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WEEKLY COMMENT: FRIDAY 20 JUNE 2014

1. Inland Revenue has released draft QWB0128: *Income Tax – Foreign tax credits for amounts withheld from United Kingdom pensions* ("the draft QWBA") as well as *QWB0128 – Operational Position*, which sets out Inland Revenue's current operational approach. Also noted is that publication *Overseas pensions and annuity schemes* IR 257 (April 2013) deals with the same issue. This week I look at the draft QWBA and I also take the opportunity to consider the tax implications of United States pensions paid to New Zealand residents who are US citizens.

2. The question is whether a foreign tax credit will be available in New Zealand for an amount withheld as tax in the UK. For the reasons given in the draft QWBA, no foreign tax credit will be allowed. This brings into play the operational approach when tax has been withheld. Inland Revenue notes that the principles outlined in the draft QWBA will apply in other situations where New Zealand has the sole taxing right for pension income. The example cited is pension income from South Africa.

3. The issue is important because foreign pension payers routinely withhold tax. If the tax withheld cannot be credited against the New Zealand income tax liability, there will be double taxation. The procedures to avoid double taxation in these circumstances can be complicated. Inland Revenue has offered affected UK taxpayers help in dealing with the UK tax authorities (refer to paragraph 13 onwards below).

The pensions clause in the UK double tax agreement

4. Article 19 of the double tax agreement with the UK deals with pensions and annuities. Article 19(1) states:

   "Pensions (including pensions paid under the social security legislation of a Contracting State), and similar remuneration in consideration of past employment or services, paid to a resident of a Contracting State, and any annuity paid to a resident of a Contracting State, shall be taxable only in that State."

5. Inland Revenue correctly interprets this as providing primary taxing rights to New Zealand if the recipient of the pension is a New Zealand tax resident.

6. The objective of a double tax agreement is to provide relief from double taxation. This is done by specifying primary taxing rights (for example, in the case of a permanent establishment) and then requiring the other country to provide a tax credit for the tax paid to the country with the primary taxing right.

7. In the double tax agreement with the UK, the instruction to provide a tax credit is contained in Article 22. That article requires New Zealand to provide a tax credit for:

   "… United Kingdom tax computed by reference to income from sources in the United Kingdom and paid under the law of the United Kingdom and in accordance with this Convention … ".

8. Inland Revenue's position as stated in the draft QWBA is that there is no requirement for New Zealand to provide a tax credit for UK pensions because the UK tax is not paid "in accordance with this Convention". The double tax agreement states that the pension derived by a New Zealand tax resident is only taxable in New Zealand.

9. Therefore, Inland Revenue states that no tax credit is available under the double tax agreement with the UK for any UK tax paid on UK pensions derived by NZ tax residents.

The NZ domestic tax position

10. The question is then whether a foreign tax credit can be claimed under s. LJ 2 of the *Income Tax Act 2007*, which states that a person resident in New Zealand who derives assessable income sourced from outside New Zealand has a tax credit for foreign income tax paid calculated under s. LJ 5.

11. This is where Inland Revenue's arguments become a little obtuse. Inland Revenue's view is that the definition of "foreign income tax" in s. LJ 3 must be interpreted in accordance with the taxes covered by the double tax agreement. Therefore, a tax not authorised by the double tax agreement and consequently not covered by the agreement is not "foreign income tax" for the purposes of subpart LJ.

12. The basis for this view is the wording of s. BH 1(4), which states that despite anything in the Income Tax Act or any other Inland Revenue Act, a double tax agreement *has effect* in relation to income tax or any other tax imposed by the Income Tax Act. This is interpreted in the draft QWBA as follows:

    "This means the DTA has an overriding effect as to income tax, including the income and tax credit sections of the Income Tax Act 2007. The income and tax credit sections, therefore, must be read together with the relevant DTA articles. Where there is any inconsistency between the two, the domestic law must be read subject to the DTA."

Advice to People who receive pensions from the UK

13. In the *Operational position* Inland Revenue advises a person who receives UK pension to fill out the relevant Form (details are provided) and sent it to Inland Revenue, who will forward the Form for processing by the UK revenue authorities.

14. Taxpayers are required to take the correct tax position in the 2014 tax return. A voluntary disclosure can be made if tax credits were incorrectly claimed in the 2013 and earlier tax returns.

15. If the taxpayer has been taxed in the United Kingdom and makes a voluntary disclosure, the due date for payment of the increased liability for New Zealand tax will be deferred until the tax refund is received from the UK. There will be no late payment penalties in New Zealand (though some use-of-money interest may apply).

The pensions clause in the US double tax agreement

16. Article 18 of the double tax agreement with the US deals with pensions and annuities. Article 18(1) states:

    "Subject to the provisions of Article 19 (Government Service):

    (a) Pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment shall be taxable only in that State; and

    (b) Pensions and other payments made under the social security legislation of a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State."

17. It can be seen that Article 18(1)(a) is similar to the UK clause: a New Zealand tax resident who derives a pension in consideration of past employment is to be taxed only in New Zealand on that pension. When such a paragraph is included in a double tax agreement, it is stated on page 10 of IR 257 that:

    " … New Zealand has the sole taxing right for the pension income. …

    If tax was also paid overseas on these particular pensions you should apply to the overseas pension scheme administrators for a refund. You cannot claim the overseas tax paid as a foreign tax credit in your New Zealand tax return."

18. It is acknowledged in IR 257 that Article 18(1)(b) provides that New Zealand has no taxing rights over social security pensions from the US.

Whether the same reasoning applies to tax withheld on a US pension

19. Article 1 of the double tax agreement with the US contains a paragraph that is not in the double tax agreement with the UK. Article 1(2) provides that:

    "The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance which may be accorded:

    (a) By the law of either Contracting State; or

    (b) By any other agreement between the Contracting States.

20. Inland Revenue's view, as already stated, is that the definition of "foreign income tax" in s. LJ 3 must be interpreted in accordance with the taxes covered by the double tax agreement, and a tax not authorised by the double tax agreement and consequently not covered by the agreement is not "foreign income tax" for the purposes of subpart LJ.

21. The question is whether the denial of the foreign tax credit on a pension from the US is the result of applying New Zealand's domestic tax legislation by itself, or in conjunction with the double tax agreement. If Inland Revenue's reasoning in the case of a UK pension is applied to an amount withheld from a US pension:

    (a) In the absence of a double tax agreement, the pension would be taxable in NZ and a foreign tax credit would be available for tax paid in the US;

    (b) Article 18(1)(a) restricts the US' entitlement to tax the pension, and therefore, amounts of tax withheld in the US are not in accordance with Article 18(1)(a) and are not "foreign income tax" under s. LJ 3;

(c) However, Article 18(1)(a) is not the only relevant article in the double tax agreement: Article 1(2) states that the double tax agreement is not to "restrict in any manner" a foreign tax credit available under New Zealand law;

(d) The question is whether the foreign tax credit is restricted under New Zealand law, as a result of applying Article 18(1)(a), or by the double tax agreement, and in the latter case the foreign tax credit should be allowed under Article 1(2);

(e) Rightly or wrongly, Inland Revenue is most likely to argue that the US tax is not "foreign income tax" under New Zealand domestic tax legislation, because the US is not allowed to tax the pension.

22. There are clearly some difficult interpretational issues involved, which are beyond the scope of this week's *Weekly Comment*. What can be said is that the foreign tax position in relation to pensions from the US is not as clear cut as in the UK case.

NZ tax resident US citizens deriving US pensions in NZ

23. The US reserves its right to tax its citizens as if the double tax agreement had not come into effect under Article 1(3), which states:

"Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and the United States may tax its citizens and United States companies, as if the Convention had not come into effect. …"

24. Therefore, if a US citizen who is a tax resident of New Zealand receives a pension from the US from which tax has been deducted, refunding that tax becomes a little more complicated. However, Article 1(4) provides, inter alia, that the US entitlement to tax its citizens under Article 1(3) does not effect the benefits conferred under Article 22 (Relief from Double Taxation).

25. In relation to whether NZ tax on a US pension derived by a US citizen who is tax resident in NZ can be credited against the US tax liability on the US pension, Article 22(3) & (4) state:

"For the purposes of computing United States tax, where a citizen of the United States or a United States company is a resident of New Zealand, the United States shall allow as a credit against United States tax the income tax paid to New Zealand …

"For the purpose of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:

(a) Income derived by a resident of the United States which may be taxed in New Zealand in accordance with this Convention shall be deemed to arise in New Zealand;

(b) Income derived by a resident of New Zealand which may be taxed in the United States in accordance with the Convention (other than income taxed by the United States solely because the beneficial owner is a citizen of the United States or a United States company) shall be deemed to arise in the United States;

(c) For purposes of paragraph 3, income beneficially owned by a resident of New Zealand who is a citizen of the United States or a United States company *shall be deemed to arise in New Zealand* to the extent necessary to give effect to the provisions of this paragraph." (emphasis added)

26. Article 22(4) of the NZ/US double tax agreement is mirrored in the *US Model Income Tax Convention of 15 November 2006* as follows:

    "Where a United States citizen is a resident of (New Zealand):

    (a) With respect to items of income that under the provisions of this Convention are exempt from United States tax or that are subject to a reduced rate of United States tax when derived by a resident of (New Zealand) who is not a United States citizen, (New Zealand) shall allow as a credit against (New Zealand) tax, only the tax paid, if any, that the United States may impose under the provisions of this Convention, other than taxes that may be imposed solely by reason of citizenship under the saving clause of paragraph 4 of Article 1 (General Scope);

    (b) For purposes of (calculating) United States tax on those items of income referred to in subparagraph a), the United States shall allow as a credit against United States tax the income tax paid to (New Zealand) … and

    (c) For the exclusive purpose of relieving double taxation in the United States under subparagraph b), *items of income referred to in subparagraph a) shall be deemed to arise in (New Zealand) to the extent necessary* to avoid double taxation of such income under subparagraph (b). (emphasis added)

27. A (non-social security) US pension derived by a NZ tax resident is exempt from US tax under Article 18(1)(a) of the double tax agreement. The pension is deemed to arise in New Zealand to give effect to Article 22. The US must give a tax credit for the NZ tax paid.

28. To use the US terminology, the US pension is "re-sourced" to New Zealand. The *United States Model Technical Explanation of November 15, 2006* states on page 75 that:

    "Since the income described in paragraph 4(a) generally will be U.S. source income, *special rules are required to re-source some of the income to the other Contracting State in order for the United States to be able to credit the tax paid to the other Contracting State. This resourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under paragraph 4(b)*. …" (emphasis added)

    " … (Article 22) is not subject to the saving clause of Article (1(3) – i.e. the US's right to tax its citizens). *Thus, the United States will allow a credit to its citizens and residents in accordance with the Article, even if such credit were to provide a benefit not available under the Code (such as the re-sourcing provided by paragraph 3* and subparagraph 4(c))." (emphasis added)

29. The US IRS states on its website page on "Foreign Tax Credit – Special Issues" that:

    (a) Tax treaties generally allow an additional credit for part of the tax imposed by the treaty partner on US source income;

    (b) This additional credit is separate from, and in addition to, the foreign tax credit for foreign taxes paid on foreign source income;

    (c) The treaty with NZ is included in the list of treaties that provide for this additional credit;

    (d) If a treaty provision allows a foreign tax credit for a specific tax that is not allowed by the Internal Revenue Code, the information must be reported with the tax return using Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).

30. US citizens in New Zealand who require more information, and the worksheet to figure the additional credit under the Australia and New Zealand treaties, should write to: Internal Revenue Service, Philadelphia, Pa 19255-0725.

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