

QUESTION WE'VE BEEN ASKED QB 12/13

INCOME TAX — IS A TAX CREDIT ALLOWED FOR STATE INCOME TAX PAID IN THE UNITED STATES OF AMERICA?

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about ss LJ 1, LJ 2, LJ 3, LJ 4, LJ 5, LK 1 and YA 2 of the Income Tax Act 2007.

Question

1. Is a tax credit allowed for state income tax paid in the United States of America (United States)?

Answer

2. Subpart LJ allows a tax credit for state income tax paid on United States-sourced income, provided the state income tax is of substantially the same nature as New Zealand income tax.
3. The tax credit allowed cannot be more than the amount of New Zealand income tax payable on the United States-sourced income.
4. The Double Taxation Relief (United States of America) Order 1983 (the DTA) does not apply. This is because state income taxes are not covered by the DTA.

Explanation

Background

5. We have been asked to clarify whether a tax credit is allowed for state income tax paid in the United States. The DTA refers to federal income tax but does not mention state income taxes. Some taxpayers have taken this to mean that a tax credit is not allowed for state income tax paid in the United States.

Discussion

6. A New Zealand resident who derives foreign-sourced income is liable for New Zealand income tax on that income. However, the New Zealand resident may be entitled to a tax credit for foreign income tax paid on that income.

Double Taxation Relief (United States of America) Order 1983

7. The DTA does not apply. This is because state income taxes are not covered by the DTA. However, the fact that the DTA does not cover state income taxes is irrelevant. Relief is available under subpart LJ.

Application of subpart LJ

8. Tax credit relief is available under subpart LJ. Section LJ 1(2) states:

Limited application of rules

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

- (a) a person resident in New Zealand derives assessable income 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.

9. Therefore, to claim a tax credit a person must:

- be resident in New Zealand for income tax purposes (s YD 1 determines residency for natural persons and s YD 2 determines residency for companies);
- have derived assessable income that is not sourced in New Zealand (s YD 4 lists the classes of income treated as having a New Zealand source); and
- have paid foreign income tax on the assessable income.

10. Section LJ 1(2)(b) states that subpart LJ will not apply if foreign income tax is paid in a country or territory listed in sch 27. There are currently no countries or territories listed in sch 27, so this limitation has no effect. A person who meets the criteria of s LJ 1(2) is entitled to a tax credit for an amount of foreign income tax paid on the foreign-sourced income (s LJ 2(1)).

11. Section LJ 3 defines “foreign income tax” to mean “an amount of income tax of a foreign country”. The meaning of “income tax” in subpart LJ is varied by s YA 2(5):

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).

12. The meaning of “income tax” is therefore varied to include tax imposed by a central, state or local government, provided the tax 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, pay-as-you-earn, resident withholding tax or non-resident withholding tax.

13. In summary, if a person satisfies the requirements of s LJ 1(2), then they are entitled to a tax credit or credits for an amount of “foreign income tax” paid under s LJ 2(1). (The number of credits will depend on the number of foreign countries and the sources or the nature of the income derived (ss LJ 4 and LJ 5).) The meaning of “income tax” in this context is modified by s YA 2(5) to mean a tax (whether imposed by a central, state or local government) that is of “substantially the same nature” as income tax.

14. Section LJ 2(2) restricts the amount of the tax credit. The tax credit allowed must not be more than the amount of New Zealand income tax payable on that foreign-sourced income, as calculated under s LJ 5.

United States state income taxes

15. Most states in the United States impose a state income tax. The Commissioner's view is that, for the most part, state income taxes will be of substantially the same nature as income tax imposed under s BB 1.
16. However, it cannot be assumed that all state income taxes are the same. Each state income tax needs to be assessed individually each tax year to determine whether it is of substantially the same nature as New Zealand income tax. The name or title of the tax is not determinative. The characteristics of the tax will need to be evaluated and compared with New Zealand income tax to establish whether it is of substantially the same nature.

Tax credits relating to attributed controlled foreign company income

17. Section LK 1(1) allows a tax credit for tax paid or payable on an amount of attributed controlled foreign company income. Tax paid or payable includes "foreign income tax". The s LJ 3 definition of "foreign income tax" also applies to subpart LK, as does s YA 2(5). To this extent, the conclusions in this item regarding s YA 2(5) apply equally to subpart LK.

Conclusion

18. A tax credit for United States state income tax is allowed under subpart LJ provided the state income tax is a tax of substantially the same nature as New Zealand income tax.
19. The tax credit allowed under s LJ 2(2) cannot be more than the amount of New Zealand income tax payable on the United States-sourced income, as calculated under s LJ 5.
20. The DTA does not apply. This is because state income taxes are not covered by the DTA. However, the fact that the DTA does not cover state taxes is irrelevant.

References

Subject references

State income tax
tax credit
United States of America

Legislative references

Income Tax Act 2007, ss BB 1,
LJ 1, LJ 2, LJ 3, LJ 4, LJ 5, LK 1, YA 2, YD 1,
YD 2, YD 4 and sch 27
Double Taxation Relief (United States of
America) Order 1983