

# *Double Taxation Agreements: New Zealand's Approach to Treaty Shopping*

LOUISA BOYD\*

## I INTRODUCTION

This article examines New Zealand's approach to treaty shopping. New Zealand is a member of the Organisation for Economic and Co-operative Development ("OECD"). New Zealand's tax treaties, like almost all tax treaties, are based on the OECD Model Tax Convention on Income and on Capital ("Model Convention").

Tax treaties provide tax benefits to residents of the contracting states, such as reduced rates of withholding tax. Non-resident taxpayers that fall outside the scope of a treaty obtain the treaty benefits by treaty shopping, that is, by creating and utilizing other entities, conduits, in a treaty state to carry out the commercial activities in the other contracting state. This article discusses the concept of treaty shopping and explains why the OECD considers it harmful.

This article also discusses the OECD's response to treaty shopping and outlines the countermeasures that have been taken in New Zealand's tax treaties. Furthermore, the issue of whether New Zealand's General Anti-Avoidance Rule could be applied to counter treaty shopping is examined. The Commentary asserts that domestic law anti-avoidance measures do not conflict with treaty obligations,<sup>1</sup> but the issue arises as to whether the adoption of the Commentary by a New Zealand court has the consequence that the OECD is effectively legislating for New Zealand.

---

\* BSc, MSc, LLB(Hons). The author would like to thank Dr Michael Littlewood of the University of Auckland Faculty of Law for his valuable assistance.

<sup>1</sup> OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (condensed version) (2005) Commentary on Article 1, [9.4] [*"Model Tax Convention"*].

## II DOUBLE TAX AGREEMENTS

### Double Taxation

#### 1 *The Problem*

Double taxation arises when there is the imposition of taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods.<sup>2</sup> For example, if a New Zealand resident derives income from some other country, then New Zealand will tax that income under the residence principle, and the other country will usually also impose tax on the same income under the source principle.

Double taxation can impede international trade and investment.<sup>3</sup> Due to double taxation, the tax burden may be such that a taxpayer may not undertake a venture in a particular state and may decide in order to maximize after-tax profit, to undertake that venture elsewhere, or not at all. Consequently, a state may miss out on an opportunity for economic growth and potential tax revenue.

#### 2 *Solutions*

There are two ways in which double taxation can be relieved: first, by unilateral measures, provided for in domestic law; secondly, by bilateral measures through a double taxation agreement (tax treaty). If unilateral relief is available to the taxpayer, then depending on the circumstances, the application of a tax treaty may not make a difference to the taxpayer's tax liability.

Tax treaties relieve the burden of double taxation by three methods. First, the exclusive right to tax some types of income is allocated to one state.<sup>4</sup> Secondly, both states have the unlimited right to tax, but the state of residence has the obligation to relieve double taxation, by either the credit, or the exemption method.<sup>5</sup> Thirdly, both states have the right to tax, but the source state's right to tax is limited and the state of residence has the obligation to relieve the burden of double taxation.<sup>6</sup>

---

2 Rohatgi, *Basic International Taxation* (2002) 2.

3 Haug, "The United State Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis" (1996) 29 *Vand J Transnat'l L* 191, 201.

4 For example arts 7(1) and 8(1) of the Model Convention.

5 For example arts 6(1), 16, and 23 of the Model Convention.

6 For example arts 10, 11, and 23 of the Model Convention.

## Treaty Shopping

### 1 The Concept

Tax treaties play an important role in international tax planning. To reduce tax liability, a taxpayer has an incentive to undertake economic activities in a state that has a tax treaty with their state of residence. If there is no applicable tax treaty, the taxpayer has an incentive to arrange their economic activities to enable them to utilize another state's tax treaty. As treaty benefits should only be available to residents of the contracting states,<sup>7</sup> the attainment of treaty benefits by non-residents is achieved by the imposition of a legal entity, a conduit, in a treaty state.<sup>8</sup> The interposed entity is usually a company, but it could also be a partnership, a trust or similar entity.<sup>9</sup>

In 1987, the OECD produced a report<sup>10</sup> ("the Conduit Report"), which discussed two main methods by which treaty shopping could be undertaken: first, a direct conduit,<sup>11</sup> and secondly, a "stepping stone" conduit.<sup>12</sup>

A direct conduit is where a company is established in a state (State A), and it receives dividends, interest or royalties from another state (State B). The company claims to be fully or partially tax-exempt from State B's withholding taxes due to a tax treaty between State A and State B. The company is wholly owned by residents of another state who are not entitled to the benefits of the State A-State B tax treaty. The company was created with the purpose of taking advantage of the treaty benefits, and consequently the assets or rights giving rise to the income were transferred to it. The income is tax-exempt in State A, for example in the case of dividends, due to a participation exemption, or due to the State A-State B tax treaty.

A stepping stone conduit is similar to a direct conduit, except that the conduit in State A, a high tax jurisdiction, is fully subject to tax and then reduces its taxable income by the deduction of expenses. The expenses, such as interest, commissions, or service fees, are paid to another related company established in another state, for example a low tax jurisdiction or a jurisdiction that provides a special tax regime, such that the income is tax-exempt.

Under both methods, the advantage arises in the source state because

---

7 See OECD Committee on Fiscal Affairs, *Model Tax Convention*, supra note 1, Commentary on Article 4, [8] for definition of 'resident of contracting state'.

8 Ibid Commentary on Article 1, [9].

9 OECD Committee on Fiscal Affairs, *International Tax Avoidance and Evasion: Four Related Studies* (1987) 88 ["*International Tax Avoidance*"].

10 Ibid 88-106.

11 Ibid 88-89.

12 Ibid 89.

the tax treaty restricts the source state's taxing right.<sup>13</sup> The economic benefit of the transaction is then utilized by a taxpayer, who is not resident in either of the treaty states.<sup>14</sup>

## 2 *The Impact of Treaty Shopping*

The Conduit Report advocates that treaty shopping is unsatisfactory for three reasons.<sup>15</sup> First, because the negotiated treaty benefits are extended to persons resident in a third state, the principle of reciprocity is breached and the negotiated balance of sacrifices is altered in an unintended way. Secondly, because the granting of treaty benefits is based on the expectation that the income is to be taxed in at least one of the contracting states, the granting of treaty benefits which results in nil or inadequate taxation is unacceptable. Finally, the state of residence of the treaty shopper has little incentive to enter into its own tax treaties, because its residents can already obtain treaty benefits by utilizing other states' treaties. Each of these reasons will be discussed to show that they may not be applicable to all tax treaties. Consequently, there may be instances in which treaty shopping is not considered to be harmful or tax avoidance.

### (a) Breach of the Principle of Reciprocity

Tax treaties are built on reciprocity; a state will not enter a tax treaty unless it has something to gain.<sup>16</sup> A state gives up or limits its rights to tax residents of the treaty partner, and reciprocally obtains the same benefits for its own residents. Consequently, if the level of capital flows between the two states is equal, then one provision that results in revenue loss for a state will be offset by another provision that increases revenue.<sup>17</sup>

If treaties are negotiated and concluded based on particular capital flows between the states, and then treaty benefits are extended to taxpayers who are residents in a third state, the negotiated revenue sacrifices are altered. As a result, the source state suffers a revenue loss, due to either the application of the reduced withholding tax rates or an erosion of its tax base.<sup>18</sup> This revenue loss could have a significant impact, especially where the source state is a net capital importer.

However, when treaties are negotiated a state's economic, social and political policies are also considerations that are taken into account.<sup>19</sup> A source state may consider that the revenue loss may be offset by other advantages that achieve different state aims. For example, for developing

---

13 Ibid 90.

14 Ibid.

15 Ibid.

16 van Weeghel, *The Improper Use of Tax Treaties* (1998) 116.

17 Haug, *supra* note 3, 218.

18 Rohatgi, *supra* note 2, 363.

19 van Weeghel, *supra* note 16, 119-160.

countries, treaty shopping can be regarded as a tax incentive to attract foreign investment,<sup>20</sup> which could provide flow-on benefits for the state. Consequently, the opportunity for treaty shopping may have been fully intended by the source state.

Furthermore, some states, such as the Netherlands,<sup>21</sup> permit and even encourage their treaty network to be utilized by non-residents, but dislike the revenue loss from being a source state.<sup>22</sup> As it is also possible that a developing country will not object to taxpayers utilizing the Dutch treaty network, then the opportunity for treaty shopping may have been fully intended by both the source state and the state of residence of the conduit.<sup>23</sup>

### (b) Inadequate Taxation of Income

States have the expectation that income is to be taxed in at least one of the states. If a state gives up its right to tax a particular item of income, then it expects that the other state will tax it.<sup>24</sup> One situation in which income may not be subject to any taxation is where a state has the exclusive right to tax that income and exempts that income from taxation. Consequently, the taxpayer incurs no tax liability in one state and yet still seeks the application of the tax treaty against the other state. If the taxpayer were entitled to treaty protection, this would result in non-taxation. There is no evidence of a general principle that a taxpayer must show that double taxation would arise as a pre-requisite to entitlement to treaty benefits.<sup>25</sup> Consequently, a treaty “becomes a convention for the avoidance of any taxation.”<sup>26</sup>

While nil or inadequate taxation may be considered objectionable in principle, this does not necessarily mean that the purpose of a tax treaty is to ensure income is taxed at least once and at an adequate level. The preamble of a tax treaty refers to the ‘avoidance of double taxation’, not the ‘avoidance of double non-taxation’. The fact that a treaty allocates the exclusive right to tax particular income to a state does not preclude that state from exercising its sovereign rights, including the right not to levy tax or to have what may be perceived by other states as ‘inadequate’ rates of taxation.

---

20 Rohatgi, *supra* note 2, 374; Shelton, *Interpretation and Application of Tax Treaties* (2004) 260.

21 van Weeghel, *supra* note 16, 109-110.

22 Rohatgi, *supra* note 2, 373.

23 For example Cyprus offshore companies have been used for investing in Russia and other Eastern European countries; Mauritius conduits have been used for investing in India; and Portugal has been used for investing into the European Union: see Marshall, cited in Haug, *supra* note 3, 213; Rohatgi, *supra* note 2, 374; and Shelton, *supra* note 20, 260.

24 van Weeghel, *supra* note 16, 105.

25 Baker, *Double Taxation Conventions* (3 ed, 2001) B.11.

26 Kingdon, “The Coherence of International Taxation” (1981) 81 *Colum L Rev* 1151, 1153.

### (c) Loss of Incentive to Enter Treaties

If treaty shopping were permitted, the state of residence of the treaty shopper, the third state, has a reduced incentive to enter into tax treaties of its own, because its residents can already obtain the benefits of another state's tax treaty,<sup>27</sup> and it has no obligation to provide reciprocal benefits to the source state's residents. Furthermore, if the third state were to enter into treaty negotiations, its bargaining power would be increased.<sup>28</sup> As the residents of this state can already utilize the benefits of other treaties, the terms of a new treaty would have to be more beneficial than that of existing treaties.<sup>29</sup>

While the elimination of double taxation is a purpose of a tax treaty, tax treaties can also serve other purposes, such as for the recovery of unpaid tax or the mutual exchange of information.<sup>30</sup> Consequently, these other purposes could serve as an incentive for a state to enter into a treaty.

The preceding discussion illustrates that there are arguments for considering treaty shopping as harmful and abusive. However, because it is possible that a source state will tolerate or encourage treaty shopping, if such a source state enters into a treaty with a state that encourages the establishment of conduits by non-residents, it is difficult to classify treaty shopping in this situation as abusive. Consequently, while the Conduit Report's objections to treaty shopping are applicable to most tax treaties, they may not be applicable to all of them.

### 3 Conduit Report Recommendations

In the Conduit Report, it was advocated that states should include a 'limitation of benefits' provision in their tax treaties to counter treaty shopping. These provisions were later included in the Commentary.<sup>31</sup> The theory underlying these provisions is that the treaty benefits should only be provided to taxpayers who have a sufficient nexus with the state of residence,<sup>32</sup> and as such, justify the taxpayer taking advantage of the treaty. The Conduit Report discussed four types of 'limitation of benefits' provisions; each provision is briefly outlined.

#### (a) The 'Look-Through' Approach

This approach examines the direct and indirect owners or beneficiaries of the entity and permits the treaty benefits only to the extent that residents

---

27 Haug, *supra* note 3, 219.

28 *Ibid* 220.

29 *Ibid*.

30 Baker, *supra* note 25, Page B.7 – B.09.

31 OECD Committee on Fiscal Affairs, *Model Convention*, *supra* note 1, Commentary on Article 1, [13]–[26].

32 Haug, *supra* note 3, 225.

of the state in which the company is resident own the company.<sup>33</sup> This the most direct method for attacking conduits, but there are disadvantages: this approach is incompatible with the principle of the separate legal status of corporate entities, as it requires ‘piercing the corporate veil’, and it may be administratively difficult.<sup>34</sup> Furthermore, this approach is ineffective against stepping stone conduits,<sup>35</sup> as it does not address the shifting of profits to another state in order to reduce taxable income.

#### (b) The Exclusion Approach

Often conduits are created by the use of tax-exempt (or nearly tax-exempt) companies that may be distinguished by special legal characteristics.<sup>36</sup> These companies enjoy special tax privileges, defined by reference to tax and commercial laws in their state of residence, which provides them with a status similar to that of a non-resident.<sup>37</sup> Therefore, under this approach treaty provisions could be used to exclude companies that meet particular statutory requirements from obtaining treaty benefits.

#### (c) The ‘Subject-to-Tax’ Approach

Under this approach, a general subject-to-tax provision could provide that treaty benefits in the source state will be granted only if the income was subject to tax in the state of residence.<sup>38</sup> This approach corresponds with the purpose of tax treaties: the prevention of double taxation.<sup>39</sup> However, the OECD does not recommend this approach,<sup>40</sup> as it would exclude entities such as charities, or other entities that have an exemption under domestic law for specific reasons, such as encouraging economic development,<sup>41</sup> from gaining treaty benefits. Secondly, this approach would not be effective against stepping stone conduits,<sup>42</sup> as it does not address the issue of reduction of taxable income.

#### (d) The Channel Approach

This approach focuses on singling out conduits by reference to the conduit arrangements themselves;<sup>43</sup> namely, the reduction of the conduit’s tax

---

33 OECD Committee on Fiscal Affairs, *International Tax Avoidance*, supra note 9, 96.

34 Ibid.

35 Ibid.

36 Ibid.

37 Ibid.

38 Ibid 97.

39 Ibid.

40 Ibid.

41 Ibid 98.

42 Ibid.

43 Ibid 99.

base.<sup>44</sup> Under this approach, a company resident in one of the contracting states would not be entitled to the treaty benefits if a certain percentage, for example 50 per cent, of the company's gross income was used to pay interest or royalties to residents of a third state.<sup>45</sup> The focus is on companies that have a high gross income but a low taxable income, because of high expenses paid to non-residents.<sup>46</sup> This approach would provide an effective solution against stepping stone conduits.<sup>47</sup>

### (e) Bona Fide Provisions

As the 'limitation of benefits' provisions are general in nature, entities that are not created for treaty shopping purposes may nonetheless fall within their scope. The Conduit Report recommends that bona fide provisions should be included to ensure that in bona fide cases the treaty benefits are granted.<sup>48</sup>

The OECD proposes that bona fide provisions could take different forms.<sup>49</sup> First, there is a 'general bona fide provision', which states that the 'limitation of benefits' provision will not apply where the company's activities are motivated by sound business reasons and thus do not have the primary purpose of obtaining treaty benefits.<sup>50</sup> Secondly, there is the 'activity provision', which provides that the 'limitation of benefits' provision will not apply where the company is engaged in substantive business operations in the state in which it is resident.<sup>51</sup> Thirdly, there is the 'amount of tax provision' that specifies that the 'limitation of benefits' provision will not apply where the reduction of tax claimed is not greater than the tax imposed by the state in which the company is resident.<sup>52</sup> Fourthly, there is the 'stock exchange provision' that grants the treaty benefits to publicly traded companies.<sup>53</sup> Lastly, there is the 'alternative relief provision',<sup>54</sup> which focuses on the ability of the taxpayer to obtain similar or better treaty benefits from an alternative treaty.<sup>55</sup>

---

44 Haug, *supra* note 3, 227.

45 *Ibid.*

46 *Ibid.*

47 OECD Committee on Fiscal Affairs, *International Tax Avoidance*, *supra* note 9, 100.

48 *Ibid.*

49 *Ibid.*

50 *Ibid.*

51 *Ibid.*

52 *Ibid.*

53 *Ibid.*

54 *Ibid.*

55 Haug, *supra* note 3, 231.



### III IS TREATY SHOPPING OF CONCERN TO NEW ZEALAND?

#### New Zealand's Tax Treaties

As at 1 June 2007, New Zealand has 33 tax treaties in force<sup>56</sup> and a further two pending.<sup>57</sup> New Zealand takes a modified stance on some provisions of the Model Convention, increasing its rights to exercise its source-based taxing rights. For example, with regard to the definitions of 'permanent establishment' and 'royalties', New Zealand negotiates definitions that are more expansive than those contained in the Model Convention. Furthermore, New Zealand has reserved its right to tax royalties at source and has included provisions to protect its source-based taxation on income derived from natural resources.

Under domestic law, the non-resident withholding tax rates<sup>58</sup> are generally 30 per cent for dividends, and 15 per cent for interest<sup>59</sup> and royalties. Typically, the maximum rates under New Zealand's tax treaties are 15 per cent on dividends,<sup>60</sup> and 10 per cent on interest<sup>61</sup> and royalties.<sup>62</sup> Therefore, if a non-resident establishes a conduit in a state with which New Zealand has a tax treaty to undertake transactions with New Zealand, this could have a significant impact on New Zealand's source-based revenue.

Generally, New Zealand adheres to the capital export neutrality principle, treating all capital investments equally, irrespective of whether the investment is made domestically or internationally, and uses the credit method to eliminate double taxation in domestic law and in its tax treaties. An advantage of using the credit method is that it discourages the transfer of assets or income to low-tax countries or tax havens, as the taxpayer will still incur New Zealand tax liability, based on the residence principle, but will obtain only a small credit to offset against their tax liability.

Since the Conduit Report, New Zealand has enacted 11 treaties with a further two pending, and 12 protocols, of which only four treaties and

---

56 Australia; Belgium; Canada; Chile; Denmark; Federal Republic of Germany; Fiji; Finland; French Republic; India; Indonesia; Ireland; Italy; Japan; Malaysia; Netherlands; Norway; Poland; Republic of China; Republic of Korea; Republic of Philippines; Republic of South Africa; Russian Federation; Singapore; Spain; Sweden; Switzerland; Taiwan; Thailand; United Arab Emirates; United Kingdom; and United States of America.

57 Austria and Mexico.

58 The Government is proposing to review, and potentially lower, the non-resident withholding tax rates, including tax treaty rates; see Hon Cullen and Hon Dunne, *New Zealand's International Tax Review: A Direction for Change* (2006) Chapter 8.

59 Non-resident withholding rates on interest can, in some circumstances, be reduced to zero by application of the Approved Issuer Levy.

60 The maximum rate, in Article 10 (Dividends) of the Model Convention if the beneficial owner is a company is 5 per cent, whereas the rate of 15 per cent is applicable to corporate entities in all 34 of New Zealand's tax treaties.

61 The maximum rate found in Article 11 (Interest) of the Model Convention is 10 per cent and this rate is found in 27 of New Zealand's tax treaties.

62 Article 12 (Royalties) of the Model Tax Convention allocates the exclusive right to tax royalties to the state of residence. The maximum rate of 10 per cent is found in 24 of New Zealand's tax treaties.

one protocol contain a 'limitation of benefits' provision. As New Zealand does not appear to follow a standard practice of incorporating 'limitation of benefits' provisions in its tax treaties, it cannot be stated with confidence that the New Zealand government is concerned about treaty shopping or that there is an underlying tax policy to prevent treaty shopping.

The impact that treaty shopping has on the source state's tax base explains why some states, such as the United States, have extensive 'limitation of benefits' provisions in their tax treaties. Considering that New Zealand is a net capital importer<sup>63</sup> and has negotiated expansive source-based taxing rights, as compared with the Model Convention, one would think that New Zealand would try to protect that revenue base by restricting the entitlement to treaty benefits.

One possible explanation for New Zealand's lack of explicit objection to treaty shopping is that New Zealand wants to attract foreign investment. The revenue that could be collected from permitting non-residents to establish conduits in New Zealand could offset any loss of revenue that New Zealand might suffer if it was a source state. Alternatively, New Zealand could obtain other non-tax benefits from being the source state that outweigh any revenue loss, such as increased capital investment. This raises the possibility that New Zealand may not be concerned about treaty shopping.

An alternative explanation could be that New Zealand is concerned about treaty shopping, but does not negotiate the inclusion of 'limitation of benefits' provisions in its treaties. The Commentary states that contracting states can include a 'limitation of benefits' provision in their treaties. However, the Model Convention does not itself contain a 'limitation of benefits' provision. Consequently, for a 'limitation of benefits' provision to be included in New Zealand treaties, New Zealand would have to negotiate for the inclusion of a non-standard provision.

## **Income Tax Act 2004**

Considering that the Conduit Report was released in 1987, if treaty shopping is of concern to New Zealand, then one might expect changes to the Income Tax Act 2004 (ITA) that reflect that treaty shopping is an issue.

New Zealand's tax treaties are incorporated into domestic law by Orders in Council, under subpart BH of the ITA and Part 10A of the Tax Administration Act 1994. Section BH 1(2) of the ITA sets out the purposes for which tax treaties may be negotiated by New Zealand. However, while this section does refer to the prevention of fiscal evasion,<sup>64</sup> it does not refer to the prevention of tax avoidance. This is the only section in the Inland

---

63 McLeod Committee, *Tax Review 2001: Issues Paper* (2001) 129.

64 Income Tax Act 2004, s BH 1(2)(f).

Revenue Acts to refer to fiscal evasion.<sup>65</sup> The meaning of ‘fiscal evasion’ in this context is unclear: it could be referring to tax avoidance and tax evasion, or it could just be referring to tax evasion. Consequently, it is not immediately obvious whether New Zealand’s legislature considers that it is a purpose of tax treaties to prevent tax avoidance.

Seven years after the release of the Conduit Report, a project to rewrite the Income Tax Act 1994 (“ITA 1994”) was initiated and a discussion document was released.<sup>66</sup> It was in this discussion document that section BF 1, the predecessor to section BH 1(2) of the ITA, was drafted. Section BF 1 listed seven purposes for which treaties may be negotiated. While the prevention of fiscal evasion was listed, the prevention of tax avoidance was not.<sup>67</sup>

Following the discussion document, the Taxation (Core Provisions) Bill and associated commentary<sup>68</sup> were released. The Bill listed the prevention of tax evasion, but not tax avoidance, as a purpose of a tax treaty.<sup>69</sup> There were no submissions on including the prevention of tax avoidance as a purpose for which tax treaties could be negotiated.<sup>70</sup> Subsequently, section 6 of the Taxation (Core Provisions) Act 1996 replaced section BB 11(2) of the ITA 1994 with section BF 1, which was renumbered as section BH 1(2).<sup>71</sup>

In 2000, the OECD updated the Commentary to allow for exchanges of information in relation to all taxes and not just income tax. New Zealand subsequently amended subpart BH of the ITA 1994 to follow the updated Convention.<sup>72</sup> This was also an opportunity to amend section BH 1(2) to clarify that the prevention of tax avoidance was also a purpose for which treaties were negotiated. However, no such amendment was made.

The fact that the ITA does not explicitly state prevention of tax avoidance as a purpose of a treaty does not mean that treaties do not have that purpose; in other words, the New Zealand legislature would not have drafted the ITA on the basis that the purpose of tax treaties was to facilitate tax avoidance.

One possible explanation for the unusual drafting of section BH 1(2) of the ITA is that the reference to ‘fiscal evasion’ could be explained by reference to the preamble of the Model Convention, which refers to only fiscal evasion. Both the English and the French texts of the Model

---

65 The Inland Revenue Acts typically refer to tax evasion or tax avoidance; see, for example, Goods and Services Tax Act 1985, s 76; Tax Administration Act 1994, s 85C; and Income Tax Act 2004, s BG 1.

66 Hon Birch and Hon Creech, *Core Provisions: Rewriting the Income Tax Act; A Discussion Document* (1995).

67 *Ibid* 64.

68 Hon Creech, *Taxation (Core Provisions) Bill: Commentary on the Bill* (1995).

69 Taxation (Core Provisions) Bill (1995 No 136-2), cl 5 BH 1(2).

70 Officials’ Report to the Finance and Expenditure Select Committee, “Report on Submissions on Taxation (Core Provisions) Bill” (1996) Brookers, 27-28 (at 20 January 2007).

71 Section BH 1 has been subsequently further amended to include the assistance in the recovery of unpaid tax as a purpose for which tax treaties are negotiated.

72 Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, s 4.

Convention are equally authoritative.<sup>73</sup> The French word ‘*évasion*’ means ‘escape’ in English,<sup>74</sup> and ‘*évasion fiscale*’ means ‘tax evasion’<sup>75</sup> and ‘tax avoidance’.<sup>76</sup> Consequently, it is likely that the reference to ‘fiscal evasion’ in the ITA is based on the French meaning of ‘*évasion*’ and refers to the escaping of tax liability, encompassing both tax avoidance and tax evasion. If this is the case, then the issue arises as to the legitimacy of using the Model Convention and French terms to interpret New Zealand’s domestic legislation.

#### IV ANTI-AVOIDANCE MEASURES IN NEW ZEALAND’S TAX TREATIES

In the 1977 Model Convention revision, the OECD expressed concern regarding the abuse of tax treaties,<sup>77</sup> and the revised Model Convention included two modifications to the treaty provisions to prevent, in certain cases, treaty shopping via conduits.<sup>78</sup> First, because only residents of the contracting states should be entitled to treaty benefits, a limitation was added to who qualified as a resident. Secondly, a limitation was included to restrict who was entitled to the benefit of the reduced withholding tax rates under Articles 10, 11, and 12 of the Model Convention, applicable to dividends, interest and royalties, respectively: to be entitled to treaty benefits the taxpayer has to be the ‘beneficial owner’.

##### Residence Requirement

The first modification was to limit ‘resident’ in Article 4 of the Model Convention, by the addition to the phrase “resident of a Contracting State” an exclusion of any person who is “liable to tax in a Contracting State in respect only of income from sources in that State and capital situated therein”.<sup>79</sup> Consequently, to qualify for the treaty benefits, a taxpayer must be liable to tax on their worldwide income (‘full tax liability’) in their state of residence.<sup>80</sup> Therefore, if an entity did not meet this requirement, the entity would be given the status of non-resident<sup>81</sup> and would not be entitled to treaty benefits.

---

73 Baker, *supra* note 25, 10B – 10B.09.

74 Collins Robert French Dictionary (6 ed, 2002).

75 *Ibid*.

76 The Oxford-Hachette French Dictionary (3 ed, 2001).

77 OECD Committee on Fiscal Affairs, *International Tax Avoidance*, *supra* note 9, 88.

78 *Ibid* 92-93.

79 *Ibid*.

80 Rohatgi, *supra* note 2, 71.

81 OECD Committee on Fiscal Affairs, *International Tax Avoidance*, *supra* note 9, 92.

An entity need not have to actually pay tax to be liable to tax.<sup>82</sup> The phrase ‘liable to tax’ refers to both present and potential tax liability.<sup>83</sup> Therefore, an entity which would otherwise be subject to comprehensive taxation, but which enjoys a specific exemption, is nonetheless liable to tax.<sup>84</sup> This is because if the exemption was revoked, or the entity failed to fulfil the qualifying requirements, then the entity would be subject to comprehensive taxation.<sup>85</sup> Therefore, a conduit could be regarded as a resident in the state in which it was situated and consequently would be entitled to claim the treaty benefits, even though the ultimate recipient of the income would not be eligible to obtain such benefits.<sup>86</sup>

As the ‘resident’ requirement is of limited assistance in preventing treaty shopping, some countries provide in their domestic law further requirements on the definition of ‘resident’, for example, that in order to qualify for residence status under a tax treaty, the taxpayer must not abuse the treaty.<sup>87</sup> It is possible that such qualifications, outside the text of the treaty, are in breach of international law.<sup>88</sup> However, the legitimacy of using domestic law restrictions to further qualify who is a resident for treaty purposes does not arise in New Zealand, as New Zealand does not have any specific anti-avoidance measures aimed at excluding a conduit established by treaty shoppers from being a resident. Consequently, a conduit can easily obtain residence, for example, by being incorporated in New Zealand.

## Beneficial Ownership Requirement

### 1 Commentary

The terms ‘beneficial owner’ and ‘beneficially owned’ arise in the context of Articles 10, 11, and 12 of the Model Convention, which provide for reduced rates of withholding taxes on interest, dividends and royalties respectively. These Articles deny the benefits of the reduced withholding tax rates if the taxpayer is not the ‘beneficial owner’ of the income.

The Conduit Report and the Commentary do not specifically define the phrase ‘beneficial owner’, but refer to an agent or nominee and consider that the phrase would cover the situation where a conduit was the formal owner of the assets, but had very narrow powers that rendered it a mere fiduciary or

---

82 Baker, *supra* note 25, 4B.05.

83 Rohatgi, *supra* note 2, 72.

84 Baker, *supra* note 25, 4B.05.

85 *Ibid.*

86 Haug, *supra* note 3, 223.

87 For example the Swiss Decree on Abuse 1962 and § 50d Abs.1a of the German EstG: see Vogel, *Klaus Vogel on Double Taxation Conventions* (3 ed 1997), Article 1, [97]-[100]; and Haug, *supra* note 3, 270; Ian Gzell, “Treaty-Shopping” (1998) 27 AT Rev 65, 67-69.

88 Jeffery *The Impact of State Sovereignty on Global Trade and International Taxation* (1999) 112; OECD Committee on Fiscal Affairs, “Tax Treaty Override” in *Model Tax Convention on Income and on Capital* (loose leaf) (2003) R(8)-6 [“Tax Treaty Override”].

an administrator.<sup>89</sup> In practice, this means that the real, economic title should prevail over the formal, legal title. In other words, effect should be given to the substance rather than the form of the transaction.<sup>90</sup>

Since 'beneficial owner' is not defined in the treaty, the definitional rule contained in Article 3(2) of the Model Convention is applicable. Under this rule, it is legitimate to have recourse to domestic law for a term that is not defined in the Model Convention, if the term is ambiguous.

In common law jurisdictions, the term 'beneficial owner' has a specific legal meaning: it applies where one person has equitable beneficial ownership of assets, as opposed to the formal legal title.<sup>91</sup> Therefore, the common law meaning would exclude from treaty benefits a legal owner who is a trustee for another.<sup>92</sup> However, the Commentary rejects application of the common law meaning of 'beneficial owner'.<sup>93</sup> If the common law definition should not be applied, this raises the issue of which meaning should apply.

Baker argues that the term should be accorded an 'international fiscal meaning', in that the meaning should not be derived from the domestic laws of the contracting states.<sup>94</sup> In the absence of a body of established case law on the meaning, the principal source for determining the 'international fiscal meaning' would be the Commentary, which largely reflects the consensus of the OECD member countries on the meaning.<sup>95</sup>

One way to test whether a conduit is the beneficial owner is to ask what would happen to the funds if the conduit went bankrupt before paying over the income to the intended, ultimate recipient.<sup>96</sup> If the ultimate recipient could claim the funds as its own, then the conduit cannot be regarded as the 'beneficial owner'. Alternatively, if the ultimate owner would merely be a creditor of the conduit, then the conduit could be regarded as the 'beneficial owner'.<sup>97</sup>

The scope of the meaning of 'beneficial owner' in the Commentary and Conduit Report is limited, as states do not have a consensus view as to what constitutes abuse of a tax treaty. As a result, the beneficial ownership requirement is intended to counter one particular type of treaty shopping: the use of agents, nominees, or conduits who are mere fiduciaries.<sup>98</sup>

---

89 OECD Committee on Fiscal Affairs, *International Tax Avoidance*, supra note 9, 93; OECD Committee on Fiscal Affairs, *Model Tax Convention*, supra note 1, Article 1, [13]-[26].

90 Haug, supra note 3, 224.

91 Muck, "The New Zealand-Netherlands Double Tax Agreement: A Significant Influence on New Zealand's Network of Double Tax Agreements" (2005) 11 NZJTL 342, 371.

92 Baker, supra note 25, 10B.13.

93 OECD Committee on Fiscal Affairs, *Model Convention*, supra note 1, Article 10, [12]; Muck, supra note 91, 371; Baker, supra note 25, 10B.13.

94 Baker, supra note 25, 10B.14.

95 There is authority that the Commentary can be referred to as an aid in the interpretation of tax treaties, which were concluded based on the OECD Model; see *C of IR v ER Squibb & Sons (NZ) Ltd* (1992) 14 NZTC 9,146, 9,155 ["*Squibb & Sons*"].

96 Baker, supra note 25, 10B.15.

97 *Ibid.*

98 *Ibid.*

## 2 A Recent 'Beneficial Ownership' Case

There is little case law on the meaning of 'beneficial ownership'.<sup>99</sup> However, recently, in *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch*,<sup>100</sup> the England and Wales Court of Appeal interpreted 'beneficial ownership' in the context of a proposed back-to-back financing arrangement.

In 2002, Indofood, incorporated in Indonesia, decided to borrow funds by selling financing notes to non-Indonesian purchasers. If the notes had been sold directly to purchasers, the Indonesian domestic law interest withholding tax rate of 20 per cent would have been applicable. To reduce the rate of withholding tax, Indofood established a wholly-owned finance subsidiary in Mauritius.

The Indonesia-Mauritius tax treaty provided for a withholding tax rate of ten per cent. However, due to concerns regarding the abuse of the treaty by non-Mauritian persons, Indonesia terminated the treaty, effective 1 January 2005; consequently, the 20 per cent tax rate was applicable.

The Mauritian finance subsidiary issued US \$280 million of notes, which were governed by English Law and had an exclusive United Kingdom jurisdiction clause, and loaned the proceeds to Indofood. Since it was Indofood's responsibility to pay the interest to the finance subsidiary net of Indonesian withholding taxes, Indofood had to 'gross up' the post-2004 interest payments, to cover the additional ten per cent tax.

Consequently, Indofood considered that it would be advantageous to redeem the notes. The terms of the notes provided that if the Indonesian withholding tax rate rose above the ten per cent rate provided for in the Indonesia-Mauritius treaty, then the finance subsidiary could redeem the notes, but only if this could not be avoided by the finance subsidiary taking "reasonable measures" available to it.

JP Morgan, the trustee for the noteholders, claimed that the finance subsidiary did have "reasonable measures" available to it: the creation of a back-to-back loan corporation in the Netherlands (Dutchco). The Indofood loan could then be transferred from the finance subsidiary to Dutchco, resulting in the creation of a debt obligation. Under the Indonesia-Netherlands tax treaty, which came into force on the 1<sup>st</sup> January 2004, Indonesian-sourced interest paid to a Dutch corporation was not subject to Indonesian withholding tax.

Under the proposed arrangement Indofood was obliged to pay the interest two business days before the due date to Dutchco. In turn, Dutchco was obligated to pay the interest one business day before the due date to the trustee, and the trustee was obligated to pay the noteholders on the due date.<sup>101</sup> Additionally, Dutchco was obliged to pay the trustee the

---

<sup>99</sup> *Ibid* 10B.11.

<sup>100</sup> [2006] BTC 8003.

<sup>101</sup> *Ibid* [43].

money that it had received from Indofood, as it was prohibited, by the note conditions, from finding money from another source.

The issue before the Court was whether the proposed back-to-back loan corporation was a “reasonable measure” available to achieve a ten per cent or less post-2004 Indonesian withholding tax rate. The Court considered that whether the establishment of Dutchco was a “reasonable measure” depended on whether the Indonesian Tax Court would view Dutchco as the ‘beneficial owner’ of the interest payable by Indofood,<sup>102</sup> such that the Indonesia-Netherlands tax treaty could be applied.

The Court endorsed the view stated in the Commentary and stated that ‘beneficial owner’ should have an ‘international fiscal meaning’.<sup>103</sup> It considered that Dutchco’s activities would be like an administrator,<sup>104</sup> limited to receiving the interest payment and immediately remitting the interest to the Mauritian finance subsidiary. It stated also that the substance of the matter had to be considered,<sup>105</sup> according to which Dutchco would never derive any economic benefit from the interest payments. Finally, the Court held that the Indonesian Tax Court would not consider that Dutchco would be the ‘beneficial owner’ of the interest,<sup>106</sup> and consequently, the utilization of Dutchco was not a “reasonable measure” available to Indofood. This case provided the Court with an ideal opportunity, based on very clear obligations, to deny that the proposed conduit would be considered as the ‘beneficial owner’.

As the payment obligations arising under the proposed structure were strict and Dutchco had very narrow powers, the extent of applicability of this decision to a situation may be limited by structuring the back-to-back loans so that the amounts, terms and payment dates of both loan obligations are not identical. This could also be achieved by ensuring that the conduit has broader powers, in which case the conduit could be regarded as the beneficial owner and, consequently, be entitled to the treaty benefits.

### **‘Limitation of Benefits’ Provisions**

The only New Zealand treaties with ‘limitation of benefits’ provisions are those with the United Kingdom,<sup>107</sup> Ireland,<sup>108</sup> the Republic of Chile,<sup>109</sup> the United States,<sup>110</sup> and the United Arab Emirates (UAE).<sup>111</sup>

---

102 *Ibid* [32] and [70].

103 *Ibid* [42].

104 *Ibid* [44].

105 *Ibid*.

106 *Ibid* [47], [70] and [77].

107 Double Taxation Relief (United Kingdom) Order 1984 (SR 1984/24) [“United Kingdom-New Zealand Treaty”].

108 Double Taxation Relief (Ireland) Order 1988 (SR 1988/189) [“Ireland-New Zealand Treaty”].

109 Double Taxation Relief (Republic of Chile) Order 2004 (SR 2004/175) [“Chile-New Zealand Treaty”].

110 Double Taxation Relief (United States of America) Order 1983 (SR 1983/196) [“United States-New Zealand Treaty”].

111 Double Taxation Relief (United Arab Emirates) Order 2004 (SR 2004/177) [“United Arab Emirates-New Zealand Treaty”].



The United Kingdom and the Ireland treaties adopt a qualitative approach to target particular types of income: dividends, interest and royalties. The United Kingdom-New Zealand treaty denies treaty benefits in circumstances where the “main purpose or one of the main purposes”<sup>112</sup> of the conduct in issue is to take advantage of the treaty. The Irish treaty states that treaty benefits are to be denied if conduct was carried out “mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons”.<sup>113</sup> Such approaches are consistent with numerous other United Kingdom and Irish treaties,<sup>114</sup> which suggests that these provisions were included in the New Zealand treaties at the request of United Kingdom and Ireland.

The Republic of Chile-New Zealand treaty<sup>115</sup> adopts two anti-treaty shopping approaches, both of which are also found in the Republic of Chile-Russian Federation 2004 treaty.<sup>116</sup> First, it contains a subject-to-tax provision, applicable to interest, dividends and royalties, in conjunction with a general bona fide provision, both of which correspond with the drafting in the Commentary.<sup>117</sup> Secondly, like other Chilean treaties,<sup>118</sup> it contains an anti-avoidance rule dealing with source taxation of specific types of income, where treaty benefits are denied if it was “the main or one of the main purposes ... to take advantage of” the treaty’s interest, dividends, or royalties provisions. Because such provisions are found in other Chilean treaties, this suggests that the inclusion of these provisions in the New Zealand treaty was at the request of Chile.

The United States is a strong advocate of including ‘limitation of

112 United Kingdom-New Zealand Treaty, *supra* note 107, Arts 11(6); 12(9) and 13(7), as amended by the Double Taxation Relief (United Kingdom) Amendment Order 2004, Articles II-IV. See Art VII as to when these amendments come into force.

113 Ireland-New Zealand Treaty, *supra* note 108, Arts 13(7) and 14(7). Article 12(8), dividends, is drafted differently, due to Ireland having a participation exemption scheme.

114 This or similar drafting is also found in, to list a few, the United Kingdom-Australia (SI No 3199 of 2003); United Kingdom-Japan (SI No 1924 of 2006); United Kingdom-Hashemite Kingdom of Jordan (SI No 3924 of 2001); United Kingdom-Lithuania (SI No 3925 of 2001); United Kingdom-Macedonia (SI No 2127 of 2007); United Kingdom-Norway (SI No 3247 of 2000); United Kingdom-Poland (SI No 3323 of 2006); and United Kingdom-South Africa (SI No 3138 of 2002). This, or similar drafting, is found in the following Irish treaties: Ireland-Australia (SI No 406 of 1983); Ireland-Chile 2005 (SI No 815 of 2005, note — this treaty is not yet in force); Ireland-Finland (SI No 289 of 1993); Ireland-Greece (SI No 774 of 2004); Ireland-State of Israel (SI No 323 of 1995); Ireland-Sweden (SI No 348 of 1987); and Ireland-United Mexican States (SI No 497 of 1998).

115 Republic of Chile-New Zealand Treaty, *supra* note 109, Arts 27(1) and (2).

116 Convention between the Government of the Republic of Chile and the Government of Russia Federation for the Avoidance of Double Tax and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, opened for signature 19 November 2004, art 27 (not yet in force). The text of the treaty is available at <<http://www.sii.cl/pagina/jurisprudencia/convenios.htm>> (at 1 August 2007).

117 OECD Committee on Fiscal Affairs, *Model Convention*, *supra* note 1, Commentary on Article 1, [15]-[19].

118 For example: Convention between the Republic of Croatia and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, opened for signature 24 June 2003, (entered into force 21 December 2004); Convention between the Republic of Chile and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, (entered into force January 2005); Convention between the Republic of Chile and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, (entered into force January 2004); Convention between the Republic of Chile and the Kingdom of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, opened for signature 4 June 2004, (entered into force December 30 2005).

benefits' provisions.<sup>119</sup> The United States-New Zealand treaty, consistent with other United States treaties, permits an entity to qualify for treaty benefits if one of three conditions is met.<sup>120</sup> First, treaty benefits are granted where residents, or in the case of the United States, citizens, or a company whose shares are substantially and regularly traded on the NASDAQ Exchange or the New Zealand Stock Exchange, must hold, directly or indirectly, at least 75 per cent of each class of shares in the company. Secondly, treaty benefits are granted where there is substantial and regular trading of the company's principal class of shares on the New Zealand Stock Exchange or NASDAQ Exchange. Thirdly, treaty benefits are granted where the establishment, acquisition, and maintenance of the company and the conduct of its operation did not have as a principal purpose the purpose of obtaining treaty benefits.

The UAE-New Zealand treaty is unusual. Since the United Arab Emirates does not have a general income tax system, the issue of double taxation does not generally occur in cross-border transactions.<sup>121</sup> The United Arab Emirates-New Zealand treaty takes a broad approach. The provision states: "[n]o benefits by way of relief from taxation shall arise under this Agreement where and to the extent to which such relief is contrary to the intent of the Agreement."<sup>122</sup> The drafting of this provision is unusual, as it does not appear in either the Conduit Report or the Commentary; nor is it present in any other New Zealand or United Arab Emirates treaty.

It is possible that this provision was included at the request of New Zealand, and it may reflect that recently, New Zealand has adopted a policy of including such a provision in its tax treaties. However, New Zealand has negotiated several treaties subsequent to the United Arab Emirates-New Zealand treaty, and yet none of the subsequent treaties<sup>123</sup> include such a provision.

As the United Arab Emirates does not have a general income tax system, this makes it an attractive place for a treaty shopper to establish a conduit. Furthermore, the allocation and limitations on taxing rights in the treaty does not result in sacrifice of revenue by the United Arab Emirates.<sup>124</sup> Under the treaty, New Zealand is providing tax benefits to United Arab Emirates residents, whereas the treaty does not provide additional tax benefits to New Zealand residents. Consequently, the inclusion of this 'limitation of benefits' provision, at New Zealand's request, could be because of the lack of reciprocity.

---

119 See Haug, *supra* note 3.

120 United States of America-New Zealand Treaty, *supra* note 110, Art 16.

121 Finance and Expenditure Committee, "International Treaty Examination of Taxation Agreements with the Republic of South Africa, the United Arab Emirates, the Republic of Chile, the United Kingdom of Great Britain and Northern Ireland, the Republic of the Philippines, and the Kingdom of the Netherlands" (2004), 7 <<http://www.parliament.nz/en-NZ/SC/Reports>> (at 31 January 2007).

122 United Arab Emirates-New Zealand Treaty, *supra* note 111, the Protocol, Art 10(b).

123 Treaties with Republic of Chile, Spain, Poland, Mexico and Austria.

124 However, overall New Zealand could gain tax revenue from increased foreign investment, facilitated by the application of the tax treaty.

## V GENERAL ANTI-AVOIDANCE RULE

A tax treaty is an agreement made between two sovereign states. By incorporation of the treaty provisions into New Zealand domestic law, the benefits of the tax treaty are conferred on New Zealand residents. Consequently, tax treaties have a dual existence; they are international agreements entered into between governments, and they become part of New Zealand's domestic law.

Treaty shopping involves reliance by taxpayers on the principles of international law contained in the treaty. Some commentators assert that domestic law and international law are two different areas of the law and as such, domestic law cannot be invoked to deny treaty benefits.<sup>125</sup> The application of domestic anti-avoidance rules and 'substance over form' principles to tax treaties is controversial and academic opinion is divided on the issue.<sup>126</sup> To date, New Zealand courts have not had the opportunity to address the issue of application of the General Anti-Avoidance Rule to a treaty shopping situation.

### Treaty Interpretation

Tax treaties are international treaties and as such are governed by the Vienna Convention on the Law of Treaties 1969 ("Vienna Convention"). Article 31 provides the general interpretative rule: treaties are to be interpreted in "good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose". The 'object and purpose' of a treaty is relevant as it gives light to the meaning of the treaty terms. It is the purpose of the treaty as evinced by its terms that is relevant to a treaty's interpretation and not the underlying purposes of each party to the treaty.<sup>127</sup> Article 32 permits recourse to supplementary materials in circumstances where the meaning is ambiguous or the result is manifestly absurd.

Article 31 provides what is to be considered as 'context'. This includes the preamble and annexes of the treaty, and agreements or instruments made between the parties in connection with the conclusion of the treaty and in regards to instruments, accepted by the other party. Usually, a tax treaty preamble states: "A Convention ... for the avoidance of double taxation and the prevention of fiscal evasion ...." While it is clear that they have a dual purpose — the elimination of double taxation and the prevention of fiscal evasion — in English, tax avoidance is not tax evasion and it is unclear whether tax avoidance falls within the scope of fiscal evasion.

---

125 Jeffery, *supra* note 88, 112.

126 See Haug, *supra* note 3, 231-237; Vogel, *supra* note 87, [95]; and Jeffery, *supra* note 88, Chapter 2; International Fiscal Association, *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions* (1995).

127 Shelton, *supra* note 20, 173-174.

As stated previously, in French ‘*évasion*’ can encompass both tax avoidance and tax evasion, and both the English and the French texts of the Model Convention are equally authoritative.<sup>128</sup> Therefore, it is likely that the reference to ‘tax evasion’ in the English version of the Model Convention preamble is based on the French Model Convention and meaning of ‘*évasion*’, and is intended to refer to both tax avoidance and tax evasion.

The Model Convention is not itself binding on states, but provides a template upon which treaties are negotiated and concluded. States are free to deviate from the Model Convention and negotiate their own terms. Consequently, the statements in the Commentary, while being a useful interpretative guide, may not be applicable to all tax treaties. It is possible that for some tax treaties, ‘tax evasion’ does refer to only tax evasion and not tax avoidance, in which case, the problem arises of how to differentiate tax treaties that have the purpose of preventing tax evasion and avoidance from those which have the purpose of only preventing tax evasion.<sup>129</sup>

All of New Zealand’s tax treaties contain provisions relating to ‘resident’ and all but one<sup>130</sup> refer to ‘beneficial owner’. These provisions could also be used as evidence that a purpose of a tax treaty is to combat tax avoidance. However, these provisions do not deny treaty benefits based on the motive or purpose of the taxpayer. These provisions define who is entitled to treaty benefits, but do not cover the situation where a taxpayer does meet the resident and beneficial owner requirements but has nonetheless established a conduit solely or mainly for the purpose of reducing tax liability.<sup>131</sup> As a result, the issue of whether the prevention of tax avoidance is a purpose of a treaty cannot be determined solely by examining the ‘resident’ and ‘beneficial owner’ provisions.

The issue arises as to whether the Commentary can be considered as part of the ‘context’ of a treaty, such that the views expressed in the Commentary could be used to clarify that the purpose of New Zealand’s tax treaties is to prevent tax avoidance and that domestic anti-avoidance measures could be legitimately applied in a tax treaty context. While the Commentary asserts that domestic anti-avoidance provisions and principles can be applied to tax avoidance situations, it should be remembered that the Commentary is an interpretative guide.<sup>132</sup> Therefore, although it is not legally binding, it is likely to be considered as highly persuasive by a court.

---

128 Baker, *supra* note 25, 10B.09.

129 For example the preamble to the treaty between Canada and Venezuela states: “Convention Between the Government of Canada and the Government of the Bolivarian Republic of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Avoidance and Evasion with Respect to Taxes on Income and Capital.”; see Goyette, “Tax Treaty Abuse: A Second Look” (2003) 51 *Can Tax J* 764, 766 n 8.

130 Double Taxation Relief (Japan) Order 1963 (SR 1963/49) does not refer to ‘beneficial owner’.

131 Jeffery, *supra* note 88, 112.

132 OECD Committee on Fiscal Affairs, *Model Tax Convention*, *supra* note 1, Introduction, [29.3].

Courts may have recourse to a wide range of extrinsic materials, under Articles 31 and 32 of the Vienna Convention, to aid interpretation of the treaty. However, the legal basis for referring to the Commentary is unclear, as the Commentary does not readily fit into any of the categories stated in the Vienna Convention.<sup>133</sup> Since the New Zealand courts have previously referred to the Commentary,<sup>134</sup> it is likely that they will continue to do so, despite the uncertain legal basis of such recourse.

## Commentary

Regarding the application of domestic law anti-avoidance measures, in the Conduit Report it was stated:<sup>135</sup>

Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of “*pacta sunt servanda*” even if considered improper.

This means that if there are no anti-avoidance provisions in the treaty, then domestic measures may not be used to deny treaty benefits in abusive situations, otherwise states would be in breach of their international obligations. The OECD has since modified its position.

The Commentary asserts that the prevention of tax avoidance is a purpose of a tax treaty,<sup>136</sup> and that as a general rule there is no conflict between the application of general anti-avoidance measures and treaty obligations.<sup>137</sup> Consequently, states do not have to grant treaty benefits where arrangements have been entered into that constitute an abuse of the treaty provisions. The Commentary recognizes two approaches. These two approaches shall be referred to as the ‘transactional approach’ and the ‘interpretative approach’, although the Commentary does not adopt this terminology.

Not all Member States agree with the views expressed in the Commentary regarding the application of domestic anti-avoidance measures. The six Member States that have expressed reservations are Belgium, Ireland, Luxembourg, the Netherlands, Portugal, and Switzerland.<sup>138</sup>

### *1 Transactional Approach*

Under this approach, some states take the view that because taxes are imposed by the domestic law provisions, as restricted by the tax treaty,

---

133 Baker, *supra* note 25, E12.

134 *Squibb & Sons*, *supra* note 95, 9,155.

135 OECD Committee on Fiscal Affairs, *International Tax Avoidance*, *supra* note 9, 101.

136 OECD Committee on Fiscal Affairs, *Model Convention*, *supra* note 1, Commentary on Article 1, [7].

137 *Ibid* [9.2].

138 *Ibid* [27.4]-[27.9].

then any abuse of a treaty provision can also be characterized as an abuse of the domestic law provisions.<sup>139</sup> Under this approach, the substance of the transaction prevails over its legal form.<sup>140</sup> To the extent that anti-avoidance rules are part of the domestic tax laws for determining the 'true facts' which give rise to tax liability, they are not addressed in tax treaties and as a result are not affected by them.<sup>141</sup>

## 2 Interpretative Approach

According to this approach, an abusive transaction or arrangement is an abuse of the tax treaty itself, as opposed to an abuse of domestic law.<sup>142</sup> Consequently, it is considered that a proper construction of the treaty permits abusive transactions to be disregarded.<sup>143</sup> This approach is based on an interpretation of the purpose and object of the tax treaty and the obligation to interpret the treaty in good faith under Article 31 of the Vienna Convention.<sup>144</sup>

One commentator suggests that because the elimination of double taxation is an express purpose of a tax treaty, it is more likely that the court would reject the application of anti-avoidance measures if double taxation would be the result.<sup>145</sup> While this view is consistent with the purpose of tax treaties, it may not be correct. If this approach were applied, then the courts would often reject the application of anti-avoidance measures.<sup>146</sup> The problem with this approach is that it bases the validity of a course of action on the consequences of upholding or not upholding that course of action.

Whether a taxpayer is considered as committing tax avoidance should not depend on whether that taxpayer would suffer the burden of double taxation if the abusive transaction was disregarded or re-characterized.<sup>147</sup> The essential element of treaty shopping is the establishment of the conduit for tax minimization purposes. It is possible to have two non-resident taxpayers, both establishing subsidiaries, and both carrying out transactions with a treaty partner of that state. One taxpayer could be treaty shopping and one not, but both taxpayers would be subject to double taxation if denied treaty benefits. The essential difference between the two taxpayers

---

139 Ibid [9.2].

140 Goyette, *supra* note 129, 780.

141 OECD Committee on Fiscal Affairs, *Model Convention*, *supra* note 1, Article 1, [9.2].

142 Ibid [9.3].

143 Ibid.

144 Ibid.

145 Goyette, *supra* note 129, 792.

146 The domestic tax laws of the contracting states may be different; consequently, the application of the treaty to a particular type of income may not make a difference to the taxpayer's liability. For example, New Zealand does not have a comprehensive capital gains tax regime, whereas other states do. Therefore, non-application of the treaty may not always result in double taxation.

147 A taxpayer may be able to obtain unilateral relief from double taxation. Therefore, even though the taxpayer is subject to double taxation they do not bear the economic burden of the double taxation.

would be their motives for establishing the subsidiary; it is the motive that results in the denial of treaty benefits. Therefore, an interpretation that does prevent double taxation is preferable, but only if there is no underlying tax avoidance motive.

As the Commentary asserts that domestic law anti-avoidance measures can be applied to counter treaty shopping, and given that the Commentary will be considered by the courts, the New Zealand Courts could adopt the views as expressed in the Commentary. One issue that arises is whether New Zealand's General Anti-Avoidance Rule is drafted in such a way that it can be applied to counter treaty shopping.

### **New Zealand's General Anti-Avoidance Rule**

The issue of whether the General Anti-Avoidance Rule was sufficiently broad in scope to apply to tax treaties was considered in Canada. Section 245(4) of the Income Tax Act, RSC 1985 (Canada) referred to "a misuse of the provisions of this Act", which leads to the conclusion that the General Anti-Avoidance Rule was not sufficiently broad to encompass transactions that were treaty abuse, but only transactions that were abuses of the Income Tax Act, RSC 1985 (Canadian).<sup>148</sup> In 1997, in obiter, the Canadian Tax Court in *RMM Canadian Enterprises Inc & Equilease Corporation v R*, stated that the General Anti-Avoidance Rule would be applicable.<sup>149</sup> However, in 2004 the Canadian Government enacted retrospective legislation amending the General Anti-Avoidance Rule to 'clarify' that it did apply to transactions that were an abuse of a treaty.<sup>150</sup>

#### *1 The Scope of New Zealand's General Anti-Avoidance Rule*

New Zealand's General Anti-Avoidance Rule is found in section BG 1 of the ITA, which provides that a "tax avoidance arrangement" is void as against the Commissioner and permits the Commissioner to counteract a tax advantage that a person has obtained from or under the tax avoidance arrangement. Section OB 1 defines "tax avoidance" and "tax avoidance arrangement". "Tax avoidance" is defined as including, inter alia, directly or indirectly, altering the incidence of any income tax, or relieving a person from liability to tax or potential tax liability. "Tax avoidance arrangement" is defined as, inter alia, any arrangement that, directly or indirectly, has tax avoidance as its purpose or effect. The drafting of the General Anti-Avoidance Rule is very broad; its application is not limited to situations in which the ITA provisions themselves are breached. Consequently, treaty shopping would fall within the scope of the rule.

---

148 Goyette, *supra* note 131, 775.

149 97 DTC 302, cited in Baker, *supra* note 25, IB.52 – 1B.53.

150 Trossman and Heale, "Tax Authorities Takes on Treaty Shoppers" (1996) 17 ITR 71, 72.

Anti-avoidance provisions, based on the concept of tax avoidance arrangement, were first enacted in section 40 of the Land and Income Tax Assessment Act 1891. The current General Anti-Avoidance Rule is based on section 99 of the Income Tax Act 1976. Therefore, the application of the General Anti-Avoidance Rule would not give rise to the issue of 'treaty override', in the sense that New Zealand has not enacted subsequent legislation to intentionally override treaty provisions. However, the application of the General Anti-Avoidance Rule to deny treaty benefits could be viewed as an override of the treaty, as a domestic law provision has been invoked and applied to an international law obligation.<sup>151</sup>

## *2 Applicability of the General Anti-Avoidance Rule to New Zealand's Tax Treaties*

As stated previously, tax treaties create international law obligations. As a general rule, legislative bodies cannot be taken to have intentionally violated international law unless there is an express intention to do so.<sup>152</sup> If domestic law were to be applied, then a state would be invoking provisions of domestic law as a justification for failure to perform a treaty, potentially in breach of Article 27 of the Vienna Convention.<sup>153</sup> For this reason, the application of domestic law rather than treaty law, without being authorized by the treaty or by general international law, could be a violation of international law.<sup>154</sup>

Under section BH 1(4), treaty provisions have overriding effect despite any conflicting provisions in the ITA or any other Inland Revenue Act. However, section BH 1(4) of the ITA also provides an exception for the recovery of unpaid tax, but there is no exception for the application of anti-avoidance measures. Consequently, it is possible to interpret section BH 1(4) such that treaty obligations override the General Anti-Avoidance Rule.

Section BB 3 of the ITA provides for the overriding effect of certain matters. Section BB 3(1) provides that the Commissioner can counteract a tax advantage from a tax avoidance arrangement. Section BB 3(2) provides that tax treaties have an overriding effect and mirrors section BH 1(4) of the ITA.

Section BB 3 is intended to reflect that tax avoidance arrangements and tax treaties should be considered as part of the process for calculating a taxpayer's tax liability,<sup>155</sup> and clearly establishes the relationship between tax treaties and the General Anti-Avoidance Rule, and the rest of the ITA. However, section BB 3 does not clearly establish the relationship between

---

151 Jeffery, *supra* note 88, 112.

152 Vogel, *supra* note 87, Article 1, [88].

153 OECD Committee on Fiscal Affairs, *Tax Treaty Override*, *supra* note 88, R(8)-6.

154 Vogel, *supra* note 87, Article 1, [88].

155 Hon Creech, *supra* note 68, 6. This view is consistent with the transactional approach in the Commentary.



tax treaties and the General Anti-Avoidance Rule. Consequently, it would be open for a treaty shopper to claim that the treaty benefits had to be granted in good faith, otherwise New Zealand, by denying treaty benefits, would breach international law.<sup>156</sup>

Furthermore, when the OECD updated the Commentary in 2000 to allow for exchanges of information in relation to all taxes, it took New Zealand a further three years to amend section BH 1(4) of the ITA 1994 to follow the updated Convention.<sup>157</sup> This amendment occurred several years after the Conduit Report and the issue of whether General Anti-Avoidance Rule could be applied to tax treaties had been under international debate for some time. The legislature could have also included an amendment to provide that the General Anti-Avoidance Rule was an exception to the overriding effect of tax treaties, but it did not do so.

There appears to be a divergence between the New Zealand position as expressed in the Commentary and the legislative intention as expressed in the ITA. If the Commentary were used as a basis for applying the General Anti-Avoidance Rule to counter treaty shopping, then potentially the Commentary would be expanding the scope of the applicability of the General Anti-Avoidance Rule. This raises the issue that the OECD is effectively legislating for New Zealand, as the OECD would be conferring a power upon the New Zealand courts when the New Zealand legislature has not itself expressly conferred that power.

## VI CONCLUSION

To date there appears to be an absence of any explicit statement from the New Zealand government that treaty shopping is of concern. The lack of 'limitation of benefits' provisions in New Zealand's tax treaties may create an incentive for foreign investors to establish conduits in states with which New Zealand has a treaty, in order to invest and undertake economic activities in New Zealand. As the ITA does not explicitly establish the relationship between the General Anti-Avoidance Rule and tax treaties, the conduit could claim that the benefits of the treaty have to be granted under the good faith principle.

If the New Zealand government is concerned about treaty shopping, then clarity in this area is required. The preferred method would be to include 'limitation of benefits' provisions in tax treaties, as this avoids the issue of potential conflict between international law and domestic law. However, the negotiation of 'limitation of benefits' provisions into tax treaties may be difficult, as 'limitation of benefits' provisions are not found in the Model Convention. Consequently, the additional concessions that

---

156 OECD Committee on Fiscal Affairs, *Tax Treaty Override*, supra note 88, R(8)-6.

157 Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, s 4.

New Zealand would have to make in negotiations to obtain the inclusion of a 'limitation of benefits' provision may prove too costly.

Alternatively, amending the ITA to clarify the relationship between the General Anti-Avoidance Rule and tax treaties would provide guidance to taxpayers, the courts, and treaty partners. If this were to occur, then when a bilateral interpretation of a tax treaty led to the conclusion that taxpayers were abusing the treaty, the ITA would expressly permit the court to apply the General Anti-Avoidance Rule to deny treaty benefits to taxpayers who nonetheless fell within the treaty's scope.