Inland Revenue
Te Tari Taake

ISSUES PAPER

Income tax – trusts and the Australian–New Zealand Double Tax Agreement

A TAX COUNSEL OFFICE DISCUSSION DOCUMENT

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Issues paper IRRUIP15

Inland Revenue has been asked to clarify the tax treatment of trusts under the network of double tax treaties that New Zealand has entered into with other countries. This issues paper approaches this area by examining how New Zealand's treaty with Australia – the Australian–New Zealand Double Tax Agreement – addresses this subject.

This issues paper presents an approach on fundamental principles where commentators have expressed a range of views. The objective is to build a considered understanding that will provide guidance in an area of uncertainty.

Contents

About this document

Inland Revenue's Tax Counsel Office (Public Advice and Guidance) develops and publishes public statements interpreting the tax laws.

Where significant uncertainty exists, it helps us to hear from interested parties before we prepare a public statement. This generates discussion so we gain a better understanding of the issues, including practical concerns. An issues paper sets out our initial views on how the relevant tax laws may apply. If it results in the issue of a draft public statement, public consultation will occur in the usual manner.

Given that issues papers produced by the Tax Counsel Office represent our initial views only, taxation officers, taxpayers and practitioners must not rely on them. Only finalised public statements represent authoritative statements by Inland Revenue of its stance on the issues covered.

Any views presented in an issues paper do not change the Commissioner's current position or practices.

LET US KNOW WHAT YOU THINK

We want to know what you think about our initial views presented in this issues paper.

We would like to know:

- whether you think the interpretation of the relevant tax laws is correct;
- whether you have practical concerns about the interpretation; and
- your ideas on how to administer these tax laws.

Email your comments to **Public.Consultation@ird.govt.nz**

Deadline for comment: **1 March 2021**

Quote reference: **PUB00339**

Introduction

1. Inland Revenue has been asked to clarify the tax treatment of trusts under the network of double tax treaties that New Zealand has with other countries. This issues paper begins to address this area by examining how New Zealand's treaty with Australia[1] – the Australian–New Zealand Double Tax Agreement (Aus–NZ DTA) – deals with this subject.

2. Analysis is initially restricted to the Aus–NZ DTA as it specifically addresses partially fiscally transparent entities such as trusts and has been recently modified by the adoption of the multilateral instrument called the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). This issues paper provides an opportunity to focus on a treaty with a country that has many thousands of New Zealand citizens as permanent residents and where the involvement of trusts with interests in both countries is likely commonplace.

3. An approach to interpreting the Aus–NZ DTA is set out from [7] as the approach to interpreting treaties is different from that to interpreting New Zealand legislation. Then follows, from [24], an in-depth examination of seven trust related issues that have been the subject of debate among commentators.

   - What is the taxable entity in a trust context?
   - Is it the residence of the trustee or the settlor, or both, that determines eligibility to the benefits of the Aus–NZ DTA?
   - Does the Aus–NZ DTA require that a trustee be treated in a separate capacity from their personal or private capacity?
   - How does the residency tie-breaker provision deal with two or more trustees of mixed residency and is the test only that for non-natural persons?
   - What is the scope of the requirement to recognise income derived by or through a trust that is treated as resident in one country as the income of a beneficiary who is taxable on it in the other country?
   - How does the obligation in the question above sit with the rights of each country to tax its own residents?

[1] The *Convention between Australia and New Zealand for the Avoidance of Double Tax with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion*, signed 26 June 2009 (and in the Schedule to the Double Taxation Relief (Australia) Order 2010), and modified by the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, signed 7 June 2017 (together, the Aus–NZ DTA).

- What is the extent of the obligation to grant a tax credit for tax paid in the other country by either the trustee or a beneficiary?

4. The paper suggests the following answers.

   - The taxable entity for a trust is the trustee if income is accumulated or a beneficiary where income is distributed to them.
   - The domestic tax residence of a New Zealand trustee primarily determines eligibility to the benefits of the Aus–NZ DTA. However, that trustee must also be liable to tax on worldwide income to qualify.
   - The Aus–NZ DTA (in the same manner as domestic legislation) requires a trustee to be treated in a separate capacity from their personal capacity and their capacity as trustee of any other trust.
   - The tie-breaker test for non-natural persons is the test applicable to a dual resident trustee. A single natural person who is a dual resident trustee could apply the test for natural persons, if the competent authorities endorsed that application.
   - Where a trust is treated as fiscally transparent in either country and income is taxed to a beneficiary as a resident of the other country, a resident of the other country is considered the recipient of the income.
   - The right of each country to tax a trust as a resident entity on an opaque basis overrides the country's obligation to treat a trust as fiscally transparent.
   - Both countries must provide relief from double tax under their existing domestic provisions where tax is imposed in the other country on a beneficiary or trustee resident in their country; and where tax is imposed on income of a trust that is treated as opaque in the other country and as income of a beneficiary resident in their country. When a trust is referred to as an entity in this paper, the person treated as the taxpayer is the trustee. Consequently, these terms (trust and trustee) are treated as interchangeable in the paper and that has no significance. The legislation in Australia identifies both the trustee and the trust estate in different provisions, (see footnote 23) but no separate treatment results for these two concepts.

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

Interpretation of double tax treaties

Inland Revenue's approach to treaty interpretation

6. When interpreting a double tax treaty different rules need to be followed than with general statutory interpretation. Therefore, we set out those rules first.

7. A useful summary of the approach to be adopted when interpreting a DTA is in Interpretation Statement IS 16/05, at [11].[2] IS 16/05 explains the role of the Vienna Convention on the Law of Treaties[3] and the relevance of the OECD's Model Tax Convention Commentary,[4] looks at case law, and then walks through the definitions in art 3 of that commentary in the following terms, with original footnotes (updated where necessary to reference the latest versions) inserted as footnotes to this document:

> 54. Most of New Zealand's DTAs follow a similar format, based on the OECD Model Tax Convention on Income and Capital (the Model Convention). The Model Convention is accompanied by the OECD Model Tax Convention Commentary (the Model Commentary), which provides commentary on the articles of the Model Convention.
>
> …
>
> **The Vienna Convention**
>
> 63. A DTA is both an international treaty and part of New Zealand's domestic law. This unique dual nature means that it is interpreted differently from domestic legislation.
>
> 64. Because it is an international treaty, a DTA is subject to the Vienna Convention on the Law of Treaties 1969[5], to which New Zealand is a signatory. Articles 31 and 32 of the Vienna Convention describe how a treaty shall be interpreted. Article 31(1) sets out the general rule of interpretation. It requires a holistic and integrated approach[6] that considers the ordinary meaning of the text in its context and in light of the

[2] "Interpretation Statement: IS 16/05: Income Tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement", *Tax Information Bulletin* Vol 28, No 12 (December 2016): 41.

[3] *Vienna Convention on the Law of Treaties*, 1155 UNTS 331 (opened for signature 23 May 1969, ratified by New Zealand on 4 August 1971, entered into force on 27 January 1980).

[4] OECD, *Model Tax Convention on Income and Capital 2017 (Full Version) Commentaries* (OECD, Paris, 2019). http://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm

[5] *Vienna Convention on the Law of Treaties*, 1155 UNTS 331 (opened for signature 23 May 1969, ratified by New Zealand on 4 August 1971, entered into force on 27 January 1980).

[6] See *CT v Lamesa Holdings BV* 97 ATC 4,752 (FCA), *McDermott Industries Pty Ltd v FCT* 2005 ATC 4398 (FCAFC) and *R v Crown Forest Industries Ltd* 95 DTC 5389 (SCC).

object and purpose of the treaty. The ordinary meaning of the terms of the treaty is necessarily the starting point, but it is also mandatory to consider the context, object and purpose of the treaty[7]. It is from the combined effect of these elements that the legally relevant interpretation must be taken.

65. Article 31(2) and (3) describe the context that can be taken into account for the purposes of the general rule.

66. Despite the interpretation reached under the general rule, art 31(4) provides that a special meaning can be given to a term if it is established that the parties to the treaty so intended.

67. Article 32 relates to supplementary means of interpretation. Recourse to supplementary means of interpretation is restricted. It can only be had to confirm the meaning reached under art 31 or to determine the meaning when the interpretation under art 31 is ambiguous, manifestly absurd or unreasonable.

68. The courts have interpreted New Zealand's DTAs in a manner consistent with these international obligations, adopting a broad and purposive approach. McCarthy P, in *CIR v United Dominions Trust Ltd* [1973] 2 NZLR 555 (CA) at 558, held that when interpreting a DTA the starting point is "not to adopt a narrow interpretation but to interpret having regard to the broad intentions of the framers as they emerge from the text."

69. … a DTA must be interpreted in a holistic and integrated manner. A DTA must not be interpreted solely by reference to the ordinary meaning of the words used or, at the other extreme, solely by reference to the purpose of the DTA. What is required is that the terms are given their ordinary meaning taking into account their context and the object and purpose of the DTA.

Relevance of the Model Commentary

70. In *CIR v JFP Energy Inc* (1990) 12 NZTC 7,176 (CA), Richardson J stated that appropriate regard should be given to the Model Commentary. While the Model Commentary is not binding, the Commissioner considers it extremely influential and an important tool for interpreting DTAs.

71. The Commissioner considers the Model Commentary can form part of the legal context of a DTA under art 31(1) of the Vienna Convention, provided the DTA article is the same or similar to the Model Convention and the Model Commentary was in existence at the time the DTA was signed. The Model Commentary may still be relevant if it was written after the DTA was signed, provided the changes to the Model Commentary are for clarification only. Similarly, the Model Convention can

[7] See *TD Securities (USA) LLC v R* 2010 TCC 186, 2010 DTC 1137 (Tax Court of Canada), *Crown Forest, Coblentz v R* (1996) 96 DTC 6,531 (Fed CA), *Weiser v HMRC* [2012] UKFTT 501 (TC), *Bayfine UK v Revenue and Customs Commissioners* [2011] EWCA Civ 304, [2011] STC 717, *CIR v JFP Energy Inc* (1990) 12 NZTC 7,176 (CA).

be a relevant supplementary means of interpretation under art 32 of the Vienna Convention[8].

Article 3 – definitions

Defined terms

72. When interpreting a DTA, it is important to consider the general definitions article (typically art 3). Article 3(1) lists definitions that apply for the purposes of the DTA, unless the context requires otherwise. The list of defined terms will vary between DTAs. The list is not exhaustive, and definitions can also be found elsewhere in a DTA. For example, art 4 (the Resident article) defines "resident of a Contracting State".

Undefined terms

73. If a DTA does not define a term, that term is to be defined under the domestic law of that state, unless the context requires otherwise. Article 3(2) of the Model Convention provides:

> 2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

74. Article 3(2) confirms that the domestic law meaning to be used is the meaning at the time the DTA is applied, not the meaning that existed at the time the DTA was signed. The Model Commentary also explains that when trying to find a domestic law definition, a tax law definition will take precedence over a non-tax law definition. Furthermore, a tax law definition from a law that imposes the relevant DTA tax will take precedence over any other definitions, including other tax law definitions.[9]

75. Article 3(2) applies "unless the context requires otherwise". The Model Commentary explains how "context" should be determined[10]:

[8] See *Thiel v FCT* 90 ATC 4717 (HCA) and *Crown Forest*.

[9] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2014, (OECD Publishing, Paris, 2014), Commentary on Article 3, [13.1] at 84, as referred to in IS 16/05. Now Model Tax Convention on Income and on Capital 2017 (full version) Commentary on Article 3: Concerning General Definitions [13.1] at 12, incorporating amendments on 21 November 2017.

[10] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2014, (OECD Publishing, Paris, 2014), Commentary on Article 3, [12] at 83. As referred to in IS 16/05. Now Model Tax Convention on Income and on Capital 2017 (full version) Commentary on Article 3: Concerning General Definitions [12] at 12, incorporating amendments on 21 November 2017.

12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

76. The context might otherwise require an interpretation that is different from the domestic law meaning where, for example, the application of a domestic law meaning would render part of the treaty inoperable or if the domestic law would give the taxpayer unjustified treaty benefits or would lead to double taxation or non-taxation.[11] [Footnote position and content are as per the original.]

8. The Court of Appeal in *CIR v Lin* [2018] NZCA 38 demonstrated that there needs to be close textural analysis of the words used in a treaty, having due regard to the contextual indications and purpose of the particular provision. In that case, the taxpayer was the shareholder of a trading company in China. She was assessed for attributed income under New Zealand's controlled foreign company (CFC) regime. The China–NZ DTA had a tax-sparing provision, intended to assist China as a developing economy, that meant the company paid no tax in China, but it was treated as if it had paid under the treaty. The High Court in *Lin v CIR* [2017] NZHC 969 agreed with the taxpayer that the relief from the double tax provision, art 23 of the China–NZ DTA, was applicable because a CFC should be treated in the same manner as a partnership; that is, as a fiscally transparent entity with income attributed to the participants. The notional tax spared in China could, therefore, be treated as tax paid by the taxpayer for credit against her CFC attributed income.

9. The Court of Appeal disagreed with the High Court, noting that the CFC regime was an anti-avoidance regime not a fiscally transparent regime and that this was an example of economic double tax. The OECD Model Commentary confirmed that art 23 was only intended to relieve juridical double tax where the same taxpayer is taxed on the same income in both countries. The tax spared on the income of the CFC in China did not meet the test of being "in respect of" the same income that was attributed to the taxpayer under the CFC regime. Those words were to be read with regard to the context and purpose of the relief measure that focused on juridical tax only.

[11] E Reimer and A Rust (eds), *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015) at 213.

Interpretation of the Aus–NZ DTA

10. Inland Revenue has not published any direct commentary on the Aus–NZ DTA. However, it is possible to ascertain Australia's views on the intended operation of particular provisions in the Aus–NZ DTA by drawing on chapter 2 of the explanatory memorandum on the DTA issued by the Australian Treasury for the International Tax Agreements Amendment Bill (No 2) 2009 (Australian Explanatory Memo).[12] Following the passing of the amendment Bill, Australia formally entered into the Aus–NZ DTA.

11. The Australian Explanatory Memo explains in detail each article of the Aus–NZ DTA. For example, it discusses art 1(2) of the DTA, noting that a fiscally transparent person referred to there would include certain trusts and partnerships where the participants, rather than the entity itself, are liable to tax on the income. It has detailed commentary on the intention of different sentences and wording. For example, it notes that while art 1(2) of the DTA covers a broad range of fiscally transparent entities, its application is intended to be consistent with the OECD conclusions on the OECD model applicable to partnerships. It also notes that art 1(2) uses wording designed to ensure it applies appropriately to income derived through entities such as certain trusts "where some items of income may be allocated to the beneficiary or participant and taxed in that person's hands, while other items of income are taxed at the entity level". In this context, taxation at entity level means trust income taxed to the trustee.

12. The Australian Explanatory Memo identifies at [2.14] that art 1(2) of the DTA, in the case of New Zealand, includes partnerships, complying trusts and foreign trusts. In Australia's case, it apples to trusts that are subject to division 6 of part III of the Income Tax Assessment Act 1936 (ITAA 1936) where the beneficiary is presently entitled to the income and assessable accordingly (but not a corporate unit trust or public trading trust subject to division 6B or division 6C of part III of the ITAA 1936).

13. The Australian Explanatory Memo usefully includes examples and diagrams to illustrate outcomes; for example, the treatment of cross-border flows of types of income derived by trusts where resident and non-resident beneficiaries are presently entitled to the income.

14. The Australian Explanatory Memo is an extremely useful and highly relevant aid in documenting the Australian view on the operation of the Aus-NZ DTA. New Zealand as the treaty partner is not bound to follow the material and at times, it may take a position that is contrary to views expressed in such a document. In saying this, Inland Revenue recognises that different interpretations being adopted by treaty partners

[12] Australian Treasury, "Chapter 2: The Australian–New Zealand Convention", *Explanatory Memorandum: International Tax Agreements Amendment Bill (No 2) 2009* (Australian Government, 2009): 21.

may be unhelpful to taxpayers applying the interpretations. If any finalised public statement contains inconsistencies with the Australian Explanatory Memo, there is a process to deal with this. Art 16 of the MLI allows taxpayers to request the mutual agreement procedure (MAP) by approaching the competent authority in either New Zealand or Australia if they believe taxation is not in accordance with the Aus-NZ DTA.

Interpretation of the MLI

15. The Aus–NZ DTA has been modified by the MLI. The Australian Taxation Office (ATO) and Inland Revenue have jointly released a synthesised text of the two documents as their shared understanding of the modifications.[13] The MLI modifies a vast number of tax treaties worldwide quickly and efficiently to consider new treaty standards relating to treaty abuse and dispute resolution that have arisen out of the OECD/G20 base erosion and profit shifting action plan.[14] It allows New Zealand to update most of its DTAs without entering bilateral negotiations with each treaty partner.

16. New Zealand had the strategy of adopting as many of the MLI provisions as was possible because the base protection measures were in line with New Zealand's existing policy. It also wanted to sign up to the mutual agreement procedure and the availability of arbitration for dispute resolution.

17. The provisions of the MLI are drafted more broadly than would be the case for the usual amending protocols because of their need to apply to several thousand treaties. As a result, there can be ambiguity in how an MLI provision applies to a particular treaty. However, this is mostly mitigated by the MLI provision replacing the corresponding existing provision if both the treaty partners notify the same provision. For example, concerns about dual residency needing to be resolved by the competent authorities of Australia and New Zealand were addressed with an administrative concession for companies (but not trustee companies) that permitted self-determination.[15]

18. The OECD prepared an explanatory statement to the MLI to "provide clarification of the approach taken in the Convention [that is, the MLI] and how each provision is intended

[13] Australian Taxation Office, *Synthesised Text of the MLI and the Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion* (Australian Government,). https://www.ato.gov.au/law/view/pdf/mli/newzealand.pdf

[14] OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD, Paris, 2013). https://dx.doi.org/10.1787/9789264202719-en

[15] Inland Revenue, *Australia and New Zealand's Administrative Approach to MLI Article 4(1)* (Inland Revenue, Wellington, 2019). http://taxpolicy.ird.govt.nz/publications/2019-other-australia-nz-admin-approach-mli-article-4-1/overview

to affect tax agreements covered by the Convention" (at [11]).[16] This statement was adopted on 24 November 2016 at the same time as the MLI. It reflects the agreed understanding of the negotiators and describes how existing treaty provisions are intended to be modified. It does not interpret the underlying base erosion and profit shifting measures except for the binding arbitration measures in arts 18–26 of the MLI. Accordingly, the provisions in arts 3–17 of the MLI:

> should be interpreted in accordance with the ordinary principles of treaty interpretation, which is that a treaty shall be interpreted in good faith in accordance with ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose. In this regard the object and purpose of the Convention is to implement the tax treaty-related [base erosion and profit shifting] measures.

19. When adopting the MLI for its treaties, the Australian Treasury prepared an explanatory memorandum for the Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018,[17] which usefully provides a detailed explanation of the impact of the MLI on Australia's treaties with frequent reference to the Aus–NZ DTA. The Australian MLI Explanatory Memo is informed by the OECD Explanatory Statement to the MLI, the OECD Model Commentary, and relevant base erosion and profit shifting reports that the MLI implements.

20. It is evident from this material that the approach required to interpret the impact of the MLI on the Aus–NZ DTA is no different from that for interpreting the Aus–NZ DTA. The Australian material explains why Australia has or has not adopted aspects of the MLI for its treaties and the rationale, having regard to the treaties' different objectives, and reflects the same approach to interpretation as we adopt in New Zealand.

21. The New Zealand equivalent to the Australian MLI Explanatory Memo does not contain the same detailed analysis of the MLI articles, but it does discuss the purpose, background and features of the MLI in a more general sense.[18]

22. When assessing the precise impact of the changes made by the MLI to the Aus–NZ DTA, the interpretative approach is to follow the ordinary principles for treaty interpretation. The Australian MLI Explanatory Memo as well as the source documents

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[16] OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (OECD, Paris, 24 November 2016). https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf

17 ATO, *Explanatory Memorandum for the Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018* (Australian Government,).

[18] Finance & Expenditure Select Committee, *International Treaty Examination of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (New Zealand Parliament, 2019).

from the OECD, including its MLI Explanatory Statement, various base erosion and profit shifting reports, and the OECD Model Commentary are useful reference materials. These relevant documents are all referenced throughout the Australian MLI Explanatory Memo and in its discussion of the MLI's impact on the Aus–NZ DTA.

The New Zealand approach to the taxation of trusts

23. The domestic approach to the taxation of trusts is the starting point because a person who is tax resident in New Zealand and liable for tax on a comprehensive worldwide basis is *prima facie* entitled to the benefits of the Aus–NZ DTA under art 4(1) of the DTA.

Tax residency and capacity of a trustee domestically

24. The income tax obligations of calculating a trust's taxable income and providing a tax return fall squarely on the trustee under s HC 2. A trustee is liable for tax on all income as if beneficially entitled under s HC 24. The return provided by the trustee under s 59(3) of the Tax Administration Act 1994 is separate from their personal return and trustee income is taxed at a flat rate of 33%. These factors confirm that in New Zealand it is the trustee that is the entity that is taxed where a trust exists. Trusts are partially fiscally transparent vehicles, so income may also be taxable to a beneficiary if distributed. However, neither beneficiaries nor settlors are taxed when income is retained in a trust.

25. Section HC 2 treats trustees, acting in that capacity, as a "notional single person" with the trustees jointly and severally liable to satisfy the income tax liability of that person. "Trustee" is defined in s YA 1 for a trust as meaning the trustee "only in the capacity of trustee of the trust" and "includes all trustees for the time being of the trust". Then s YA 5 sets out a general rule for the capacity of trustees, identifying that it is a separate capacity from their other capacities; namely, their personal or corporate capacity or their capacity as a trustee of a different trust.

26. Under the Tax Administration Act 1994, "natural person" is defined in s 3(1) to "not include a natural person who is acting in the capacity of a trustee". There are, however, some exceptions to this when it comes to the operation of the financial relief and hardship provisions in ss 177 and 177A of the Tax Administration Act 1994.

27. It would seem then that to determine the tax residency of the notional single person who is a trustee, enquiry must necessarily focus on the residency of the trustee in their capacity as trustee of a particular trust.

28. However, despite that focus on capacity in terms of income derivation and return filing, when it comes to determining the tax residency of a trustee, the rules for determining the tax residence of a natural person and a company apply equally to that person in their capacity as a trustee. See ss YD 1(12) and YD 2(1B).

29. In short, if a natural person or a company is tax resident in New Zealand under domestic law, then they will also be resident in New Zealand when acting in their capacity as a trustee. This approach is confirmed in Interpretation Statement IS 16/03.[19]

Trustees of mixed residency

30. Where trustees are of mixed residency, Inland Revenue has until recently adopted an interpretative test such that a trustee (as a notional single person) was treated as non-resident only if all trustees (or one if there was only one) were non-resident. In all other cases, trustees of mixed residency were treated as New Zealand tax resident. See Interpretation Statement IS 18/01, at [3.11].[20] This test has now been legislated as s HC 2(3), effective from 23 March 2020:

> *Residence*
>
> (3) If no election under section HC 33 is made for the trust, the notional single person referred to in subsection (2) is—
>
> (a) a New Zealand resident when 1 or more of the trustees is resident in New Zealand:
>
> (b) a non-resident when none of the trustees is resident in New Zealand.

31. This test applies only when no election has been made under s HC 33 to be a complying trust, since the result of such an election under s HC 33(1C) is that the tax obligations of the trustee are determined on the basis that both the trustee and settlor are New Zealand tax resident (see Example 1).

[19] "Interpretation Statement IS 16/03: Tax Residence", *Tax Information Bulletin* Vol 28, No 10 (October 2016): 2, at 36–48 (Part 3: Residence and trusts).

[20] "Interpretation Statement IS 18/01: Taxation of Trusts – income tax", *Tax Information Bulletin* Vol 30, No 7 (August 2018): 17.

Example 1: Errol dies in New Zealand leaving a testamentary trust with his wife Muriel and son and daughter as trustees. Muriel is tax resident in New Zealand but the son and daughter both live offshore. Because of Muriel's New Zealand residency, the trustee as a notional single person is deemed to be a New Zealand tax resident, is responsible for making tax returns, and is liable for tax on worldwide trustee income at 33%.

Significance of the settlor-based regime in New Zealand

32. New Zealand is somewhat anomalous internationally in not having a statutory concept of trust residence. Contrast that with Australia, which treats a trust as resident if at least one trustee is Australian at any time in the preceding 12 months or if the central management and control of the trust is in Australia.[21] Here, the New Zealand residence of a settlor serves as the basis for exerting a worldwide taxing claim, and this is irrespective of the residency of the trustee. Mark Brabazon suggests this should perhaps be recognised in comparative international terms as a form of fiscal residence for a trust in New Zealand.[22]

33. Brabazon observes (at 348):

> most countries that recognise trusts in their tax system treat them as differentially transparent, attributing income for the purposes of current taxation to beneficiaries and/or to a fiscal entity representing the trust and/or to a person who has settled or transferred net value on or to the trust. The terminology by which this person is described varies from country to country. New Zealand uses the term settlor. The United States term "grantor" is probably the most useful label for international or comparative discourse because it captures the basic idea and is not encumbered by the need to explain the technical distinction between a formal settlor and a person who feeds an existing trust with a transfer of property or other value. Conceptualisation of the trust entity for tax purposes also varies. It may be equated with the trust as a fiscal person, the trustees as a collective entity or the trust property.[23] [The footnote appears at the bottom of the page.]

34. Brabazon concludes that a trust entity is whatever a particular tax system identifies as being taxable on trust income that is not attributed to beneficiaries or grantors. He then observes that most jurisdictions go on to attribute tax residency to their chosen

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[21] Income Tax Assessment Act 1936 (Cth), s 338.

[22] M Brabazon "Trust Residence, Grantor Taxation and the Settlor Regime in New Zealand" (2016) 22 NZJTLP 346.

[23] For example, in the United States, the trust is a fiscal person with prime responsibility for trust income. In the United Kingdom, the trustees of a settlement are treated as a notional single person. In Australia, trustees are taxable under ss 99 and 99A of the ITAA 1936, but for many purposes the "trust estate" is referred to as an entity having taxable income and so on. Sections 960–100 of the ITAA 1936 refer to a trust as an entity and separately to its trustees collectively as an entity.

trust entity and apply the residence limb of their tax claim accordingly. Typically, this means the "tax claim" is determined using such things as:

- the separate fiscal residency of one or more or all of the trustees; or
- other decision makers such as people who have control of substantial decisions of the trust; or
- central management and control of the trust; or
- the jurisdiction of applicable law under the trust deed.

35. John Prebble, who was an advisor to the Consultative Committee on Full Imputation and International Tax Reform that proposed the current trust rules in March 1988, offered up an explanation for the approach taken in New Zealand:[24]

> Under the Act trustees and beneficiaries may be taxpayers, but not trusts themselves. There is, therefore, no need to attribute residence to a trust.

36. Brabazon regards Prebble's explanation as unsatisfactory, even if it reflects the thinking of the committee that recommended the regime. Brabazon reasons that the trustee is being taxed in a separate capacity that is disengaged from the personal residency of the trustee. He argues this has sown unnecessary confusion and invites anomalous outcomes particularly under treaties. For example, he suggests that if the settlor nexus is not recognised under a treaty as a species of fiscal residency (at footnote 73 on page 360):

> the trustees (whether in New Zealand or elsewhere) of a trust with a resident grantor will be unable to claim treaty benefits in respect of trustee income which New Zealand taxes on a worldwide basis.

37. If a trustee is New Zealand resident, then they will be able to claim treaty benefits if they are bearing tax on a worldwide basis in their capacity as trustee. So too will a non-resident trustee of a complying trust that has made an election under s HC 33. But a non-resident trustee of a non-complying trust, although still taxable in New Zealand on worldwide income (because it has a New Zealand settlor), would not, it is proffered here, qualify as a New Zealand resident entitled to treaty benefits. See from [71] for an explanation of this conclusion.

38. The New Zealand residency of the settlor is in economic terms the claim to taxing the worldwide income of a trust they settle. But the New Zealand trust tax regime also permits trusts settled by non-residents to elect to be complying trusts comprehensively taxed and does not attribute the income of a trust to the settlor. The

[24] J Prebble, "NZ Trust Taxation: The domestic rules", *Bulletin for International Fiscal Documentation* Vol 53 (1999): 190, at 192.

closest the regime gets to this is that a New Zealand settlor of a non-complying trust is liable under s HC 29 as agent for the tax on the income of a non-resident trustee of that trust, but not if the trustee is resident.

39. A settlor is principally liable for tax on trustee income only if they have made a voluntary election under s HC 33(2) to be liable for tax as if they were a New Zealand resident trustee, which would permit a non-complying trust or a foreign trust to become a complying trust. The settlor is not the only party who can make such an election; it is also open to a trustee or beneficiary. It is the trustee who is liable for tax on trustee income under the Act. The trustee may also be liable for tax on beneficiary income, but in the capacity as agent not principal.

40. The residence of the settlor does not determine the residence of a trust under the trust rules in the Act; the residency of the person(s) or company that is the trustee who is treated as a notional single person does, unless an election has been made under s HC 33. New Zealand has a "settlor-based" regime but one that does not attribute trust income to that settlor as principal. Liability in New Zealand falls squarely on the trustee for income retained and not distributed as beneficiary income, unless a trustee, settlor or beneficiary has elected to take on that liability under s HC 33 when a trust elects to become a complying trust.

41. This view in no way denies the anchoring of the trust regime to the settlor's residence. It is a result of the trust rules not including a test for the residency of trusts as such; rather, the design is to tax the trustee (whether resident or not) in ways that depend on the residency status of the settlor or by elections made tied to a liability for comprehensive taxation in New Zealand.

42. Prebble's simple articulation of the position is, in the Commissioner's view, correct. No residence is prescribed for a trust because the residence of a trustee and beneficiary can be determined, and they are the two parties to a trust who are taxed. The legislation has chosen to treat a trustee as a notional single person and prescribed the means to determine the residency of that person in their capacity as trustee, whether they are one or more natural persons or a corporate. The legislation also provides a means of determining the residency where trustees have mixed places of residency, so that complexity is covered.

43. The settlor-based regime does result in two exceptions to the normal tax framework. A non-resident trustee of a trust settled by a New Zealander is liable for tax on worldwide income under s HC 25 and a New Zealand trustee of a registered foreign trust settled by a non-resident settlor may not be liable for tax on foreign-sourced income under s HC 26. Both these situations sit outside the usual parameters of

New Zealand's taxation framework; that is, not taxing non-residents on foreign-sourced income but taxing residents on worldwide income.

Trustee residency requirements for complying trusts

44. To qualify as a complying trust under s HC 10(1)(a)(i) the trustee must usually be resident in New Zealand. Unless resident, the trustee is likely to derive non-resident passive income or non-resident foreign-sourced income or exempt income under s CW 54. Those features rule out being a complying trust under s HC 10(1). However, if the trustee is a non-resident, complying trust status can still be maintained under this provision if, for example, the trust only derives foreign sourced income (taxable under s HC 25(2) and not included in non-resident's foreign sourced income under s BD 1(4)(c)) and meets all its tax obligations. A non-resident trustee with New Zealand sourced income can also retain complying trust status by meeting the requirements of s HC 10(1)(ab). That is, by the settlor, the trustee or a beneficiary making an election under s HC 33 to satisfy the income liability of the trustee and then ensuring tax is paid on worldwide trustee income. Consequently, both residents and non-residents can successfully operate as trustees of a complying trust that is comprehensively taxed in New Zealand.

45. Where a non-resident trustee is involved, the election and requirement to pay tax on worldwide income ensures they are taxed in the same manner as a resident trustee. But they have been, until recently, taxed **like** a resident under s HC 33(2), **not as** a resident. The former wording of that provision was in these terms:

> The person making the election—
>
> (a) must satisfy the income tax liability that the trustee would have if the trust has a New Zealand resident as settlor and the trustee were a New Zealand resident;

46. However, changes made in the Taxation (Kiwisaver, Student Loans and Remedial Matters) Act 2020 (Kiwisaver Act) from enactment on 23 March 2020, result in the status of the trustee post-election, being deemed to be New Zealand resident. New s HC 33(1C) states:

> (1C) From when an election by a person under subsection (1) applies under subsection (3), the tax obligations of the trustee of the trust arising from the trust are determined on the basis that—
>
> (a) the trustee is a New Zealand resident; and
>
> (b) the trust has a settlor who is a New Zealand resident.

47. The default position under s HC 33(1B) is that a trustee is deemed to have made an election (where a complying trust no longer meets the requirements under s HC 10(1)(a)(i)) merely by filing a tax return that indicates it is a complying trust and

continuing to meet its New Zealand tax obligations on worldwide trustee income. Under this default election, the trustee is also now deemed to be a New Zealand resident. This deemed residency status would appear to meet the residency requirements of art 4(1) of the Aus–NZ DTA:

> any person who under the laws of that State, is liable to tax as a resident of that State.

48. The Kiwisaver Act also expanded the breadth of s HC 33 so it can be used to make a retrospective election back four years before the beginning of the electing year under new s HC 33(3)(b)(iii). This means non-complying trusts and foreign trusts will be able to become complying trusts retrospectively and be treated as if the trustee was resident, even where the trustee was non-resident over that four-year period. To be eligible, there is a requirement to meet all the New Zealand tax obligations on worldwide trustee income over that period, including any interest and penalties. (See Example 2.)

Example 2: Alexandra Puputof emigrated from Russia to New Zealand in 2013. Alexandra did not make any election under s HC 30 by the election expiry date for the Puputof trust she settled before moving to New Zealand. The trustee is a trustee company in Lichtenstein, and the Puputof trust has a portfolio of shares with a significant number of mining shares listed on the Australian Stock Exchange (ASX).

Alexandra then makes an election (as settlor) to be liable for the tax obligations of the trustee under s HC 33(3)(b)(iii), requesting that the trust be a complying trust from 30 June 2018, the election expiry date in s HC 30(5), one year after she ceased to be a transitional resident. She makes payment of all relevant New Zealand tax and any use-of-money interest and penalties on trustee income over this back period. Dividends derived by the trustee from the mining shares in Australia have had non-resident withholding tax deducted at rates higher than would have applied if the Puputof trust had been treated as resident in New Zealand under the Aus–NZ DTA.

Inland Revenue advises Alexandra that New Zealand will grant a foreign tax credit only for Australian tax paid capped at the amounts chargeable under art 10 of the DTA. The trustees of the Puputof trust then apply to Australia for a refund of the extra non-resident withholding tax imposed on the grounds that after the election they are treated as New Zealand resident under the Aus–NZ DTA from the date Alexandra ceased to be a transitional resident.

49. How the Aus–NZ DTA would apply to such a retrospective election is reasonably settled. Article 3(3) of the DTA provides that undefined terms have the meaning that they have at that time domestically. This is an ambulatory approach based on the law as it changes from time to time. Here, the Aus–NZ DTA specifically refers in art 4(1) to

the expression "resident of a Contracting State" as meaning "any person who under the laws of that State, is liable to tax as a resident of that State". Where a treaty makes specific reference to domestic law, it has "a special meaning within art. 31(4) of the Vienna Convention"[25] and must be interpreted in accordance with the relevant law as required. Technically, the trustee will be New Zealand resident for the period covered by the election under New Zealand domestic law, so the requirements of art 4(1) of the DTA will be met.

50. This ambulatory approach to the determination of domestic provisions referred to in a treaty is confirmed by Craig Elliffe.[26] However, he warns:

> But, as noted in the OECD Model Commentary, this ambulatory process of determining the law should not be used to radically undermine the intention of contracting states when they conclude the DTA.[27]

51. The Australian Explanatory Memo contains no evidence from when the two countries entered into the Aus–NZ DTA that a static interpretation of "liable to tax as a resident" should be employed. Consequently, it should accommodate a retrospective election and the resulting deemed New Zealand residency of a trustee made under new s HC 33(3)(b)(iii).

Which New Zealand trusts will qualify as resident and entitled to DTA benefits under art 4

Persons who are residents of a Contracting State

52. Article 1 of the Aus–NZ DTA confirms that the Aus–NZ DTA applies to "persons who are residents of one or both of the Contracting States". A trust is not a "person" as a matter of common law: it is an equitable obligation on a trustee who holds property under a fiduciary duty to the beneficiaries.[28] But art 3(1)(j) of the DTA confirms that under the Aus–NZ DTA "person" includes "a trust". Also included under "person" are individuals, companies and any other body of persons.

[25] J Schwarz, *Schwarz on Tax Treaties* (3rd ed, CCH, United Kingdom, 2013) at [12-300], 126.

[26] C Elliffe, *International and Cross-Border Taxation in New Zealand* (2nd ed, Thomson Reuters, New Zealand, 2018), at [40.5].

[27] Commentary on art 3 at [12] in OECD, *Model Tax Convention on Income and Capital Condensed Version* (9th ed, OECD, Paris, 15 July 2014).

[28] "Interpretation Statement: IS 19/04: Income Tax – distributions from foreign trusts", *Tax Information Bulletin* Vol 32, No 1 (February 2020): 28, at [30].

53. Article 4(1) of the DTA defines the term "resident":

> For the purposes of this Agreement, a person is a resident of a Contracting State:
>
> (a) in the case of New Zealand, if the person is a resident in New Zealand for the purposes of New Zealand tax; and
>
> (b) in the case of Australia, if the person is a resident of Australia for the purposes of Australian tax.

54. The ATO in Taxation Ruling TR 2005/14, states from [33] that for the purpose of determining residency of a trustee of a NZ foreign trust under the Aus–NZ DTA, the relevant person is the trustee (and not the trust):[29]

> The term "person" is defined in Article 3(1)(j) of the NZ Agreement to include an individual, a company and any other body of persons. Clearly a trustee can be a person as a trustee will be either an individual or a company.
>
> The terms of the NZ Agreement demonstrate that the treaty applies at the trustee level rather than at the trust level. Article 3(4) of the NZ Agreement deems a trustee who is subject to tax in relation to dividends, interest and royalties as being beneficially entitled to the dividends, interest and royalties for the purposes of Articles 10, 11 and 12. The Article makes it clear that the trustee can benefit from the reduced rates of tax available under the NZ Agreement where the trustee and not the beneficiary is taxed on the income.
>
> On the assumption that the trustee is, as trustee, resident in New Zealand for the purposes of New Zealand tax, Article 4(1) is satisfied.

55. The reason why a trust is also included in the Aus–NZ DTA as a person is discussed in the Australian Explanatory Memo at [2.55]:

> The intention is for the term "person" to be given a broad meaning for the purposes of the Convention. During negotiations, the delegates noted that a reference to a "trust" was included in the definition of the term "person":
>
> > "to ensure that trusts may be covered by a reference to a 'person' that is fiscally transparent' in paragraph 2 of Article 1 (Persons Covered) and for purposes of paragraph 7 of Article 4 (Resident) which refers to a 'managed investment trust."

56. This confirms that there was no intention under the Aus–NZ DTA of substituting a trust for a trustee when it comes to an assessment of what entity derives income or gains of a trust that are not distributed; rather, the purpose was to make sure trusts were included in the scope of "persons that are fiscally transparent" in art 1(2) of the DTA

[29] ATO, *Taxation Ruling: Income tax – Application of the Australia/New Zealand Double Tax Agreement to New Zealand resident trustees of New Zealand foreign trusts* (TR 2005/14, Australian Government, 2005).

and that Australian-managed investment trusts, given special flow-through treatment under art 4(7) of the DTA, were also regarded as a covered "person".

57. The Commissioner is of the view that a trustee is covered by the definition of person under the Aus–NZ DTA when it consists of an individual or a company or more than one of those options.

Liable to tax as a resident

58. Focusing on art 4(1) of the Aus–NZ DTA, the question is, what type of trustee is "liable to tax as a resident of that State"? The Australian Explanatory Memo states at [2.73] that the term "is intended to capture those persons who are subject to comprehensive taxation under a country's domestic taxation laws".

59. It follows that if at least one trustee is New Zealand resident and liable to tax on trustee income, then the trust will qualify as New Zealand resident under the Aus–NZ DTA. This would include a New Zealand resident trustee of a trust settled by a non-resident if it met all its New Zealand tax obligations and become a dual status trust, ie both a foreign trust and a complying trust[30]. The logical counterpart is that where the sole trustee or all trustees are non-resident, they would not qualify, because they cannot be liable to tax "as a resident". However, as discussed above, a non-resident trustee of a complying trust that has made an election under s HC 33 is deemed to be resident from 23 March 2020.

Excluding those only liable on sources in that State

60. The second sentence of art 4(1) of the Aus–NZ DTA qualifies who can be "a resident trustee" because it excludes "any person who is liable to tax in that State in respect only of income from sources in that State". The ATO's Taxation Ruling TR 2005/14 concludes this excludes the New Zealand trustee of a foreign trust that qualifies for the exemption in s HC 26 on foreign-sourced income. This must be correct because, as TR 2005/14 observes, the New Zealand trustee of such a foreign trust is taxed on New Zealand–sourced income only in their capacity as trustee.

61. It is only foreign trusts with a New Zealand resident trustee that have registered in New Zealand that are now entitled to the exemption on foreign-sourced income under s HC 26. A foreign trust with a New Zealand resident trustee that was not registered

[30] Interpretation Statement: IS 18/01: Taxation of Trusts", *Tax Information Bulletin* Vol 30, No 7 (August 2018): 54, from [8.47] discusses dual status trusts.

would need to be a dual status trust to qualify as resident under the Aus-NZ DTA. That is one that met the trustee tax obligations in New Zealand on wordwide income.

62. A key question remaining is whether the residence of a trustee under the Aus–NZ DTA is restricted to their capacity as a trustee (as the ATO suggests) or whether it extends to their liability on foreign-sourced income in other capacities such as their personal capacity.

Relevance of liability of trustee in personal capacity

63. John Prebble takes a different view to the ATO.[31] He suggests the focus of a DTA is on a person's liability to tax on sources of income, not on the person's capacity. He, therefore, concludes that if the New Zealand trustee of a foreign trust is liable to tax on their personal foreign-sourced income (that is, not in their capacity as trustee), then they are not excluded by the second sentence of art 4(1) of the DTA if they are exempt on tax on foreign sourced income in their capacity as trustee.

64. The Commissioner prefers the view in TR 2005/14 at [40] that is, that the domestic law of both Australia and New Zealand treat a trustee as a separate taxpayer in respect of trust income and their personal income. The assessments made on a trustee are again separate from their personal assessment in both countries and the tax rates applying to trustees in both countries are different from those applying to individuals and companies. The focus in art 4(1) of the DTA is on the treatment of the person as trustee under the domestic laws of Australia and New Zealand. In both countries, capacity is fundamental to the liability to tax as a trustee, even if it is not in terms of the claim to residency in New Zealand.

65. This view is shared by Jeremy Beckham and Craig Elliffe.[32] They interpreted art 4 of the OECD Model Treaty (which is the same as art 4 of the Aus–NZ DTA) by examining the OECD Model Commentary, then looked at the object and purpose of art 4 and its broader role in the context of good faith interpretation under the Vienna Convention, as well as under relevant case law. From this, they concluded, as did the ATO, that the proper focus is to examine the exposure to tax of the person in their capacity as trustee:

> We conclude that a proper construction of the residency article in a DTA could allow a State of source to legitimately disregard the domestic residency of a New Zealand trustee

[31] J Prebble, "Trusts and Double Taxation Agreements", *eJournal of Tax Research* Vol 2, No 2 (2004): 192.

[32] J Beckham and C Elliffe, "The Inconvenient Problem with New Zealand's Foreign Trust Regime" (2012) 18 NZJTLP 166 at 168.

and therefore consider the New Zealand trustee of a foreign trust is not entitled to the benefits of the relevant DTA.

66. Legitimately disregarding the domestic residency of the trustee follows from the fact that they are not, in their capacity as trustee of a New Zealand foreign trust, exposed to worldwide taxation even though they would be in their personal capacity as an individual or a corporate if they were New Zealand resident.

Article 4 assumes a required liability to worldwide tax

67. Beckham and Elliffe's take from the OECD Model Commentary is that art 4(1) of the OECD Model Convention assumes an "explicit requirement of worldwide taxation". This is then reinforced by the OECD Model Commentary view that art 4(1) "should have limited application to those States that take a territorial approach to taxation in their jurisdictions"[33], for example, Hong Kong.

68. The approach in New Zealand is that trustees of both complying and non-complying trusts are liable to tax in New Zealand on worldwide income. This is irrespective of the residency status of the trustee. In contrast, registered New Zealand foreign trusts, which must have at least one New Zealand resident trustee (such that there is a domestic requirement of New Zealand trustee residency as a notional single person), are not.

69. One would assume the Aus-NZ DTA, therefore, would apply to any trustee of a complying or non-complying trust. However, the design of New Zealand's domestic regime is to tax non-resident trustees of non-complying trusts on worldwide trustee income without treating them as resident. In contrast, non-resident trustees of complying trusts are treated as resident in terms of liability to tax under s HC 33(1C).[34]

70. Whilst at first this difference in treatment might appear incongruous; the New Zealand domestic regime is designed to discourage non-complying trusts by exposing beneficiaries of them to penal tax rates of 45% on taxable distributions and all capital gains distributed are treated as income unless they are part of corpus. As discussed above, non-complying trusts from 23 March 2020 have been able to retrospectively elect to be complying trusts up to four years in the past. This means that, if non-

[33] *OECD Model Tax Convention,* Commentary on art 4, at [8.3]

[34] An exception remains for a non-resident trustee of a complying trust if they do not make an election under s HC 33 because they do not derive any non-resident passive income and pay full tax on foreign sourced income. This class of trust is however likely to be very limited in number since they could not hold a New Zealand bank account or they would derive non-resident passive income.

complying trusts have been denied the benefits of a double tax treaty because of the foreign residency of the trustee, they now have options to mitigate this in future.

Non-resident trustee of a non-complying trust

71. Putting aside the ability to now elect to be a complying trust (with four-year retrospective application), interpretive issues have been identified as to whether non-complying trusts with non-resident trustees have treaty rights under art 4(1) of the Aus–NZ DTA. That is, in this context, whether a non-complying trust with a non-resident trustee is permitted benefits under the Aus–NZ DTA given that it is liable for tax on its worldwide income under New Zealand domestic law. Another issue of contention is whether a non-complying trust with a non-resident trustee will get the benefits of the Aus–NZ DTA because it has a New Zealand settlor who has liability for New Zealand tax as an agent for the trustee.

72. A New Zealand settlor is liable for trustee income as agent of a non-resident trustee of a non-complying trust to facilitate collection of the tax. Such trusts are typically established in ignorance of New Zealand's tax regime or, perhaps, in the expectation of keeping assets outside New Zealand with the possibility of non-disclosure. The regime is designed expressly to tax non-complying trusts in a penal fashion so that the settlor, trustee or beneficiary are encouraged to elect to be personally liable for the tax obligations of the trustee and convert them to complying trusts.

73. Article 4(1) of the DTA defines a resident as meaning "any person who … is liable to tax as a resident of that State". A non-resident trustee of a non-complying trust with a New Zealand settlor is liable to tax in New Zealand on worldwide trustee income and that accords with the clear inference of art 4(1). However, it is considered not possible to interpret "liable to tax as a resident" as including taxation of a recognised non-resident, even if that liability is to comprehensive taxation, ie no exclusion for foreign sourced income.

74. Given a non-resident trustee of a non-complying trust is liable to comprehensive tax in New Zealand could they be included as a resident under a purposive interpretation of art 4(1)? As art 3(4) expressly treats trustees who retain Australian sourced dividends , interest or royalties as beneficially owned by a New Zealand resident if they are subject to tax on it in New Zealand, it would seem to be a step too far to include them under art 4(1) without a similar deeming provision. Furthermore, a trustee of a non-complying trust will have frequently not meet their New Zealand tax obligations (otherwise they would be a complying trust) and it is evident that art 4(1) is intended to apply where there is a comprehensive liability to New Zealand tax. Non-compliance does not sit well with this concept. With these considerations in mind it would seem

the better view is that a non-resident trustee of a non-complying trust will not qualify as resident under art 3(4). However, we would welcome submissions on this conclusion.

75. The New Zealand settlor of a non-complying trust in this situation is liable under s HC 29(2) for the very same tax as the non-resident trustee, but as agent only. The question is whether that agency liability is enough to satisfy the Aus–NZ DTA concept of being liable to tax as a resident. Under s HD 2, an agent is jointly and severally liable for the tax obligations of the principal and the Commissioner is empowered to issue an assessment to both parties for the same tax. By s HD 5(1), an assessment made against the settlor is enough authority for payment of the tax by the agent. Therefore, there is little practical difference between having a liability as agent and having a liability as principal. Does that mean there is enough to include non-complying trusts with a non-resident trustee as New Zealand resident under the Aus–NZ DTA because of the settlor's New Zealand residence and their agency tax liability on the trustee's income?

76. The ordinary meaning of the text of art 4(1) of the DTA is the starting point. On a standard plain meaning analysis, it would seem the liability of a trustee as a non-resident would not suffice, even though the New Zealand settlor is also liable as agent. But under the accepted approach to treaty interpretation, it is necessary to consider the context, object and purpose of the Aus–NZ DTA as well. The purpose of the DTA has been replaced by the text in art 6(1) of the MLI. It is now expressed in these terms:

> Intending to eliminate double taxation with respect to the taxes covered by the Convention without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the Convention for the indirect benefit of residents of third jurisdictions).

77. If the trustee were Australian, there is a real prospect of double tax. Australia could claim the trust as Australian resident because of the trustee's residence and tax the trustee on income not distributed at the rate of 45%. New Zealand would do the same (at 33%) under its domestic legislation because of the New Zealand settlor, and potentially could recover that tax (if not paid by the Australian trustee) by assessing the New Zealand settlor as agent. However, a foreign tax credit would be available unilaterally in New Zealand for any Australian tax paid (but capped at 33%) leaving no further tax to pay in New Zealand.

78. If the New Zealand settlor was controlling the Australian trustee's decisions as a matter of fact, there would appear to be a better case for asserting New Zealand residence (based on the residency tie-breaker test in art 4(3) of the DTA) and referring it to the competent authorities for decision. However, if the trustee in Australia was in real

control such that the place of effective management (PoEM) was clearly in Australia, the only potential argument left would be the liability of the settlor as agent and, that liability manifesting into an assessment against the New Zealand settlor. However it seems likely that agency liability for the New Zealand settlor under s HC 29 would not arise if the trustee was determined to be Australian resident under the tie breaker as a treaty overrides domestic law and therefore the trustee would not have a liability to tax in New Zealand, other than on New Zealand sourced income (if any) as a non-resident.

79. Any potential argument under art 11 of the MLI (which forms part of the Aus-NZ DTA) that the treaty cannot affect New Zealand's right to tax its own residents is not likely to succeed as the liability of the New Zealand settlor is based only on agency and the liability of the trustee as principal would be determined by the tie breaker decision in Australia's favour.

80. Although non-resident trustees of non-complying trusts are not treated as resident under domestic legislation, so are not eligible as New Zealand residents under art 4(1) of the DTA, we explore (from [86]) their potential entitlement to withholding tax rate benefits under art 3(4).

Example 3: Burl Ives is an Australian who is working as a dredge operator for a gold-mining company in Otago. Burl stays on long enough to become New Zealand tax resident due to the amount of gold being processed with the result that his contract is extended indefinitely. He has a trust he settled back in Australia of which he and his brother are trustees.

Burl is too busy to take care of his tax affairs and does nothing about administering the trust or paying tax on the income after becoming New Zealand resident. He is, however, regularly investing in Australian mining shares through the trust, which are its only asset, and he has sole signing authority on the share broker and bank accounts of the trust. The trust is accumulating all income and reinvesting it back into the stock market. Long after Burl ceases to be a transitional resident, a tax audit reveals the existence of the trust, and Inland Revenue treats it as a non-complying trust from the election expiry date in s HC 30.

The first matter to determine is whether the trustee is a resident of Australia or New Zealand under the Aus–NZ DTA. While Burl's brother in Australia is listed as co-trustee, he has not been involved in any decision making associated with the trust. All of Burl's decisions as trustee have been made in New Zealand, and there is no real input from Australia since Burl has been in New Zealand. Consequently, the place of effective management of the trust is evidently in New Zealand. This means tax on dividends derived from the mining shares in Australia should be restricted to non-resident withholding tax capped at the rates in art 10 of the DTA as the trustee (as a notional single person) is likely to be New Zealand resident under the tie-breaker test in art 4(3) of the DTA.

Non-resident trustee of a complying trust

81. In contrast to a non-complying trust, a complying trust with a non-resident trustee is in a different category because they are a compliant New Zealand taxpayer with the trustee necessarily meeting the tax obligations on world-wide trustee income.

82. A non-resident trustee of a New Zealand complying trust would usually need to qualify as such under s HC 10(1)(ab) as they would likely derive non-resident passive income and not qualify as a complying trust under s HC 10(1)(a) unless they had just foreign income . Once an election is made under s HC 33, the tax obligations of the trust are determined on the basis that both the trustee and settlor are New Zealand resident.

83. *Lin*'s case indicates you cannot import an expansive meaning into phrases used in a tax treaty that follow the OECD Model Convention,[35] if that detracts from their context and purpose. The OECD Model Commentary makes it clear that art 4(1) of the Aus–NZ DTA is intended to apply to persons taxed as residents of a contracting state on their worldwide income. That is consistent with application to a non-resident trustee who is taxed as a New Zealand resident on worldwide income. (See Example 4.)

Example 4: Sam is an American movie mogul. Her daughter Nelly (who is a United States citizen) has moved to Queenstown and is living in a property owned by the Nirvana Trust settled by Sam and of which Sam is also trustee. The trust has several holiday homes in New Zealand and one in Byron Bay in Australia.

Sam has made an election for the trust to be a complying trust as the income is mainly Airbnb rental income in New Zealand with only a little from the Byron Bay property in Australia. The trust has been distributing this income annually to Nelly as beneficiary income so she can maintain her lifestyle while living in New Zealand with her New Zealand partner.

The trustee is treated as New Zealand resident after the election, so Sam applies to the ATO requesting it treats the Nirvana Trust as New Zealand resident under art 4(1) of the Aus–NZ DTA and recognise that Nelly is receiving the Byron Bay net rental income as beneficiary income and is a New Zealand tax resident despite her United States

[35] OECD, *Model Tax Convention on Income and Capital 2017* (OECD, Paris, 2019). http://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm

citizenship. The request is that the ATO treats this income as income of a New Zealand resident beneficiary from a property owned by a New Zealand resident trust and tax her at the relevant Australian marginal rate on that income, rather than to tax Sam as trustee.

Summary of initial conclusions

84. Our initial conclusions can be summarised as follows.

- The Aus–NZ DTA identifies that a person is defined to include a trust to ensure a trust can be covered as an entity under particular articles (for example, as a fiscally transparent entity under art 1(2) of the DTA). However, when assessing whether a New Zealand trust is a person entitled to benefits under art 4(1) of the DTA, the relevant person is the trustee where income or gains are retained in a trust or is a beneficiary when they are in receipt of a trust distribution.
- The test in art 4(1) applies to a trustee solely in their capacity as trustee of a particular trust and not to their personal capacity.
- A trustee will be entitled to the benefits of the Aus–NZ DTA if the trustee is treated as resident in New Zealand under domestic tax law (assuming they are not a dual resident), even though New Zealand's trust regime is settlor based. To qualify, a trustee must also be liable to tax in New Zealand, in their capacity as trustee, on foreign-sourced income.
- A non-resident trustee of a complying trust will be treated as resident in New Zealand under art 4(1) in their capacity as that trustee if an election has been made under s HC 33. This will include a retrospective election.
- A non-resident trustee of a non-complying trust will not meet the requirements of art 4(1).
- Trustees of mixed residency will qualify under art 4(1) if at least one trustee is New Zealand resident.

85. Submissions are invited on these conclusions.

Beneficial entitlement benefits under art 3(4) of the Aus–NZ DTA

Scope of the provision

86. Article 3(4) of the Aus–NZ DTA treats trustees as entitled to reduced rates of withholding tax on dividends, interest and royalties they are taxable on as trustee income:

> For the purposes of Articles 10, 11 and 12, dividends, interest or royalties arising in a Contracting State and derived by or through a trust shall be deemed to be beneficially owned by a resident of the other Contracting State where such income is subject to tax in that other State in the hands of a trustee of that trust.

87. The Australian Explanatory Memo on the Aus–NZ DTA explains the background to this provision, and it is interesting to note the Australian perspective:

> 2.67 This provision accords with New Zealand treaty practice and has a similar effect to paragraph 2 of Article 3 of the existing New Zealand Agreement. It ensures that the trustee is treated as the beneficial owner of dividends, interest or royalties for the purposes of obtaining benefits under the respective Articles, but only where those dividends, interest or royalties are subject to tax in the hands of the trustee.
>
> 2.68 Where tax paid by a trustee is credited against the tax payable by a beneficiary who is not a resident of Australia in accordance with section 98A of the ITAA 1936, the trustee will not be regarded as subject to tax on that income.
>
> 2.69 Furthermore, the trustee will not be regarded as subject to tax on income derived through the trust where the tax is refunded. In the course of negotiations, the two delegations noted that:
>
>> "It is understood that a trustee is not regarded as being subject to tax to the extent that the trustee pays tax that is subsequently refunded to a non-resident beneficiary."
>
> 2.70 For example, where a trust derives foreign income to which no beneficiary is presently entitled, the trustee is assessable on that income if the trust is an Australian resident trust. The later distribution of that income to a beneficiary may allow a beneficiary to claim a refund of the tax paid by the trustee under section 99D of the ITAA 1936 if the income is attributable to a period in which the beneficiary was not an Australian resident. In such cases, the trustee will not be regarded as subject to tax for the purposes of paragraph 4 of Article 3. It follows that, where the income comprises dividends, interest or royalties arising in New Zealand, New Zealand will not be limited by Articles 10, 11 and 12 of the Convention.

2.71 Where dividends, interest or royalties arising in one country are taxed in the hands of a beneficiary who is a resident of the other country, it is intended that the beneficiary would generally be treated as the beneficial owner of the income.

Beneficiaries are already included

88. If a New Zealand beneficiary of a New Zealand trust derives Australian-sourced beneficiary income, then they are treated as the beneficial owner under the Aus–NZ DTA and are entitled to the reduced rates of withholding tax available where that income comprises dividends, interest or royalties that they are taxable on in New Zealand. If that beneficiary is not New Zealand resident, then the Aus–NZ DTA is not applicable; rather, their country of residence and any treaty it has with Australia dictates the position.

89. What different types of trustees will the provision apply to? On a purpose and context analysis, the provision is providing reduced rate benefits where a trustee derives the income that under common law might not be regarded as "beneficially owned", but is treated as such, provided the trustee is taxable on it in New Zealand. It should not matter that the trustee is not, in fact, a New Zealand resident. As long as the trustee is taxable in New Zealand on the income, then they are treated as if resident.

90. Article 4(2) of the DTA defines what a "resident of a Contracting State" means for the purposes of the Aus-NZ DTA. It means any person who, under the laws of that State, is liable for tax as a resident of that State. It has already been concluded this would not extend to a non-resident trustee of a non-complying trust because they are not liable to tax as a resident. If art 3(4) of the DTA was intended to expand the range of eligible trustees to include non-residents, the Australian Explanatory Memo or OECD Model Commentary might be expected to mention this, but they do not.

91. Article 3(4) of the DTA deems the income to be beneficially owned by a resident trustee if the trustee is taxed on the income in New Zealand. Where the fundamental element of being taxable is satisfied, the provision does the deeming of both beneficial ownership and New Zealand residency for the trustee. It should, therefore, also apply to a non-resident trustee of a non-complying trust that is taxable on Australian income in New Zealand under s HC 25.

92. On a plain meaning analysis, having due regard to context and purpose, art 3(4) of the DTA (which is limited to reduced rates of withholding tax on interest, dividends and royalties) should extend to such types of Australian income derived as trustee income by a non-resident trustee of a non-complying trust. It will also apply to non-resident trustees of complying trusts (whether before or after the Kiwisaver Act changes to s HC33 that have effect from 23 March 2020) and to all New Zealand resident trustees

of both complying and non-complying trusts. It would not extend to a resident trustee of a New Zealand foreign trust or a non-resident trustee of a foreign trust as they would not be taxable in New Zealand on the income.

93. The implications are that non-resident trustees of a non-complying trust can obtain some limited benefits under the Aus–NZ DTA if they have trustee income from Australia in the form of interest, dividends or royalties despite not meeting the requirements of art 4(1) of the DTA. This might be contentious if the trustee subsequently failed to pay tax in New Zealand on the income.

Overview of the tie-breaker test

94. Which tie-breaker test applies to a dual resident trustee? Where a person is a tax resident of both Australia and New Zealand, their residency status is determined under art 4(2) of the DTA if they are an individual or under art 4(3) of the DTA if they are a person other than an individual. The MLI replaced this latter provision, so the decision for non-individuals is no longer self-assessed and must now be made by mutual agreement between the competent authorities.

95. As seen, "person" is defined in the Aus–NZ DTA as including a trust. A trustee can be an individual or an entity such as a company, and both are included in the term "person" under the DTA. A trustee in both New Zealand and Australia can be a group of persons and it can include persons of mixed residency as well as individuals and companies.

96. The Aus–NZ DTA treats a trustee as the taxable entity for a trust as evidenced by art 3(4) of the DTA, and the domestic approach in both Australia and New Zealand confirms this too. Where an individual is the trustee, both Australia and New Zealand treat that individual as having a separate capacity as a trustee from their private capacity for income tax purposes. However, for tax residency purposes in New Zealand the trustee capacity is ignored, so that tax residency of an individual trustee (whether a natural person or a company) is determined in the same manner as their personal residency.

97. Where two or more individual trustees are of mixed residency, the tests for determining the dominant place of residency of an individual in art 4(2) of the DTA, such as the availability of a permanent home, are unable to determine the position for the trustee as a notional single person, since such individuals typically live in different countries. Accordingly, in such cases, the tie-breaker test for determining the residency of a trustee in a group of mixed residency trustees can logically be only art 4(3) of the DTA; that is, the provision for persons other than individuals.

98. This approach of treating a trustee as a non-individual is also somewhat reinforced by art 4(7) of the DTA, which expressly treats an Australian-managed investment trust (MIT) as an individual resident of Australia and as the beneficial owner, to the extent of the Australian residents who invest in such MITs. The reason is set out in the Australian Explanatory Memo, which explains at [2.89–2.93] that these vehicles are fiscally transparent, widely held investment vehicles that may invest in New Zealand, and Australian investors in these MITs find it difficult to individually claim treaty benefits in the source country. The implication from this singling out in art 4 of the DTA of a particular type of trust, is that normally trustees would not qualify as individuals under art 4 of the DTA.

99. The ATO, in TR 2005/14, prefers the view that the trustee operates in a separate notional capacity from their status as a private individual when performing functions as trustee and this is reflected in the Aus–NZ DTA. Personal tax affairs are considered separate and distinct. Whilst acknowledging the alternative view of Prebble,[36] the ATO looks at [44] to the tax treatment of New Zealand trustees under domestic law to support its position:

> The complete separation for tax purposes of the assessments in respect of the trustee in their capacity as trustee and in their other capacity cannot be ignored. For this reason, it is more appropriate to treat the trustee as separate persons when applying the NZ agreement.

100. The ATO's conclusion of a trustee being a separate notional person under the Aus–NZ DTA is supported by Beckham and Elliffe[37] over the Prebble view:

> From the principle that the State of source should take into account when applying the convention "the way in which an item of income … is treated in the jurisdiction of the person claiming benefits of the Convention as a resident"[38] the conclusion made by the ATO of separate notional persons seems preferable. [Footnote in the quote is at the bottom of the page.]

101. The context of that ATO conclusion was the lack of relevance of a New Zealand trustee being taxable on their personal foreign-sourced income when assessing if they were taxable on it in their capacity as trustee of a New Zealand foreign trust. However, Beckham and Elliffe's comment has application for the whole of the Aus–NZ DTA.

102. When considering the status of a trustee as a person who is dual resident under the Aus–NZ DTA there is no doubt that their capacity as a "notional single person" under

[36] J Prebble, "Trusts and Double Taxation Agreements", *eJournal of Tax Research*, Vol 2, No 2 (2004): 192.

[37] J Beckham and C Elliffe, "The Inconvenient Problem with NZ's Foreign Trust Regime" (2021) 18 NZJTLP (2012) 166, at 185.

[38] OECD Model Tax Convention, Commentary on Art 1, above n 10, at [6.3]

our domestic law is a highly relevant factor, as is the fact that the Act is express in its recognition of a trustee of a particular trust as having a separate capacity. And yet, for domestic residency purposes, trustee capacity and private capacity are not differentiated.

103. Where a trustee is a company or natural persons of mixed residency, art 4(2) of the DTA is not the appropriate test, which can be only the non-individual test under art 4(3) of the DTA. If, however, the trustee is one natural person, art 4(2) could be applied without difficulty to determine residency. The question is whether the domestic tax fiction of a notional single person of separate capacity in terms of income assessment means that in the capacity as a trustee they are not an "individual" as contemplated by the provision.

104. This remains the published view of the ATO. If a case arose, the competent authorities of both countries would need to agree the approach, and if they could not, then the dual resident person would not be eligible for benefits under the Aus–NZ DTA. It, therefore, seems the likely result is that New Zealand's Competent Authority would adopt the same approach as the ATO expressed in its ruling, even where there is only one natural person as trustee. This approach means that all dual residency determinations for trustees would need to proceed under the non-individual test in art 4(3) of the DTA and be determined by the competent authorities.

105. The consequence of this view is that if the trustee is a dual resident, then the competent authorities must determine the residency. This is discussed in the next section.

Competent authorities' determination approach for dual resident trustees

106. Article 4(3) of the Aus-NZ DTA was recently replaced by art 4(1) and (4)(3)(e) of the MLI. It requires the competent authorities of New Zealand and Australia to determine the place of residency of persons other than individuals by mutual agreement, "having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors". If the authorities cannot agree, the person is not entitled to access the reliefs and exemptions available under the DTA.

107. The same test is applied whether the trustee is a single person or a group of persons, given that domestically a trustee is treated as a notional single person.

108. The two authorities agreed an administrative approach in May 2019[39] – dual resident companies may self-assess their status. This approach is expected to result in the great majority of trans-Tasman corporates being excluded from the competent authority determination process. The administrative concession, however, expressly excludes companies in their capacity as a trustee:

> Ordinary company takes its meaning from plain English that is, an entity that is not a trust, partnership, cooperative, or other like vehicle. For the purpose of assessing this criterion, 'ordinary company' does not include an entity acting in the capacity of a trustee.

109. The process to be used when making an application to the competent authorities is set out on the Inland Revenue Policy and Regulatory website as follows (and see also Example 5):[40]

> To obtain a determination of residence of a non-individual taxpayer under this provision of the Convention, you will need to apply in writing to either competent authority requesting consideration of the matter by setting out in some detail the relevant facts and circumstances of your case.
>
> If applying to the New Zealand Competent Authority, please direct your correspondence to:
>
> New Zealand Competent Authority
> International Revenue Strategy
> P O Box 2198 Wellington 6140 New Zealand
> competentauthority@ird.govt.nz
>
> Your letter to the New Zealand Competent Authority should include the following:
>
> - The registered name of the entity, registered office addresses (including any overseas addresses), IRD number, and details of the entity's tax agent.
> - A statement describing why the entity is not eligible to use Australia and New Zealand's administrative approach to MLI Article 4(1).
> - A submission on the entity's jurisdiction of residence for treaty purposes, including the commencement date of such self-determination. This submission should be supported by relevant evidence, including: ◦confirmation of where the entity is incorporated or otherwise constituted;

[39] Inland Revenue, *Australia and New Zealand's Administrative Approach to MLI Article 4(1)* (Inland Revenue, Wellington, 2019). http://taxpolicy.ird.govt.nz/publications/2019-other-australia-nz-admin-approach-mli-article-4-1/overview

[40] Inland Revenue, "Article 4(3): competent authority determinations". *Tax Policy – Tax treaties* (webpage). http://taxpolicy.ird.govt.nz/tax-treaties/australia#faq-article-4-3

- a brief description of who makes the key management and commercial decisions for the entity, and where these decisions are in substance made;
- where the meetings of the board of directors or equivalent body are usually held;
- where the chief executive officer and other senior directors usually carry out their activities;
- where senior day-to-day management of the entity is usually carried on;
- where accounting records, and board minutes or equivalent documents recording key management or commercial decisions, are prepared and maintained;
- where the majority of the company's business activities are carried on; and
- any other evidence that you consider relevant to the determination of residence for treaty purposes.

All information received by the New Zealand Competent Authority will also be provided to the Australian Competent Authority. If either competent authority requires additional information or documentation to complete the evaluation of the application, they may request it. The competent authorities will endeavour to issue a determination in accordance with Article 4(1) within 6 months of receipt of the application, subject to the provision by the taxpayer of all information necessary for the competent authorities to be satisfied the determination can be made. The final outcome will be communicated in writing to the taxpayer or their agent.

Example 5: Briar, an Australian tax resident, and Rose, a New Zealand tax resident, are the two trustees of a New Zealand complying trust. They hold all their meetings digitally, and their decisions must be unanimous under the trust deed. When considering any issues to do with the trust, they always first consult with the New Zealand settlor Jane, who also attends all digital meetings. Jane organises accounting and legal advice for the trust using New Zealand advisors and ensures this is disseminated to the trustees ahead of any meetings. A review of the advice and decisions made indicates the trustees always follow the advice of Jane's advisors and largely act on her recommendations.

Under domestic legislation, both New Zealand and Australia would claim the trustee (notionally a single person) as being resident. If an application was made to the competent authorities to decide the issue under art 4(3) of the DTA, then the prime focus will be on the PoEM of the trust, but "other relevant factors" permits a reasonably wide enquiry to be undertaken, where relevant.

It is likely the focus would fall on the most significant influence on the trustees' decisions. Evidence exists that Jane's recommendations as settlor of the trust are routinely followed and that advice Jane obtains from professional advisors in New Zealand is followed by the trustees to the letter. This likely indicates that the trustee (trust) residency would be New Zealand under the tie-breaker test.

110. In *HMRC v Smallwood* [2010] EWCA Civ 778, the English Court of Appeal, by majority, held that a "scheme of management" of a trust was located in the UK despite the trustee's residence being temporarily exported to Mauritius, during which time, certain shares were sold producing a significant capital gain. The scheme to sell the shares, after migrating the trustee's residence from the UK to Mauritius, was devised by the settlor in conjunction with advisors in England and then carried out to the letter. It was determined that the scheme of management carried out by the trustees in Mauritius, was devised and orchestrated from the UK and went beyond the day-to-day management exercised by the trustees for the time being in Mauritius, where the gain would not have been taxed unlike in the UK. The court agreed with the taxpayer that the Mauritian corporate trustee was not compelled to sell the shares, but decided the trustee acted in accordance with a pre-agreed plan when it made the decision to sell and instructed a broker to undertake it. In the end, the PoEM and, therefore, the residency of the trust under the treaty between the UK and Mauritius, was held to have remained in the UK.

111. Importantly, the test for PoEM the court used in *Smallwood* (which it called the "scheme of management") was identical to that required to be used in the Aus–NZ DTA, as the relevant treaty between the UK and Mauritius, like the Aus–NZ DTA, followed the OECD Model Convention.

112. In *Smallwood,* the court noted PoEM was not a defined term in the treaty but was interpreted as meaning the place that is the centre of top-level management; that is, where key management and commercial decisions are made. The court also noted that this test was endorsed by Prof Dr Klaus Vogel in his commentary on the OECD Model Convention[41] and by German and UK case law. Reference was made in *Smallwood* at [48] to the OECD Model Commentary on art 4(3) of the OECD Model Convention as a suitable formulation of the test:

> The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one

[41] Ekkehart Reimer and Alexander Rust (eds) *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015)

place of management. But it can have only one place of effective management at any one time.

113. The facts then are all important when the competent authorities determine the residency under the Aus–NZ DTA of a dual resident trustee. As illustrated by *Smallwood*, it is quite possible that the place where a corporate trustee resides and makes decisions may not necessarily determine the trust's place of residence, particularly where a settlor or professionals acting for the settlor have active involvement or significant influence in decision making.

114. Frequently, of course, both a settlor and professionals who act for that settlor, may also have roles as trustees. If other trustees play a subservient role in decision making to the trustee who is also a settlor (for example, there is a consistent pattern of rubber-stamping decisions made by the settlor–trustee), this would undoubtedly be influential when deciding cases of dual residency.

115. It remains, however, a matter of fact whether the place where the settlor resides affects the determination of the dual residence of a trustee. *Smallwood* is an example of a case where the courts looked behind the actions of a trustee residing in a tax haven solely to conduct a particular transaction to reduce a tax exposure in the UK. They used a conventional test (PoEM) in the Model Convention to do this and did not need to resort to any anti-avoidance provisions.

116. It is not likely the facts in *Smallwood* would occur in a case involving a trustee who is a dual tax resident of both Australia and New Zealand because neither country is a tax haven and Australia does not recognise a New Zealand trustee of a New Zealand foreign trust that is not taxed on foreign income as entitled to benefits of the Aus–NZ DTA. But a similar issue might arise if, for example, a New Zealand corporate trustee of a complying trust with some Australian directors sold a parcel of ASX shares. If the PoEM of the corporate trustee was held to be in Australia, the net gains would be taxable there. However, if the PoEM of the trustee was held to be in New Zealand, they would not be taxable so long as the shares did not constitute taxable Australian property.

117. The initial conclusions in this paper on the Aus–NZ DTA test for determining the status of a dual resident trustee are as follows:

- In all situations, other than where a single individual is the trustee, only the non-individual test under art 4(3) of the DTA is applicable.
- Where the trustee is a single individual, art 4(2) of the DTA could be used only if the competent authorities agreed to that. The ATO's published position is that in this situation, art 4(3) applies and not art 4(2).

- On the assumption that the ATO view has not altered since its ruling in TR 2005/14 and art 4(3) prescribes the test for all trustees, the prime focus of an application to the competent authorities should be on the PoEM of the trustee. Such an enquiry will focus on where effective management occurs; that is, where the key management and commercial decisions are made rather than the day-to-day management, and the trustee can have only one such place at any time.

Submissions are invited on these conclusions.

Impact on trusts of the fiscal transparency provisions in art 1(2) of the DTA

Issue

118. Given the terms of art 1(2) of the Aus–NZ DTA, the primary issue here is whether the source country where the trust is resident must recognise beneficiary income as derived by a resident of the other country, and the consequences of that recognition in different scenarios. This issue arises in a situation such as where there is a discretionary New Zealand beneficiary of an Australian resident trust who is presently entitled to a net foreign-sourced capital gain made by the trustee, which is taxable to an Australian resident but is not taxable if made by a non-resident. An example would be gains on shares listed on the New York Stock Exchange (NYSE) taxable as foreign investment fund income to the beneficiary in New Zealand under the comparative value method or if required to make a quick sale adjustment under s EX 52(6).

119. If a New Zealand resident, and not the trustee of an Australian resident trust estate, is required by art 1(2) of the DTA to be treated as deriving such income, this could fundamentally change the tax outcome in Australia. This is because such a gain is taxable to an Australian resident trustee under its capital gains tax (CGT) legislation but not if made directly by a non-resident. That will be examined in the next sections of this paper.

120. New Zealand does not recognise an Australian resident investor in a New Zealand unit trust as the person deriving the income just because that Australian resident is taxable on their share of the income in Australia. As is revealed from [137], there are exceptions to the apparent impact of art 1(2).

Article 1(2) of the DTA has been modified by the MLI

121. Before its replacement by art 3(1) of the MLI, art 1(2) of the Aus–NZ DTA was expressed in these terms:

> In the case of an item of income (including profits or gains) derived by or through a person that is fiscally transparent with respect to that item of income under the laws of either State such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income of a resident.

122. The substituted provision reads as follows with the reference to the "Convention" being to the Aus-NZ DTA:

> For the purposes of [*the Convention*], income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either [*Contracting State*] shall be considered to be income of a resident of a [*Contracting State*] but only to the extent that the income is treated, for purposes of taxation by that [*Contracting State*], as the income of a resident of that [*Contracting State*].

123. Mark Brabazon comments on this:[42]

> The treaty already contains a transparent entity clause as article 1(2). That clause reflects the influence of US treaty practice and the transparent entity clause in the 2006 US Model, although the wording is slightly different. There is probably no difference of meaning between article 1(2) of the treaty and MLI article 3(1) which will replace it.

124. The important common features of art 3(1) of the MLI and art 1(2) of the Aus–NZ DTA are:

- the fact the trust needs be treated as fiscally transparent in only Australia or New Zealand to qualify;
- it applies when income is derived by or through a trust;
- the beneficiary only needs to be taxable on the income in their country of residence for the other country to be required to recognise the income as being derived by a resident of the other country; and
- this treatment applies "to the extent that" income of a trust is treated as income of a beneficiary in their country of residence.

[42] M Brabazon, "After the Flood: Transparent and hybrid entities in Australian tax treaties after the MLI", *eJournal of Tax Research* Vol 17, No 1 (2019): 1, at 26.

125. Given these common features, and with Brabazon's support, it is concluded that the two provisions are materially the same. This means the commentary on art 1(2) of the DTA in the Australian Explanatory Memo remains a useful guide as to their approach to the present amended provision.

Interpretation of the provision

126. The Australian Explanatory Memo discusses art 1(2) of the Aus–NZ DTA:

> [2.8] Paragraph 2 addresses special issues arising in relation to income that is derived by or through entities such as certain partnerships and trusts, that are fiscally transparent with respect to that income; that is, where the participants in the entity are liable to tax on the income, rather than the entity itself …
>
> [2.9] The intention of paragraph 2 is to ensure that treaty benefits are available to residents who participate in these entities where income derived through such entities is allocated to those members for tax purposes …
>
> [2.10] its application is intended to be consistent with the OECD conclusions on the application of the OECD *Model Tax Convention on Income and on Capital* (OECD Model) *to partnerships* … Further, the inclusion of the words 'with respect to that item of income' is included to ensure that this rule will apply appropriately to income derived through entities such as certain trusts, where some items of income may be allocated to the beneficiary or participant and taxed in that person's hands, while other items of income are taxed at the entity level …
>
> [2.12] The paragraph also refers to income 'derived by or through' such a person. This is to take account of the fact that the same income may be regarded as derived by the entity in one country, while the other country considers that, notwithstanding that it is received by the entity, it is derived by the participants …
>
> [2.14] In general, paragraph 2 relates to particular items of income of entities that are fiscally transparent under the law of one or other country, including certain partnerships and trusts. In the case of Australia it includes … trusts which are subject to Division 6 of Part III where the beneficiary is **presently entitled** to the income and assessable accordingly (but not a corporate unit trust or public trading trust subject to Division 6B or 6C of Part III). In the case of New Zealand it includes … complying trusts and foreign trusts. [Emphasis added]

127. The Australian concept of "present entitlement" is central to its recognition of trust income as being that of a beneficiary and not of the trustee. Where the trust is not fixed, such as a discretionary trust, a trustee must resolve, by balance date annually, to make distributions of current income to identified beneficiaries in certain amounts or proportions. In recognition that the exact amount may not be determinable by balance date, it is enough if the trustee's resolution identifies what proportion of the

net income is to be allocated to the beneficiary by the balance date. However, these resolutions cannot be backdated.[43]

Australia's treatment of capital gains distributed to non-resident beneficiaries by Australian resident trusts that are not fixed

128. The Australian Explanatory Memo (at [2.13]) confirms that art 1(2) of the Aus–NZ DTA applies to all forms of income, including amounts taxable on a net profit basis; that is, in Australia's case, it includes capital gains. Given recent draft taxation determinations of the ATO (TD 2019/D6 and TD 2019/D7),[44] this is of particular interest.

129. Where there is an Australian resident trust, net capital gains are taxable in Australia if they are Australian sourced, but are not taxable Australian property (TD 2019/D6), or are foreign-sourced gains (TD 2019/D7) distributed to non-resident beneficiaries who do not have a fixed interest in the trust. Tax is imposed on the trustee initially at a rate that approximates the marginal rate of the beneficiary. The beneficiary is also taxable in Australia on the same amount, but a credit is available for tax paid by the trustee.

130. Tax professionals and bodies such as Chartered Accountants of Australia and New Zealand have debated this view in submissions. They say it is an unintended result following a change to the CGT legislation in 2011 (for an unrelated purpose) and counter to the wider policy of not taxing non-residents on foreign-sourced income. They suggest the correct view should be that such non-resident beneficiaries are not

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[43] See the *Taylor v FCT* (1970) 110 CLR 444 at 452, 70 ATC 4026 at 4030, 1 ATR 582 at 586 (HCA). Taxation Ruling IT 319 further explains the concept of present entitlement (Australian Taxation Office, *Taxation Ruling* IT 319*: Presently entitled: The effect of the decision in Taylor v FCT [1970] HCA 10*, Australian Government, 1970).https://www.ato.gov.au/law/view/document?LocID=%22ITR%2FIT319%2FNAT%2FATO%22&PiT=99991231235958

Taxation Ruling IT 2622 provides guidelines on the present entitlement of beneficiaries to income from a deceased estate (Australian Taxation Office, *Taxation Ruling IT 2622: Income Tax: present entitlement during the stages of administration of deceased estates* (Australian Government, 1990). https://www.ato.gov.au/law/view/document?docid=ITR/IT2622/NAT/ATO/00001).

[44] Australian Taxation Office, *Draft Taxation Determination: Income tax – Does subdivision 855-A (or subsection 768-915(1)) of the Income Tax Assessment Act 1997 disregard a capital gain that a foreign resident (or temporary resident) beneficiary of a resident non-fixed trust makes because of subsection 115-215(3)?* (TD 2019/D6, Australian Government, 2019). https://www.ato.gov.au/law/view/pdf/pbr/td2019-d006.pdf and Australian Taxation Office, *Draft Taxation Determination: Income tax – Is the source concept in Division 6 of Part III of the Income Tax Assessment Act 1936 relevant in determining whether a non-resident beneficiary of a resident trust (or trustee for them) is assessed on an amount of trust capital gain arising under subdivision 115-C of the Income Tax Assessment Act 1997?* (TD 2019/D7, Australian Government, 2019). https://www.ato.gov.au/law/view/pdf/pbr/td2019-d007.pdf

taxable on distributions of any foreign-sourced gains or on Australian-sourced capital gains that would not be taxable to them in Australia if derived directly or through a fixed trust. They also criticise the draft determinations for excluding any analysis of the impact of Australia's DTAs.[45] However two recent court decisions back up the draft determinations.[46]

131. It is interesting to note that these court decisions did not deal with the impact of a tax treaty, so the impact of a fiscal transparency provision in a treaty on the conclusions in the draft determinations remains an open question. What then is the impact of art 1(2) of the Aus-NZ DTA on the view reached in the two draft determinations?

132. An example to which TD 2019/D6 applies would be a net capital gain on an Australian company listed on the ASX distributed to a New Zealand beneficiary by an Australian discretionary trust. TD 2019/D7 takes this example further to include a net capital gain made on a US company listed on the NYSE distributed to a New Zealand beneficiary by the same trust.

133. A New Zealand resident beneficiary of an Australian resident discretionary trust would be taxed in New Zealand on distributions made to them that consisted of beneficiary income. Gains made on listed ASX shares would generally constitute beneficiary income in New Zealand only if held on revenue account by the trust. Gains made on listed NYSE shares may constitute income in New Zealand under the foreign investment fund regime, depending on the method adopted, such as comparative value or the quick sales adjustment made under the fair dividend rate method. Article 1(2) of the DTA applies only to the extent that a New Zealand beneficiary is taxable on the distribution amount in New Zealand.

134. On a plain reading of the wording of art 1(2) of the DTA one would think that the approach suggested in the draft determinations would require modification by the Aus–NZ DTA and the ATO would be required to treat a New Zealand resident, not the trustee, as deriving the income, if they were presently entitled to it and it was taxable in New Zealand. If the New Zealand beneficiary derived such capital gains in Australia directly or from a fixed trust, they would not be taxable on them in Australia.

135. If the trustee of a discretionary resident Australian trust retained the net gains made on ASX listed shares or NYSE shares, paid tax on them at 45% and later distributed them to a New Zealand discretionary beneficiary in a subsequent income year, that beneficiary would be entitled to a refund of tax paid by the trustee under s 99D of the

[45] See, for example, R Somers and P Harper, "Structuring cross-border transactions: Part 1", *Taxation in Australia* Vol 54, No 9, (April 2020): 486.

[46] *N & M Martin Holdings Pty Ltd v C of T* [2020] FCA 1186; *Peter Greensill Family Trust Co Pty Ltd (trustee) v C of T* [2020] FCA 559 [subject to appeal].

ITAA 1936. (Any refund is, however, subject to the Australian Commissioner's discretion where a purpose was to enable the beneficiary to obtain the refund.)

136. The taxation in Australia of these net capital gains to presently entitled non-resident discretionary beneficiaries appears out of step with the refund available under s 99D of the ITAA 1936 when distribution is made after accumulation by the trustee. This underscores the possibility that the approach set out in the draft determinations, although endorsed by the Australian courts as consistent with the legislation, is not an outcome of completely coherent policy settings.

No impact on the right to tax resident entities

137. Both Australia and New Zealand have always made it clear that art 1(2) of the Aus–NZ DTA does not affect their right to tax their own residents without treaty limitation. The Australian Explanatory Memo notes this at [2.25]:

> Where the two countries allocate the income to different resident persons (for example, where one country considers that the income is derived by a resident entity, while the other country considers that the income is derived by a resident that is a participant in that entity), both countries may tax the income in accordance with this provision. Income derived from a country through an entity organised in that country will not be eligible for treaty benefits if the income is treated as derived by a resident entity under the tax laws of that country. In such case, the income would be regarded as domestic source income of a resident which in accordance with normal treaty principles, would not be limited by the Convention. During negotiations, the two delegations noted that:
>
> > "It is understood that (this) paragraph shall not affect the taxation by Contracting States of its residents."

138. The Aus–NZ DTA has been amended by the adoption of art 11(1) of the MLI to specifically clarify that it does not affect either country's ability to tax its own residents except for the benefits under arts 7(3), 9(2),19, 20, 23–25 and 28 of the DTA. Those exceptions do not significantly affect the issues canvassed in this paper. The Australian MLI Explanatory Memo notes at [3.106]:

> Article 11 is a savings clause and will codify a widely accepted principle that is already understood to apply to Australia's tax agreements.

139. It is clear that the central premise of the draft determinations is that, under s 95 of the ITAA 1936, a trust's net income is calculated on the assumption that the trustee is an Australian resident, so the trustee includes income from all sources, whether in Australia or elsewhere. The capital gain event then happens to the trustee under the relevant CGT provision and not the beneficiary unless it is a fixed trust. Beneficiaries of

fixed trusts are singled out for different treatment, suggesting other beneficiaries are in a different category.

140. A discretionary non-resident beneficiary is still treated as deriving the income to which they are presently entitled, but they are not treated as having made the gain that would have entitled them to a CGT exemption as a non-resident. They are, however, entitled to a credit for the tax the trustee paid on that gain against their own liability on the net gain in Australia.

141. Australia could assert the approach in the draft determinations fits the criteria for continued taxation of a trust on capital gains the trustee makes as a "resident entity" set out in [2.25] of the Australian Explanatory Memo (as quoted in [137]). That being so, Australia, despite the Aus–NZ DTA, would not recognise a New Zealand beneficiary of a discretionary resident Australian trust as making the net capital gains they are presently entitled to, even where such beneficiaries are taxable on such gains in New Zealand.

142. Australia could also assert that it does still recognise a New Zealand resident as deriving the net capital gains as income and a credit is available for tax the trustee paid, meaning it should not be regarded as subject to tax. Where a credit is provided, the Australian Explanatory Memo suggests at [2.68] that this is treated as if the trustee is not subject to tax:

> Where tax paid by a trustee is credited against the tax payable by a beneficiary who is not resident of Australia in accordance with section 98A of the ITAA 1936, the trustee will not be regarded as subject to tax on that income.

143. If taken, such an approach would mean apparent compliance with art 1(2) of the DTA even though the outcome is that net capital gain amounts not taxed to non-residents (with direct holdings or when distributed to non-residents after accumulation by a trustee) would be taxable to a presently entitled New Zealand discretionary beneficiary. It remains to be seen if New Zealand would agree with this interpretation.

144. It may only be a matter of time before a Court in Australia considers how a tax treaty would impact this treatment. Despite professional bodies urging a review of the relevant policy settings in Australia, such a review is unlikely to occur in the short to medium term, especially when the *Greensill* appeal is outstanding.

Treatment where a trust is treated as fiscally transparent only in the participant's country

145. Example 2.6 in the Australian Explanatory Memo illustrates the discussion at [2.25] using an entity, NZ Co, owned by an Australian company with an Australian shareholder, that New Zealand regards as a company, but which Australia recognises as a fiscally transparent partnership. The example confirms that New Zealand would not need to grant source tax reductions under art 11 of the Aus–NZ DTA (interest) on interest income paid by a New Zealand resident to NZ Co. This straightforward example of a situation where New Zealand does not recognise fiscal transparency, but Australia does, unfortunately does not provide any insight to the expected treatment of an Australian resident trust that is treated as a partially fiscally transparent vehicle in both Australia and New Zealand.

146. The Australian Explanatory Memo at [2.26] confirms that where the same income is taxed in the hands of different persons as in Example 2.6, art 23(3) of the DTA (elimination of double taxation) ensures that relief from double taxation is available. The operation of art 23(3) is discussed in the next section of this paper.

Whether the Australian MLI Explanatory Memorandum provides further insights

147. The Australian MLI Explanatory Memo states at [2.25] that art 1(2) of the Aus–NZ DTA as modified by art 3(1) of the MLI does not replace integrity rules that clarify how a provision in the DTA applies to a particular item of income derived by a resident of Australia or New Zealand. One example quoted is art 7(7) of the DTA, which deems a beneficiary of a business trust to have a permanent establishment and attributes a share of profits to that permanent establishment. A further example is referred to at [2.24] and confirms that art 1(2) of the DTA would not apply to income received by a MIT to which art 4(7) of the DTA applies. This ensures New Zealand–sourced income such an MIT receives must be treated by New Zealand as the income of an individual Australian to the extent of the trust's Australian resident beneficial owners.

148. There is little further information in the Australian MLI Explanatory Memo on art 1(2) of the DTA and fiscally transparent arrangements and entities that was not already conveyed in the earlier Australian Explanatory Memo (on the Aus–NZ DTA).

Article 1(2) of the DTA is more constrained than it appears

149. It is evident from this discussion and the Australian Explanatory Memo that art 1(2) of the Aus–NZ DTA is not nearly as broad as it appears to be from an initial plain reading of its wording. The context and purpose of the requirement for recognition of fiscally transparent entities is somewhat compromised if Australia regards a discretionary trust as a resident entity making and taxable on net capital gains, even where New Zealand taxes a New Zealand resident beneficiary who is presently entitled to the same income. In this situation, relief is limited to the tax credit provisions provided domestically in New Zealand as guaranteed by art 23 of the DTA.

150. If the income is not taxable in New Zealand, such as net gains on ASX listed shares held on capital account distributed by a resident Australian discretionary trust to a New Zealand beneficiary, then no relief is available under the Aus–NZ DTA for tax imposed in Australia. This is even though that tax would not have been imposed had the beneficiary directly invested in the ASX shares.

Summary of the impact of art 1(2) of the DTA on trusts

151. Although art 1(2) of the Aus–NZ DTA has been modified by the MLI, there have been no material alterations as a result. Amended art 1(2) requires both New Zealand and Australia to recognise the residents of the other country as the recipients of income rather than a trust in their country (including capital gains taxed on a net basis and included in income), to the extent that the income is taxed to that beneficiary in their place of residence. It applies where either New Zealand or Australia recognises the trust as wholly or partly fiscally transparent and whether the trustee retains some income or distributes it all.

152. Australia records this provision in the Australian Explanatory Memo as applying to presently entitled beneficiaries of Australian resident trusts that are (broadly) not taxed as companies in Australia. It also identifies it as applying to both complying and foreign trusts in the New Zealand context, but is silent about non-complying trusts. (See Example 6.)

Example 6: Miriama is the trustee of a New Zealand complying trust, the Enzed Trust. She makes a distribution of New Zealand–sourced rental income to Bruce, an Australian resident, as beneficiary income. New Zealand treats Bruce as deriving the income not Miriama as trustee and, as in Australia, Miriama is obliged to pay tax in New Zealand as agent for Bruce, at a rate applicable for an individual, which she deducts from the distribution. Australia then grants a tax credit to Bruce for tax paid in New Zealand under art 23(2) of the Aus–NZ DTA.

153. Neither country has surrendered its right to tax an entity it regards as resident as a result of this fiscally transparent provision (that is, art 1(2) of the DTA). This means, for example, that if a New Zealand resident unit trust with Australian unit holders derives New Zealand–sourced income, New Zealand can continue to tax it as a company notwithstanding that income is treated as the unit holders' income in Australia if they are presently entitled to it.

154. The Australian Explanatory Memo assumes that presently entitled beneficiaries of Australian resident trusts are treated as recipients of the income distributed to them under their domestic regime. The draft determinations do not consider the impact of double tax treaties, but based on the Australian Explanatory Memo, Australia could assert their approach is supported by the fact the non-resident beneficiary is treated as deriving the income in accord with art 1(2) and a credit is available for tax paid by the trustee so that should be regarded as the trustee not having paid tax. The treatment of the trustee as the person making the capital gain could be defended as justified under the exception for resident entities in art 11 of the MLI, which forms part of the Aus–NZ DTA. It remains to be seen if New Zealand would agree with this approach. There is always the power to refer it to the Mutual Agreement Procedure where there is any disagreement.

155. Trusts are partially fiscally transparent vehicles in that some income may be taxed to the trustee and some to beneficiaries, depending on the terms of the trust and the trustee's decisions. A trust is different from, say, a partnership where all income is allocated to the partners and treated as theirs annually. The provision also operates if the trustee retains some income and distributes some.

156. Article 1(2) of the DTA does not affect other express "integrity" provisions in the DTA. For example, it does not affect art 7(7), which imputes a permanent establishment of a business trust to a beneficiary; nor does it affect art 4(7), which requires New Zealand to treat New Zealand–sourced income of an Australian MIT as the income of an individual resident of Australia to the extent that its Australian resident investors are beneficially entitled to that income.

157. Submissions are invited on these conclusions.

Impact on trusts of art 23 of the DTA

Scope of the issue

158. This section looks at several issues. What are the tax credit obligations for New Zealand on Australian-sourced income derived by a New Zealand beneficiary under art 23(2) of the Aus–NZ DTA? Are credits effectively limited to those available unilaterally under the Act? Is that tax credit obligation any different under art 23(3) of the DTA where fiscal transparency is recognised only where the beneficiary resides? On a broader level, is art 23 of the DTA limited to relieving juridical double tax and not economic double tax, as per the decision in *Lin*?

159. Also examined is the impact of art 23 of the DTA on New Zealand beneficiaries of Australian trusts. As seen, it is evident approaches may differ in relation to the treatment of net capital gains (treated as either income or capital) distributed to discretionary beneficiaries compared with other income, particularly foreign-sourced income.

Applies to juridical double tax

160. Article 23(2) of the Aus–NZ DTA requires New Zealand and Australia to provide a credit under their respective domestic provisions when a New Zealand resident pays Australian tax against the New Zealand tax payable on the same income and vice versa. There is an express exclusion in the case of a dividend for tax payable on the profits from which the dividend is paid. This exclusion underscores that the focus of art 23 of the DTA is solely on juridical double tax; that is, where the same person is taxed on the same income in both countries. The OECD Commentary on art 23 of the Model Convention also makes this same point about relieving juridical double tax in its opening remarks, unless the parties have agreed otherwise.

161. As discussed above, the Court of Appeal in *Lin* found that the High Court was incorrect when it assumed that a controlled foreign corporation (CFC) was in the same position as a partnership such that it came within the juridical double tax framework. The court of appeal held that tax spared (or paid) by a CFC in China and then tax paid by the taxpayer in New Zealand under the CFC regime, was an example of economic double tax not covered under art 23 of the DTA. Trusts, as partially fiscally transparent vehicles in both New Zealand and Australia, are, however, specifically covered under arts 1(2)

and 23(3) of the DTA, and, as fiscally transparent entities, they are potentially in the same position as partnerships on the juridical double tax spectrum.

Impact where the beneficiary is taxed in the country where the trust is resident

162. If a New Zealand beneficiary is taxed in Australia (including where tax is imposed on the trustee as agent, as occurs in New Zealand) on a distribution of Australian-sourced income from an Australian resident trust, art 23(2) of the Aus–NZ DTA will apply. New Zealand is required to provide a credit for the Australian tax paid (capped at the amount payable in New Zealand) under the relevant domestic provisions. For details as to the relevant legislation and operational requirements for such a foreign tax credit claim, see Interpretation Statement IS 16/05.[47]

163. Although IS 16/05 does not refer to trusts, there is no difference to the approach it discusses when a New Zealand beneficiary receives a distribution of offshore income and the approach when the same person deriving income does so directly from offshore (that is, not through a trust).

Impact where the trust is taxed in the country of residence

164. Article 23(3) of the Aus/NZ DTA expands the tax credit obligation to situations where a trust that meets the requirements of art 1(2) of the DTA is taxed as a resident entity on income that is also taxed in the other country to a beneficiary of the trust:

> Where in accordance with paragraph 2 of Article 1 [of the DTA], an item of income is taxed in a Contracting State in the hands of a person that is fiscally transparent under the laws of the other State, and is also taxed in the hands of a resident of the other State as a participant in such person, that other State shall provide relief in respect of taxes imposed in the first-mentioned State on that item of income in accordance with provisions of this Article.

165. The Australian Explanatory Memo comments on the operation of art 23(3) of the DTA, noting:

> [2.318] … this Article ensures that double taxation will be relieved in situations where … the same income is taxed in Australia and New Zealand in the hands of different persons.

[47] *Interpretation Statement: IS 16/05: How to Claim a Foreign Tax Credit Where the Foreign Tax Paid Is Covered by a Double Tax Agreement* (2016). https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/interpretation-statements/is-1605.pdf?la=en

> This situation may arise where the two countries allocate the income to different persons for tax purposes.
>
> [2.320] Paragraph 3 [of art 23 of the DTA] also applies where the country in which the income arises regards the income as derived by a resident entity, while the other country regards the entity as fiscally transparent and allocates the income to its own residents who are participants in the entity … In these circumstances, paragraph 3 provides that the country of residence of the participants will provide relief in respect of taxes imposed in the source country.

166. The first paragraph quoted above [2.318] refers to income allocated by Australia and New Zealand to different persons. The second paragraph [2.320] refers to income that has a source in one of the countries and is seen as derived by a resident entity in the country of source, and that entity is regarded as fiscally transparent in the other country. The inference is that both paragraphs apply to the same income being taxed in each country. Potentially, the first paragraph could also include income that is not sourced in the country where the entity is and the second paragraph could exclude this income.

167. Under the approach taken in the draft determinations (TD 2019/D6 and TD 2019/D7), Australia is treating a discretionary resident trust as the entity making the capital gain and taxing the trustee as a result. But it is also taxing the New Zealand beneficiary on the same gain (under a different provision) and allowing a credit to that beneficiary for tax paid by the trustee. Where a credit is provided to the New Zealand beneficiary for the full trustee tax paid, this arguably would not be treated as the Australian resident trust meeting the requirements of art 23(3) of the DTA.[48] The appropriate provision would then be art 23(2) of the DTA (to the extent the amount was taxable in New Zealand), as the credit from tax paid by the trustee is used to satisfy the liability of the New Zealand beneficiary on the same net capital gain.

168. This raises the question of whether New Zealand would be obliged to recognise, under art 23(2), the Australian tax paid by the New Zealand beneficiary as including the amount of the credit given for tax paid by the Australian trustee. As that credit is used to satisfy the liability of the beneficiary in Australia, the answer seems logically to be yes.

[48] Refer to the quote from the Australian Explanatory Memo at [140]. Note however New Zealand does not see itself as bound by this Australian view.

No obligation to grant a foreign tax credit under the DTA where a trust is taxed as a resident on foreign-sourced income and gains

169. Article 23 of the Aus–NZ DTA (referred to as the Convention) is affected by art 3(2) of the MLI, which provides:

> the provisions of Article 23 of the Convention that require a Contracting State to provide a credit equal to the tax paid under the laws of the other Contracting State in accordance with the Convention] shall not apply to the extent that such provisions allow taxation by that other [*Contracting State*] solely because the income is also income derived by a resident of that other [*Contracting State*].

170. The Australian MLI Explanatory Memo explains how art 3(2) of the MLI impacts on the scope of art 23 of the Aus-NZ DTA at [2.29]:

> Article 3(2) therefore ensures that a Party is only required to provide relief from double taxation to the extent that the relevant income is taxable in the partner jurisdiction in accordance with the source taxing rights allocated under the relevant tax agreement (for instance where that partner jurisdiction is the jurisdiction of source of the relevant income or the jurisdiction where there is a permanent establishment to which the relevant income is attributable).

171. The Australian MLI Explanatory Memo at [2.30] indicates that the 2017 update to the OECD Model and the OECD Model Commentary on arts 23A and 23B of the OECD Model at [11.1–11.2] is relevant in interpreting art 3(2) of the MLI. The OECD MLI Explanatory Statement notes at [41] that the genesis of art 3(2) of the MLI was the Action 6 OECD report.[49] The OECD (at 90) suggests the Commentary on art 23 of the OECD Model Convention have the following added :

> 11.1 In some cases, the same income or capital may be taxed by each Contracting State as income or capital of one its residents. This may happen where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income . The phrase "(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)" clarifies that in such cases, both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer and that each State is therefore only obliged to provide relief of double taxation to the extent that

[49] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 final report* (OECD, Paris, 2015). https://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm

> taxation by the other State is in accordance with provisions of the Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attribute, thereby excluding taxation that would solely be in accordance with paragraph 3 of Article1. Whilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect.

172. In addition to art 11 of the MLI which permits Australia to tax its residents despite the DTA, Australia could cite art 13(7) of the Aus–NZ DTA as authority for its right to tax the global capital gains of an entity such as a discretionary trust it considers to be Australian resident:

> The provisions of this Article [13 Alienation of Property] shall not affect the right of Australia to tax, in accordance with its laws, income, profits or gains from the alienation of any property derived by a person who is a resident of Australia at any time during the year of income in which the property is alienated, or has been so resident at any time during the 6 years immediately preceding that year.

173. The draft determinations propose that Australia is entitled to tax a resident discretionary Australian trust on foreign-sourced capital gains even if a non-resident beneficiary is presently entitled to that income. A plain reading of the Australian MLI Explanatory Memo at [2.29] suggests New Zealand would <u>not be obliged</u> to give a New Zealand beneficiary recipient of such income a tax credit under art 23(3) of the DTA for Australian tax imposed on the Australian trustee on foreign-sourced net gains. But the fact a beneficiary receives a credit in Australia for any tax imposed on the trustee in these circumstances suggests art 23(3) would not be applicable in any event.

174. New Zealand would not be relieved from providing a New Zealand beneficiary a credit for tax imposed on foreign-sourced capital gains under art 23(2) of the DTA because the beneficiary does not have tax imposed on them by Australia as a resident of Australia. Australia does not impose tax on any other foreign-sourced income that a non-resident beneficiary is presently entitled to, and New Zealand does not tax non-resident beneficiaries on foreign-sourced income either. (See Example 7).

Example 7: Wiremu is a discretionary New Zealand beneficiary of the Australian resident Strine Trust. A capital gain on NYSE-listed shares is made by Baza, the Australian trustee who has held the shares less than 12 months. The net gain is distributed as income in the same income year to Wiremu such that he is presently entitled to the income in Australian terms. The income is also taxable in New Zealand as beneficiary income of Wiremu because the gain on the shares is treated as a quick sale under the fair dividend rate option of the foreign investment funds regime.

Tax is imposed in Australia on Baza as trustee on the net gain, but this is then credited against the Australian liability of Wiremu on the resulting income distribution. Under the Aus–NZ DTA, Baza is not treated as having a liability to tax because of the credit applied to Wiremu. Even though the net gain is foreign sourced, New Zealand must still provide a foreign tax credit under art 23(2) of the DTA for tax paid in Australia by Wiremu (including the amount satisfied from the trustee's credit), because Wiremu's liability did not arise from being taxed as a resident of Australia. New Zealand's relief obligation is, however, restricted to tax imposed under the foreign investment fund regime for income under the fair dividend rate option applicable to that quick sale.

175. New Zealand would be obliged to provide a foreign tax credit to a presently entitled New Zealand beneficiary under art 23(3) of the DTA, if Australia imposed tax on an Australian resident trust that constituted a permanent establishment.

176. Submissions are invited on these conclusions

Practical implications of art 23 of the DTA on trusts

177. Save for the situation discussed in the two draft determinations, both New Zealand and Australia have a similar domestic approach to the taxation of trusts. Trusts are treated as fiscally transparent where a beneficiary is entitled to current year income and not if the trustee retains that income. If a beneficiary is presently entitled to income in Australia or if a beneficiary receives beneficiary income in New Zealand, that income is taxed as the beneficiary's income and not that of the trustee. In these circumstances, art 23(2) of the Aus–NZ DTA applies, and each country must use its domestic foreign tax credit provisions for the benefit of its resident beneficiaries.

178. Article 23(3) of the DTA is not applicable to the circumstances in the draft determinations as the non-resident beneficiary can credit any tax paid by the trustee on a net capital gain against their own liability on that same gain when distributed to them. The relevant provision in such circumstances is art 23(2) of the DTA.

179. Article 23(3) does not require Australia to provide a credit for tax paid by a New Zealand trustee on income taxed as trustee income in New Zealand but subsequently distributed as exempt income to an Australian beneficiary in a later income year. New Zealand imposes tax on the trustee only because it is New Zealand resident. The Australian beneficiary, if taxed on the income in Australia, will not be taxed on the income in the same income year as the trustee in New Zealand.

180. Article 23(3) will apply where a trust is a permanent establishment and taxed as such when current income is distributed to a beneficiary of such trust in the other country.

181. Article 23(3) will apply to New Zealand unit trusts taxed as companies in New Zealand but treated as fiscally transparent in Australia and other similar situations.

Credits limited to those available unilaterally

182. Paragraphs (1) and (2) of art 23 of the Aus–NZ DTA both couch the relief available to eliminate double tax on juridical income as being subject to the provisions of the laws of Australia and New Zealand respectively that allow a foreign tax credit against domestic tax.

183. The Australian Explanatory Memo confirms at [2.315] that effect is given to the tax credit relief obligation imposed on Australia by application of the general foreign income tax offset provisions (Division 770 of the ITAA 1997).

184. In New Zealand, the applicable foreign tax provisions are discussed in Interpretation Statement IS 16/05. Where the income derived from Australia is foreign investment fund income the Inland Revenue Department NZ, *Guide to foreign investment funds and the fair dividend rate* IR 461 (October 2019) can be referred to for details of and an example on claiming foreign tax credits.

Summary of the impact of art 23 of the DTA on trusts

185. Article 23 of the Aus–NZ DTA offers relief for only juridical double tax not economic double tax. For trusts that are partially fiscally transparent vehicles in both Australia and New Zealand this means if the trustee or the beneficiary is taxed on the income and a participant in the other country is taxed on the same income, a tax credit must be provided by the participant's country. Leaving aside the draft determinations, which are specific to Australia's CGT legislation, the approach in Australia and New Zealand has been similar with Australia taxing beneficiaries that are presently entitled and New Zealand taxing beneficiaries when current year income is distributed within an extended period permitted under s HC 6(1B). Neither country taxes non-resident beneficiaries of resident trusts on foreign-sourced income distributed to them.

186. Where a New Zealand beneficiary of an Australian resident trust is taxed in Australia, New Zealand is obliged to provide a tax credit for Australian tax imposed on that beneficiary under art 23(2) of the DTA, and the same is true for Australian beneficiaries of New Zealand trusts under art 23(1) of the DTA. In both cases, the relief is through the relevant domestic provisions.

187. Article 23(2) of the DTA not art 23(3) would apply to New Zealand beneficiaries of Australian discretionary trusts affected by the draft determinations.

188. Article 23(3) of the DTA will apply to trusts that have permanent establishments and to situations such as unit trusts treated as opaque in New Zealand and regarded as fiscally transparent in Australia.

189. When an Australian or New Zealand resident trustee accumulates income so that it is taxed to the trustee, there is no obligation for the relevant country in which a beneficiary is resident to provide a credit for that tax under art 23 of the DTA if the income is subsequently distributed to a beneficiary. That is because the beneficiary is not liable to tax on the same income as the trustee in the same period and because the trustee is liable to pay tax on the income solely because of its status as a resident.

190. New Zealand domestic legislation permits a credit for tax only in the nature of a withholding tax from taxable distributions (in contrast to distributions of beneficiary income, ie current year income) made by Australian resident trusts to New Zealand beneficiaries under s LJ 6(2), and it is the domestic credit provisions that are the relief mechanism prescribed under art 23 of the DTA. Article 23 does not expand the double tax relief beyond what Australia and New Zealand each provide unilaterally.

Summary of initial conclusions

191. In summary, our initial prime conclusions are as follows.

What is the taxable entity of a trust?

192. The trustee is the taxable entity both domestically and under the Aus–NZ DTA. A trustee is treated as beneficially entitled as a resident person to interest, dividends and royalties that it retains under the Aus–NZ DTA. A beneficiary is the relevant taxable entity when income is distributed.

Is it the residence of the trustee or the settlor or both that determines eligibility to the benefits of the Aus–NZ DTA?

193. The residence of the trustee and not the settlor determines eligibility to the benefits of the Aus–NZ DTA as a resident. The role that a settlor plays in the effective management of a trust may have an impact on tie-breaker determinations where a trustee is dual resident.

Does the Aus–NZ DTA require that a trustee be treated in a separate capacity from their personal or private capacity?

194. Yes, the Aus–NZ DTA reflects the domestic approach of treating a trustee as acting in their capacity as trustee of a particular trust and not in their private capacity.

How does the residency tie-breaker test deal with two or more trustees of mixed residency, and is the test only for non-natural persons?

195. The tie-breaker test in art 4(3) of the Aus–NZ DTA for persons other than an individual applies. Where a sole dual resident individual is the trustee, the competent authorities need to first agree that art 4(2) of the DTA can be used to determine the matter.

What is the scope of the requirement to recognise income derived by or through a partly fiscally transparent entity as the income of a resident who is taxable on it in the other country?

196. The Aus–NZ DTA directs both countries to recognise a resident of the other country as the recipient of income from a trust if it is taxable to a beneficiary in the other jurisdiction. This means a non-resident beneficiary is treated as the beneficial owner of the income in the jurisdiction in which the trust/trustee is treated as resident. However, it is overridden by the preservation of the right of a country to tax its resident entities (discussed next).

How does the obligation above sit with the rights of each country to tax its own residents?

197. The right to tax a resident trust/trustee domestically overrides the obligation to recognise a beneficiary as the recipient of income from such an entity under art 11 of the MLI. In other words, the Aus–NZ DTA treats trusts as <u>partially</u> fiscally transparent entities, so each country can choose domestically not to recognise a beneficiary from the other country as the recipient of income and treat it as income of the resident trust/trustee.

What is the extent of the obligation to grant a tax credit for tax paid in the other country by either the trustee or a beneficiary?

198. Each country has an obligation to grant relief under its prevailing domestic provisions for juridical tax. That is, where the same income is taxed to a beneficiary in both countries, the beneficiary’s country of residence must provide the relief, and where a trust/trustee is taxed in one country and the same income is taxed to a beneficiary in the other country.

Closing comments

199. This issues paper represents the Tax Counsel Office’s initial views on the issues discussed. This paper is to stimulate discussion and invite feedback from interested parties.

200. As mentioned at the outset, taxation officers, taxpayers and practitioners must not rely on issues papers. Only finalised items represent authoritative statements by Inland Revenue of its stance on the issues.

201. We would like to know:

- whether you think the interpretation of the relevant tax laws is correct;
- whether you have practical concerns about the interpretation; and
- your ideas on how to administer these tax laws.

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Appendix – Legislation

The issues paper refers to the following provisions in the Income Tax Act 2007.

CW 54 Foreign-sourced amounts derived by trustees

To the extent to which section HC 26 (Foreign-sourced amounts: resident trustees) applies to a foreign-sourced amount that a trustee who is resident in New Zealand derives in an income year, the amount is exempt income.

HC 2 Obligations of joint trustees for calculating income and providing returns

What this section applies to

(1) This section applies for the purposes of the obligations imposed by section BB 2 (Main obligations) on 2 or more persons who derive income jointly as trustees of a trust.

Single person

(2) The trustees of the trust are treated in that capacity as if they were a notional single person and are jointly and severally liable to satisfy the obligations imposed by section BB 2 on the notional single person.

Residence

(3) If no election under section HC 33 is made for the trust, the notional single person referred to in subsection (2) is—

- (a) a New Zealand resident when 1 or more of the trustees is resident in New Zealand:
- (b) a non-resident when none of the trustees is resident in New Zealand.

HC 6 Beneficiary income

Date by which income must be allocated

(1B) The date referred to in subsection (1)(b) is the later of the following:

- (a) a date that falls within 6 months of the end of the income year; or
- (b) the earlier of—
  - (i) the date on which the trustee files the return of income for the income year; or
  - (ii) the date by which the trustee must file a return for the income year under section 37 of the Tax Administration Act 1994.

HC 10 Complying trusts

Requirements for complying trusts

(1) A trust is a complying trust in relation to a distribution if—

(a) the following requirements are met for the life of the trust up to the time of distribution:

(i) no trustee income derived includes an amount of non-resident passive income, or non-residents' foreign-sourced income, or exempt income under section CW 54 (Foreign-sourced amounts derived by trustees); and

(ii) (the tax obligations relating to the trustee's income tax liability have been satisfied for every tax year; or

(ab) the requirements of paragraph (a) are not met and—

(i) a person makes an election meeting the requirements of section HC 30(2) and the requirements of subsection (2) are met; or

(ii) a person makes an election meeting the requirements of section HC 33(1) and for all income years beginning on or after the date on which the election applies to the trust and before the time of distribution, the trustee's tax obligations relating to the trustee's income tax liability for the trustee income, determined consistently with section HC 33(1C), are satisfied; or

(b) it is a superannuation fund.

HC 24 Trustees' obligations

Liability as individual for trustee income

(1) A trustee must satisfy the income tax liability for their taxable income as if they were an individual beneficially entitled to the trustee income.

No tax credits

(2) In determining the income tax liability, the trustee is not entitled to have a tax credit under subparts LC and LD (which relate to tax credits for natural persons and for certain gifts).

Beneficiary income of minors

(3) Section HC 35 applies to treat beneficiary income derived by a minor as if it were trustee income.

Calculating trustees' deductions

(4) Section DV 9(2) (Trusts) applies for the purposes of calculating a trustee's deductions.

Superannuation funds

(5) Sections CX 40, and DV 1 to DV 4 (which relate to superannuation funds) override this section.

HC 25 Foreign-sourced amounts: non-resident trustees

When this section applies

(6) This section applies when a non-resident trustee derives, as trustee income, in an income year a foreign-sourced amount that would be assessable income if derived by a person resident in New Zealand.

Trustee income

(7) Despite section BD 1(4)(a), (b), and (5)(c) (Income, exempt income, excluded income, non-residents' foreign-sourced income, and assessable income), the amount is assessable income of the trustee if, at any time in the income year,—

(a) a settlor of the trust is a New Zealand resident who is not a transitional resident; or

(b) the trust is a superannuation fund; or

(c) the trust is a testamentary trust or an inter vivos trust, of which—

(i) a trustee is resident in New Zealand; and

(ii) a settlor died resident in New Zealand (whether or not they died in the income year) or the last surviving settlor was resident in New Zealand when that settlor ceased to exist.

First exception

(8) Subsection (2) does not apply if—

(a) the trustee is resident outside New Zealand at all times in the income year; and

(b) no settlement has been made on the trust after 17 December 1987 and, if an election has been made under section HZ 2 (Trusts that may become complying trusts), the election has not been made by the trustee.

Second exception

(9) Subsection (2) does not apply if—

(a) (a)the trustee is resident outside New Zealand at all times in the income year; and

(b) (b)when a settlement has been made on the trust after 17 December 1987, it was made only by a settlor who is not resident in New Zealand—

(i) at the date of the settlement; and

(ii) at any time between 17 December 1987 and the date of settlement.

Extent to which subsections (3) and (4) apply

(10) Subsections (3) and (4) do not—

(a) affect a settlor's income tax liability under the trust rules:

(b) apply to determine whether the tax obligations in relation to the trustee's income tax liability are met for the purposes of section HC 10(1)(a)(ii) and meeting the requirements for a complying trust.

Treatment of non-resident trustee in other provisions

(11) For the purpose only of calculating the taxable income of a trustee referred to in subsection (2), and not otherwise, the trustee is treated as resident in New Zealand for the purposes of—

(a) sections EW 9 and EW 11 (which relate to financial arrangements):

(b) section LJ 2 (Tax credits for foreign income tax):

(c) section OE 1 (General rules for persons with branch equivalent tax accounts):

(d) the international tax rules.

HC 26 Foreign-sourced amounts: resident trustees

Exempt income

(1) A foreign-sourced amount that a New Zealand resident trustee derives in an income year, and is included in trustee income for the income year, is exempt income under section CW 54 (Foreign-sourced amounts derived by trustees) if—

(a) no settlor of the trust is at any time in the income year a New Zealand resident who is not a transitional resident or, if no settlor exists in the income year, the last surviving settlor was a non-resident when that settlor ceased to exist; and

(ab) no election under section HC 33 has been made for the trust; and

(b) the trust is not—

(i) a superannuation fund; or

(ii) a testamentary trust or an inter vivos trust of which a settlor died resident in New Zealand (whether or not they died in the income year); and

(c) for a foreign trust for which a resident trustee applies for registration within the period (the application period) given by section 59C of the Tax Administration Act 1994 and that is registered by the end of the income year (the post-deadline year) beginning next after the end of the application period,—

(i) the trust has a trust deed; and

(ii) the income year ends after the day on which the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017 receives the Royal assent; and

(iii) for an income year that includes part of the application period or is the post-deadline year, the trust is registered before the end of the post-deadline year and is not deregistered before the foreign-sourced amount is derived; and

(iv) for an income year beginning after the end of the post-deadline year, the trust is registered when the foreign-sourced amount is derived; and

(v) the trustee complies with the requirements under sections 22, 59B, 59C, and 59D of the Tax Administration Act 1994 that the trustee must meet during the income year; and

(d) for a foreign trust to which paragraph © does not apply,—

(i) the trust has a trust deed; and

(ii) the trust is registered at the beginning of the income year; and

(iii) the trust is registered when the foreign-sourced amount is derived; and

(iv) the trustee complies with the requirements under sections 22, 59B, 59C, and 59D of the Tax Administration Act 1994 that the trustee must meet during the income year; and

(e) the amount is not beneficiary income derived by a minor that is treated as if it were trustee income.

Time for compliance with requirements

(1B) For a trustee to satisfy subsection (1)©(v) or (d)(iv) for an income year, the trustee must—

(a) comply in the income year with the requirements referred to in the subparagraph:

(b) satisfy the Commissioner that the trustee made reasonable efforts in the income year to comply with the requirements referred to in the subparagraph and corrected the failure to comply within a reasonable period of time after the trustee became aware of the failure.

When subsection (3) applies [Repealed]

(2) [Repealed]

When knowledge offence committed [Repealed]

(3) [Repealed]

Exception [Repealed]

(4) [Repealed]

HC 29 Settlors' liability to income tax

When this section applies

(5) This section applies to a person who makes a settlement to or for the benefit of a trust after 17 December 1987, and the settlor is resident in New Zealand in an income year. It applies whether or not they settled property on the trust on or before that date. Subsections (3) and (4) override this subsection.

Liable as agent

(6) If a trustee of the trust derives trustee income in the income year, the settlor is liable as agent of the trustee for income tax payable by the trustee. For a trust with more than 1 settlor, the liability is joint and several. However, this subsection does not apply to income tax that the trustee is liable for as agent under section HC 32.

Exclusion: resident trustee

(7) This section does not apply if the trust has a resident trustee for the full income year or, if the first settlement on the terms of the trust is made during the income year, from the day on which the settlement is made to the end of the income year.

Exclusion: trust types

(8) This section does not apply to the settlor of—

- (a) a charitable trust; or
- (b) a superannuation fund; or
- (c) a trust to the extent to which trustee income is derived from the settlor's remitting an amount under a financial arrangement to which section EW 31 or EZ 38 (which relate to base price adjustments) applies.

Exclusion: settlor not resident at time of settlement

(9) This section does not apply if the settlor is a natural person who, unless they make an election under section HC 33,—

- (a) is not resident in New Zealand at the time of any settlement on the trust; and
- (b) had not after 17 December 1987 previously been resident in New Zealand.

Exclusion: other settlor more appropriately liable

(10) This section does not apply to the extent to which the settlor establishes, through full disclosure to the Commissioner of the settlements made, that another person who has settled property on the trust should be liable, having regard to the respective settlements made.

Limited effect of disclosure

(11) Subsection (6) does not apply to determine whether the tax obligations in relation to the trustee's income tax liability are met for the purposes of section HC 10(1)(a) and (ab) and meeting the requirements for a complying trust.

HC 33 Choosing to satisfy income tax liability of trustee

Election to satisfy tax liability

(1) A person who is a trustee, settlor, or beneficiary of a trust as described in subsection (2) may choose to satisfy the income tax liability of the trustee of the trust.

Trustee treated as making election

(1B) A trustee is treated as making an election under subsection (1), if—

(a) for the period beginning at the start of the income year in which a settlement is first made on the trust and ending before the date on which the trust ceases to be a complying trust as described in paragraph (b), the trust is a complying trust under section HC 10(1)(a); and

(b) the trust ceases to meet the requirement in section HC 10(1)(a)(i) in an income year (the non-complying year); and

(c) the trustee meets the tax obligations relating to the income tax liability referred to in subsection (2), for the non-complying year and notifies the Commissioner that the trust is a complying trust for the non-complying year,—

(i) for a trustee that is required to file a return of income for the non-complying year, in the return of income and by the due date for the return of income:

(ii) for a trustee that is not required to file a return of income for the non-complying year, by the due date for a return, by a resident foreign trustee, required by section 59D of the Tax Administration Act 1994 for the non-complying year.

Status of person making election and settlor

(1C) From when an election by a person under subsection (1) applies under subsection (3), the tax obligations of the trustee of the trust arising from the trust are determined on the basis that—

(d) the trustee is a New Zealand resident; and

(e) the trust has a settlor who is a New Zealand resident.

Liability of person making election

(2) The person making the election—

(a) must satisfy the tax obligations of the trustee relating to the income tax liability of the trustee; and

(b) is not required to satisfy the income tax liability of the beneficiary that the trustee must satisfy as agent under section HC 32.

Application of election

(3) The election under subsection (1) applies—

(a) for an election to which section HC 30 applies, on and after the date on which the election is made; or

(b) for an election to which section HC 30 does not apply and that does not meet the requirements of subsection (1B), on and after whichever date (the effective date) the person making the election chooses of—

(i) the date of the election (the electing date):

(ii) the beginning of the income year (the electing year) that includes the electing date:

(iii) the beginning of an income year that is 4 years or less before the beginning of the electing year; or

(c) for an election to which section HC 30 does not apply and that meets the requirements of subsection (1B), on and after the beginning of the non-complying year referred to in subsection (1B)(b).

Period of election under subsection (1B)

(3B) An election meeting the requirements of subsection (1B) is effective until the beginning of an income year for which the trustee does not—

(d) meet the tax obligations of the trustee relating to the income tax liability of the trustee for the income year:

(e) notify the Commissioner that the trust is a complying trust for the income year in the way that would be required by subsection (1B)(c) for a non-complying year.

Time of providing election

(4) If the trustee of a trust is required to file a return of income for an income year, a person making an election under subsection (1) must notify the Commissioner of the election and provide to the Commissioner the information required by section 113F of the Tax Administration Act 1994 within the time allowed for filing a return of income for the income year. If section HC 30 applies, they must give notification by the election expiry date.

Effect on distributions

(5) For a trust (the distributing trust) and an election for which the tax treatment of the trust is not given by section HC 30(3),—

(a) a distribution made before the beginning of the electing year has the taxation consequences that it would have in the absence of the election:

(b) a distribution made after the beginning of the electing year from income derived by the trustee before the effective date is treated as being a distribution by a trust having the status, of foreign trust or non-complying trust or complying trust, that the distributing trust has when the income is derived:

(c) a distribution made after the beginning of the electing year from income derived on or after the effective date is treated as being made by the trustee as trustee of—

(i) a complying trust, if the requirements of section HC 10(1)(ab) are met for the trustee income derived on or after the effective date:

(ii) a non-complying trust, if subparagraph (i) does not apply:

(d) for the purposes of paragraphs (b) and (c), the amount derived before the effective date by the trustee in an income year that includes, but does not begin with, the effective date is—

(i) the amount derived before the effective date in the income year, if the person making the election does not choose to rely on subparagraph (ii); or

(ii) a proportion of the income derived in the income year equal to the proportion of the days in the income year that are before the effective date.

No liability for penalties from increased assessments in some circumstances

(6) (6)When a person makes an election for a trust under section HC 33(1) with an effective date given by subsection (3)(b)(iii) and the election results in an increase in the assessed income tax liability of the trustee, or in the amount of resident withholding tax payable by the trustee, for an income year before the electing year, the person and the trustee are not liable for a penalty under Part 9 of the Tax Administration Act 1994 arising from the increase if the Commissioner accepts that the trustee's tax position for each income year beginning on or after the effective date and before the electing year is none of—

(a) an unacceptable tax position under section 141B of the Tax Administration Act 1994:

(b) an abusive tax position under section 141D of that Act:

(c) a tax position that causes the trustee to be liable to pay a shortfall penalty for evasion or a similar act under section 141E of that Act.

HD 2 Joint liability of principal and agent for tax obligations

A principal and an agent are jointly and severally liable for the tax obligations relating to the agency, and the Commissioner may issue an assessment for the same tax to both an agent and their principal. The liability of 1 remains despite an assessment of the other.

HD 5 Matters between principals and agents

Assessment as authority

(7) The Commissioner's assessment is, as between principal and agent, sufficient authority for the payment of tax by the agent.

LJ 6 Taxable distributions and NRWT rules

When credit not allowed

(8) The person is not allowed a tax credit in relation to any foreign income tax paid on the taxable distribution unless the tax has substantially the same nature as non-resident withholding tax (NRWT).

trustee,—

- (a) for a trust,—
  - (i) means the trustee only in the capacity of trustee of the trust; and
  - (ii) includes all trustees, for the time being, of the trust:
- (b) includes an executor and administrator:
- (c) includes the Public Trust:
- (d) includes the Maori Trustee:
- (e) for a superannuation scheme that is a trust or that is treated by this Act as a trust, includes a person by whom the investments of the scheme, or a part of the scheme, are managed or controlled:
- (f) is defined in section CW 26G (Meaning of trustee) for the purposes of section CW 26C (Meaning of exempt ESS)

YA 5 General rule: capacity of trustees

Trustees acting in separate capacity

(9) A person who is acting as a trustee of a trust is acting in a capacity that is separate from their other capacities.

Other capacities

(10) The other capacities of the person referred to in subsection (1) may include—

- (a) (a)their personal capacity:
- (b) (b)their capacity as a body corporate that is a legal person:
- (c) (c)their capacity as a trustee of another trust or as an agent.

YD 1 Residence of natural persons

Treatment of trustees

(12) In this section, a natural person includes a natural person who is acting in the capacity of trustee.

YD 2 Residence of companies

Treatment of trustees

(1B) In this section, a company includes a company that is acting in the capacity of trustee.