Trusts & Trustees Advance Access published March 19, 2014

New Zealand trusts and double taxation agreements

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Abstract

For many years there have been a variety of views expressed as to the ability of trustees to obtain the benefits of double tax agreements. Central to most analyses is a discussion of the well known Canadian *Crown Forest* case. This article sets out to analyse this and other cases, rulings and commentaries, in the light of New Zealand tax legislation. The answer lies, in part, in looking to the type of trust under consideration, and it is suggested that by approaching the problem from this starting point, some clarity will be achieved.

New Zealand trusts

New Zealand has 38 Double Taxation Agreements.[1] It also, at last count, is home to about four to five hundred thousand domestic trusts[2] and approximately seven and a half thousand foreign trusts.[3]

Domestic trusts are trusts with a New Zealand resident settlor and New Zealand assets; foreign trusts are those with a settlor who is not resident in New Zealand. The figures for domestic trusts cannot be precise because under New Zealand law, only a trustee which earns income must register with the New Zealand Inland Revenue Department, and many domestic trusts earn no income or are not liable to taxes in New Zealand; large number of New Zealand domestic trusts hold property only, for the purposes of succession planning or asset protection, rather than to produce or receive income. Reporting of capital assets is not required because New Zealand has no capital gains, capital transfer, or inheritance taxes. There is no other requirement other than for tax purposes to register a trust in New Zealand.

The majority of trusts in New Zealand, both foreign and domestic, are discretionary, accumulating, trusts. That is, they have a wide class of beneficiaries who have no immediate right to trust capital or income, and the trustee may accumulate the income for the lifetime of the trust. If current reform proposals are implemented,[4] this accumulation period could be up to 150 years. At present it is 80 years. In such cases it is not possible, to establish to whom income or capital is to be paid immediately. This accounts in part, for the income tax policy that applies to New Zealand trusts.

Taxation of trusts in New Zealand

Trust income is taxed either as income of the trustee (not the trust) or income of a beneficiary. The beneficiary is only taxed if he or she has an immediate

*The writer would like to acknowledge the contribution of Martin Klevstul (mklevstul@conemarshall.com) to the case analysis on Prevost and Velcro decisions, and the assistance of Claudia Chan (cshan@conemarshall.com).

1. List of Countries: Australia, Austria, Belgium, Canada, Chile, China, Czech Republic, Denmark, Fiji, Finland, India, Indonesia, Ireland, Italy, Japan, Korea, Malaysia, Mexico, Netherlands, Norway, Philippines, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Arab Emirates, and United Kingdom, France, Germany, Hong Kong, Poland and United States of America.
2. Law Commission; Review of the Law of Trusts – August 2013, p 6.
3. Information supplied by New Zealand Inland Revenue Department.
4. Law Commission (n 2), p 16.

doi:10.1093/tandt/ttu007

right to, or has received income. This is provided for by subpart HC of the Income Tax Act 2007 (the "Act"). To achieve this, the Act divides trusts into three types: complying (or what we have called domestic trusts, as above), non-complying trusts, and foreign trusts[5] that have also been defined above. A non-complying trust is a foreign trust that has lost its foreign status by the settlor's assumption of New Zealand tax residency, and whose trustee has not declared the trust to be a domestic trust.[6]

All these trusts are classified according to their nature at the time the trustee makes a distribution. Therefore, a foreign trust is a trust which if at the time of a distribution to a beneficiary has had no settlor resident in New Zealand.[7]

Subpart HC also defines a charitable trust. This is a trust where, in an income year, all income derived or accumulated by the trust held for charitable purposes. That income is defined as charitable income.[8]

As mentioned, trust income in respect of all of these types of trusts is either beneficiary income or trustee income. It is beneficiary income if there has been a distribution or allocation of income to a beneficiary or a beneficiary has an absolute right to income (this is usually called a fixed trust). If this has not occurred, then the income is trustee income.

From this analysis it is clear that where there is an accumulating discretionary trust, where no income has been distributed to a beneficiary in an income year, that income can only be treated as taxable income of the trustee. For this purpose the Act makes no reference to the source of this income. The critical point is that where income of whatever origin is not beneficiary income, that is, income which 'vests absolutely in interest in a beneficiary' or is 'paid to a beneficiary of the trust' in the income year, it can only be income of the trustee.

Income of a discretionary accumulating trust

For tax purposes it is important to more closely define discretionary and accumulating trusts, as they apply to income and capital held by the trustee. A discretionary trust is a trust in which the trust instrument provides that income may be distributed in the amounts and proportions as determined by the trustee, or some other person with that power, to a beneficiary of the trust. The beneficiary who eventually receives capital or income may not exist at the time the trust is formed. Therefore the status of the trust income will be determined year on year according to the exercise, or not, of the powers of distribution. In that sense a discretionary trust is the same as what is called in the USA a complex trust, as the trustee may determine whether to distribute or retain income.

A discretionary accumulation trust goes a step further. In this trust, income may not only be distributed in variable amounts amongst beneficiaries, it may be retained by the trustee for an extended time also. In New Zealand, this accumulation may continue for up to 80 years,[9] by which time the beneficiaries as at the date of settlement may well be dead and buried. Under proposals made by the New Zealand Law Commission,[10] this period could be extended to 150 years, by which all the natural persons mentioned in the trust, even with the benefit of a fish and soy diet, could no longer be on Earth. Consequently, where there is a discretionary, and accumulating trust, not only is it impossible to determine what income or capital share a beneficiary will get at any time, but the income could be retained by the trustee for many years.

If these principles are applied to the tax analysis set out above, then there may conceivably be no benefi-

5. S HC(1)(c) Income Tax Act 2007 ('ITA').
6. S HC9 ITA (this period runs from 17 December 1987).
7. S HC11 ITA.
8. S HC13 ITA.
9. Perpetuities Act 1964, s6.
10. ibid p 16, para 64.

ciary income for three or more generations. The clear consequence of this is that the undistributed income earned by the trust can only be income of the trustee for New Zealand tax purposes.

This is why the Act provides that 'all trustees must satisfy the income tax liability for their taxable income as if they were an individual *beneficially entitled* to the trustee income'[11] for, in fact, there may not be any other person who has the right to the income in any tax year.

Exempt income

Not all income is taxable in New Zealand. Subpart CW of the Act defines exempt income as non-taxable in New Zealand; it is tautologically expressed to be income that would other than by reason of the exemption be taxable in New Zealand. This category includes a wide variety of receipts: foreign sourced income, foreign sourced dividends, special allowances for certain entities, and certain types of trustees. Specifically, section CW53 exempts distributions from complying trusts, and section CW54 exempts foreign sourced amounts received by a New Zealand trustee of a foreign trust:

> *to the extent to which S HC26 . . . 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.*

In turn, subsection (1) of HC26 states that:

> *a foreign sourced amount that a New Zealand trustee derives in an income year is exempt income under S CW54 if no settlor of the trust is at any time in the income year a New Zealand resident . . .*

Without this exemption a trustee of a foreign trust would pay tax on all foreign sourced income it received.

The trustee must be resident in New Zealand. A trustee resident in New Zealand for these purposes is defined[12] as a person (which includes a company) who acts as a trustee of a foreign trust that is not registered as a charitable entity, and is resident in New Zealand. In the case of a company, residency is achieved by incorporation in New Zealand.[13] A natural person is a New Zealand resident if he or she is resident, for tax purposes, in New Zealand.

The consequence of this is that when a New Zealand resident trustee of an accumulating discretionary foreign trust receives income from a non-New Zealand source, that trustee is exempt from tax on that income. In respect of other income, the trustee remains taxable in New Zealand.

When will a trustee want to use a Double Tax Agreement?

We are now at the stage where we can deal with the question of the rights of a New Zealand trustee of a foreign trust to obtain Double Tax Agreement (DTA) benefits. But first it is important to clear some assumptions away.

1. This question can only arise in the case of a discretionary accumulating trust. Where there is a fixed right to income or an income distribution has been made, the trustee and therefore any treaty partner must treat the income received from any source as beneficiary income; it will be the beneficiary's tax position that is relevant. The beneficiary will be the taxpayer, not the trustee.
2. There is no practical difference between a charitable trust and a foreign trust in this respect. Both are given a tax exemption, in the same part of the Act. In fact, the charitable trust that is settled by a non-resident would get exemption on two grounds, one by reason of its status as a foreign trust, another by reason of its being a charitable trust.

11. S HC24(1) ITA.
12. S33(1); Tax Administration Act 1994.
13. YD2(1)(a) ITA.

3. Not all trustees of foreign trusts will be interested in treaty relief. In fact there will be, in the writer's opinion, only a minority who will need to claim treaty relief, and this is his experience in practice. Most trustees of New Zealand foreign trusts do not derive income from any source. The majority simply hold capital assets, such as company shares, and other assets that produce no taxation in New Zealand. As such the majority of New Zealand foreign trusts are holding assets as custodial entities, used for asset protection and succession planning: they are static structures with no activity.
4. In practice, the income (if any) which will be relevant will be dividends, royalties, and income.
5. Under the scheme of the Act, as seen above, if there is no beneficiary income, the tax payer must be considered to be the trustee, not the trust, for the purposes of the DTA analysis, under New Zealand law.

New Zealand's DTAs

New Zealand's DTAs are a mixed bag. The oldest dates back to 1963 (Japan, now being renegotiated). Many of its European DTAs were signed in 1976. The United Kingdom Agreement was reputed signed during a convivial evening at Annabels nightclub in London in August 1983, by the then New Zealand Minister of Finance. Most other agreements were signed in the 1970s and 1980s, many before the Organisation for Economic Co-operation and Development ("OECD") began to develop its model treaties and treaty and analyses. Not all follow the OECD model.

It follows that it is difficult to apply a standardized analysis, especially where the view is clouded by rules of practice, different understandings of Anglo-Saxon trust law, an entirely different approach to legal ownership under civil law[14] and local practice.

For instance, there are three aspects of New Zealand's DTAs that depart from the standard OECD model.

1. The USA and Canadian DTAs explicitly recognize trusts as a person (Articles 1(c) and 1(d) respectively).
2. A qualification as to residency based on liability to tax is not mentioned in the Australian, Canadian, Fijian, Indonesian, Japanese, Malaysian, Singaporean, Swedish, and UK treaties. This is considered in the section following.
3. The Australian, Belgian, Canadian, Danish, Fijian, Finnish, Korean, Malaysian, Norse, Singapore, and Swedish treaties have a particular definition of beneficial ownership by a trustee for the purpose of taxation of dividends, royalties and interest.

Residency under New Zealand's DTAs

In most New Zealand treaties, residency is dealt with by a clause based on the OECD model: Article 4(1):

> *For the purposes of this Convention, the term resident of a Contracting State: means any person who, under the laws of that State, is liable to tax therein by reason of his domicile residence . . . etc.*

In some cases (excluding the treaties in mentioned paragraph 2) this is followed by the following qualification:

> *But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State, or capital situated therein*

In all cases the qualification of residency for the purposes of a treaty will be determined by the other

14. Cone: Common law trusts by persons based in civil jurisdictions: does New Zealand offer a solution? Trust and Trustees, Vol 16, No 3, April 2010, p 177.

contracting State. However, the Article in all cases still requires that State to give consideration to the position under New Zealand law, which is why the preceding analysis of the New Zealand tax treatments of trusts was considered.

Subject to any variation under any treaty it is clear that whether or not the second qualification is included, Article 4(1) requires the trustee to be resident for tax purposes according to New Zealand law. A New Zealand corporate trustee, or a New Zealand resident person who acts as a trustee, clearly is. This is re-emphasized by the provisions of S HC26, where, for the section to apply (as compared with the preceding section HC25, which defines non-resident trustees) the trustee must be resident in New Zealand. The fact that the trustee is relieved from liability for tax on one stream of income, in common with many other New Zealand tax payers who get similar exemptions under subpart CX, does not alter this primary point.

However, simple residence does not give a complete answer. The question is also as to the trustee's liability to tax in New Zealand. As we have seen a trustee of a discretionary accumulating trust, which retains income, is, under New Zealand law, liable to tax in New Zealand, as the beneficial owner. Against this it may be said that if it receives some income that is exempt from tax under New Zealand law, so this will disqualify it from treaty benefits. But, the consequence of this is that if any part of its income is exempt, it is disqualified in respect of all income. The result of this interpretation is that all New Zealand residents would be treated as non-resident for all treaty purposes as they do not qualify for relief because a part of their income is exempt. This is an extreme and seemingly anomalous result especially given the examples of exempt income that apply in New Zealand. The conclusion is echoed in the OECD's Official Commentary to Article 4 of its 1992 Model Tax Treaty where it is stated[15] that to adopt a restrictive interpretation of Article 4(1) might 'exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended'. This interpretation is supported by Vogel,[16] and Baker.[17] Prebble is of the view that:[18]

> Article 4(1)(a) does not focus on particular income streams, treating a tax person as resident in respect of one income stream and not in respect of the other.

In support of this paragraph 8.6 of the 2002 OECD Commentary states[19]:

> In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax. But they are exempt only if they meet all the requirements for exemption specified in the tax laws. They are, thus, subject to the tax law of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax.

In the light of all of this authority the decision in *Crown Forest Industries Ltd v Canada*,[20] which is often cited in support of the opposite interpretation that only full tax liability will satisfy the test for residency under a DTA, deserves consideration.

This case concerned payments to a company called Norsk Pacific Steamship Company ('Norsk') which operated a business in the USA. If Norsk was treated as a US resident, it would get the benefit of the US/Canada DTA, and the withholding tax on the payments would be reduced from 25 per cent to 10 per cent.

The appellant, who made the payments, argued that Norsk was resident in the USA. In this case the

15. OECD Commentary on Model Tax Countries 1992, p 4–4.
16. Vogel on Double Taxation Conventions, 3rd edn 20, 1997, art 4 para 31, pp 233–34.
17. P Baker, *Double Taxation Conventions and International Tax Law* (2nd, edn, Sweet & Maxwell 2012) p 4–2/3.
18. J Prebble, 'Trusts and Double Taxation Agreements' eJournal of Tax Research, Vol 2, No. 2, 2004 at p 196–97.
19. ibid 196–97.
20. [1995] 2 S.C.R. 802.

residency was predicated not on physical residency, as Norsk was a Bahamian company, but on a notional residency on the basis that its place of business and management was in the USA. The courts at first and second instance held (subject to one dissenting judgment) that this was enough. However, in the Supreme Court, Iacobucci J noted that the residency Article of the DTA, IV(i), did not refer to a trade or business being conducted in the USA and therefore was not a factor in which the appellant could rely. That left the appellant with the argument that the place of management of Norsk was the relevant factor. Iacobucci J went on to say that in addition to that ground, there must be 'the existence of some causal connection'[21] and that Norsk's place of management was not 'causally or even proximately connected to the basis of Norsk's tax liability in the US'.[22] It was because only income flowing from the business was connected to the USA, rather than its subjection to the US tax system by reason of its residency. So, the court held that referring to the place of management (along with other factors), elevated '**a factor** used in determining its tax liability into **the actual grounds** for that tax liability' (Court's emphasis).[23]

At this point the essential ground of the Supreme Court's decision is clear. There was a conflation by the lower courts of the test for residence by reason of having a place of business, or a place of management in the US, the former being irrelevant, and the latter being for the purpose of assessing tax, not for determining residency.

However, the court then went on to distinguish between full tax liability, and partial tax liability, and not being 'liable to taxation on some portion of income'.[24] The argument here related only to source liability, and so could be said to have the same rationale as had already been identified, and this is supported by the court's words when it says that what is required for treaty benefits is exposure to such 'comprehensive a tax liability as is imposed by a state'.[25] It may have been the result of the argument made by the US Government as intervener which lead to the reasonable view expressed by the court that:

> the goal of the Convention is not to permit companies incorporated in a third party country (Bahamas) to benefit from reduced tax liability merely by virtue of dealing with a Canadian company through an office situated in the United States[26]

nor did the court think it was intended that a foreign corporation would obtain the benefit of the DTA only on income effectively connected with the USA.

The important point to note is that the Supreme Court of Canada's judgment recognize that, when dealing with residence clauses similar to Article 4(1) of the OECD Model, the focus should be the treatment of the taxpayer in question, as opposed to treatment of the various streams of income received by that person. The point of that analysis is that the criteria for the foundation of residence are concerned with facts about the taxpayer, not its income.

However the Supreme Court further states at paragraph 58; 'Full tax liability is not satisfied in a case where an entity is liable to tax in a jurisdiction *only on a part of its income*.'[27] [Emphasis added]. This is the passage usually referred to by commentators.

Nevertheless, it is important to note that the court would have taken a different approach if the company had been incorporated in the USA:

> I see nothing fundamentally unjust with the situation where, owing to the nature of US tax legislation, the

21. ibid 815.
22. ibid.
23. ibid 817.
24. ibid p 821.
25. ibid.
26. ibid p 825.
27. ibid p 829.

> Convention would be limited to those who actually incorporated in the U.S.[28]

It is submitted therefore that the Supreme Court's decision is not irreconcilable with the position outlined in this article, as it is not crucial to the Supreme Court's position to interpret 'full tax liability' as meaning 'not eligible for any exemptions'.

The position taken by the Court was in fact that a non-resident company that is partially taxable in a country cannot take DTA benefits. This is quite different from saying that a company incorporated in a country which has a DTA with another country, cannot get the benefit of the DTA because it may obtain a tax exemption on part of its income in its country of residence.

Further the Supreme Court's objection to Norsk being eligible to be treated as a resident under the U.S./Canada DTA was that they saw Norsk as part of a 'treaty shopping' scheme. As the Court states:[29]

> The goal of the Convention is not to permit companies incorporated in a third party country (the Bahamas) to benefit from a reduced tax liability on source income merely by virtue of dealing with a Canadian company through an office situated in the United States . . . It seems to me that both Norsk and the respondent are seeking to minimise their tax liability by picking and choosing the international tax regimes most immediately beneficial to them.

Certainly Avery Jones, in his seminal article on this topic[30] argues that the point is that where a person's connecting characteristics with a state (ie residing) are the same as those of persons fully liable and actually subject to tax, the former can be said to be liable to tax even though he may not be subject to tax as a result of some special domestic provision.[31] This is consistent with what appears to be the rationale of *Crown Forest*. This would also seem to be consistent with the scheme and tax treatment relating to trustees of foreign trusts under the Act: in other words, in the case of a discretionary and accumulating trust, the trustee is treated as liable to tax in respect of all income received, whether exempt or not, unless the income has been passed to a beneficiary in the relevant income year.

The pass through argument

As shown above a discretionary accumulating trust it is possible that income distributions could be withheld by the trustee for a considerable time in New Zealand—at this point up to 80 years.

It has already been mentioned that a discretionary and an accumulating trust is similar to a complex trust under the law of the USA. In an instructive article published in 2006, Yutaka Kitamana considers the use of Japanese trusts in planning using the 2004 Japan-US Double Tax Agreement.[32] In considering Article 4(6) of that treaty, the author notes that where an entity is categorized differently by the respective treaty partners, the income will be treated as the income of the beneficial members or participants in the entity accordingly to the law of its state of residence, in common with almost all other DTAs. He notes that according to the technical US explanation by Department of Treasury of the DTA[33] an entity:

> not treated as a fiscally transparent entity under the tax laws of the other Contracting State, generally will be eligible for the benefits of the Convention only if the entity is a resident of the Contracting State.

28. ibid p 832.
29. ibid 825.
30. The Treatment of Trusts under the OECD Model Convention (1989) BTR, 41, 65.
31. ibid 66.
32. The Application of the Japan – US Tax Treaty to Trusts Tax Notes International, February 2006, p 577.
33. U.S. Department of the Treasury Technical Explanation of the Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed at Washington on November 6, 2005, at 1 (Feb.24, 2004), 2004 WTD 39-11, Doc 2004-4036, at p 16.

This technical explanation goes on to state that fiscally transparent entities:

> are entities the income of which is taxed at the beneficiary, member or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not considered fiscally transparent entities.[34]

This analysis follows the same threads of logic set out above, whereby:

a. Income which is passed to the beneficiary is not trustee income; and
b. Income which is partially exempt in the recipient country where the trustee is resident, will not disqualify the trustee from treaty benefits.

The author then expands on the difference between complex and simple trusts under US law. He defines complex trusts as trusts 'that allow the trustees to accumulate income, and permit or direct them to make distributions in excess of current income'.[35] Accordingly, undistributed income held by a complex trust is treated as income of that entity. Therefore, an Exceptional Trust in Japan—a trust in which income is not taxed until it is distributed to the beneficiaries[36] is considered to be a non-transparent entity.

The author then raises the question as to whether the trustees of Exceptional Trusts in Japan fall within the residency qualifications of the treaty. In dealing with this point he refers to the OECD 2005 Commentary on the Convention quoted above, and cited in the Crown Forest case.[37]

Consequently, he considers that an Exceptional Trust in Japan, because it is a 'complex' trust will obtain the benefits of the Japan/US DTA.

This view is not shared by the Australian Tax Office ("ATO") in respect of the New Zealand/Australia DTA. In its Ruling TR2004/D24 it argues that[38] there are parallels between:

> conduit companies and treatment of these [foreign trusts] in New Zealand. In both cases foreign income may follow through the vehicle to foreign owners through an entity that is not taxed in the jurisdiction.

Therefore, they conclude it is within the wording and spirit of Article 4(2) of the Australia New Zealand DTA (reproduced below)[39] to disallow trustees of New Zealand foreign trusts from treaty benefits.

There are a number of problems with this interpretation:

1. It does not identify a discretionary accumulating, or complex trust, in which income will not be passed through as in a conduit, to a trust whose income will pass through directly to the beneficiaries.[40] There is a great conceptual difference between a conduit company and a discretionary accumulating trust, let alone a foreign trust in which the beneficiary have an immediate right to income. In fact, the ATOs concern could be easily met by recognizing that income passed to

34. ibid.
35. ibid p 583.
36. ibid p 586, col 2.
37. Foot note 19.
38. para 77.
39. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then their status shall be determined as follows:

    a. the individual shall be deemed to be a resident only of the State in which a permanent home is available to that individual; but if a permanent home is available in both States, or in neither of them, that individual shall be deemed to be a resident only of the State with which the individual's personal and economic relations are closer (centre of vital interests);
    b. if the State in which the centre of vital interests is situated cannot be determined, the individual shall be deemed to be a resident only of the State in which that individual has an habitual abode;
    c. if the individual has an habitual abode in both States or in neither of them, the individual shall be deemed to be a resident only of the State of which that individual is a national.

40. See eg Prebble (n 18) p 192.

trust beneficiaries, had to be considered, under the DTA, by reference to the tax status of the beneficiary.
2. There is no real argument that if a trust is transparent, as in a conduit, the treaty relief will depend on the status of the recipients of the income, and this accepted by most commentators.
3. The purpose of the ruling is to prevent abuse of the Australian tax system, which the Ruling itself agrees is the fundamental problem, and this can be achieved without a forced interpretation of the New Zealand law, and the DTA.
4. The consequence of the analysis would seem to deprive any entity that may have a partial tax exemption in New Zealand from treaty benefits. This seems to be contrary to the OECD's interpretation.

Beneficial ownership and DTAs

Section HC24(1) of the Act states that a trustee is to be treated as an individual beneficially entitled to the trustee (not beneficiary) income.

Some of New Zealand's DTAs[41] use the words 'beneficial owner' in determining whether treaty relief can be obtained in respect of royalties, dividends or interest. However, the question as to whether in the absence of such wording, trustees can be treated as beneficial owners, for treaty purposes, is of greater importance.

There is ample authority to support this, in the context of accumulating discretionary trusts.

In Vogel, Double Taxation Conventions[42] it is stated in relation to a beneficial owner that the beneficial owner is he who is free to decide:

1. whether or not the capital or other assets should be used or made available for the use by others or
2. on how the yields therefrom should be used; or
3. both.

Clearly a complex trust that is not discretionary and is fixed will result in the trustee not being the beneficial owner of the income, as the income passes automatically to the beneficiaries. This is consistent with New Zealand tax law and results in the taxation liability falling on the recipient beneficiary. As stated in Butterworth's Law of Trusts[43] relative to a discretionary trust:

> the trustees may thus have the power to decide who shall benefit and what the benefits shall be. A potential beneficiary cannot be said to be the owner of an equitable interest until the trustees exercise their discretion in his favour.

Consequently the trustee may be treated as the beneficial owner.

Baker, Double Taxation Conventions[44] notes that:

> *the essential issue here is whether the trustee is in receipt of dividends, interests or royalties is the beneficial owner. The view taken elsewhere [in the text] is that the term beneficial owner should not be given the technical meaning it has in some common law jurisdictions, but should be given a broader treaty meaning. Thus a trustee (other than the one who is obliged to pay directly to a beneficiary) should be regarded a beneficial owner.*

In fact, in civil law jurisdictions that have not adopted the Hague Convention on the Recognition of Trusts, the lack of a concept of trust may reinforce that position as the country will have no choice, if it does not recognize the beneficial ownership, by reason of the existence of a trust but to recognize the trustee as the absolute owner.

It therefore seems hard to argue that where there is a fully discretionary accumulating trust, which has broad powers of appointment in respect of income and capital, that there can be any answer other than that the income flowing from the trust assets is

41. See n 3 above.
42. Vogel, *Double Taxation Conventions* (3rd edn) p 562.
43. Butterworth's Law of Trusts, 1st edn, p 108.
44. Baker, *Double Taxation Conventions* (5th edn) para 1B.23.

beneficially owned by the trustee, as it is otherwise impossible to determine who the beneficial owner will be.

The Prevost and Velcro decisions

Support for the position that the trustee of a discretionary accumulating trust is the beneficial owner of its income for treaty purposes can also be derived from two recent Canadian cases: (i) *Her Majesty the Queen v Prévost Car Inc* [2010] 2 FCR 65, a 2009 decision of the Federal Court of Appeal (FCA), and; (ii) *Velcro Canada Inc v Her Majesty the Queen* [2012] CTC 2029, a 2011 decision of the Tax Court of Canada (TCC). These cases deal with companies, but the analysis is equally applicable to trusts.

Prévost was an appeal by the Canadian Revenue Authority (CRA) against a decision by the TCC. The structure at issue involved a Canadian operating company which was 100% owned by a Dutch holding company. The Dutch company was in turn held by a Swedish and a UK company in more or less equal shares. At issue was the question whether or not the dividends paid by the Canadian company to the Dutch company were eligible for the reduced rate of non-resident withholding tax available under the Canada/Netherlands DTA.

The CRA argued that the Dutch company was not the beneficial owner of the dividends, and therefore the dividend payments were not eligible for treaty benefits. The Crown's argument was based on a shareholders' agreement, the effect of which was that the Dutch company would customarily remit around 80 per cent of the dividend payments to the Swedish and the UK company. The CRA's position was essentially that the Dutch company was a conduit, and the ultimate beneficial owners of the dividends paid by the Canadian company were the Swedish and the UK company.

That position was rejected at first instance, and also failed to convince the Federal Court of Appeal upon review. In line with the Supreme Court's judgment in *Crown Forest*, the Federal Court referred to the Commentaries on the OECD Model Convention, and the 1986 OECD Conduit Companies Report as resources for interpreting the provisions of bilateral tax treaties. In light of the Commentaries and the Report, the Federal Court accepted the reasoning of the TCC that:

> When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as a conduit.[45]

Consequently, as the Federal Court found no evidence that the Dutch company held the shares in the Canadian company on somebody else's account, and was not otherwise under any legal obligation to remit the dividend payments to the Swedish and the UK company, it was the beneficial owner of those dividends, and was thus entitled to benefit from a reduced rate of withholding tax in accordance with the Canada/Netherlands DTA.

In essence the Federal Court's position was that the Dutch company was the owner of the funds flowing from the Canadian company until such time as it declared a dividend in favour of the Swedish and UK companies. Whether or not it declared a dividend was a matter entirely within the discretion of the Dutch Company, so it could not be said that it had[46] 'absolutely no discretion as to the use or application of the funds put through it'. The analogies with the position of a trustee in relation to a discretionary accumulating trust are self-evident.

The *Velcro* case involved a more complex structure. Velcro Canada manufactured fastening products for the auto industry. It used the Velcro trademark under license from a Dutch company ('Company A') and paid royalties to that company. Under the Canada/Netherlands DTA, those royalties were subject to a reduced rate of non-resident withholding tax.

45. Queen v Prevost Car Inc [2010] 2 F.C.R. 65 p 31.
46. ibid 45 p 31, para 100.

In 1997, the Velcro group reorganized its corporate structure. As part of that restructuring, Company A was migrated to the Netherlands Antilles. As Canada and the Netherlands Antilles do not have a DTA, there was an assignment of Company A's rights under the licensing agreement to another Dutch company ('Company B'). As part of the assignment agreement Company A was explicitly recognized as a third-party beneficiary with the right to enforce Company B's rights under the agreement against Velcro Canada. The agreement also required Company B to remit an amount equivalent to a fixed percentage of the royalty stream to Company A.

The CRA argued that, as the assignment agreement required Company B to pay what amounted to a percentage of the royalties to Company A, Company B was therefore a mere conduit for Company A, and had[47] 'absolutely no discretion as to the use or application of the funds put through it as a conduit'. Consequently, Company B could not be said to be the beneficial owner of the royalties for the purposes of the DTA, and as a result was not entitled to benefit from a reduced rate of non-resident withholding tax.

The Tax Court of Canada, in rejecting the CRA's argument, relied heavily on the FCA's decision in *Prévost*, but also gave a much more nuanced approach to the central issues addressed in that case. The court identified out four separate strands to the concept of beneficial ownership for DTA purposes: (a) possession; (b) use; (c) risk, and; (d) control. It analysed each of those elements in turn, and found that Company B had possession, use and control of the royalties, and bore them at its own risk. Therefore, the court concluded that Company B was the beneficial owner of the royalties.

Amongst the key facts that the court identified were:

1. Company B was in receipt of multiple royalty streams, not just from Velcro Canada, all of which were co-mingled in Company B's bank accounts.
2. Company B had exclusive possession and control of its bank accounts.
3. Company B used the monies in its accounts for various purposes other than making payments to Company A. For example, it paid its telephone bills, professional fees and interest on loans that it had taken out.
4. Company B's bank account bore interest. That interest was the exclusive property of Company B.
5. Company B would convert the royalties, which were received in Canadian dollars, to either US dollars or Euros for payments to Company A and its other creditors.
6. Company B bore the foreign exchange risks on those conversions exclusively, and was not protected by an indemnity from any other party in that regard.

However, the single most important factor in the decision was that, despite the fact that Company B:[48]

> did have an obligation to pay a certain amount of money to [Company A] which was equivalent to 90% of the royalties received. The funds paid were not necessarily the same funds as the royalty payments received because the original payments were co-mingled with the other assets of [Company B] . . . These monies are not necessarily defined as specific monies, they may be identified as a percentage of a certain amount . . . but there is no automated flow of specific monies because of the discretion of [Company B] with respect to the use of these monies.

So, again, we can see that the discretion of the holder of the funds in question is the key factor in determining whether or not that person is the beneficial owner of those funds for DTA purposes.

Velcro sets a low threshold for the degree of discretion required. If even the fairly minimal level of

47. Velcro Canada Inv v Her Majesty the Queen [2012] CTC 2029 p 9, para 24.
48. ibid 47 p 24, para 44 and 45.

discretion at evidence in *Velcro* was sufficient to satisfy the test for beneficial ownership under a bilateral tax treaty, then the much greater degree of discretion which the trustee of a discretionary accumulating trust has in regard to the trust fund must be more than sufficient. There must therefore be a strong argument that the trustee of a discretionary accumulating trust will be treated as a beneficial owner for the purposes of a DTA.

Conclusion

In an article published in Trusts and Trustees in 2012,[49] Beckham & Elliffe took a different view. Apart from erroneously describing New Zealand as a tax haven, which is contrary to anything like the generally accepted, or the OECD definitions, of 'tax haven',[50] the authors argue that a state of source could legitimately disregard the domestic residency of a New Zealand trustee (although it is not made clear whether this would only refer to a foreign trust, or any trustee that derived exempt income).[51] The possibility that a source country may take that view as to a foreign trust, is of course always open.

However, it is submitted that where this trust is a discretionary accumulating trust, this argument may be more difficult to sustain. The learned authors refer to the OECD 1987 conduit company report and the reasoning of the ATO, but this can only apply where there are truly pass through qualities to the trust, which have always been seen in a different light to trusts that do not distribute income. Where these facts do not appear, the arguments we have seen in *Velcro* and *Prévost* are more likely to apply. The *Crown Forest* case, which is referred to in some detail by the learned authors, in fact applies to a different set of facts, and on the essential ground that it's activities did not fall within the requirements for physical residency under the Canada/US DTA. Ultimately, in the words of Professor John Prebble[52] 'it is possible that the drafters of the OECD Model intended that trustees should never qualify for treaty benefits; but that conclusion is implausible'.

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49. Vol 18, Issue 9, October 2012, 833.
50. ibid p 834.
51. ibid p 205.
52. See Prebble (n 18) p 205.