INTERPRETATION STATEMENT: 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?

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

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Scope of this statement

1. There are two circumstances where a taxpayer may be entitled to claim a foreign tax credit against their New Zealand income tax liability for foreign tax paid:

   - if the foreign tax is covered by a Double Taxation Agreement (DTA), a credit may be allowed under, and in accordance with, the terms of that DTA; or
   - if the foreign tax is not covered by a DTA, a foreign tax credit may be allowed directly under subparts LJ or LK.

2. A tax **is** covered by a DTA if the tax is expressly listed in the DTA as one of the taxes covered, or if the DTA applies to subsequently enacted taxes that are identical or substantially similar to one of the taxes expressly covered. If a credit is allowed under the DTA, the amount of that credit will be calculated under subpart LJ of the Act. If a credit is not available under the DTA, then there will be no foreign tax credit relief. A list of countries or territories that have DTAs with New Zealand can be found on the Inland Revenue website at www.ird.govt.nz/international/residency/dta/.

3. A foreign tax is **not** covered by a DTA if:

   - New Zealand does not have a DTA with the foreign jurisdiction imposing the tax; or
   - there is a DTA between New Zealand and the foreign jurisdiction but the foreign tax is not a tax that the DTA applies to.

4. This Interpretation Statement only applies to taxes that are **not** covered by a DTA.

Introduction

5. If a taxpayer pays a foreign tax that is not covered by a DTA the taxpayer may be entitled to a tax credit under subpart LJ. One of the requirements for entitlement is that the foreign tax must be "income tax" as defined in s YA 2(5). This means the foreign tax must be:

   - a tax of substantially the same nature as income tax imposed under s BB 1, or
   - a tax of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT) or non-resident withholding tax (NRWT) and imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

6. This Interpretation Statement sets out the Commissioner's view of how s YA 2(5) should be interpreted and applied. It has three parts:

   - Part 1 – sets out the test of how s YA 2(5) should be interpreted and applied. It identifies the characteristics the Commissioner expects a foreign tax to have to be a tax of substantially the same nature as income tax imposed under s BB 1 or a tax of substantially the same nature as provisional tax, PAYE, RWT or NRWT.
   - Part 2 – contains the analysis that underpins the test. This part examines the relevant legislation and case law.

- Part 3 – applies the test to three foreign taxes to illustrate how the Commissioner will apply s YA 2(5). The three foreign taxes are:
  - Solomon Islands PAYE;
  - United States of America Federal Insurance contributions; and
  - United Kingdom National Insurance contributions.

7. The interpretation of s YA 2(5) is considered in the context of a claim for a foreign tax credit under subpart LJ. However, the interpretation will also be relevant to other subparts of Part L, such as subpart LK (Tax credits relating to attributed controlled foreign company income). To this extent, the conclusions in this item regarding s YA 2(5) apply equally to all relevant subparts of Part L.

Part 1 - the section YA 2(5) test

8. To qualify for a foreign tax credit under subpart LJ, a taxpayer must have paid foreign income tax on a segment of foreign-sourced income. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". The meaning of "income tax" in this context is varied by s YA 2(5). Section YA 2(5)(a) extends the definition of income tax to include taxes that are of substantially the same nature as income tax imposed under s BB 1. Section YA 2(5)(b) further extends the definition of income tax to include taxes that are of substantially the same nature as provisional tax, PAYE, RWT or NRWT and are imposed as a collection mechanism for a foreign tax. Under s YA 2(5)(b), the foreign tax being collected must be of substantially the same nature as income tax imposed under s BB 1. Section YA 2(5) applies to taxes imposed by state or local government, in addition to centrally imposed taxes.

9. The ordinary meaning of "substantially the same nature" suggests that the qualities or characteristics of the foreign tax must be significantly or essentially like the qualities or characteristics of income tax imposed under s BB 1. In the case of s YA 2(5)(b), this means the tax imposed must be significantly or essentially like provisional tax, PAYE, RWT or NRWT and be imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

10. Case law suggests that "substantially the same" requires sameness in substance or effect but not necessarily in form. It means the foreign tax imposed must be "in the main, for the greatest part and in substance" the same as New Zealand income tax. This is the standard against which the foreign tax is to be judged. The Commissioner's view is that the comparison must be between the nature of the foreign tax imposed and the nature of income tax imposed under s BB 1. This means focusing on the amount of foreign tax that has been paid, including how it is calculated, and comparing it to the nature of New Zealand income tax.

11. The Commissioner's view is that the nature of New Zealand income tax is determined at a high level. It requires an understanding of the fundamental features of New Zealand income tax rather than the detail. For this purpose, the nature of New Zealand income tax has been defined in paragraph 12 below.

12. A foreign tax is likely to satisfy the requirements of s YA 2(5) if the following conditions are met:

    The foreign tax must:

    - be compulsory and enforceable by law;
    - be imposed by, and payable to, a central, state, or local government;

- be intended for a public purpose (although it is generally irrelevant whether it is tagged for a specific public purpose);
- tax "income" as defined under the Act;
    - This condition will be satisfied even though there are minor differences between income taxed under s BB 1 and income taxed under the foreign tax.
- be calculated as a proportion of income;
    - The rate of the tax is not important.
    - Whether the tax is payable at a fixed rate or at graduated rates is not important.
    - This condition will still generally be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.
- be imposed on net income (gross income minus deductions) or taxable income (net income minus losses).
    - A taxing method designed to produce a reasonable approximation of actual net/taxable income may be acceptable.
    - Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.

The foreign tax must not be:

- A penalty.
- A payment of interest.
- A service charge or licence fee.
- A payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).

The following factors are not determinative:

- Whether the tax rate is set by an annual taxing Act.
- Whether the tax is imposed under separate legislation from the principal taxing legislation.
- The name given to the tax.

Taxes that do not satisfy the s YA 2(5) test:

- The following are examples of taxes that are not of the same nature as income tax imposed under s BB 1. Accordingly, they do not satisfy the s YA 2(5) test:
    - Goods and services taxes and value added taxes.
    - Customs or import duties.
    - Insurance levies.
    - Gift taxes.
    - Property rates.
    - Asset taxes.

- Wealth taxes.
- Inheritance taxes and estate duties.
- Excise taxes and duties.

13. The onus is on the taxpayer to demonstrate that the foreign tax is eligible for a foreign tax credit.

Foreign tax refunds

14. A person must make an adjustment if they receive a refund of foreign income tax.

15. If the person receives the refund before they have self-assessed, the amount of the foreign tax credit will be 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)).

16. If the person receives the refund after they have self-assessed, the person must pay to 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)). In these circumstances, the date for payment is 30 days after the later of:

    - the date the person received the refund, or
    - the date of the notice of assessment in which the person used the credit (s LJ 7(4)).

Part 2 - Analysis

17. This part of the Interpretation Statement provides the analysis that supports the test outlined in Part 1. This Part considers:

    - the legislative framework of subpart LJ;
    - the following key terms and phrases:
        - "tax";
        - "income tax imposed under section BB 1"; and
        - "of substantially the same nature"; and
    - case law that compares a foreign tax to income tax.

Legislative framework – subpart LJ

18. A New Zealand resident who derives foreign-sourced income that is subject to New Zealand income tax may be entitled to a tax credit for any foreign income tax paid on that income (ss LJ 1(2) and LJ 2(1)).

19. Subpart LJ sets out the process for claiming tax credits where foreign income tax has been paid. It does this in two steps. First, it provides the method for dividing foreign-sourced income into segments. It then allows a tax credit for foreign income tax paid on each segment of that foreign-sourced income (s LJ 1). No credit will be allowed for any unrecognised taxes specified in sch 27 (s LJ 1(2)(b) (there are currently none listed)).

20. Credits are calculated on the basis of income segments. A tax credit is available for foreign income tax paid on each segment of foreign-sourced income. (There are special rules for amounts derived from an attributing interest in a foreign investment fund – ss LJ 2(6) and (7).) Section LJ 4 defines "segment of foreign-sourced income" as follows:

> 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.

21. The number of credits a taxpayer gets will depend on the number of foreign countries and the sources or the nature of the income derived (ss LJ 2(1) and LJ 4).

22. To attract a foreign tax credit, foreign income tax must have been paid on the segment of foreign-sourced income. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". "Income tax" is defined in s YA 1 to mean "…income tax imposed under section BB 1 (Imposition of income tax) except to the extent to which it has a different meaning under section YA 2 (Meaning of income tax varied)". Section YA 2(5) modifies the meaning of "income tax" when it is used in this context. It provides:

> *Tax of other countries*
>
> (5) The term **income tax**, when specifically used in relation to tax of another country, whether imposed by a central, state, or local government,—
>
> (a) means a tax of substantially the same nature as income tax imposed under section BB 1 (Imposition of income tax); and
>
> (b) includes a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT), or non-resident withholding tax (NRWT).

23. Section LJ 5 explains how to calculate the amount of New Zealand income tax payable on each segment of foreign-sourced income. This calculation is necessary because the credit cannot be more than the amount of New Zealand income tax payable on that segment of foreign-sourced income (s LJ 2(2)).

24. Therefore, to qualify for a tax credit, a taxpayer must:

- be resident in New Zealand;
- have derived assessable income sourced from outside New Zealand; and
- have paid foreign tax on that income.

25. Further, the foreign tax paid must be a tax of substantially the same nature as income tax imposed under s BB 1. Alternatively, the foreign tax could be a tax that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, provided it is imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

26. The focus of the inquiry is on the nature of the foreign tax paid. In the Commissioner's view, s YA 2(5) requires a comparison between the nature of the foreign tax imposed on the amount of income, including how it is calculated, and the nature of income tax imposed under s BB 1. This means focusing on the characteristics of the foreign tax paid.

27. Certain taxes are not of substantially the same nature as "income tax imposed under s BB 1" for comparative purposes. "Ancillary tax" (defined in s YA 1 to include taxes such as fringe benefit tax, qualifying company election tax and withdrawal tax) is not included because it is not imposed on taxable income. Penalties and interest are also excluded from the definition of "income tax".

28. It is the meaning of the phrase "a tax of substantially the same nature as income tax" that is the subject of the following analysis. The effect of s YA 2(5)(b), and how it extends the meaning of income tax in s YA 2(5)(a), is also considered.

Meaning of "tax"

Introduction

29. To satisfy s YA 2(5), a taxpayer must prove that the foreign tax paid on a segment of foreign-sourced income is either a tax of substantially the same nature as income tax imposed under s BB 1 or a tax imposed as a collection mechanism for a foreign tax that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT.

30. The first step in this analysis is to establish that the foreign tax is a "tax" and not some other form of payment or charge. By definition, all "income tax" must first be a "tax". The paragraphs below discuss the meaning of the word "tax".

Legislation

31. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". Income tax in this context is varied by s YA 2(5)(a) to mean "**a tax** of substantially the same nature as income tax imposed under section BB 1". Section YA 2(5)(b) extends the meaning to include "**a tax**" that satisfies that subparagraph.

32. Section YA 1 defines "tax" as follows:

> **tax** means income tax, but in the provisions in which the term "income tax" has an extended or limited meaning, "tax" has a corresponding meaning

33. This definition is not helpful in determining what characteristics are necessary for a charge to be a "tax".

Ordinary meaning

34. "Tax" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011), to mean:

> **Tax ▸ n. 1** a compulsory contribution to state revenue, levied by the government on personal income and business profits or added to the cost of some goods, services, and transactions.

35. This definition is consistent with the case law discussed below.

Case Law

New Zealand

36. In *Case 37* (1967) 3 NZTBR 442, a taxpayer received an Indian army pension from the United Kingdom Government. Each year, an amount was deducted from the pension as "Indian Military Widows' and Orphans' Fund subscriptions". The taxpayer argued this deduction should be allowed as a credit because it was equivalent to New Zealand social security income tax. The Taxation Board of Review (the board) applied the definition of "tax" from the Australian decision of *Leake v C of T* (1934) 36 WALR 66 (WASC) (discussed below at para [53]). At 447:

> The outstanding characteristic of a tax is, as Dwyer J. observed in *Leake's* case (*supra),* "that it is a compulsory contribution, imposed by the sovereign authority on, and required from, the general body of subjects or citizens, as distinguished from isolated levies on individuals".

37. The board held that no credit was permitted as the contribution was not a tax. The contribution was imposed by a private mutual insurance institution to provide pensions for widows and dependants. It was not imposed by the sovereign authority and required from the general body of citizens.

38. In *Haliburton & Ors v Broadcasting Commission* (CA 14-99, 15 July 1999), the Court of Appeal considered whether the public broadcasting fee contravened s 22 of the Constitution Act 1986. Section 22 states that it shall not be lawful for the Crown to levy a tax, except by or under an Act of Parliament. The appellants argued that the broadcasting fee was a tax and because it was imposed by the Broadcasting Commission it was not levied by or under an Act of Parliament.

39. The court said that a tax is:

- a compulsory contribution,
- to support government,
- made under state authority,
- made for a public purpose, and
- not a service charge or a licence fee.

40. The court assumed the public broadcasting fee was a tax within the meaning of s 22 and concluded that the fee was imposed by or under an Act of Parliament. (See also: *Carter Holt Harvey Ltd v North Shore City Council* [2006] 2 NZLR 787 (HC) and *Warnock v Director-General of Social Welfare* [2004] NZAR 274 (HC).)

Australia

41. Many of the key Australian decisions on whether a particular payment is a tax arise in the context of Australian constitutional law. While the constitutional context is quite different from the taxation context, the questions - "what is a tax?" or "what is a law imposing taxation?" - do not appear to have any special constitutional meaning that might limit their application. The inquiry is ultimately about the ordinary meaning of the word "tax".

<u>Constitutional case law</u>

42. In *R v Barger* (1908) 6 CLR 41 (HCA), the Australian High Court was asked to decide whether a particular excise tariff was a tax. The tariff was imposed only on those goods manufactured by companies that did not pay reasonable wages to their workers.

43. The court held that the tariff was a tax. Isaacs J, in a dissenting judgment, stated (at 99) that the true test of whether an Act is a taxing Act is:

> Is the money demanded as a contribution to revenue irrespective of any legality or illegality in the circumstances upon which the liability depends, or is it claimed as solely a penalty for an unlawful act or omission, other than non-payment of or incidental to a tax?
>
> It is not sufficient to say the effect is the same. It may even be the very purpose of the federal taxing authority to drive the taxed object out of existence; but as the power to tax includes the power "to embarrass or to destroy," neither the purpose nor the effect is an objection to the exercise of the power.

44. Despite Isaacs J's judgment being a dissenting one, *Barger* is considered authority for the proposition that a penalty cannot be a tax. (See also *FCT v Clyne* (1958) 100 CLR 246 (HCA) and *MacCormick v FCT* (1984) 158 CLR 622 (HCA).)

45. *Matthews v Chicory Marketing Board* (VIC) (1938) 60 CLR 263 (HCA) is considered the leading Australian authority on the meaning of "tax". The Australian High Court held that a levy, imposed on chicory producers at the rate of £1 for every ½ acre of chicory planted, was a tax. Latham CJ, in a minority judgment, set out what is now considered the "classic" definition of a tax, at 276:

> The levy is, in my opinion, plainly a tax. It is a compulsory exaction of money by a public authority for public purposes, enforceable by law, and is not a payment for services rendered.

46. The issue in *Air Caledonie International v Commonwealth of Australia* (1988) 165 CLR 462 (HCA) was whether a fee imposed for immigration clearance was a tax. The court's starting point was the definition of tax from *Chicory.* However, the court stated that *Chicory* should not be seen as providing an exhaustive definition of tax. For example, it might not be necessary for a tax to be a compulsory exaction of money, by a public authority, for a public purpose.

47. The court also considered the relationship between a tax and a fee for services. The court explained that a payment is unlikely to be a fee for services where it is compulsory and there is no discernible relationship with the value of what is acquired. The court then went on to hold that the immigration clearance fee was a tax. This case has been referred to in several New Zealand decisions. (See for example, *Air New Zealand Ltd v Wellington International Airport Ltd* [2009] NZCA 259, [2009] 3 NZLR 713 and *Warnock*.)

48. In *Australian Tape Manufacturers Association v Commonwealth of Australia* (1993) 176 CLR 480 (HCA) the issue was whether a royalty imposed on blank tapes was a tax. The royalty was paid to a collecting society. The collecting society would then distribute the funds by way of a royalty to copyright owners. (This was an attempt by the Australian Government to deal with the widespread problem of unauthorised copying of sound recordings onto blank tapes.) The Australian High Court held the levy was a tax. It asserted that it is not essential to the concept of a tax that the exaction should be by a public authority. The court also decided the fact the levy was paid to a society rather than into the consolidated fund did not stop it from being for a public purpose. This is because Parliament has the power to authorise a statutory authority to levy a tax.

49. The issue in *Roy Morgan Research Pty Ltd v FCT & Anor* [2011] HCA 35, [2011] ATC ¶20,282 was whether a superannuation guarantee charge (SGC) was a tax. If an employer failed to provide all employees with a minimum level of superannuation, then any shortfall became the SGC. The SGC was to act as an incentive to employers to make superannuation contributions for their employees. The revenue raised by the SGC was paid into the consolidated revenue fund.

50. The court held that the SGC was a tax. The fact that the SGC was paid into the consolidated revenue fund established that the SGC was imposed for a public purpose.

General cases

51. In addition to the constitutional cases, there are also some general Australian cases that have considered the meaning of tax.

52. In *Morris Leventhal & Ors v David Jones Ltd* (1930) AC 259 (PC), the Privy Council was asked to determine whether a "bridge tax" was a land tax. The bridge tax was imposed on the unimproved value of land in Sydney and used to

fund the building of the Sydney Harbour Bridge. The Privy Council held that a charge will be a tax even if it is imposed on a specified class of property or persons, and even if it is imposed for a specific purpose.

53. In *Leake v C of T,* the Supreme Court confirmed that a hospital fund contribution was a tax. This contribution was collected by the Commissioner of Taxation and paid into an account at the Treasury. Every person who earned income, salary or wages was required to pay it. The contributions collected were then used to fund public hospitals.

54. The Commissioner argued the levy was not a tax because it was raised for a special purpose: to support the hospital fund. It was not raised as part of the general revenue of the Crown.

55. The court held that the contribution was a tax. The court confirmed that a charge can be a tax even if it is not called a tax. It identified the key distinguishing features of a tax:

- A tax is a compulsory contribution.
- A tax is imposed by the sovereign authority.
- A tax is imposed on, and required from, the general body of citizens.
- A tax can be distinguished from isolated levies on individuals.

56. The court also confirmed that particular fees, local assessments and tolls are not taxes. Furthermore, the court noted the charge did not need to be paid into the consolidated revenue fund for it to be a tax.

Canada

57. As with the Australian authorities, the leading Canadian cases on whether a particular payment is a tax have arisen in the context of constitutional challenges to the legality of particular charges. The leading authority in this area is *Lawson v Interior Tree Fruit and Vegetable Committee of Direction & The Attorney General of Canada* [1931] SCR 357. This case was referred to in the Australian cases of *Chicory* and *Roy Morgan.*

58. In *Lawson,* the Interior Tree Fruit and Vegetable Committee of Direction was given exclusive power to control and regulate the marketing of all tree fruit and vegetables under the Produce Marketing Act. The Committee imposed licence fees and levies to recover their costs. The Supreme Court held the fees charged were taxes. Duff J said that a charge is properly classified as a tax if four criteria are met:

- The charge is enforceable by law.
- The charge is imposed under authority of the legislature.
- The charge is levied by a public body.
- The charge is made for a public purpose.

59. On the issue of "public purpose", Duff J noted at 363:

> The levy is also made for a public purpose. When such compulsory, not to say dictatorial, powers are vested in such a body by the legislature, the purposes for which they are given are conclusively presumed to be public purposes.

60. So even though it was the Committee imposing the tax, it did so because it was empowered by the legislature. Therefore, the purpose of the tax is automatically considered to be for a public purpose.

61. The Supreme Court in *Eurig Estate (Re)* [1998] 2 SCR 565 applied *Lawson* when it held that Ontario's probate levy was a tax and not a fee. The court made the following distinction between a service fee and a tax, at 579:

> In determining whether that nexus exists, courts will not insist that fees correspond precisely to the cost of the relevant service. As long as a reasonable connection is shown between the cost of the service provided and the amount charged, that will suffice. The evidence in this appeal fails to disclose any correlation between the amount charged for grants of letters probate and the cost of providing that service. The Agreed Statement of Facts clearly shows that the procedures involved in granting letters probate do not vary with the value of the estate. Although the cost of granting letters probate bears no relation to the value of an estate, the probate levy varies directly with the value of the estate. The result is the absence of a nexus between the levy and the cost of the service, which indicates that the levy is a tax and not a fee.

(See also: the Privy Council decision in *Lower Mainland Dairy Products Sales Adjustment Committee* v *Crystal Dairy Limited* [1933] AC 168 (PC), and *Westbank First Nation* v *British Columbia Hydro and Power Authority* [1999] 3 SCR 134.)

Conclusion on meaning of "tax"

62. The ordinary meaning of tax is a compulsory contribution to government revenue, levied by the government on a person's income or business profits or added to the cost of goods, services or transactions.

63. More specifically, a tax is:

- a compulsory contribution or exaction (*Haliburton, Chicory, Leake*);
- imposed on and required from the general body of citizens (*Leake*);
- levied to support government (*Haliburton, Barger*);
  - but an impost need not be paid into the consolidated revenue fund for it to be a tax (*Leake, Eurig, Australian Tape Manufacturers*);
- levied for a public purpose (*Haliburton, Chicory, Lawson);*
  - there is some overlap between public purpose and State authority (*Australian Tape Manufacturers*);
  - if an impost is paid into the consolidated revenue fund then this will establish a public purpose *(Roy Morgan);*
- 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);*
- enforceable by law (*Chicory, Lawson*).

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

- imposed on a specified class of property or persons (*Morris Leventhal*),
- imposed for a specific purpose (*Morris Leventhal*),
- not called a tax (*Leake*).

65. The following are not taxes:

- A service charge or licence fee (*Haliburton, Chicory).*
  - A tax can be distinguished from isolated levies on individuals (*Leake*).
  - A payment will not be a service charge where there is no correlation between the amount charged and the cost of providing the service (*Eurig*).
  - However, if a person has no choice whether to acquire the services or the amount of the charge has no discernible relationship with the value of what is acquired, then it may be a tax (*Air Caledonie*).
- A payment imposed as a penalty (*Barger).*

66. In conclusion, a foreign charge that bears all the features at para [63] above will be a "tax" for the purposes of s YA 2(5). A foreign charge that bears some of these features may also be a "tax". If the foreign charge is a service charge or a licence fee or if it is imposed as a penalty, then it will not be a "tax".

67. As well as being a "tax", the foreign charge paid must be of substantially the same nature as income tax imposed under s BB 1 or of substantially the same nature as provisional tax, PAYE, RWT or NRWT and be a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1. This factor is considered next.

Meaning of "income tax imposed under section BB 1"

Introduction

68. Section YA 2(5)(a) requires that the foreign tax must be of substantially the same nature as income tax imposed under s BB 1. Section YA 2(5)(b) extends the meaning of foreign tax to include a tax that is of substantially the same nature as provisional tax, PAYE, RWT, or NRWT provided it is imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1. The following paragraphs will consider what is meant by "income tax imposed under section BB 1". The item will then consider how the phrase "of substantially the same nature" modifies the s BB 1 definition of "income tax", at paras [83]–[108].

Legislation

69. There is no exhaustive definition of income tax in the Act. However, s YA 1 provides a broad definition of income tax. Section YA 1 states:

> **Income tax** means income tax imposed under section BB 1 (Imposition of income tax) except to the extent to which it has a different meaning under section YA 2 (Meaning of income tax varied)

70. Section BB 1 is the key charging provision in the Act. It provides that:

> **BB 1 Imposition of income tax**
>
> Income tax is imposed on taxable income, at the rate or rates of tax fixed by an annual taxing Act, and is payable to the Crown under this Act and the Tax Administration Act 1994.

71. Section BB 1 therefore identifies three key characteristics of income tax:

- Income tax is imposed on taxable income.
- Income tax is imposed at the rate or rates of tax fixed by an annual taxing Act.

- Income tax is payable to the Crown.

Imposed on taxable income

72. Section BB 1 "imposes" income tax on "taxable income". "Impose" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) to mean:

> **Impose** ▸ v. **1** force to be accepted, done, or complied with.

73. This shows that income tax is a compulsory payment.

74. "Taxable income" is defined in s YA 1 to mean: "taxable income for a tax year calculated under section BC 5 (Taxable income)". Section BC 5 states:

> **BC 5 Taxable income**
>
> A person's **taxable income** for a tax year is determined by subtracting any available tax loss that the person has from their net income under Part I (Treatment of tax losses).

75. The requirement that income tax be imposed on taxable income suggests a tax that taxes gross income will not fall within the definition of income tax. Income tax must be imposed on taxable income (gross income less deductions and losses).

76. It could be argued that PAYE is essentially a tax on gross income as no deductions are generally allowed because of the employment limitation (s DA 2(4)). Similar arguments could be made for RWT and NRWT in some circumstances. However, s YA 2(5)(b) expressly includes as "income tax" 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.

77. The tax must also tax "income". Part C of the Act defines income. Section CA 1 states that an amount is "income" if it is income under a provision in Part C or if it is income under ordinary concepts.

78. The Act taxes income from both labour (eg salary and wages) and capital investment (eg dividends and interest).

Rate or rates fixed by an annual taxing Act

79. Section BB 1 provides that income tax is imposed on taxable income "at the rate or rates of tax fixed by an annual taxing Act".

80. The use of the words "rate or rates" indicates that income tax can be imposed at different rates depending on the entity or person being taxed (eg corporate tax rate or personal tax rate). The words also allow income tax to be imposed at a flat rate or at graduated rates.

Payable to the Crown

81. Section BB 1 states that income tax is payable to the Crown. In the New Zealand context, the Crown is the New Zealand government. If a tax is paid to a private company or organisation, for example, then it will not be income tax imposed under s BB 1.

Conclusion on the meaning of "income tax imposed under section BB 1"

82. Section BB 1 identifies the following characteristics of New Zealand income tax:
    - Income tax is compulsory.
    - Income tax is imposed on taxable income, not gross income.

- Income tax only taxes "income" as defined in Part C.
- Income tax can be imposed at either a flat or graduated rate.
- Income tax can be imposed at different rates depending on the person or entity being taxed.
- The rate of income tax is fixed by an Act on an annual basis.
- Income tax is payable to the Crown.

Section YA 2(5): Meaning of "of substantially the same nature"

Introduction

83. Having determined the characteristics of income tax imposed under s BB 1, the following paragraphs consider how s YA 2(5) modifies the s BB 1 definition of income tax.

Legislation

84. Section YA 1 defines "income tax" to mean income tax imposed under s BB 1, except to the extent to which it has a different meaning under s YA 2. This means that, in certain circumstances, s YA 2 modifies the definition of "income tax" in s BB 1. Of relevance in the current context is s YA 2(5), which modifies the s BB 1 definition of "income tax" when that phrase is used in relation to "tax of another country".

Imposed by a central, state or local government

85. Section YA 2(5) applies where the tax has been imposed by a central, state or local government. This therefore modifies the definition of income tax under s BB 1, which requires that income tax be "payable to the Crown". When the term "income tax" is used in relation to tax of another country, it includes taxes imposed by a central, state or local government.

Of substantially the same nature

86. Section YA 2(5)(a) extends the concept of income tax to a foreign tax of "substantially the same nature" as income tax imposed under s BB 1. Section YA 2(5)(b) also extends the concept of income tax to a foreign tax that is of "substantially the same nature" as provisional tax, PAYE, RWT or NRWT, provided the tax is imposed as a collection mechanism for the foreign tax. The Commissioner considers that the reference to "the foreign tax" in s YA 2(5)(b) refers back to the tax described in s YA 2(5)(a). This means that under s YA 2(5)(b) the foreign tax being collected by one of the listed collection mechanism taxes (that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT) must itself be a tax of "substantially the same nature" as income tax imposed under s BB 1.

87. It is therefore important to understand what is meant by "of substantially the same nature". This is the standard against which the foreign tax must be judged.

Ordinary Meaning

Of substantially the same nature

88. As the phrase "of substantially the same nature" does not appear to have any specific legal or technical meaning, it is useful to consider the ordinary meaning.

89. The terms "substantially", "same" and "nature" are relevantly defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011), to mean:

> **Substantially ▶ adv. 1** to a great or significant extent. **2.** for the most part; essentially.
>
> **Same ▶ adj. 1** identical; unchanged.
>
> **Nature ▶ 2**. the basic or inherent features, qualities, or characteristics

90. Combining these definitions, "of substantially the same nature as income tax imposed under section BB 1" means that the qualities or characteristics of the foreign tax must be significantly or essentially like the qualities or characteristics of income tax imposed under s BB 1. In the case of s YA 2(5)(b), this means that a tax imposed as a collection mechanism for the foreign tax must be significantly or essentially like provisional tax, PAYE, RWT or NRWT.

Case Law

Of substantially the same nature

91. There are only two New Zealand cases that consider the application of s YA 2(5).

92. In *Case 37* (discussed above at para [36]), a taxpayer received an Indian army pension from the United Kingdom Government. Each year, an amount was deducted from the pension as "Indian Military Widows' and Orphans' Fund subscriptions". The taxpayer argued this deduction should be allowed as a credit under s 170 of the Land and Income Tax Act 1954 (the s YA 2(5)(a) equivalent), as this deduction was substantially of the same nature as New Zealand social security income tax. (The earlier Acts phrased the test "substantially of the same nature" rather than "of substantially the same nature".) At the relevant time, New Zealand social security income tax fell within the definition of income tax in s 170.

93. The board held that the Fund did not "bear any comparable relationship with this country's social security scheme". The main reason for this finding appears to be that New Zealand social security benefits were paid out of the consolidated revenue account from money appropriated by Parliament. By contrast, the Fund was a private mutual insurance institution that existed solely for the provision of pensions for widows and orphans.

94. The board also had regard to other differences between the Fund and New Zealand social security. At 447:

> Counsel for the respondent, in comparing the New Zealand social security scheme with the Fund to which the appellant contributed, referred to various points of distinction, among them being: that whereas, in this country, benefits might become payable to a person who was neither a taxpayer nor a dependant of a taxpayer, the rules of the Fund expressly provided for contributions and payments to be made by a limited class of persons and for pensions to be paid to beneficiaries claiming through those persons; that the obligation of a contributor to the Fund to make payments thereto was a continuing one from which he was not relieved even if he was not in receipt of pay (R 8); and that the rules of the Fund provided for subscriptions to be refunded under certain circumstances (R 13). A study of the Rules of the Fund discloses many more differences between them and the provisions of the New Zealand social security legislation.

95. The board considered whether the contribution was a tax, in the general sense of the word, by looking to the ordinary meaning and case law, including the Australian decision in *Leake*. The board concluded that the contribution to the

Fund was not a tax because it was a private institution that existed for the provision of pensions to a restricted class of persons.

96. *Case F11* (1983) 6 NZTC 59,613 also considers the meaning of "substantially of the same nature as income tax" in s 293 of the Income Tax Act 1976 (the s YA 2(5) equivalent). In *Case F11,* the taxpayer had spent a year working in the United Kingdom. During that time, she paid United Kingdom income tax and made national insurance (NI) contributions. Both were compulsory payments deducted at source. The taxpayer was granted a tax credit for United Kingdom income tax, but not for the NI contributions. The issue for the authority was whether the NI contributions were substantially of the same nature as New Zealand income tax.

97. The taxpayer argued that NI was just another way of collecting income tax. New Zealand imposes a single tax to fund both general and social security services. The United Kingdom imposes a separate tax to fund social security services. The taxpayer submitted that to regard one method of collection as income tax and not the other was semantics and not in the interests of justice.

98. The authority found for the Commissioner. Judge Barber held the taxpayer had not discharged the onus of proof. However, he noted the taxpayer would not have been able to in any event, as the nature of NI was far narrower than the nature of income tax. (Although he did acknowledge that the issue was not argued before him in any detail.) Therefore, *Case F11* is authority for the proposition that NI is not "substantially of the same nature as income tax". (NI is considered in more detail in example 3, at para [214] below.)

Substantially the same

99. The meaning of "substantially the same" was considered by the Employment Court in *National Distribution Union Inc v General Distributors Ltd* [2007] ERNZ 120 (EmpC). While the context was quite different, the Employment Court had to determine the ordinary meaning of the phrase "substantially the same". On this basis, the analysis is potentially useful.

100. Section 59B of the Employment Relations Act 2000 states that it is not a breach of the duty of good faith for an employer to pass on to a non-union employee a term that is the same or substantially the same as a term in the collective employment agreement, unless the employer does so with the intention and effect of undermining the collective agreement.

101. The Union argued that the employer, General Distributors, passed on a pay rise term that was substantially the same as a pay rise term in the collective agreement with the intention and effect of undermining the collective agreement. It was accepted that the pay rise was not exactly the same, so the question for the court was whether the pay rise was "substantially the same".

102. The court accepted that "substantially the same" requires sameness in substance or effect but not necessarily in form. In the current context, this might mean that a foreign tax is still a tax of "substantially the same" nature as income tax under s BB 1 if it taxes an amount also taxed under the Act, but in a different way or using a different method. The taxing effect is the same, but the form or method of taxing is different.

103. The Employment Court also said:

> [97] Mr Langton addressed judicial interpretations of the word substantially, and referred us to the 2005 Supplement to *Words and Phrases Legally Defined* and, in relation to the phrase in Australia "including a child who is being wholly or substantially maintained by a person". The text notes:

> In the present context the word "substantially" appears in contrast to the word "wholly" but forms a phrase with it. If "substantially" bore the meaning … something more than merely incidental, there would have been no need at all for the word "wholly" to have appeared. It is the word "wholly" that gives context here to the word "substantially". In the context, … the word means something less than "wholly" but more than merely "insubstantial" or "insignificant" and is appropriately paraphrased by the word "in the main" or "as to the greater part".

> [98] So, Mr Langton submitted, "in the main", "for the greatest part" and "in substance", the wage increases agreed with non-union employees must be the same to come within the definition of "substantially the same" in s 59B(1).
>
> …
>
> [102] Mr Langton accepted that whether the terms were "substantially the same" depends on how the Court interprets that phrase. Counsel submitted that the Legislature must have intended it to be something more than "similar" and more than "substantially similar", otherwise it would have used these words or phrases. GDL says that the word "same" has been deliberately qualified by the adjective "substantially".
>
> [103] On the issue of what amounts to substantial sameness, we prefer Mr Langton's submissions to Mr Fleming's. It is common ground that the wage increases given to the non-union employees were not the same and the issue is whether they were substantially the same. It seems to us that the more appropriate adjectives to describe a comparison of the collective and individual wage increases would be similar or even substantially similar. But, as Mr Langton emphasised, Parliament has stipulated for the higher or more precise standard of sameness, whether on its own or, as is in issue here, qualified by the adjective "substantial". That connotes a higher degree of identity than the plaintiff contends for and the evidence exhibits.

104. The court decided that "substantially the same" must mean more than "substantially similar". It is a higher and more precise standard.

105. Applying this decision to s YA 2(5)(a), when comparing a foreign tax to New Zealand income tax it is the substance or effect of the tax that must be examined, not the form of the tax. The substance or effect of the tax must be "in the main, for the greatest part and in substance" the same as New Zealand income tax. This analysis would be the same for s YA 2(5)(b). When comparing a tax imposed as a collection mechanism for the foreign tax, the substance or effect of the tax must be "in the main, for the greatest part and in substance" like provisional tax, PAYE, RWT or NRWT.

Conclusion on the meaning of "substantially the same nature"

106. When the term "income tax" is used in relation to a foreign tax, its meaning is modified by s YA 2(5) in the following way:

- Income tax may be imposed by a central, state or local government; and
- Income tax means:
  - a tax that is of substantially the same nature as income tax imposed under s BB 1; or
  - a tax imposed as a collection mechanism for the foreign tax that is of substantially the same nature as provisional tax, PAYE, RWT and NRWT, provided the foreign tax being collected is of substantially the same nature as income tax imposed under s BB 1.

107. The ordinary meaning of "substantially the same nature as income tax imposed under s BB 1" suggests that the qualities or characteristics of the foreign tax must be significantly or essentially like income tax imposed under s BB 1. In the case of s YA 2(5)(b), this means the tax imposed as a collection mechanism

for the foreign tax must be significantly or essentially like provisional tax, PAYE, RWT or NRWT.

108. The case law also identified some features of a tax that could be compared when trying to determine whether a foreign tax is of substantially the same nature as New Zealand income tax. *Case 37* was decided at a time when income tax was divided into two parts, income tax and social security income tax. Consequently, some of the features of income tax in that case are different to the current New Zealand income tax legislation. However, the decision is still useful as it shows how a New Zealand court has approached the "substantially of the same nature" test when comparing a foreign tax to a New Zealand tax (in that case, social security income tax). In *Case 37,* the fact that the Fund was a private institution that existed for the provision of pensions to a restricted class of persons meant that it was not substantially of the same nature as New Zealand social security income tax. New Zealand social security income tax provided benefits from the consolidated revenue account to a wider class of persons.

109. The decision in *National Distribution Union* suggests that "substantially the same" requires sameness in substance or effect but not necessarily in form. Applied in the current context, 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. The case also notes that "substantially the same" is a higher, more stringent test than "substantially similar". The foreign tax must be "in the main, for the greatest part and in substance" of the same nature as New Zealand income tax. This analysis would apply equally to s YA 2(5)(b).

Case law comparing foreign taxes to income tax

110. As there is limited New Zealand case law that considers whether a foreign tax is of "substantially the same nature" as income tax imposed under s BB 1, it is useful to refer to cases from other areas of law and from other jurisdictions. The following cases are examples of where the courts have had to decide whether a particular charge is an "income tax" or is sufficiently similar to a particular income tax.

111. It is important to note that all these cases apply a different standard of comparison to the standard set out in s YA 2(5) of "substantially the same". However, the decisions are useful as they show how the courts have approached the task of comparing taxes.

New Zealand

112. The New Zealand courts have not directly considered the meaning of "income tax" in a taxation context. However, there are three cases that have considered whether New Zealand social security contributions, unemployment relief tax and national security tax could be considered income taxes for the purposes of paying out annuities under a will. Care needs to be taken when applying decisions in different contexts. However, the Australian courts have applied two of the cases in determining whether to grant a foreign tax exemption under the Australian equivalent of s YA 2(5) (although the Australian section is worded differently). See, for example, *Case R68* 84 ATC 482 and *Case S52* 85 ATC 388. The focus in these cases is the ordinary meaning of income tax. Therefore, the New Zealand cases are potentially relevant.

113. *In re Richards (Deceased), Richards v Richards* [1935] NZLR 909 (SC) concerned a testator who granted an annuity "to be paid clear and free from all deductions whatsoever and free of all duties and taxes". The issue was

whether the annuity should be paid free of the unemployment relief tax, ie whether the estate should provide additional funds to meet the unemployment relief tax (the precursor to the social security contribution).

114. Northcroft J held that the reference "to be paid clear and free from all deductions whatsoever and free of all duties and taxes" was wide enough to include income tax. Northcroft J further held that the unemployment relief tax was "of the character of income tax" as it was calculated by reference to the income of the taxpayer and assessed in the same way as income tax. Therefore, the annuity should be paid free of the unemployment relief tax.

115. *Re Hirst, Public Trustee v Hirst* [1941] 3 All ER 466 (Ch) is a United Kingdom High Court decision. However, because the issue was whether the New Zealand social security contribution (SSC) was an income tax, it has been grouped with the New Zealand cases.

116. In *Hirst,* an English testator left annuities to two New Zealand relatives. The annuities were to be paid "clear of all deductions whatsoever…" including "…income tax at the current rate deductible at source or payable in New Zealand". The issue was whether the New Zealand SSC was an income tax and whether the annuities were to be paid free of that tax.

117. The court held that the SSC could not properly be described as income tax. It was a separate tax (from income tax) imposed by separate legislation. This meant it could not be income tax. In reaching this decision the court was influenced by the language of the Social Security Act 1938. That Act stated that the SSC should be administered "as if it were income tax". According to Morton J, this indicated the contribution was not an income tax.

118. Despite concluding the SSC was not an income tax, the court nevertheless found it sufficiently resembled income tax in the way it was assessed, collected and recovered. For this reason it was decided the annuities should be paid free of the SSC.

119. The same issue came before the New Zealand Court of Appeal in *In Re Paterson (Deceased), Rennick v Guardian Trust and Executors Co of NZ Ltd* [1944] NZLR 104 (CA). Applying *Hirst,* the court held that New Zealand SSC and national security tax were not income taxes. However, they were of the character of income tax so the annuity in question should be paid free of these taxes.

120. Myers CJ concluded that only income tax imposed under the Land and Income Tax Act 1923 could be considered income tax. He observed that a tax might be a tax on income, but that will not be enough to make it an income tax as that term is ordinarily understood.

121. Myers CJ agreed with Northcroft J in *Richards* that the SSC, while not an income tax, was of the character of income tax. It was calculated by reference to the income of the taxpayer and was a charge on that income. However, it could not properly be described as income tax.

122. *Hirst* and *Paterson* are authority for the view that if a tax is separate from the main income tax and imposed under a separate Act from the main income tax Act, then it will not be an income tax. This is the case even if the tax is assessed and collected in the same way as the main income tax. However, it is noted that these cases were considering whether a tax **was** income tax, not whether the tax was **of substantially the same nature as** income tax. In the Commissioner's opinion, whether a tax is contained within the income tax Act of a foreign country is not a helpful question in determining whether a

foreign tax is sufficiently like New Zealand income tax. It is the nature and characteristics of the tax imposed that are relevant.

Australia

General case law

123. The facts in *de Romero v Read* (1932) 48 CLR 649 (HCA) were that, under a deed of separation, Mr R agreed to pay his wife a clear annual sum "free from all State income tax".

124. Evatt J, in his dissenting judgment, considered whether the unemployment relief tax (a social security tax) was included in the expression "all State income tax". (The other judges did not have to decide this question.)

125. Evatt J held that the unemployment relief tax was an income tax. He noted a charge could still be a tax even if it was paid into a special fund and used for a special purpose. He also held that it is the subject matter and essence of the charge that will determine whether it is an income tax, not the label it is given. At 675:

> It is true that the tax in question is not called "income" tax but "unemployment relief" tax. But in essence it is an additional income tax assessed in accordance with the *Income Tax (Management) Act* itself. The subject matter of the tax, so far as it affects the present case, is "net assessable income", which means the gross income after excluding all income exempt from tax and after making the allowed deductions. By sec. 18 of the *Prevention and Relief of Unemployment Act*, "net assessable income" is to be assessed in like manner as taxable income under the *Income Tax (Management) Act 1928*, the principal Act. Sec. 22 brings into play the machinery of income tax assessment, including sec. 83 itself.

126. So the fact that the tax was not called an income tax did not prevent it from being an additional income tax.

Tax exemption cases

127. Australia currently operates a foreign income tax offset regime. For income periods prior to 30 June 2008, a foreign tax credit regime applied. Prior to 1 July 1987, Australia had an exemption system.

128. The Commissioner considers that, whether the relief is allowed as an offset, an exemption or a credit, the underlying principles that determine which taxes are creditable should not change. However, it is arguable that under the exemption system the courts applied a tougher standard than they would with tax credits or offsets. This is because under the exemption system *all* income subject to foreign tax was exempt from Australian income tax. Under an offset or credit system, an offset or credit is only allowed for foreign income tax paid up to the amount of Australian tax payable on that income.

129. In *Case 20* (1957) 7 CTBR (NS) 91, an Australian-resident professor worked in the United States of America (United States) for just under a year. During this period, Federal insurance (FICA) contributions were deducted from his salary. No other United States income taxes were deducted. The taxpayer claimed an exemption for his United States income on the basis that the FICA contributions were an income tax for the purposes of s 23(q) of the Income Tax Assessment Act 1936-1955. Section 23(q) only required that the foreign tax be "an income tax". (This is not the same as the s YA 2(5) test, which requires the foreign tax to be a tax "of substantially the same nature as income tax imposed under section BB 1".)

130. The Commissioner denied the claim and the board was asked to decide whether the FICA contributions were an income tax.

131. There was no consensus between the three members on this issue and as a result the taxpayer's claim was disallowed. After considering the authorities, (*Hirst, Paterson, Morris Leventhal* and *de Romero,* among others), the Chairman concluded that FICA was an income tax. It was levied, collected and paid on the income of every individual. The fact that the tax was used for a specific purpose did not prevent it from being regarded as income tax.

132. The second board member decided the case involved a conflict of laws. On this basis, the taxpayer was required to prove the differences between English law and United States law by expert evidence. As no expert evidence had been produced, the taxpayer's claim failed.

133. The third board member held that FICA contributions were not payments of income tax and concluded that "payments to such a fund are in my view entirely foreign to the concept of the term "income tax"".

134. Given the different approaches and conclusions of the board members, no definite conclusions can be drawn from this case.

135. In *Case 112* (1958) 7 CTBR (NS) 733, a New Zealand-resident taxpayer owned a patent. He granted the manufacturing and selling rights to the patent to an Australian company. The taxpayer was required to visit Australia twice a year to provide services to the company. The taxpayer was paid a fee for these visits. While the fee was not assessable income for New Zealand tax purposes, it was subject to the New Zealand social security contribution. On this basis, the taxpayer argued that the fee was taxed in New Zealand and should therefore be exempt from tax in Australia.

136. The board held that the contribution was not a tax. It applied *Hirst* and *Paterson* and concluded that it was a separate tax imposed by separate legislation.

137. In *Case R68* 84 ATC 482, an Australian resident taxpayer had worked for a year in Saudi Arabia. The Commissioner included the Saudi Arabian salary in the taxpayer's assessable income for that tax year. The taxpayer claimed the salary should be exempt from Australian income tax because it had been taxed in Saudi Arabia.

138. The taxpayer was not required to pay Saudi Arabian income tax, but he did have Saudi Arabian social insurance (SSI) contributions deducted from his salary. The contributions went into a special bank account (not the consolidated revenue fund) to provide compensation for industrial injuries, occupational diseases, disability, old age and death.

139. The issue was whether the SSI was an income tax. The board started with the definition of tax from *Leake*, but noted that this definition would need to be supplemented by the requirement that the tax should relate to income. The board decided that the SSI was not an income tax. In fact, the board doubted whether the SSI was a tax at all.

140. The fact that the SSI was only imposed on a segment of the population (wage-earning men), it was imposed for a specific purpose, and it was paid into a special bank account and not the consolidated revenue fund, led the board to conclude that it was not an income tax.

141. In *Case S52* 85 ATC 388, an Australian-resident taxpayer had taken up a short-term university appointment in the United States. The taxpayer was not required to pay federal income tax, but he was required to make FICA contributions. The taxpayer claimed that his United States salary should be exempt from Australian tax because the salary had been subject to income tax

in the United States. The issue for the board was whether the FICA contributions were an income tax. This was the same issue considered in *Case 20* above. The board held that even though FICA was not a tax under United States revenue law, it was income tax for the purposes of s 23(q) (the exemption provision):

> 12. Applied to the present case, I have concluded that FICA constitutes "income tax" for purposes of sec. 23(q). The obligation to make the payment is part of the US Internal Revenue Code, it is paid by the employee "in addition to other taxes" (sec. 3101), is stated to be tax to be struck as a percentage of wages (up to the limit imposed by statute). In practice, a proportion of salary is withheld for FICA out of each and every instalment of salary. It follows that even though the tax is limited to only part of [sic] salary, none the less it is deemed to be a tax on the whole of the amount.

142. This case distinguishes *Hirst* and *Paterson* on two grounds. The first was that the New Zealand Social Security legislation was not part of the Income Tax Acts. However, it is arguable that neither is FICA. FICA is imposed under the Federal Insurance Contribution Act and codified at Title 26, Subtitle C, Chapter 1 of the United States Code.

143. The second ground for distinguishing *Hirst* and *Paterson* was their different context. *Hirst* and *Paterson* concerned the interpretation of wills. However, the board decided to follow the *de Romero* and *Morris Leventhal* cases where the context was also quite different: a separation agreement and a contractual dispute.

144. The board also incorrectly refers to the decision in *Case 20* as reaching an identical decision on identical facts. As explained above, in *Case 20* the taxpayer lost because the board failed to reach a unanimous view on whether FICA contributions were an income tax. In the current case the taxpayer won. The decisions were clearly not identical.

145. In *Case U52* 87 ATC 347, an Australian-resident taxpayer was entitled to a pension from the Yugoslav Government. Before he immigrated to Australia, he divorced his wife and became liable to pay her maintenance. He arranged to have his pension paid to her to satisfy the maintenance obligations.

146. The pension was subject to a deduction known as a "self-contribution" to the Self Managing Interest Community of Pension and Invalid Insurance of the Workers of Croatia at Split (SIZMIORH"). The taxpayer argued that the pension should be excluded from his taxable income as it was subject to tax in Yugoslavia. The issue for the tribunal was whether this contribution was a tax.

147. The tribunal held that the contribution was not a tax. The tribunal reviewed the nature of the SIZMIORH, which was understood to be a co-operative organisation that helped to finance the collective needs of the community and its members. The tribunal likened the contribution to the Saudi Arabian SSI considered in *Case R68*, and concluded that a levy by a co-operative organisation would not have the character of a tax, even though that co-operative was formed within the context of the legal organisation of the State.

United Kingdom

148. To qualify for the United Kingdom unilateral tax credit, the foreign tax must be paid under the law of the foreign territory, calculated by reference to the income arising in the foreign territory, and must correspond to United Kingdom tax (s 9(1) of the Taxation (International and Other Provisions) Act 2010). "Corresponds to United Kingdom tax" appears to be a lower standard of comparison than the s YA 2(5) test of "substantially the same".

Tax credit case

149. In *Yates (HMIT) v GCA International (formerly Gaffney Cline & Associates Ltd)* [1991] BTC 107 (Ch), the taxpayer company entered into a service contract worth £209,300 with a Venezuelan company. Venezuela levied a tax of 25% on 90% of the total contract value. The taxpayer claimed tax credit relief. The Revenue argued that the Venezuelan tax did not correspond to income or corporation tax because a tax on 90% of gross receipts was a turnover tax.

150. The court held that the Venezuelan tax did correspond to United Kingdom income tax or corporation tax. In fact, a translation of the law showed it was called "income tax". The court noted that the intention of the Venezuelan tax code was to charge tax on net profits. It therefore served the same function as an income tax. It was not a turnover tax.

General cases

151. In the case of *In Re Reckitt; Reckitt v Reckitt* [1932] 2 Ch 144 (CA), a testator gave £200,000 to his trustees to invest and to pay his widow an annual sum of £5,000 for life "free of income tax". The issue for the Court of Appeal was whether that amount was also to be paid free of super-tax or sur-tax.

152. The Court of Appeal held that the sur-tax was an income tax and the annuity should be paid free of sur-tax as well as income tax. The court said at 151:

> … super-tax or sur-tax is in essence an additional income tax, and, as there is no indication to restrict the words to income tax as known for so many years, it must follow that freedom is given to the widow in respect of both income tax, as we know it, and the additional income tax which has now been given the name of sur-tax.

153. In reaching this decision, the court did not attempt to define "income tax" as a separate concept; instead it contrasted the sur-tax with income tax. The court noted there were differences between the two taxes. For example, the taxpayer initiated payment of the sur-tax, whereas the Revenue assessed income tax. The frequency and method of collection of sur-tax was also different. However, the court concluded that the sur-tax was in essence an additional income tax.

154. *Reckitt* is therefore authority for the view that a tax can be assessed and collected in a different way from income tax, yet might still be an income tax.

Canada

Foreign Tax Credit Cases

155. The following cases concern the application of the Canadian foreign tax credit rules. Section 126 of the Income Tax Act 1985 provides a foreign tax credit for an income or profits tax paid in foreign jurisdictions.

156. In *Kempe v The Queen* [2001] 1 CTC 2060 (TCC), the court was asked to decide whether a German church tax was eligible for a foreign tax deduction. Some, but not all German churches were entitled to collect German church tax. The churches used the tax to fulfil their ecclesiastical duties. The tax was payable by all members of a church. The tax was charged at 8% on income tax or wages tax.

157. The German tax authorities administered the church tax. Proceeds collected by the authorities were then paid over to the respective churches, after a collection fee had been deducted. The church tax had a legal basis in the Constitution and was levied on the basis of German Federal State law.

158. The court held that the church tax was a tax. It cited *Lawson* as authority for the proposition that a tax is a levy, enforceable by law, imposed under authority of a legislature, imposed by a public body and levied for a public purpose. The church tax was enforceable against the appellant and imposed under authority of the German legislature. The tax was also compulsory. At 10:

> As to the compulsory nature of this tax, the ability to avoid the tax by giving up citizenship or church membership does not make it any the less a tax. The imposition of church tax is, I conclude, a compulsory obligation.

159. The court also held that the church tax was an income tax. This was because the tax is generally based on the income or wages tax. The court noted that the tax's designated destination (presumably to fund the church activities) did not change its characteristic as a tax on income or wages.

160. It is the Commissioner's view that German church tax would not satisfy the s YA 2(5) test. This is because the tax is in the nature of a service charge collected by the government and then distributed to the particular church that the taxpayer attends. The tax is payable by all members of the congregation and the proceeds go to fund the activities of the church. If a person leaves the church, their obligation to pay the tax ends. The church tax also fails to satisfy the "public purpose" requirement. The church tax is not intended for a public purpose – it is intended for the benefit of the German taxpayer's own church.

161. *Yates v Her Majesty the Queen* 2001 DTC 761 (TCC) concerned a taxpayer's claim for a foreign tax credit for United Kingdom NI contributions. The taxpayer was a dual United Kingdom/Canadian citizen. He had sought, but been refused, a foreign tax credit for Class 3 United Kingdom NI contributions. He had voluntarily applied to pay the contributions to maintain his United Kingdom pension.

162. The court, in applying *Lawson*, held that the NI contributions were not compulsory and therefore they did not amount to a tax. The court also noted that the contributions were not calculated as a percentage of income earned, as no income was being earned in the United Kingdom.

163. In *Nadeau v The Queen* 2004 TCC 433, 2007 DTC 1670, the taxpayer was a United States citizen and resident of Canada, employed as a teacher in Maine. The taxpayer had sought, but been refused, a foreign tax credit for premiums paid to the United States of Maine Retirement System (MSRS). The MSRS is a retirement system for Maine public servants and teachers. The MSRS contributions were intended to provide the public servants and teachers with pension, sickness, disability and death benefits.

164. The court dismissed the taxpayer's appeal and held the MSRS contributions were not a tax. The court was attempting to determine whether the foreign tax paid was an income or profits taxes under s 126(7). The court decided that the MSRS contribution was not a tax and stopped the inquiry there. The court applied *Lawson* and *Eurig* and held that the MSRS contributions were not collected to raise revenue for the common good. They were intended to provide a limited class of persons – Maine public servants and teachers – with various benefits. On this basis, the contributions were not a foreign tax for tax credit purposes.

Conclusion on the case law comparing taxes to income tax

New Zealand case law

165. The court in *Richards* held that unemployment relief tax was of the character of income tax because it was calculated by reference to the taxpayer's income and assessed in the same way as income tax.

166. *Paterson* noted that while a tax may have the character of income tax, this will actually not be enough to make it income tax. *Paterson* is authority for the proposition that income tax has a "well-understood meaning" and unless a tax satisfies that meaning, it will not be income tax.

167. Whether a tax is separate from the main income tax or imposed under a separate Act from the main income tax Act are not questions that are helpful in determining whether a foreign tax is sufficiently like New Zealand income tax (see para [122] above). It is the characteristics of the tax in question that are relevant.

Summary of Australian case law

168. The court in *de Romero* held that it is the subject matter and essence of the impost that will determine whether it is an income tax, not the label it is given.

169. The cases have identified the following characteristics of an income tax:

- Just because the charge is paid into a special account (and not the consolidated revenue account) and used for a special purpose does not mean it is not an income tax (*de Romero*).
- Payment into the consolidated revenue account may indicate that the charge is an income tax (*Case R68*). However, if the amount is paid into a private account, then it would be highly unlikely to be an income tax.
- It is not always necessary for an impost to be called a tax for it to be one (*Case R68*).
- Funds used for a specific purpose and to benefit a restricted class of persons might not be an income tax (*Cases R68* and *S52*).
- A levy by a co-operative organisation does not have the character of a tax, even if the co-operative is formed within the context of the legal organisation of the State (*Case U52).*

170. There is some uncertainty surrounding FICA taxes. *Case S52* held that they were an income tax and *Case 20* found they were not.

Summary of United Kingdom Case Law

171. *Yates (HMIT)* considered the title of the tax to be relevant. It also held that a tax would correspond to United Kingdom income tax if it serves the same function as United Kingdom income tax, even if it does not tax in the same way.

172. *Reckitt* concluded that a sur-tax was an income tax because it was like income tax, even though it was assessed and collected in a different way.

Summary of Canadian Case Law

173. Class 3 United Kingdom NI contributions were not a tax as the contributions were not compulsory. The contributions were also not calculated as a percentage of income earned, as no income was being earned in the United Kingdom *(Yates).*

174. The court in *Kempe* held that German church tax was an income tax. The tax was an income tax as it was based on the income or wages tax. However, it is the Commissioner's opinion that German church tax would not satisfy the test in s YA 2(5) because the tax is in the nature of a service charge. It would also fail to satisfy the "public purpose" requirement.

175. *Nadeau* is authority for the view that something will be a tax if it is collected for a public purpose (the common good). In this case, the MSRS contributions were not a tax as they were collected to provide a limited class of persons with benefits (or in the case of a death benefit, a benefit to persons associated with those persons).

Part 3 - Examples

Introduction

176. The following examples are included to assist in explaining the application of the law.

177. The following facts have been assumed:

- The person is a New Zealand tax resident.
- The person is subject to tax in both countries.
- The person has paid the foreign tax.
- The income mentioned in the example is the only income of that person for that tax year.
- All the other requirements of subpart LJ are satisfied.

178. The onus is on the taxpayer to demonstrate that the foreign tax is eligible for a tax credit under s YA 2(5).

Example 1 – Solomon Islands PAYE

Facts

179. Jake spent the 2011/12 New Zealand tax year working as a diving instructor in the Solomon Islands for a local dive company called "Big Blue".

180. During his time in the Solomon Islands, Jake had Solomon Islands PAYE deducted from his salary by Big Blue under the PAYE system. The PAYE was then remitted to the Solomon Islands Inland Revenue Division.

181. Jake returned to New Zealand at the end of the 2011/12 New Zealand tax year and prepared his New Zealand tax return for the period that he was in the Solomon Islands. He seeks a tax credit under subpart LJ for Solomon Islands PAYE. Is Jake entitled to a foreign tax credit?

Application of the s YA 2(5) Test

182. As Jake has paid Solomon Islands PAYE, the tax falls to be considered under s YA 2(5)(b). Section YA 2(5)(b) requires a two-part inquiry. Is Solomon Islands PAYE of substantially the same nature as New Zealand PAYE? And if so, is it imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1?

183. Solomon Islands PAYE is of substantially the same nature as New Zealand PAYE. Solomon Islands PAYE is withheld from employment income by the employer and remitted to the Solomon Islands Inland Revenue in the same way that New Zealand PAYE is withheld and remitted.

184. Solomon Islands PAYE is also imposed as a collection mechanism for Solomon Islands Income Tax. Whether Solomon Islands income tax is a tax of substantially the same nature as income tax imposed under s BB 1 is considered below.

Relevant factors	
Compulsory and enforceable by law.	The Solomon Islands government imposes income tax on taxpayers under the Solomon Islands Income Tax Act ([Cap 123] Consolidated to 14 November 2012). Payment is compulsory and enforceable by law.
Imposed by, and payable to, a central, state or local government.	Solomon Islands income tax is imposed by the Solomon Islands government and administered and collected by the Inland Revenue Division (IRD).
Intended for a public purpose (although it is irrelevant whether it is tagged for a specific public purpose).	The revenue that IRD collects is for a public purpose as it enables the government to stimulate development and provide vital social services throughout the Solomon Islands. (Solomon Islands Inland Revenue Division website: www.ird.gov.sb - accessed on 3 March 2014.)
The foreign tax must tax "income" as defined under the Act. • Some minor variations will be acceptable.	The Solomon Islands Income Tax Act identifies income that is subject to tax. This includes: • gains or profits from employment (s 3(1)(a)(ii)). • Section 5(a) confirms that "gains or profits" includes amounts from wages or salaries. • Section 36A states that an employer shall deduct tax from an employee's gross employment income, as prescribed in the Tax Deduction Rules 2005 (Solomon Islands).

Calculated as a proportion of income. • The rate of the tax is not important. • Whether the tax is payable at a fixed rate or at graduated rates is not important. • This condition might still be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.	Solomon Islands income tax is calculated as a proportion of income. Individuals are entitled to an exemption for their first $15,080 earned. The balance of any income is then subject to income tax at graduating rates.
Imposed on taxable or net income. • A taxing formula designed to produce a reasonable approximation of actual taxable/net income may be acceptable. • Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.	Solomon Islands income tax is imposed on "chargeable income", which is a similar concept to "taxable income" under the New Zealand Act. Income tax for employees is collected under the Solomon Islands PAYE system.
Not a penalty.	Solomon Islands income tax is not a penalty.
Not a service charge or licence fee.	Solomon Islands income tax is not a service charge or a licence fee.
Not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).	Solomon Islands income tax is not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors). There is no connection between payment of income tax and any specific benefit.

Conclusion

185. Jake is entitled to a foreign tax credit for Solomon Islands PAYE. Solomon Islands PAYE satisfies the test in s YA 2(5)(b) as it is a tax of substantially the same nature as New Zealand PAYE and it is imposed as a collection mechanism for a tax (Solomon Islands income tax) that is of substantially the same nature as New Zealand income tax.

186. Solomon Islands income tax is compulsory, imposed by central government and intended for a public purpose. It taxes employment income in substantially the same way that the New Zealand Act does, and it is calculated as a proportion of income.

187. Solomon Islands income tax is imposed on chargeable income, which correlates to the New Zealand concept of "taxable income". It is not a penalty, service charge, licence fee or a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).

188. Jake's foreign tax credit cannot be more than the amount of New Zealand income tax payable on his Solomon Islands employment income.

Example 2 – United States of America Federal Insurance Contributions

Facts

189. Tim spent the 2011/12 New Zealand tax year working for an IT company in the United States. During this time, FICA contributions were deducted from Tim's salary. Tim has noted that social security and unemployment taxes are specifically excluded from the Double Taxation Relief (United States of America) Order 1983 at Art 2(3)(b). Tim would like to know whether it is possible to get a foreign tax credit for FICA contributions.

What is FICA?

190. Under the United States Federal Insurance Contribution Act (as codified at Title 26, Subtitle C, Chapter 21 of the United States Code (USC)) employees and employers are required to make payments to the Federal government to fund social security benefits. These payments are known as FICA contributions or taxes.

191. FICA consists of two taxes. The first tax is for old-age, survivors and disability insurance (OASDI) (also referred to as the Social Security tax). It provides retirement benefits, survivor benefits (where an insured worker dies and leaves a spouse/child) and disability benefits.

192. The second tax is known as Medicare. Medicare is used to fund hospital insurance for the elderly, younger people with disabilities, and people with end-stage renal disease.

193. FICA taxes are payroll taxes. For the 2012 tax year, FICA was imposed on employees at the rate of 5.65%. This consists of 4.2% OASDI and 1.45% Medicare. OASDI was imposed on wages up to $110,100. There is no limit on wages subject to Medicare.

194. An employer is required to deduct FICA from employees' gross wages. This amount, coupled with the employer contribution, is then remitted to the Internal Revenue Service along with income tax. An employer who fails to make the required payments or fails to pay on time will be liable for a penalty.

195. For completeness, it is noted that employer FICA contributions would not satisfy the test in s YA 2(5). This is because they are not imposed on the employer's taxable or net income.

Who is FICA imposed on?

196. FICA taxes are imposed on the wages of all employees. Employers are also required to make contributions. Both the employer and employee contributions are compulsory.

Eligibility and benefits

OASDI

197. The amount an employee pays throughout their working life is indirectly tied to the OASDI benefit that they receive on retirement. To receive most benefits, a person must be "fully insured". This means the person must have worked long enough and put enough money into the system. This is tracked using credits.

198. A person receives one credit for each quarter year they work. To be eligible for retirement benefits a person needs 40 credits (meaning they need to have worked for at least 10 years). They also need to earn a certain amount of money each quarter to get a credit for that quarter. The minimum age to qualify for a retirement benefit depends on when a person was born. Those born after 1960 qualify for a retirement benefit when they reach 67.

199. The amount of the monthly benefit paid depends on the person's earnings during their working life and the age at which they retire. People who earned more will get more back. However, the system is weighted so that low income workers will receive a higher percentage of their former wages than high income earners.

200. A person can qualify for a disability benefit with fewer credits. To be entitled to a disability benefit a person must have:

- a medical condition that meets the definition of "disability" in the social security legislation; and
- worked long enough and recently enough to be covered (this will vary depending on the age of the person).

201. If a person who is covered by OASDI dies, their surviving spouse/children can receive a survivor benefit.

202. The United States Supreme Court, in *Flemming v Nestor* (1960) 363 US 603 (SC), held that entitlement to social security benefits is not a legally binding contractual right. Congress can change the rules regarding eligibility and has done so many times. The rules can be made more generous or more restrictive and benefits that are granted can be withdrawn. The FICA legislation specifically reserves the right of Congress to "alter, amend or repeal" any of the social security and Medicare provisions.

Medicare

203. People aged 65 and over are entitled to receive Medicare benefits if they:

- receive a social security benefit;
- have worked long enough to be eligible for a social security benefit;
- would be entitled to a social security benefit based on their spouse's work record and their spouse is aged at least 62; or

- have worked long enough in a federal, state or local government job to be insured for Medicare.

204. People aged under 65 who receive disability benefits or who have end-stage renal disease may also qualify for Medicare.

205. As with OASDI, Congress has reserved the right to "alter, amend or repeal" any of the Medicare provisions.

Trust Funds

206. FICA taxes are collected by the United States Internal Revenue Service (IRS) and paid into the United States Treasury General Fund. They are then appropriated to three separate funds: the Federal Hospital Insurance Trust Fund, the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. Amounts held in these funds are not held for any particular individual. Likewise, employer contributions are not held in trust for any particular employee. The US social security system is a pay as you go scheme, under which current employer and employee contributions are used to fund the payment of retirement benefits to the current recipients of retirement benefits.

207. The analysis below combines employee Medicare and OASDI contributions. They are two separate taxes. However, as the same factors apply to each tax, they are considered together. Employer contributions are not considered.

Application of the s YA 2(5) Test

Relevant factors	
Compulsory and enforceable by law.	FICA is compulsory and enforceable by law.
Imposed by, and payable to, a central, state or local government.	FICA is imposed under the Federal Insurance Contribution Act. FICA is collected by the IRS and paid into the United States Treasury General Fund.
Intended for a public purpose (although it is irrelevant whether it is tagged for a specific public purpose).	FICA is intended for a public purpose. FICA is used to provide benefits to insured people. The employee contribution is connected with a benefit. With OASDI, the amount an employee pays throughout their working life is indirectly tied to the OASDI benefit they receive on retirement. With Medicare, an employee also needs to have paid Medicare for at least 10 years prior to reaching retirement age. This may mean that there is a private element to the contribution.

The foreign tax must tax "income" as defined under the Act. • Some minor variations will be acceptable.	FICA taxes employment income in substantially the same way that the New Zealand Act taxes employment income.
Calculated as a proportion of income. • The rate of the tax is not important. • Whether the tax is payable at a fixed rate or at graduated rates is not important. • This condition might still be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.	FICA is calculated as a percentage of an employee's gross income.
Imposed on taxable or net income. • A taxing formula designed to produce a reasonable approximation of actual net/taxable income may be acceptable. • Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.	Because they are payroll taxes, OASDI and Medicare contributions are imposed on an employee's gross income. They are imposed in a similar way to New Zealand PAYE.
Not a penalty.	FICA is not a penalty.
Not a service charge or licence fee.	FICA is not a service charge or licence fee.

Not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).	FICA is essentially a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors). The employee contribution is linked to a benefit entitlement. Without making contributions the employee will not be eligible to receive the relevant benefits. How much the employee pays in will broadly correlate to what they ultimately receive. One of the main arguments for claiming that FICA is a tax, and not a contribution to a fund or scheme, is that under FICA an employee does not have an enforceable contractual right to receive a benefit. The United States Congress has the power to change eligibility requirements or even to repeal the benefit. However, the same could be said for most government-run social insurance schemes. There is always the risk that the government will not have enough funds to pay out benefits. However, these potential risks do not detract from the essential characteristic of the payments – which are payments made to secure entitlement to future benefits.

Conclusion on FICA

208. Tim is not entitled to a foreign tax credit for his FICA contributions as FICA does not satisfy the test in s YA 2(5)(a). FICA is not a tax of substantially the same nature as New Zealand income tax imposed under s BB 1. FICA contributions also do not satisfy s YA 2(5)(b). While they are deducted from employment income in much the same way as New Zealand PAYE, they are not a collection mechanism for a separate tax that is of substantially the same nature as income tax imposed under s BB 1.

209. Employee FICA contributions do satisfy certain elements of the test. They are compulsory and imposed by central (Federal) government. They are calculated as a proportion of the employee's income. They are imposed on gross income in much the same way as the New Zealand Act imposes income tax on employee income – via a PAYE system. Further, employee FICA contributions are not penalties, service charges or licence fees.

210. It is also arguable that FICA contributions are intended for a public purpose, ie to pay benefits to eligible recipients. However, it is also the case that the payments are made for a private purpose, ie to secure eligibility to a potential private benefit.

211. Employee FICA contributions fail the s YA 2(5) test as they can be characterised as a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors). By making the payment into the fund, the employee becomes entitled to receive benefits to which they would not otherwise have been entitled. The benefits are not available to all citizens, only those citizens that

are fully insured. The United States Supreme Court in *Flemming v Nestor* held that this entitlement is not a legally binding contractual right. However, the Commissioner considers that as the payment is linked to a future benefit (whether that benefit is ever realised or not), then it has the features of a payment into a fund or scheme.

212. As employee FICA contributions are likely to have a private as well as a public benefit, and because they have the characteristics of a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors), the Commissioner considers that employee FICA contributions do not satisfy the requirements of s YA 2(5).

213. Br Pub 09/02: Federal Insurance Contributions Act (FICA) – Fringe benefit tax liability, *Tax Information Bulletin,* Vol 21, No 4 (June 2009): 2 looked at whether employer FICA contributions are subject to fringe benefit tax. The Public Ruling was mainly concerned with whether employer FICA contributions gave rise to a fringe benefit. However, it touched briefly on employee FICA contributions and noted that *Flemming v Nestor* establishes that a person who makes payments under FICA does not acquire a right to a benefit analogous to a property right as a consequence. As mentioned above, this Interpretation Statement accepts that the employee FICA contributions do not result in an enforceable right. However, the essential characteristic of the payment is a payment made to secure an entitlement to a future benefit. Only people that make contributions are entitled to benefit. This can be compared to a general income tax where payers do not receive any benefit as a consequence of being a taxpayer. Subject to the eligibility requirements of government benefits (such as social security, unemployment, etc), the same benefits are available to all citizens whether they are required to pay, or have paid, income tax.

Example 3 – United Kingdom National Insurance Contributions

Facts

214. Melanie spent the 2011/12 New Zealand tax year working as a pharmacist in London. Melanie's only income for this tax year is employment income from her job in London. United Kingdom income tax and Class 1 Employee National Insurance (NI) contributions have been deducted via the United Kingdom PAYE system from this income.

215. Melanie returned to New Zealand at the end of the tax year. She notes that she is able to claim a foreign tax credit for United Kingdom income tax under the Double Taxation Relief (United Kingdom) Order 1984 (the DTA). However the DTA does not mention NI contributions. Melanie would like to know whether she is able to claim a foreign tax credit under subpart LJ for United Kingdom NI contributions. Are United Kingdom NI contributions of substantially the same nature as income tax imposed under s BB 1?

What is National Insurance?

216. United Kingdom NI is a scheme where employees, employers and the self-employed make contributions towards the cost of certain state benefits. The scheme is administered by Her Majesty's Revenue and Customs (HMRC) and contributions are collected by HMRC through the PAYE system along with income tax.

217. NI contributions are mandatory contributions paid by employees and employers on earnings and by employers on certain benefits in kind provided to employees. The self-employed are also required to make NI contributions – partly by a fixed weekly or monthly payment and partly on a percentage of net

profits above a certain threshold. Individuals may also make voluntary NI contributions. A person is required to make NI contributions if they are:

- an employee or self-employed,
- aged 16 years or over (although Class 1 and Class 2 employee contributions are not payable by a person over the state pension age), and
- their earnings are at a prescribed level.

218. Employers are also required to make NI contributions.

Classes of NI contributions

219. There are six different classes of NI contributions. These are summarised as follows:

- Class 1 NI contributions are paid by employers and employees. The employee contribution is deducted from the employee's gross wages by the employer. The employer then adds an employer contribution and submits the amount to HMRC along with income tax.
- Class 1A NI contributions are paid by employers on the value of benefits in kind provided to their employees.
- Class 1B NI contributions are payable whenever an employer enters into a PAYE settlement agreement for tax. Class 1B contributions are payable only by employers.
- Class 2 NI contributions are fixed weekly amounts paid by the self-employed. While the amount is calculated weekly, it is typically paid monthly or quarterly. Payments are due regardless of trading profits or losses (although those with low earnings can apply for an exemption).
- Class 3 NI contributions are voluntary payments paid by a person wishing to fill a gap in their contribution record. The gap may have arisen because the person was not working or because their earnings were too low. This allows a person to preserve their entitlement to certain state benefits. Class 3 NI contributions are paid at a flat rate.
- Class 4 NI contributions are paid by the self-employed as a proportion of their net profits. The amount due is calculated with income tax at the end of the year.

Benefit entitlements

220. A person's entitlement to contributory state benefits (and the amount of those benefits) depends on the class of NI contribution paid:

- Class 1 NI contributions (paid by employees and employers) provide the employee with an entitlement to all contributory benefits. The Class 1 employer NI contributions do not provide the employee with an entitlement to contributory benefits. Entitlement is determined solely by the amount paid by the employee. (For employee contributions, contributory benefits are determined only by NI contributions below something called the "Upper Accrual Point".)
- Classes 1A and 1B NI contributions (paid by employers) do not count towards any contributory benefits.
- Class 2 NI contributions (paid by the self-employed) provide an entitlement to the state pension and bereavement benefits only.

- Class 3 NI contributions (voluntary) count towards state pension and bereavement benefits only.
- Class 4 NI contributions (paid by the self-employed) do not count towards any contributory benefits. This is because the self-employed qualify for benefits by paying Class 2 NI contributions.

221. In addition, entitlement to a contributory benefit depends on how long a person has paid in NI contributions. There are different calculations for each of the different classes and for each of the different benefits.

The National Insurance Fund

222. The National Insurance scheme is administered by HMRC. HMRC collects the NI contributions through the PAYE system. The NI contributions go into the National Insurance Fund (NIF). The NIF is separate from the Consolidated Fund.

Application of the s YA 2(5) Test

Relevant factors	
Compulsory and enforceable by law.	It is compulsory for a person to make NI contributions if they are: • an employee (Class 1) or self-employed (Class 2 and Class 4), • aged between 16 and state pension age, and • their earnings are at a prescribed level. Employers are also required to make NI contributions (Classes 1, 1A and 1B). Class 3 NI contributions are voluntary.
Imposed by, and payable to, a central, state or local government.	NI contributions are imposed by central government. NI contributions are collected and administered by HMRC. A proportion of NI contributions are used to fund the National Health Service (NHS). The remainder of the NI contributions are then paid by HMRC into the NIF. The NIF is separate from the Consolidated Fund.

Intended for a public purpose (although it is irrelevant whether it is tagged for a specific public purpose).	A proportion of all NI contributions are used to help fund the NHS. A proportion is also used to fund non-contributory benefits. Use of the NHS and access to non-contributory benefits are available to everyone. There is no eligibility requirement. On this basis, the NI contributions are being used for a public purpose. However, a proportion of NI contributions are also used to fund contributory benefits. This is not a public purpose. In this instance, NI contributions are used to fund a private benefit.
The foreign tax must tax "income" as defined under the Act. • Some minor variations will be acceptable.	Class 1 employee NI contributions tax employment income. The New Zealand Act also taxes and collects employment income substantially the same way. Class 1 employer NI contributions and Classes 1A and 1B NI contributions do not tax income (of the employer). Class 2 NI contributions are a flat fee and not a tax on income/profits. They are payable regardless of income/profits. Class 3 NI contributions are voluntary and paid at a flat rate unrelated to income. Class 4 NI contributions tax net profits of the self-employed. The "income" that is taxed is the type of income that is taxed under the Act.

Calculated as a proportion of income. • The rate of the tax is not important. • Whether the tax is payable at a fixed rate or at graduated rates is not important. • This condition might still be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.	Class 1 employee NI contributions are calculated as a proportion of income. Class 1 employer NI contributions are calculated on the basis of the employee's income and not the employer's. This means Class 1 employer contributions are not calculated as a proportion of income of the employer. Classes 1A and 1B NI contributions are also not calculated as a proportion of income. They are paid by the employer. Class 2 NI contributions are not calculated as a proportion of income. Class 2 NI contributions are calculated at a flat rate of £2.65 per week. Class 3 NI contributions are voluntary and usually made because the person is not earning any income. They are imposed at a flat rate and therefore not calculated as a proportion of income. Class 4 NI contributions are calculated as a proportion of the self-employed person's profits.
Imposed on taxable or net income. • A taxing formula designed to produce a reasonable approximation of actual net/taxable income may be acceptable. • Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.	Class 1 employee NI contributions are imposed on gross income and deducted from employees' wages by the employer. In this way, they could be characterised as a collection mechanism for the NI contributions of the same nature as New Zealand PAYE and so would satisfy this requirement. Class 1 employer NI contributions and Classes 1A and 1B are not imposed on the employer's income. Class 2 NI contributions are imposed as a flat fee. They are payable regardless of profits or losses. Class 3 NI contributions are a voluntary payment paid at a flat rate unrelated to income. Class 4 NI contributions are calculated on net profits. Net profit is broadly the same as "taxable income". Therefore, Class 4 NI contributions would satisfy this requirement.

Not a penalty.	NI contributions are not a penalty.
Not a service charge or licence fee.	NI contributions are not a service charge or licence fee.
Not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors)	Class 1 employee NI contributions and Classes 2 and 3 NI contributions are effectively payments into a fund or scheme where the entitlement to the benefit is limited to those who contribute. There are deemed contributions for certain people who do not contribute. For example, a spouse who does not work because of parental responsibilities is entitled to deemed contributions. The benefit of the payment is linked via a person's NI contributions account to contributions made. Class 4 NI contributions and employer contributions (Classes 1, 1A and 1B) can also be classed as payments into a fund or scheme where the entitlement to the benefit is limited to those who contribute. The only difference with these classes of NI contributions is that the contributor does not personally stand to benefit as a consequence of payment.

Conclusion on NI contributions

223. Melanie is not entitled to a foreign tax credit, as United Kingdom NI contributions do not satisfy the test in s YA 2(5). United Kingdom NI contributions are not a tax of substantially the same nature as New Zealand income tax imposed under s BB 1. They are also not a tax of substantially the same nature as PAYE. While they are collected in much the same way via the PAYE system, they are not a collection mechanism for a separate foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

224. All NI contributions have the characteristics of a payment into a scheme or fund where the entitlement to the benefit is limited to those who contribute. Most NI contributions are connected with an entitlement to a specific benefit – for example, the state pension. Consequently, United Kingdom NI contributions do not satisfy the test in s YA 2(5).

225. *Case F11* is the only New Zealand authority to consider whether NI contributions are substantially of the same nature as New Zealand income tax (this was the phrase used in s 293 of the Income Tax Act 1976, applicable at the time). The Taxation Review Authority held that the taxpayer had failed to discharge the burden of proof to show that NI contributions were substantially of the same nature as New Zealand income tax. However, Judge Barber stated that it would not be possible to discharge the burden of proof in any event as the nature of NI contributions seemed to be far narrower than the nature of income tax. (Although he acknowledged that the point was not argued before

him in any detail.) The findings in this case are consistent with the view taken in this Interpretation Statement.

References

Related rulings/statements

Br Pub 09/02: "Federal Insurance Contributions Act (FICA) – Fringe benefit tax liability", *Tax Information Bulletin* Vol 21, No 4 (June 2009): 2

Subject references

Foreign tax
Foreign tax credit
Income tax
Solomon Islands Income Tax
United Kingdom National Insurance Contributions
United States Federal Insurance Contributions

Legislative references

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Tax Administration Act 1994, s 149A(2)
Art 2(1) of the Double Taxation Relief (United Kingdom) Order 1984
Double Taxation Relief (United States of America) Order 1983

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R v Barger (1908) 6 CLR 41 (HCA)
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Roy Morgan Research Pty Ltd v FCT & Anor [2011] HCA 35, [2011] ATC ¶20,282
Warnock v Director-General of Social Welfare [2004] NZAR 274 (HC)
Westbank First Nation v British Columbia Hydro and Power Authority [1999] 3 SCR 134
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Yates (HMIT) v GCA International (formerly Gaffney Cline & Associates Ltd) [1991] BTC 107 (Ch)

Other references

Concise Oxford English Dictionary (12th ed, Oxford University Press, New York, 2011)

Appendix – Legislation

Income Tax Act 2007

1. Section BB 1 provides:

BB 1 Imposition of income tax

Income tax is imposed on taxable income, at the rate or rates of tax fixed by an annual taxing Act, and is payable to the Crown under this Act and the Tax Administration Act 1994.

1. Sections LJ 1-LJ 5 provide:

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 for the purposes of a law of another territory in relation to which a double tax agreement has been made is resident in that territory, and the law imposes foreign tax, a dividend paid by the company is treated as being derived from a source in that other territory for the purposes of the double tax agreement.

Double tax agreements

(5) This subpart and sections BH 1 (Double tax agreements) and CD 19(1) (Foreign tax credits and refunds linked to dividends) and section 88 of the Tax Administration Act 1994 as far as they are applicable, and modified as necessary, apply for the purposes of section LJ 2, as if that section were a double tax agreement.

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

(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).

LJ 3 Meaning of foreign income tax

For the purposes of this Part, **foreign income tax** means an amount of income tax of a foreign country.

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 cannot be less than zero: .

$$\frac{\text{(segment – person's deductions)}}{\text{person's net income}} \times \text{notional liability}$$

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 BD 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:

$$\frac{\text{Person's notional income tax liability}}{\text{NZ tax}}$$

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—

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

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).

2. Section YA 1 defines "income tax", "tax" and "taxable income" to mean:

income tax means income tax imposed under section BB 1 (Imposition of income tax) except to the extent to which it has a different meaning under section YA 2 (Meaning of income tax varied)

tax means income tax, but in the provisions in which the term "income tax" has an extended or limited meaning, "tax" has a corresponding meaning

taxable income means taxable income for a tax year calculated under section BC 5 (Taxable income)

3. Section YA 2 provides:

YA 2 Meaning of income tax varied

DTA and time bar provisions: ancillary tax

(1) The term **income tax** includes ancillary tax in—

(a) section BB 3(2) (Overriding effect of certain matters):

(b) section BH 1 (Double tax agreements):

(c) sections 107A to 108B of the Tax Administration Act 1994.

DTA provisions: tax recovery agreements

(2) The term **income tax** includes a tax that is prescribed in a tax recovery agreement made under Part 10A of the Tax Administration Act 1994 in—

(a) section BB 3(2):

(b) section BH 1.

General tax avoidance provisions: ancillary tax

(3) The term **income tax** includes ancillary tax, but not excluded ancillary tax, in—

(a) section BB 3(1):

(b) sections BG 1 (Tax avoidance) and GA 1 (Commissioner's power to adjust):

(c) the definition of **tax avoidance**.

Modified application of section GA 1

(4) When section GA 1 is applied in the case of an ancillary tax,—

(a) the words "taxable income" in section GA 1(2) are treated as replaced by the words "liability to the ancillary tax"; and

(b) the following paragraph is treated as added to section GA 1(5): "(e) an amount subject to the ancillary tax".

Tax of other countries

(5) The term **income tax**, when specifically used in relation to tax of another country, whether imposed by a central, state, or local government,—

(a) means a tax of substantially the same nature as income tax imposed under section BB 1 (Imposition of income tax); and

(b) includes a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT), or non-resident withholding tax (NRWT).

UFTC rules (Repealed)

(6) (Repealed)

FDP, imputation, and BETA rules

(7) The term **income tax**, in relation to tax that has been paid by a person, includes provisional tax in—

(a) the FDP rules:

(b) the imputation rules:

(c) subpart OE (Branch equivalent tax accounts (BETA)).