be imposed by "a central, state, or local government" and not just "the Crown" as in s. BB 1.

Meaning of "substantially the same nature as income tax"

16. Section YA 2(5) defines foreign income tax as "a tax of substantially the same nature as income tax imposed under s. BB 1" and includes collection mechanisms that are "of substantially the same nature as" provisional tax, PAYE, RWT and NRWT.

17. In *Case 37* (1967) 3 NZTBR 442, a deduction from an Indian army pension paid into a Fund that was a private mutual insurance institution that existed solely for the provision of pensions for widows and orphans was held not to be substantially of the same nature as New Zealand social security income tax. In *Case F11* (1983) 6 NZTC 59,613, UK national insurance (NI) contributions were held to be not "substantially of the same nature as income tax".

18. The meaning of "substantially the same" was considered by the Employment Court in *National Distribution Union Inc v General Distributors Ltd* [2007] NZEmpC 13, [2007] ERNZ 120. The court decided that "substantially the same" must mean more than "substantially similar". It is noted in the draft IS that this case suggests that "substantially the same" requires sameness in substance or effect but not necessarily in form. This could mean that a foreign tax is still "substantially the same" if it taxes amounts taxed under the Act, but does so in a different way or using a different method.

Case law comparing foreign taxes to income tax

19. A number of cases are discussed where the taxpayer contended that a foreign tax was paid. The conclusions from the New Zealand cases discussed are:

(a) Unemployment relief tax (the precursor to the social security contribution) was held to be "of the character of income tax" in *re Richards (Deceased), Richards v Richards* [1935] NZLR 909 (SC), because it was calculated by reference to the income of the taxpayer and assessed in the same way as income tax;

(b) The New Zealand social security contribution (SCC) was held not to be an income tax by the UK High Court in *Re Hirst, Public Trustee v Hirst* [1941] 3 All ER 466 (Ch) because it was imposed by a separate act;

(c) New Zealand SCC and national security tax were similarly held not to be income taxes in *Re Paterson* [1944] NZLR 104 (CA); the chief justice concluded that only income tax imposed under the Land and Income Tax Act 1923 could be considered income tax; however, the Commissioner is of the view that whether a tax is imposed under a separate act is not a helpful question when determining when comparing foreign tax to NZ income tax – it is the characteristics of the tax that are relevant.

20. Australian case law has identified the following characteristics of an income tax:

(a) Payment of the charge into a special account (but not a private account) will not by itself mean the charge is not an income tax – *de Romero v Read* [1932] HCA 65, (1932) 48 CLR 649, in which unemployment relief tax that was paid into a special fund and used for a special purpose was an income tax, and the label it was given did not matter, it is the subject matter and essence of the tax that is relevant;

(b) Saudi Arabian social insurance contributions (SSI) were held not to be a tax in *Case R68* 84 ATC 482, because they were imposed on only a segment of the population (wage-earning men), imposed for a specific purpose, and paid into a special bank account and not the consolidated revenue fund;

(c) A "self-contribution" to the Self Managing Interest Community of Pension and Invalid Insurance of the Workers of Croatia at Split was held not to be a tax in *Case U52* 87 ATC 347 because it was paid to a co-operative organisation that helped to finance the collective needs of the community and its members, although it was formed within the context of the legal organisation of the State.

21. In UK case law:

(a) The title of the tax was held to be relevant in *Yates (HMIT) v GCA International (formerly Gaffney Cline & Associates Ltd)* [1991] BTC 107 (Ch) in which a translation of Venezuelan law showed a tax on 90% of a contract value was called "income tax", and it was intended to be a charge on net profits so it served the same function as an income tax; and

(b) A superannuation tax was held to be an income tax in *Re Reckitt; Reckitt v Reckitt* [1932] 2 Ch 144 (CA), therefore, the Commissioner regards it as authority for the view that a tax can be assessed and collected in a different way from income tax, but still be an income tax.

22. Finally, in Canadian case law:

(a) Class 3 UK national insurance contributions were not compulsory and did not amount to a tax in *Yates v Her Majesty the Queen* 2001 CanLII 772 (TCC), 2001 DTC 761 (TCC);

(b) A church tax was held to be a tax in *Kempe v The Queen* 2000 CanLII 213 (TCC), [2001] 1 CTC 2060 (TCC), however the Commissioner's view is that a church tax would not be "of substantially the same nature as income tax" because it is in the nature of a service charge collected by the government and distributed to a particular church that the taxpayer attends, and if the person leaves the church their obligation to pay the tax ends;

(c) Premiums paid to the Maine Retirement System in the US were held to be not a tax in *Nadeau v The Queen* 2004 TCC 433 (CanLII), 2007 DTC 1670, because they were intended to provide the employees of Maine with Pension, sickness, disability and death benefits.

Examples

23. The draft IS contains 3 quite detailed examples:

(a) *Example 1 concerns Solomon Islands income tax*: there is an entitlement to a foreign tax credit in New Zealand because it is compulsory, imposed by the central government, intended for a public purpose, taxes income in substantially the same way that the New Zealand Act does, and is calculated as a proportion of income.

(b) *Example 2 concerns US federal insurance contributions*: contributions under the US Federal Insurance Contributions Act (FICA) are determined not to result in a NZ foreign tax credit because they can be characterised as a payment into a fund or scheme where the benefit of the payment is limited to those who contribute (even though they are compulsory, calculated as a proportion of the employee's income, and do not give rise to an enforceable right to benefit).

(c) *Example 3 concerns UK national insurance (NI) contributions*: NI contributions will not give rise to a foreign tax credit because they have the characteristics of a payment into a scheme or fund where the benefit of the payment is limited to those who contribute, also following *Case F11*.

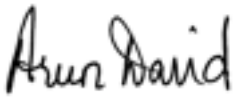
Social security agreements

24. A number of countries have entered into bilateral social security agreements. For example, the US and Australia have entered into a Totalization Agreement to improve Social Security protection for people who spend part of their working life in both countries:

(a) Where an Australian employer sends an employee to work in the US for five years or less, the worker remains subject to the Australian superannuation guarantee programme only; and

(b) Where a US employer sends a worker to work in Australia for five years or less, the worker remains subject to social security contributions only.

25. New Zealand has not entered into any international social security agreements, because New Zealand social security is simply paid out of income tax. In addition, there are not as yet any compulsory superannuation deductions required to be made in New Zealand.



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