The corporate tax unit &

Perceptions of Tax Evasion as a Crime

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ISSN 1448-2398

eJournal of Tax Research (2004) vol. 2, no. 2, pp. 192-209

Trusts and Double Taxation Agreements

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Abstract
This paper considers the correct interpretation of double tax agreements in the context of locally resident accumulation trusts established in New Zealand or Australia, that have foreign settlors and foreign-source income

practice, although the answers to the questions are the same in both countries there are significant second-order differences. The

> for purposes of this paper to call the clause beginning “But this term …” the “proviso” to Article 4(1).]

Most of New Zealand’s treaties follow Article 4(1) of the OECD Model or a simplified version of it: Belgium, China, Denmark, Finland, France, Germany, India, Ireland, Italy, the Netherlands, Norway, the Philippines, and Switzerland. The treaty with Indonesia omits the proviso or any counterpart of it. The Swedish treaty and most treaties with British Commonwealth countries have a much simpler format, but a format that, like the Indonesian treaty, contains no proviso: Australia, Canada, Fiji, Malaysia, Singapore, Sweden, and the United Kingdom. The New Zealand-United Kingdom Article 4(1), for example, reads:

> For the purposes of this Convention, the term “resident of a Contracting

probably be a resident of a state for treaty purposes."[6] Avery Jones points out that this conclusion fits awkwardly with treaty rules that apply to resolve dual residence issues that arise for trustees, because the criteria by which treaties determine the residence of individuals (availability of a permanent home, centre of vital interests, an habitual abode, and nationality)[7] are not appropriately applied to persons in their capacity as trustees. Referring initially to Canadian law, Avery Jones explains:[8]

It is arguable that because a trustee in his capacity as such does not have a permanent home, a centre of vital interests, an habitual abode or a nationality (particularly in the case of a corporate trustee), the tests set out in article 4(2) are inappropriate and therefore inapplicable. If this argument prevails, article 4(3) applying the place of effective management to persons other than individuals, would presumably apply. … Article 4(3) would apply in the United Kingdom, where a trustee is not treated as an individual, and the United States, and Australia.

Avery Jones's argument appears to be that although, as explained in the previous paragraph, a trustee is a *person*, and therefore can be resident somewhere for treaty purposes, it is not appropriate to determine the residence of a trustee by tests that apply to *individuals*. The need to make this argument gives rise to the question as to whether Avery Jones's basic premise can be correct. If a trustee is a "person" for treaty purposes, but if trustees who are individuals are not to be treated as such, the text of Article 4(2) and (3) does not aptly apply to them. But if this is so, why should we assume that Article 4(1) is meant to apply to trustees as well? That is, one could argue that a state that adopts Article 4(2) and (3) is perhaps assuming that none of Article 4 (in particular, not Article 4(1)) applies to taxpayers in their capacity as trustees. This conclusion leads back to the argument of Robert Venables, discussed above, that the personal residence of individuals does not determine their residence as trustees if they happen to be trustees. Nevertheless, it is worth examining particular treaty drafts to determine whether there are possible contrary views, at least in respect of some versions of Article 4(1). One thesis of this paper is that, all things considered, these contrary views must command considerable respect.

INTERPRETING DIFFERENT FORMS OF R

reasonably make an attempt to identify the relevant questions and sometimes to answer them.

taxed as an ordinary corporate taxpayer. The second is the company in its capacity as a trustee. Qualification for or disqualification from treaty protection of someone in the company's second (trustee) capacity has no effect on the company's treaty rights as an ordinary corporate taxpayer.

This response is attractive from a policy point of view. No doubt, that is how treaties *should* work.[12] The problem is that the text of a double tax convention that is drafted in terms of the New Zealand-France treaty offers no support for this interpretation. One can argue that a taxpayer who is a trustee cannot be resident in respect of trust income, but the text contains no basis for saying that a taxpayer can be resident for some fiscal purposes and not for others. More so, if a taxpayer that is a trustee is excluded from treaty benefit, why stop at that point? What about taxpayers who might one day be trustees? Such a result seems to be compelled by the logic of the "nothing" alternative, but it would be absurd to exclude taxpayers from treaty benefits on the basis that they might one day become trustees. As argued above, it seems to follow that trustees may take treaty benefits, both as trustees and in their own capacities as taxpayers.

SUBSTANTIVE INTERPRETATION NOT COMPELLING

A more substantive interpretation might suggest that the focus should be neither on the taxpayer, nor on whether the taxpayer is potentially liable to tax on some foreign source income, but on items of foreign source income, on a case-by-case basis. Is the New Zealand taxpayer assessable to New Zealand tax on this particular income from France, being trustee income? If not, the argument runs, the treaty should not protect the income. The answer to this argument is that the proviso deals with persons, not items of income. A person either is, or is not, entitled to treaty protection. Article 4(1)(b) of the New Zealand-United States treaty, on the other hand, considers income on an item-by-item basis, as already explained. When New Zealand's treaties were drafted, income on an item-by-item basis could have been added to the treaty text to the effect of the New Zealand-United States Article 4(1)(b). The omission arguably shows an intention to retain the taxpayer-by-taxpayer approach that is mandated by a literal interpretation of the proviso. The better view, therefore, is that the French treaty, and others like it, protect income derived by New Zealand resident trustees even where the receipts are trustee income and not subject to New Zealand tax.

It follows with greater force that where the corresponding article takes the simplified form that is found in the United Kingdom treaty,[13] foreign source trustee income derived by New Zealand resident trustees enjoys treaty protection in the same manner. This conclusion, and the conclusion in the previous paragraph, may be modified by consideration of the second question raised by double tax agreements that is relevant in the present context. This question is whether a trustee can be said to derive income as a "beneficial owner", which is commonly a pre-requisite for treaty protection, at least in respect of passive income. That question is considered next.

See also the view of Robert Venables QC, discussed above under heading 3.

Convention between New Zealand and the United Kingdom for the Avoidance of Double Taxation (1983) Article 4 (1): "For the purposes of this Convention, the term 'resident of a Contracting State'

DOUBLE TAX AGREEMENTS AND LIMITS ON WITHHOLDING TAX

Apart from the treaty with Japan, all New Zealand's double tax agreements provide for a reduction in withholding tax on interest, dividends, and royalties that flow between parties resident in New Zealand and th

THE REQUIREMENT OF BENEFICIAL OWNERSHIP

If a New Zealand resident trustee were to receive, say, royalties, from someone in the United Kingdom, would the trust be able to take advantage of the ten per cent limitation on withholding tax on royalties that is imposed in the United Kingdom-New Zealand Treaty? The answer to this question is a matter for the law of the United Kingdom, rather than for New Zealand law; the answer depends on how United Kingdom courts would interpret the double tax agreement. Similarly, in respect of interest, dividends, or royalties received by the trustee from any other jurisdiction with which New Zealand has a double tax agreement, the effect of the beneficial ownership requirement is a question for the courts of that jurisdiction.

Having said that, one should note that in a number of countries the beneficial ownership condition is thought to have relatively little effect in practice. That is, taxpayers pay out dividends, interest, and royalties to people or companies that are residents of treaty partner countries, and, reputedly more often than not, deduct withholding tax at only the reduced treaty rate without questioning whether the recipient is the beneficial owner of the income. This is said to happen without adverse reaction by the revenue authorities in the source country, though some fiscal rn11(i)(so56.3(d)1(clearl the Commentary shed no light on this question. The Commentary changed again in the 2003 edition of the Model, to read in respect of Article 12:[17]

> The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the state of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source

who wrote the Commentary, at least some trustees may be "beneficial owners" for purposes of the relevant treaty articles. That is, at lease some trustees are not disqualified from treaty benefits by a narrow, technical interpretation of "beneficial owner".

"BENEFICIAL OWNERSHIP"AND THE NEW ZEALAND OBSERVATION

A number of New Zealand's treaties address the question of the interpretation of "beneficial owner" or "beneficial entitlement" by provisions in the interpretation article, which is ordinarily Article 3. There is a typical example in the agreement with Canada:

> In determining, for the purposes of Articles 10, 11, or 12, whether dividends, interest, or royalties are beneficially owned by a resident of a contracting state, dividends, interest, or royalties in respect of which a trustee is subject to tax in that Contracting State shall be treated as being beneficially owned by that trustee.

Such provisions in treaties to which New Zealand is a party have their origin in a New Zealand observation to Article 3 (General Definitions) of the OECD Model:

> For the purposes of Articles 10, 11, and 12, New Zealand would wish to treat dividends, interest, and royalties in respect of which a trustee is subject to tax in the State of which he is a resident as being beneficially owned by that trustee.

The New Zealand observation and provisions in treaties that reflect it are relevant to cases where trustees *are* subject to tax in the state of residence. They do not directly address the question that is at issue in this paper: whether trustees who derive passive income can be described as "beneficial owners" of that income even thought they are *not* subject to tax on the income in their state of residence. Indirectly, however, the New Zealand-Canadian provision and others like it suggest that trustees are not "beneficial owners" as the expression is used in treaties, (otherwise there would be no need for the provision) and, if they are to be treated as beneficial owners when they bear tax on the income in question, there must be a special rule to enable that to happen. trghy2(ar8(5)-6(s)-7.1( )-5argu arh.9(at 5)-6.9l)-7e.6(y)-11.2(a(whl)-7titl9(tr8(5)-6(s)-7.1( )]TJ0 -1

"Beneficial Ownership"

possible beneficial owners it could have done so. Moreover, there was no change in the ambulatory draft of the Model that was promulgated in 1995.

The 2003 amendments to the Commentary that have been discussed[23] reinforce the argument. If the question of whether "beneficial owner" can include some trustees was a live issue in 1977, by 2003 the OECD Committee on Fiscal Affairs can have been in no doubt that this question was a major, perhaps the major, issue in the interpretation of relevant articles in the model. The fact that, in these circumstances, the Committee said that "the term 'beneficial owner' is not used in a narrow, technical sense" is most significant. Until publication of the 2003 edition of the Model, du Toit's arguments that "beneficial owner" should be interpreted according to trustee law in common law countries had a good deal of traction. From 2003, the prohibition on interpreting the

rules that provide a definite answer to the question of whether trustees can be classified as beneficial owners. Such treaties are the paradigm cases for this paper. An example is the New Zealand-United Kingdom treaty. To quote again from Article 12:

> Interest arising in a Contracting state which is derived by a resident of the other Contracting State may be taxed in that other State may … be taxed in the Contracting State in which it arises … but where the beneficial owner of such interest is a resident of the other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

Consider first a New Zealand resident trustee who derives and accumulates interest from the United Kingdom, but who is not taxable on the interest because there is no New Zealand resident settlor. One argument is that the trustee should not be entitled to treaty benefits because New Zealand will not tax the income.[31] But suppose that the same trustee distributes the income to a New Zealand resident beneficiary in a later year. New Zealand will tax this beneficiary. Indeed, New Zealand will impose tax at a penal rate in response to the deferral that the income has enjoyed since the trustee derived it.[32] In these circumstances, it would not seem unreasonable for the trustee to enjoy a treaty benefit. Whichever set of facts obtains the New Zealand-United Kingdom treaty must be interpreted in the same way: either "beneficial owner" includes a trustee who accumulates or it does not. Those who advance the argument now under discussion say that only a positive answer is consistent with the general policy of double tax conventions.

FRENCH TEXT AND CONCLUSION

A third argument is that the French text of the OECD Model, supports the proposition that "beneficial ownership" included ownership by a trustee. The French expression is "bénéficiare éffectif". Because French law does not recognise trusteeship "bénéficiare éffectif" includes both full owners and trustees. Since the French and English texts of the Model are equally authoritative it follows that the English text must have the same meaning. Admittedly, this meaning does not necessarily travel the long route from the French version of the Model to a New Zealand treaty. However, the broad adherence to the OECD Model that is apparent in all bilateral tax conventions indicates a strong international commitment to consistency of interpretation.

The matters discussed in the foregoing paragraphs may offer some comfort to trustees who receive passive income from foreign countries that are treaty partners of the trustees' jurisdictions of residence. There is much to be said for the point of view that "beneficial owner" should be interpreted in the same manner in all treaties, and for the argument that Vogel's civil law meaning of the expression should be considered as some kind of lowest common denominator. Although it would be rash to claim that this lowest denominator is established as the law, the 2003 amendments to the Commentary[33] add a good deal of force to Professor Vogel's arguments.

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respect of financial arrangements. For example, discounts on bonds and foreign exchange gains or losses are treated as revenue items.[34] A second example is gains that result from profit-making schemes, or gains from the sale of property that was acquired with the intention of sale.[35] The tax bite is more comprehensive when the property in question is land.[36] Thirdly, the principle in *Californian Copper Syndicate*

There is no alienation of property article in New Zealand's treaties with Fiji, Japan, Malaysia, or Singapore. The relevant articles in the treaties with Australia, Sweden and Canada do not contain residual property exemption provisions like the New Zealand-United States rule. New Zealand's treaty with Norway has a residual property exemption provision, but there are certain limitations in respect of property that comprises substantial participatory shareholdings.

The New Zealand-Ireland treaty has a residual property exemption provision, but it is followed by a proviso of uncertain scope:

> Provided that where under the law of that Contracting State [the state of residence of the alienator] an individual, in respect of such gains, is subject to tax thereon by reference only to the amount thereof which is received in that Contracting State, the foregoing provisions of this paragraph shall not operate in relation to so much of such gains as is not received in that Contracting State.

In spirit, this proviso is presumably meant to withhold the benefits of the New Zealand-Ireland residual property exemption provision from taxpayers who are not

> Income or gains from the alienation of any property other than that referred to in paragraphs (1), (2), and (3) of this Article, shall be taxable ["only" omitted] in the Contracting state of which the alienator is resident.

It is probable that the omission from the New Zealand-United Kingdom convention is inadvertent, and the treaty should be read as if it included "only". Perhaps the main argument is that otherwise Article 14(4) is pointless, because the country of residence does not need the authority of the treaty to tax the gains in question.

Whether this argument should be accepted is a matter for the United Kingdom courts. If it is accepted, the result appears to be that a New Zealand trustee who derives a gain from the sale of movable property in the United Kingdom (apart, mainly, from property that forms part of a permanent establishment of the taxpayer) is not taxable on that gain.