IS NEW ZEALAND SETTLING?
A CRITICAL INQUIRY INTO THE
TAXATION OF TRUSTS

Jessica Riley

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“The hardest thing in the world to understand is the income tax.”

Albert Einstein.

"Of all the exploits of equity the largest and most important is the invention and development of the Trust. It is an 'institute' of great elasticity and generality; as elastic, as general, as contract.”

Professor F.W. Maitland, Downing Professor of the Laws of England, Cambridge.

“Although the law of trusts predates income tax by some six centuries, in a curious way they are intertwined, as the concepts of income and capital inherent in income tax are drawn from trust law … It is a remarkable testimony to both the flexibility and adaptability of trusts and trust law that the taxation of trusts is a critical part of New Zealand’s current tax system.”

Professor Craig Elliffe, Professor of taxation law and policy, University of Auckland.

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ABSTRACT

Trust activity in both a domestic and international context has presented itself as an issue warranting increased attention in recent times. Whilst the Law Commission has been addressing the concerns surrounding the integrity of this device in the context of creditor and relationship property claims in New Zealand, the Organisation for Economic Co-operation and Development's base erosion and profit shifting project has led to increased scrutiny of New Zealand's foreign trusts by Inland Revenue. It is thus considered an appropriate time to conduct an inquiry into the soundness or otherwise of New Zealand's unique 'settlor-based' regime. This dissertation aims to undertake such a critical analysis into the taxation of trusts and focuses special attention on the introduction of the current regime in 1988 and its lasting implications. The intersection of these two relatively complex areas of law has arguably caused a slight disconnect between tax and trust practitioners, as the Income Tax Act 2007 instituted rules which did not correspond to well-established trust law principles. This dissertation is based on the law as it stands 30 September 2015.

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To my family and friends for their love and support, especially my parents,
Nicholas and Stephanie.

ABBREVIATIONS

ATO	Australian Taxation Office
BEPS	Base erosion and profit shifting
CD	Consultative Document on International Tax Reform
CSR	Corporate Social Responsibility
DTA	Double Taxation Agreement
EU	European Union
FATCA	Foreign Account Tax Compliance Act 2010 (US)
FATF	Financial Action Task Force
FSI	Financial Secrecy Index
GFC	Global Financial Crisis
IFSDG	International Funds Services Development Group
ITA	Income Tax Act 2007 (NZ)
MFAT	Ministry of Foreign Affairs and Trade
MNE	Multinational enterprise
NZFT	New Zealand foreign trust
OECD	Organisation for Economic Co-operation and Development
SWM	Shareholder Wealth Maximisation
TAA	Tax Administration Act 1994 (NZ)
TJN	Tax Justice Network

CONTENTS

Introduction

Both tax law and trust law comprise aspects of New Zealand's legal system which tug at the fabric of our society: tax drives behaviour and government taxation policies drove the populace to use trusts at an increasingly high rate during the 20th century.[1] Whilst the social and economic conditions of last century have shifted, the popularity of trusts in New Zealand has remained.

The intersection of tax and trust occurs when the legislature decides on how best to reach the income generated by this most fluid of instruments. Taxpayers' ability to use such flexible instruments in wealth management has been met with the development of the taxation of trusts regime, currently contained in subpart HC of the Income Tax Act 2007 (ITA). These legislatively defined 'trust rules'[2] institute what has been termed the 'settlor regime'.[3] This method of taxing trusts is unique to New Zealand in that it requires reference to the residence of the trust's settlor.[4]

New Zealand's taxation of trusts rules were overhauled in 1988 as part of wider international tax reforms aimed at protecting the New Zealand tax base from the "myriad opportunities for residents to avoid or defer New Zealand tax"[5] by the use of entities such as foreign trusts. The Consultative Committee on Full Imputation and International Tax Reform[6] ('the Valabh Committee') recognised an effective international tax regime as a trade-off for lower tax rates. Fast-forward to the present day and it is yet again international tax considerations that are causing the Government to rethink the appropriateness of the settlor regime as its chosen method for taxing trusts.

[1] Law Commission *Review of Trust Law in New Zealand: Introductory Issues Paper* (NZLC IP19, 2010) at [2.36].
[2] Income Tax Act 2007, s YA 1.
[3] CCH New Zealand Limited issuing body *New Zealand income tax law and practice (Online)* (Revised edition, CCH New Zealand, Auckland, 2014) at [455-040].
[4] Other Commonwealth jurisdictions such as Australia and the United Kingdom, broadly determine tax liability according to trustee residence.
[5] Consultative Committee on Full Imputation and International Tax Reform *International Tax Reform Full Imputation Part 2* (July 1988) at v.
[6] The committee was named after its Chair, Arthur Valabh, and was a New Zealand government committee tasked with reviewing various aspects of the income tax system.

In 2013 Inland Revenue addressed the "global media and political reaction"[7] to aggressive tax planning techniques used by multinationals, collectively referred to as "base erosion and profit shifting" (BEPS). In addition to the OECD's 15 point Action Plan on BEPS, Inland Revenue is adopting its own initiatives to address potential deficiencies in New Zealand's tax rules noting that "current international tax settings could be improved to address BEPS concerns".[8] Significantly, a review of the tax treatment of foreign trusts is set to progress in 2015[9] in response to purported criticism of New Zealand as a "tax haven in respect of trusts".[10]

The uniqueness of New Zealand's tax treatment of trusts is interesting yet the relationship between tax and trusts is relatively unchartered academic territory. The markedly high use of trusts by New Zealanders and perceived scrutiny in the recent BEPS-focussed environment provide both domestic and international catalysts for an inquiry into the origins and soundness of the settlor-based rules, as well as any potential lasting implications of this regime.

Chapter I focuses on the development of trusts generally, and specifically in New Zealand, whilst simultaneously exploring the causative effect of tax on the origins of trust use.

Chapter II achieves the converse goal of analysing the influence of the important trust law distinction between income and capital on the shaping of the income tax as it stands today. Subsequently, the basic principles of the taxation of trusts and the settlor-based regime are outlined.

Chapter III addresses the international concern with BEPS and its potential implications for the foreign trust industry given Inland Revenue's stated desire of review.

Chapter IV addresses the way trusts are used domestically and the approach of Inland Revenue and the Courts to the settlor-based regime.

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[7] Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals* (Inland Revenue, PAS2013/152, August 2013).
[8] Policy and Strategy, Inland Revenue *Policy report: Timeline for BEPS-related tax policy work* (Inland Revenue, IR2014/531, November 2014) at 2.
[9] Policy and Strategy, Inland Revenue *Tax policy report: BEPS progress update* (Inland Revenue, IR2014/366, August 2014).
[10] Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals*, above n 7 at 15.

This paper will argue that tax has played a pivotal role in the shaping of trust use in New Zealand. There is no demonstrable need to move away from the settlor-based regime, nevertheless, it is an appropriate time to take proper account of the origins and motivations of the taxation of trusts regime, as well as its lasting implications and any tensions it has occasioned.

Chapter I: The Development of Trusts from a Tax Perspective

A A Brief Overview of Trusts

At its most basic level, "a trust is … a fiduciary relationship, between trustees and beneficiaries".[11] The leading English text *Underhill and Hayton Law of Trusts* provides the following more detailed definition:[12]

> A trust is an equitable obligation, binding a person (called a trustee) to deal with property (called trust property) owned by him as a separate fund, distinct from his own private property, for the benefit of persons (called beneficiaries) of whom he may himself be one, and any of whom may enforce the obligation.

Although this description omits reference to charitable and purpose trusts,[13] it provides a sound working definition for the purposes of this paper, as focus will largely be centred on private trusts.

1 The origins and development of the trust with a tax emphasis

The trust developed from the "use"[14] and its early history is threaded throughout the property holding arrangements of 13th century England. In its recent review, the Law Commission noted at the outset of its description of the trust's development[15] the remarkable similarity in purpose of the historical uses to which the trust was put in mediaeval times, and its continued safeguarding role in modern society. It is, admittedly, no longer extended absence due to religious crusade nor restrictions on the friary's property holdings that incentivise the widespread transfer of property to trusts experienced today in New Zealand. However, the underlying principle of protection operating behind the use of trusts is not anachronistic, even if the form of the instrument has evolved. While ecclesiastical considerations are no longer

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[11] Law Commission *Introductory Issues Paper*, above n 1, at [3.24].
[12] DJ Hayton, PBJ Matthews and CCJ Mitchell *Underhill and Hayton Law of Trusts and Trustees,* (18th ed, LexisNexis, London, 2007) at [1.1(1)].
[13] Greg Kelly and Chris Kelly *Garrow and Kelly Law of Trusts and Trustees* (7th ed, LexisNexis, Wellington, 2013) at [1.57].
[14] Law Commission *Introductory Issues Paper*, above n 1, at [2.1].
[15] At [2.1].

explanative there is another causal factor present in 13th century England[16] which holds equally true today: landowners sought to avoid feudal dues in the form of inheritance tax and "mortmains".

"Mortmains" (literally translated from French to mean "dead hand") were statutes targeted at the practice of bequeathing property in perpetuity to the Church to avoid feudal dues. The "dead hand" in this context is reference to the inalienability of property held by religious orders but generally, and as addressed by the Law Commission's review of the rule against perpetuities,[17] there is a reluctance to allow testators to control assets and prevent their circulation in the economy beyond death. The fact that a simplified statutory rule against perpetuities[18] has been recommended demonstrates how little has changed in the way trusts are presently, and were historically, used.

While taxpayers no longer transfer property to the Church, it is to discretionary trusts that they still turn. Tax has been determinative of trust use from the very start. As itemised at the 2015 NZLS Trusts Conference,[19] there still exist tax effective reasons for the use of trusts. It is due to the nascent intertwining of tax and trusts that their intersection may be seen as important.

Writing on the origins of the "use", Maitland expounded the etymology of the word, namely its derivation from the Latin *ad opus* meaning "on behalf" of another. Illustrative of the inceptive relationship between taxation and trusts, Maitland's initial observation on the history of the "use" as evidenced by its appearance in documents as the Latin *ad opus* is that:[20]

> A man will sometimes receive money to the use (*ad opus*) of another person; in particular money is constantly being received for the king's use. Kings must have many ministers and officers who are always receiving money, and we have to distinguish what they receive for their own proper use…from what they receive on behalf of the king.

[16] Law Commission *Preferred Approach* (NZLC IP31, 2012) at [2.6].
[17] Law Commission *Introductory Issues Paper*, above n 1, at [14.13].
[18] Namely, only allowing for trusts to have a lifespan of 150 years maximum: Law Commission *Preferred Approach*, above n 16, at [14.17].
[19] Stephen Tomlinson and Graham Tubb "Tax Planning and Trusts – Drawing The Line" (paper presented to New Zealand Law Society Continuing Legal Education Trusts Conference, June 2015).
[20] FW Maitland "The Origin of Uses" (1894) 8 Harv L Rev 127 at 128.

Money received on behalf of the king or ruling government is generated by taxation. An analogy may be drawn between the trust and a nation's tax system: in adhering to the abovementioned *Underhill and Hayton* definition, it could be argued that trust property, that is revenue generated by the levying of taxes, is received by the government upon whom there are "binding" obligations, namely statutorily regulated expenditure,[21] and both political and legal[22] accountability mechanisms restricting them to deal with said property "for the benefit of persons", namely its citizens, "of whom …[it]… may be one". Certainly, most lay persons would associate the word 'beneficiary' more immediately with social welfare than private property and the applicability of like terminology may reveal a deeper similarity.

The patent discrepancy between the taxpayer as beneficiary of public spending and a beneficiary of a private trust is the nature of the 'trustee': one is sovereign, the supreme rule-making body whose legislative decisions, properly enacted, are untouchable in New Zealand by the Courts; the other is "the most important"[23] product of, and bound by, equity as it inheres in the Court's jurisdiction, and "one of the most frequently quoted aphorisms of tax law interpretation is that there is no equity about a tax".[24] John Prebble highlights the difficulty in applying trust law concepts of income and capital to the idea of income tax because "[j]udges in trust cases divide gains between two citizens. But judges in tax cases decide what portion of a citizen's property is taken for the state by the legislation."[25]

It may be accepted that, in analogising income tax and a trust, one decision-maker controls the law, and the other is nothing more than subject to its rules. Perhaps the reason why this area of law is considered complex,[26] even "very complex"[27] is because in a trust, legal ownership simply does not import the consequences which tax law is well-equipped to deal with. The legislature is capable of applying tax to that which it so chooses but requires

[21] Section 4(1) of the Public Finance Act 1989 sets out that the Crown must "not incur expenses or capital expenditure, except as expressly authorised by an appropriation, or other authority, by or under an Act" and section 22 of the Constitution Act 1986 also provides for no taxation without legislation.
[22] See, for example, section 15 of the Public Audit Act 2001 requiring the audit of "financial statements, accounts, and other information" of public entities.
[23] WS Holdsworth *A History of English Law* (7th ed, Methuen & Co Ltd, London 1938) at 454.
[24] John Prebble "100 Years of Income Tax" (February 1993) International Bureau of Fiscal Documentation 59 at 65.
[25] At 61.
[26] See, for example, "Taxation of Trusts" Matters of Trust <mattersoftrust.co.nz/taxation-of-trusts/>.
[27] The data collected for the purposes of the Financial Secrecy Index notes that in New Zealand "[t]he rules for the taxation of trust income and trustees are very complex.": Tax Justice Network "New Zealand" (7 November 2013) Financial Secrecy Index <www.financialsecrecyindex.com/>.

something to grasp at and hold on to: the trust is a slightly more elusive and amorphous equitable creature than statute normally interacts with. There is, however, similar mechanics between the constructs of tax and trusts but a cohesion in the taxation of trusts, befitting of the harmony which exists at a basic level between the two, is not easily achieved.

2 The trust in New Zealand

The trust resembled its modern form by the 19th century in England[28] and had become acknowledged as a discrete area of law.[29] It was "particularly taxation policies"[30] in 20th century New Zealand that rendered the discretionary family trust an increasingly popular asset-planning tool. Specifically, such policies included estate duty[31] and gift duty,[32] introduced in 1866 and 1885 respectively, as well as marginal personal tax rates in the 1950s which were nearly double current levels.[33]

So-called "mirror" trusts and debt-forgiveness programmes are a result of taxpayers' attempts to lessen estate and gift duties. "Death taxes are ancient taxes"[34] and have been adopted by countries the world over in one shape or another. By contrast, gift duty was peculiar to New Zealand and has been thought of as a "purely indigenous initiative".[35] Its application from 1885 until its abolition in 2011[36] meant it outlived estate duty by 18 years.[37] Gift duty was enacted as an adjunct to prevent the avoidance of estate duty[38] and to raise revenue.[39] However, due to the 10% lesser rate of gift duty as opposed to estate duty[40] "there was enormous scope for the affluent to reduce their overall liability by gifting their property

[28] Law Commission *Introductory Issues Paper*, above n 1, at [2.31].
[29] At [2.33].
[30] At [2.36].
[31] Stamp Act 1866.
[32] Deceased Persons' Estates Duties Act 1881 Amendment Act 1885.
[33] For example, in 1957 the top rate of taxation was 60% on income exceeding $7,200: W M Patterson "When is a Trust a Trust?" (paper presented at the Legal Research Foundation Seminar "A Modern Law of Trusts", Auckland, 28 August 2009).
[34] Louis Eisenstein "The Rise and Decline of the Estate Tax" (1956) 11 Tax Law Rev 223 at 223.
[35] Michael Littlewood "The Histories of Death Duties and Gift Duty in New Zealand" (2012) 18 NZ J Tax L & Policy 66 at 83.
[36] Taxation (Tax Administration and Remedial Matters) Act 2011, s 245.
[37] Estate Duty Abolition Act 1993, s 3.
[38] Littlewood, above n 35, at 84.
[39] Policy Advice Division of Inland Revenue *A Special Report: Gift Duty Abolition* (Inland Revenue, 1 September 2011) at 1.
[40] Gift duty was set at a rate of 5% whereas estate duty was 15%.

away, even where their gifts were subject to duty".[41] Under a 1911 amendment,[42] a £1,000 limit on the total duty-free gifts made every year was imposed: this limitation gave rise to gifting programmes. And to whom (or to what, more importantly) did the wealthy gift their property? The answer is discretionary family trusts.

3 *The relevance or irrelevance of gift duty*

As outlined in Littlewood's article, gift duty endured beyond death duty for such an extended period due to a change in government.[43] The state of affairs in 2011 was such that a meagre 0.4% of reported gifts were liable for gift duty due to the widespread use of gifting programmes.[44] Lawyers and accountants may have been benefitting from the tax's continued existence[45] but the Government was not.[46] The Finance and Expenditure Select Committee addressed the concern that the abolition of gift duty would increase trust use but was not persuaded due to lack of evidence and it not being "the appropriate mechanism to deal with any inadequacies in New Zealand trust law."[47]

The Government in the late 1990s declined against abolishing gift duty because it was hoped to incidentally deter people from transferring their assets to trusts.[48] Officials recommended its retention until investigation into tax avoidance opportunities could be undertaken.[49] But "the potential tax savings from [gifting] arrangements often significantly outweigh[ed] the compliance costs".[50] That is, the appeal of utilising a trust structure for tax purposes trumped the minor inconvenience and expense[51] of gifting programmes. Although potential reduction in income tax liability was "the number one concern" relating to the repeal of gift duty, the

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[41] Littlewood, above n 35, at 84.
[42] Death Duties Amendment Act 1911, s 8.
[43] The National government that concluded gift duty would serve no additional purpose was replaced by a Labour government for three successive elections.
[44] Policy Advice Division of Inland Revenue and the Treasury *Taxation (Tax Administration and Remedial Matters) Bill Officials' Report to the Finance and Expenditure Select Committee on Submissions on the Bill* (Inland Revenue, April 2011) at 5.
[45] Compliance costs to the private sector were $70 million p.a.: Finance and Expenditure Committee *Taxation (Tax Administration and Remedial Matters) Bill Commentary* (20 June 2011) at 2.
[46] At 2.
[47] At 2.
[48] Littlewood, above n 35, at 99.
[49] Policy Advice Division *Regulatory Impact Statement: Gift Duty Repeal* (Inland Revenue Department, 4 October 2010) at [12].
[50] At [16].
[51] Practitioners' estimate of $285 (plus GST) to draw up an annual deed of forgiveness and file this alongside a gift statement: at [29].

Government concluded that the degree of protection provided may be exaggerated: gifting programmes were most frequently used in a family trusts context, where debt forgiveness would usually not be taxable due to the 'natural love and affection exception'.[52]

Perhaps the broader point regarding gift duty's relatively long-lived existence is that it instilled a culture of gradual asset transfers under its out-dated 1984 $27,000 thresholds that New Zealand trust users were more than willing to adopt in order to receive the trust's tax benefits. The abolition of gift duty does not appear to have affected trust use dramatically.[53] Taxpayers and their advisers were resolutely committed to engaging in gifting programmes, a practice supported by caselaw.[54] Perhaps the idea of outright transfer is less attractive and New Zealanders appreciated the sense of continued legal ownership of a repayable debt. Gift duty should not be seen as a disincentive to trust use. As was highlighted in the practical 1977 "Estate Planning A Handbook for Accountants", "against wealth taxes the trust presents excellent asset 'stabilisation' opportunities, in conjunction with optimal gift duty avoidance through forgiveness of the price in stages."[55]

B Modern Trust Use: A Few Statistics and Explaining Partiality

Trusts are popular in New Zealand, even comparatively so if one looks at similar Commonwealth jurisdictions: "New Zealanders have a predilection for trusts beyond that experienced in similar countries".[56] As an indicator of popularity, 63% of Members of Parliament from both sides of the house declared interests in trusts in 2014.[57] In the tax year ended March 2013 there were 240,300 IR6: Estate and Trusts income tax returns filed.[58]

[52] At [60]; the exception was set out in the Income Tax Act 1994, s EH 52.
[53] This in spite of the Law Commission's prediction and similar comments made to that effect at the NZLS Trusts Conference, see Stephen Tomlinson and Graham Tubb "Tax Planning and Trusts – Drawing The Line" (paper presented to New Zealand Law Society Continuing Legal Education Trusts Conference, June 2015) 143 at 146.
[54] *Re Marshall (Deceased) Commissioner of Inland Revenue v Public Trustee* [1965] NZLR 851.
[55] CM Arthur *Estate Planning A Handbook for Accountants* (Sweet & Maxwell (NZ) Ltd, 1977) at 163.
[56] Law Commission *Introductory Issues Paper*, above n 1, at [2.31].
[57] Maarten Wevers "Register of Pecuniary and Other Specified Interests of Members of Parliament: Summary of annual returns as at 31 January 2015" New Zealand Parliament <www.parliament.nz>. This figure was calculated based on 76 out of 121 members declaring at least one beneficial interest.
[58] "Number of customers by return types, 2004 to 2013" (1 December 2014) Inland Revenue <http://www.ird.govt.nz>.

Adopting the Law Commission's methodology,[59] albeit using more recent census data,[60] it may be calculated that there is 1 trust for every 19 New Zealanders.[61]

It should be noted that such figures produce conservative estimates based solely on returns filed for income earning trusts.[62] Anecdotal evidence suggests that the number of trusts could be closer to 400,000[63] and the Ministry of Justice reported an estimate of between 300,000 and 500,000 trusts.[64] Even a cautious assessment demonstrates New Zealanders' inclination to use trusts in managing their assets.

In 1972 it was recognised that trusts enjoyed the position of "status symbol[s]".[65] Despite historically being used by wealthy families, it is difficult to maintain that trusts are confined as an instrument of the upper class. Although one trust exists for every 18 New Zealanders, only 2% of New Zealanders earn an income of over $150,000.[66] In like terms, there is one trust for every 19 New Zealanders but only one 'wealthy' income for every 52 New Zealanders. Middle-income New Zealanders have demonstrated a desire to 'get in' on the benefits of family trusts, no doubt prompting the comment that "family trusts…are used by a wide cross-section of the community, including the very wealthy to those of more modest means…"[67]

Trust use in New Zealand is akin to a social phenomenon. "[F]avourable" tax treatment has been cited an explanation for the popularity of New Zealand trusts, particularly compared to other countries' effective tax disincentives.[68] Although the lack of estate duty, gift duty,

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[59] Law Commission *Introductory Issues Paper*, above n 1, at [1.13].
[60] 4.47 million: "National Population Estimates: At 30 June 2013" (14 August 2013) Statistics New Zealand <www.stats.govt.nz>.
[61] See Appendix 2 for a table of trust use in Australia (one trust for every 30 Australians), the UK (one trust for every 399 UK citizens) and Canada (1 trust for every 162 Canadians).
[62] Trusts may not earn assessable income due to the nature of assets held or the source of income, e.g. foreign trusts.
[63] Law Commission *Introductory Issues Paper*, above n 1, at [1.13].
[64] It was also noted that "trusts are an important part of New Zealand society and the economy": "Trust Law Reform" Ministry of Justice <www.justice.govt.nz>.
[65] R C Pope *The Practice and Pitfalls of Trusts and Wills* (New Zealand Society of Accountants, Wellington, 1972) at 71.
[66] Bill English, Minister of Finance "Budget 2015 Executive Summary" (21 May 2015) The Treasury < http://www.treasury.govt.nz>.
[67] Law Commission *Introductory Issues Paper*, above n 1, at [1.15].
[68] Law Commission *Preferred Approach*, above n 16, at [1.24].

stamp duty and capital gains tax may provide a superficial explanation,[69] there seems to be a more indoctrinated preference for trusts in New Zealand. This dissertation will hopefully expound the need to look beyond the obvious, namely the lack of certain taxes, as an explanation for partiality to domestic trust use. A deeper-rooted perception of the trust as a property management device could have been entrenched as an indirect result of settlor-based tax treatment.

[69] The explanation is not entirely satisfactory. Stamp duty exists in the UK and Australia, but not Canada; estate duty exists only in the UK; and although a capital gains tax is applied by all three countries this does not explain the much higher per capita use of trusts in Australia. See Appendix 2 for the exact figures of country-by-country trust use.

Chapter II: The Income Tax's Definition and its Application to Trusts Today

A The Effect of Trust Law on the Development of the Income Tax

Not only did the initial use of trusts stem from a desire to ease the burden of taxes, but trust law concepts subsequently shaped the development of the income tax. Perhaps the most consequential distinction in tax law is that between income and capital. This distinction is fundamental to lawyers and accountants delivering advice and occupies a good deal of judicial reasoning as attempts are made to provide accessible rules.[70]

The United States Supreme Court recounted that "the fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree on the land, the latter to the fruit".[71] But Prebble highlights that the economists' conclusion is that this distinction does not matter.[72] The global approach to income taxation of the United States is based on "elastic notions of economic reality"[73] to be contrasted with the schedular UK model. A schedular conception bypasses economic gains and simply posits that in order to be considered income, a receipt must fall within one of the statutory heads or "schedules".[74] This approach, while not exactly replicated, can be seen in New Zealand where income is defined non-globally as follows: "an amount is income of a person if it is their income under a provision in this Part".[75] The catchall 'ordinary concepts' income[76] has allowed caselaw to develop a range of indicia signalling acceptable characteristics of "default"[77] income, as distinct from capital, receipts.

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[70] John Prebble "100 Years of Income Tax", above n 24, at 61.
[71] *Eisner v Macomber* 252 US 189 (1919) at 206.
[72] John Prebble "100 Years of Income Tax", above n 24, at 61.
[73] Tipping J's description of what New Zealand income tax should not be determined by in *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350 at 13,360. See Henry Simons *Personal Income Taxation* (University of Chicago Press, 1938) at 50: economic income is "[t]he algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question … and includes not only conventional income but all capital gains, including gifts, inheritances and lottery winnings".
[74] John Tiley and Glen Loutzenhiser *Revenue Law Introduction to UK Tax Law; Income Tax; Capital Gains Tax; Inheritance Tax* (7th ed, Hart Publishing Ltd, Oxford, 2012) at 137.
[75] Income Tax Act 2007, s CA 1(1).
[76] Income Tax Act 2007, s CA 1(2).
[77] John Prebble "New Zealand Taxation and Taxation Law" in Xavier Cabannes (ed) *Issues on Taxation in the South Pacific/Regards sur la Fiscalité dans le Pacifique Sud* Comparative Law Journal of the Pacific Hors Série XVIII (New Zealand Association for Comparative Law & Association de Législation Comparée des Pays du Pacifique, Wellington, 2015) 99 at 112.

Importantly, there is no possibility in New Zealand or the UK to accept an amount as income "even if some economist or other theoretician says it is".[78] Tiley acknowledges that in England the judicial decision to exclude capital was readily comprehensible given English legislative history in which several forms of capital were subjected to separate taxes. Additionally, the "sharp distinction"[79] between income and capital in the already substantial body of trust law played an important role. Tiley accepts the nature of this distinction as "fundamental".[80] Prebble also cites the "traditional answer" of incorporating trust law's separation of income and capital into the judicial interpretation of income tax but minimises its significance because "there is no logically sustainable distinction between capital gains and income gains";[81] human nature – namely, judges' dogged refusal to pay heed to economists' views and only apply income tax to recurring gains, not windfalls or long-term asset holdings – was an "equally significant" contributing factor.

In his essay "What is Income?" Martin Daunton outlines that "resistance to taxation of capital gains was based on the concept of *res* which arose from trust law".[82] The question arose as to whether trustees were obliged to preserve the fruit (income) or tree (capital) in managing trust property. A trustee's failure in his or her duty of even-handedness, for example by eroding capital in favour of an income beneficiary as was seen in *Re Mulligan*,[83] constitutes a serious fiduciary breach. The issue of preserving income or capital reared its head frequently in the aristocratic settlements of the 19th century, culminating in the conclusion that the capital (or *res*) deserved protection. Consequently, "income *was* considered and defined, and the assumptions underlying these debates were then transposed to the income tax."[84]

Ultimately, a core definitional distinction in income tax is derived from a fundamental trust law concept. Trust law was important in developing the parameters of what defines income; tax laws initially drove taxpayers to use trusts. There is a circularity between tax and trusts and the coinciding of the two should arguably pay careful attention to legal form: a strict

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[78] John Tiley and Glen Loutzenhiser *Revenue Law Introduction to UK Tax Law; Income Tax; Capital Gains Tax; Inheritance Tax* (7th ed, Hart Publishing Ltd, Oxford, 2012) at 137.
[79] At 144.
[80] At 145.
[81] John Prebble "100 Years of Income Tax", above n 24, at 61.
[82] Martin Daunton "What is Income?" in John Tiley (ed) *Studies in the History of Tax Law* (Hart Publishing, Oxford, 2004) 3 at 8.
[83] *Re Mulligan* [1998] 1 NZLR 481.
[84] Martin Daunton, above n 82, at 8.

legal categorisation of income is intrinsic to the UK or New Zealand approach albeit different considerations have shaped a more global or economic understanding in other jurisdictions.

B How to Tax a Trust?

Taxing a trust is unlike taxing an individual or a company with distinct legal personhood. Applying income tax to a fiduciary relationship is not a self-evident exercise. A trust, unlike a company, does not have a relatively uniform structure with ownership split into a number of shareholders[85] and a board of directors charged with management[86] and subject to a range of statutory duties.[87] Trusts, by contrast, are oft-cited for their 'flexibility'[88] which is largely due to the norm that "most modern trusts allow trustees virtually unfettered powers in respect of trust property".[89] However, this practice has in turn presented problems, which the Law Commission is seeking to address, manifested by the issue of dispositions to trusts allowing settlors to skirt their obligations.[90]

In New Zealand, the basic principle underpinning the taxation of trusts regime is that trustees derive income in a representative capacity for the ultimate owners of the income, the beneficiaries.[91] Income is treated as a single stream[92] but subject to "dual derivation",[93] namely the legislature aims to tax income once only in either the beneficiaries' or the trustees' hands. Once an amount is derived trustees may exercise powers of appointment in distributing income to beneficiaries in accordance with the trust deed.

Trust income is categorised into beneficiary income or trustee income.[94] Trustee income has a residual statutory definition: it is everything that is not beneficiary income.[95] Where an amount is taxed as trustee income in a given year, a subsequent distribution is understandably

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[85] Companies Act 1993, s 1(b).
[86] Companies Act 1993, s 128.
[87] Companies Act 1993, ss 131-138.
[88] See Law Commission *Some Issues with the Use of Trusts in New Zealand Review of the Law of Trusts: Second Issues Paper* (NZLC IP20, 2010) at [2.27] & [5.5].
[89] Vicki Amundsen *Taxation of Trusts* (2nd ed, CCH New Zealand Ltd, Auckland, 2011) at [1-110].
[90] Law Commission *Second Issues Paper*, above n 88, at [1.11].
[91] Inland Revenue *Explanation of Taxation of Trusts: Appendix* (Inland Revenue, Tax Information Bulletin Vol 1 No 5, November 1989) at [4.88].
[92] Prebble "New Zealand Taxation and Taxation Law", above n 77, at 119.
[93] Craig Elliffe *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, Wellington, 2015) at [2.5.1].
[94] Income Tax Act 2007, s HC 5(1).
[95] Income Tax Act 2007, s HC 7(1).

not taxed.[96] Furthermore, the legislation allows a grace period of six months[97] after derivation within which an amount must be absolutely vested in or paid[98] to beneficiaries and taxed accordingly. The special tax rate applied to trustee income is 33%[99] which currently aligns with the maximum marginal rate for individuals.[100]

Beneficiary income[101] is taxed at the individual beneficiary's personal tax rate. Undistributed income is trustee income, which is similarly labelled accumulated income as it sits untouched in the trust. There is essentially a bipartite system under the current taxation of trusts regime. Firstly, assortment into the above definitions covers the tax consequences associated with the initial receipt of trust income and potential distribution in the same year. However, where income is left undistributed after the tax year and grace period, the secondary element of classification at distribution assumes significance. This classification determines the taxation of distributions other than beneficiary income and the applicable tax rate.[102]

At the time of every distribution, a trust is classified as complying, foreign or non-complying and the "most striking aspect"[103] is the need in New Zealand, unlike most other countries,[104] to refer to the tax residence of the settlor in this determination. A complying trust is an ordinary New Zealand trust as generally most trusts settled by residents will fulfil the requirement that all trustee income has been subject to tax in New Zealand.[105] Foreign trusts are defined as those for which no New Zealand resident has been a settlor since settlement until distribution.[106] A non-complying trust is defined by exclusion as neither a foreign nor

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96 Established by the Court of Appeal in *Commissioner of Taxation v Luttrell* [1949] 3 NZLR 823.
97 Income Tax Act 2007, s HC 6(1B).
98 Under section OB 1 of the Income Tax Act 2004, 'beneficiary income' included an amount derived which the trustee "pays or applies it to or for the benefit of the beneficiary". Inland Revenue indicated that "the revisions to s HC 6 and the definition of "beneficiary income"… are not intended to change what is "beneficiary income"… Therefore, the previous law and commentary (including the case law on the meaning of "applies") are still relevant.": Public Rulings Unit *Income Tax – Whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income* (Inland Revenue, IS 12/02, 29 June 2012).
99 Income Tax Act 2007, Schedule 1 Cl 3.
100 Income Tax Act 2007, Schedule 1 Cl 1. This was not the case during the period 2000 until 2010 as during this time the highest personal tax rate was increased to 39% while the trustee tax rate was left at 33%.
101 See Appendix 1 for the statutory definition, Income Tax Act 2007, s HC 6.
102 CCH New Zealand Limited issuing body *2015 New Zealand Master Tax Guide* (CCH New Zealand Ltd, Auckland, 2015) at [25-025].
103 At [455-040].
104 At [25-010].
105 Income Tax Act 2007, s HC 10.
106 Income Tax Act 2007, s HC 11.

complying trust;[107] Inland Revenue explains that this should capture "generally a trust that has a resident settlor, has been established overseas with non-resident trustees, and has not been liable for New Zealand income tax since it was first settled".[108]

This income division and subsequent distribution classification regime[109] ensures that trust income and capital gains that can be connected with New Zealand under the trust rules are appropriately taxed.[110] The concept of a "taxable distribution" only applies to foreign or non-complying trusts.[111] Foreign trust distributions are amounts of a person's income,[112] provided they do not constitute non-residents foreign-sourced income, [113] and are accordingly taxed at a beneficiary's marginal rate. Non-complying trust distributions are excluded income[114] so that the higher 45% rate may be imposed under section BF(1)(b). This penal rate and the inclusion of capital profits or gains are mandated because New Zealand tax has been avoided or deferred through the use of trusts which are now categorised as 'non-complying'.[115]

A notable aspect of the taxation of trusts regime is the consequence that when foreigners settle property on New Zealand resident trustees, foreign-sourced income is exempt.[116] If, by immediate contrast, a trust has a New Zealand resident settlor at any point during an income year, irrespective of trustee residence, foreign-sourced income is assessable in the hands of the trustee as per section HC 25.[117] Without a New Zealand settlor, such income is otherwise

[107] Income Tax Act 2007, s HC 12.
[108] "Types of Trusts" (10 October 2008) Inland Revenue <http://www.ird.govt.nz>.
[109] See Appendix 2 for a table, adapted from an OECD Peer Review Report, that summarises the results of the categorisation of trusts for the purposes of distributing accumulated trustee income.
[110] See both CCH New Zealand Limited issuing body *2015 New Zealand Master Tax Guide* (CCH New Zealand Ltd, Auckland, 2015) at [25-305] and Vicki Amundsen *Taxation of Trusts* (2nd ed, CCH New Zealand Ltd, Auckland, 2011) at [5-080].
[111] Amundsen *Taxation of Trusts*, above n 89, at [5-080].
[112] Income Tax Act 2007, ss HC 18 and CV 13.
[113] Non-residents are not liable on otherwise taxable distributions if the amount of income derived is foreign-sourced: s BD 1(4)-(5) but if the amounts are New Zealand sourced the distribution would be taxable in the hands of foreign beneficiaries albeit this is not contained in a specific provision. A foreign-sourced amount is income that does not have a source in New Zealand pursuant to s YD 4: s YA 1. Assessable income is thus restricted to New Zealand sourced income for non-resident beneficiaries. A trustee may be liable as an agent for the beneficiary: s HC 32. This lack of specificity is largely because the 'taxable distribution' concept applies only to foreign and non-complying trusts which are defined by reference to the trust's settlor and not the trusts' beneficiaries.
[114] Income Tax Act 2007, ss HC 19 and CX 59.
[115] Inland Revenue *Explanation of Taxation of Trusts: Appendix*, above n 91, at [2.16].
[116] Income Tax Act 2007, ss HC 26 and CW 54.
[117] Income Tax Act 2007, s HC 25.

excluded as set out in section BD 1.[118] The essential point is the irrelevance of trustee residence and the paramount importance of settlor residence.

Accordingly, much hinges on the definition of 'settlor' and practitioners are advised that care should be taken.[119] This statutory definition is a "cornerstone"[120] of the regime and is accordingly wide, broadly targeting anyone who transfers value to a trust.

C The Settlor Regime

The "starting point"[121] or "usual approach"[122] of the ITA 2007 is that the government seeks to tax non-residents on income sourced in New Zealand and tax New Zealand residents on their world-wide income. These "cardinal principles"[123] are referred to as 'source' and 'residence' based taxation. Professor Reuven Avi-Yonah summarises the fundamental principles as follows:[124]

> Residence taxation of income is based on the principle that people and firms should contribute towards the public services provided for them by the country where they live, on all their income wherever it comes from. Source taxation is justified by the view that the country which provides the opportunity to generate income or profits should have the right to tax it.

Under residence-based taxation, New Zealand resident trustees should be liable to tax on worldwide and domestic income, yet this is not the case. Unlike the standard practice among "common law jurisdictions that are not tax havens"[125] to levy tax based on trustee residence, New Zealand has opted for a "substantive economic"[126] or "gross/global"[127] approach by

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118 Income Tax Act 2007, ss BD 1(4)-(5).
119 Amundsen *Taxation of Trusts*, above n 89, at [5-050].
120 *International Tax Reform Full Imputation Part 2*, above n 5, at [6.4.1].
121 Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals*, above n 7, at 8.
122 Law Commission *Second Issues Paper*, above n 88, at [3.53].
123 The principles were previously set out at section 242 of the Income Tax Act 1976. See John Bassett "The residence problem: where do you put your trust?" *New Zealand Tax Planning Report* (CCH New Zealand Ltd, Auckland, 1987).
124 Reuven Avi-Yonah "Source and Residence Taxation" (15 September 2005) Tax Justice Network < http://www.taxjustice.net>.
125 Prebble "New Zealand Taxation and Taxation Law", above n 77, at 119.
126 At 119.
127 CCH New Zealand Limited issuing body *New Zealand income tax law and practice (Online)* (Revised edition, CCH New Zealand, Auckland, 2014) at [455-040].

determining the tax liability of trustee income and taxable distributions in relation to settlor residence. The pertinent question is, therefore, how did this come about?

1 Legislative history

Roger Douglas' 1987 budget introduced anti-haven tax measures targeting the deferral or complete avoidance of New Zealand tax, which was considered widespread and a drain on government revenue.[128] These measures were part of a wider base-broadening reform package directly sparked by the major economic crisis of the period.[129] The Minister of Finance's aim underpinning the measures was to "protect the tax base and preserve the integrity of the tax system".[130] The complexity of anti-tax haven reforms and the end-goal of a comprehensive regime combatting international tax avoidance necessitated an in depth consultation process by the Government.

At heart, the measures so introduced sought to tax New Zealand residents on income derived from an interest in non-resident companies or trusts. Indeed, the Minister in his preface highlighted that both companies and trusts should have consistent treatment in terms of foreign income.[131] This overriding desire to treat trusts and companies alike is evident throughout the scheme of the accompanying Consultative Document (CD). The Valabh Committee was also cognisant of the CD's undifferentiating treatment of foreign trusts and companies (because a "trust can substitute for a company").[132] However, as the Government recently noted, the tax treatment of trusts is "hybrid" as opposed to the "standard company taxation approach".[133] The presence of aspects of an "individual taxation" approach[134] may have rendered the trust comparatively flexible as against the confines of company taxation, such as shareholder continuity.

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[128] "Consultative Document on International Tax Reform" in *New Zealand Tax Discussion Documents (Online)* (CCH New Zealand Ltd, Auckland) 1987 [60-037] at 1.
[129] John Head "The Political Economy of Tax Reform: A Neo-Musgravian Perspective with Illustrations from Canada, US, Australian and New Zealand Experience" in JG Head and RE Krever (ed) *Tax Reform in the 21st Century: A Volume in Memory of Richard Musgrave* (Kluwer Law International, 2009) 19 at 37.
[130] "Consultative Document on International Tax Reform", above n 128, at 1.
[131] At 2.
[132] Consultative Committee on Full Imputation and International Tax Reform *International Tax Reform Full Imputation Part 1* (March 1988) at 43.
[133] Policy and Strategy, Inland Revenue and the Treasury *Closely Held Company Taxation Issues* (Inland Revenue, Official Issues Paper, September 2015) at [2.13].
[134] For example, if certain forms of income are derived tax-free or lightly taxed, the individuals receive these benefits, and losses can be set off personally or carried forward freely.

It was recognized that "no other country has to date eliminated the deferral of domestic tax on foreign income earned through non-resident companies and trusts as completely as these measures propose"[135] and the Valabh Committee was set up to receive and consider submissions. The concern was enunciated that there was "blatant erosion of the tax base" which obstructs domestic reform:[136] a system vulnerable to international tax deferral and avoidance cannot institute lower uniform rates domestically unless all taxpayers bear their fair share of tax.

The CD identified the fundamental deficiency of New Zealand's international tax measures as inherent in the lack of reality or practical effect of the residence-based principle of taxation, noting that:[137]

> In principle, residents are subject to New Zealand tax on their income derived from all sources — that is, their worldwide income. In practice, however, foreign income derived by residents is often not subject to New Zealand tax.

It is thus evident where the departure from ordinary principles of international taxation has its roots.

The Valabh Committee's Part 1 report[138] reformulated the CD's first main objective as protecting the tax base from avoidance or deferral by the accumulation of income in offshore entities, noting that there is no meaningful difference between avoidance and deferral since the latter amounts to a permanent reduction in the present value of tax collected.

Targeting the avoidance of tax on New Zealand sourced income by diversion through tax haven entities, including trusts, was widely supported as was, albeit to a lesser extent,[139] taxing the accumulation of foreign-sourced income in such entities. However, the comprehensive anti-deferral objective, addressing the lack of taxation of New Zealand

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[135] "Consultative Document on International Tax Reform", above n 128, at 3.5.
[136] At 3.2.
[137] At 3.3.
[138] *International Tax Reform Full Imputation Part 1*, above n 132, at 4.
[139] It is noted that there was "general, though less solid, support for a regime which taxes the accumulation of foreign-sourced income in tax haven entities": *International Tax Reform Full Imputation Part 1*, above n 132, at [1.5.2].

income on an accrual basis in foreign entities met with "considerable opposition".[140] Tax was previously payable only when distributions from trusts were made. As elucidated by Inland Revenue in its Tax Information Bulletin, this was a "consequence of the fact that there [was] only one trust income"[141] unlike the bipartite categorisation of amounts under present legislation.

Interestingly, the Government initially sought to use the existing rules to determine trust residence stating that "[a] non-resident trust will thus be a trust that does not have any trustee resident in New Zealand".[142] Nonetheless, the CD then proceeded to formulate the original idea behind the current regime. Owing to the infeasibility of ascertaining the existence of resident beneficiaries in a given year, the settlor was chosen as an appropriate target to achieve the objective of the reforms.

Significantly, the Valabh Committee recognised that the proposal to base taxability on settlor residence "ignores the legal relationships between a settlor and a trustee since the former has no right to the income of the trust".[143] The substantive approach first becomes apparent at the observation that:[144]

> In reality, however, a settlor often has substantial influence over the trustee, usually on an informal basis though there may be specific provision in the trust deed and, in practice if not in law, may be able to wind up the trust and take back the property. Thus, the economic substance of a trust may differ from its legal appearance.

With the end goal of placing legal liability for tax on the trustee, the Valabh Committee found that this could be achieved by defining trusts with resident settlors to be New Zealand residents. It is noted that the CD's basic approach "closely follows" the United States' grantor trust provisions.

In his essay analysing the influence of Montesquieu on English taxation, John Snape writes that "tax legislation requires more prudence and wisdom than any other aspect of

[140] At [1.5.3].
[141] Inland Revenue *Explanation of Taxation of Trusts: Appendix*, above n 91, at [4.89].
[142] "Consultative Document on International Tax Reform", above n 128, at 4.3.
[143] *International Tax Reform Full Imputation Part 1*, above n 132, at [5.2.1].
[144] At [5.2.1].

government".[145] Moreover, Montesquieu in his discussion on taxation in *L'Esprit des lois* of 1748[146] stated that when laying a tax upon citizens, prudence dictates matching the tax to the form of government under which they live. New Zealand's form of government is the Westminster parliamentary system, and it is trite to say that this country's legal system and much of its jurisprudence is derived from, and aligned with, the United.[147] In addition to its global, as opposed to schedular, approach to defining income, the United States does not follow usual concepts of international taxation, but instead is one of only two countries worldwide[148] to follow the unique citizen-based taxation approach. The United States imposes tax on the worldwide income of all its citizens, wherever located, despite the difficulty and expense for taxpayers and the Internal Revenue Service.[149]

The United States' tax net is cast widely and its financial clout has further enabled it to institute international tax evasion measures such as the Foreign Account Tax Compliance Act 2010 (FATCA) albeit the regime's onerous reporting obligations on foreign financial institutions has attracted criticism for amounting to "unilateral global extraterritorial application of US tax law".[150]

New Zealand's methods of taxation operate on fundamentally different premises and the reform documentation contains no explanation as to why the United States approach was considered appropriate or desirable. Richardson P's comments in *A Taxpayer* are indicative:[151]

> The approach taken to the reach of taxes over income in other jurisdictions with their different economies and with different assumptions as to the influence of property and other

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[145] John Snape "Montesquieu – 'The Lively President' and the English Way of Taxation?" in John Tiley (ed) *Studies in the History of Tax Law* (Hart Publishing, Oxford, 2012) 73 at 84.

[146] Charles Louis de Secondat 'De L'Esprit des lois' [1748] in *Montesquieu*, *Oeuvres completes* (R Caillois (ed)), 2 vols (Paris, Gallimard (Bibliothèque de la Pléiade), 1951) II at 225.

[147] See Richardson P's comment in *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350 at 13,350 that "[g]iven New Zealand's legal history it is not surprising that the courts looked to English jurisprudence for guidance".

[148] "Citizenship-based taxation: Only the United States" Relinquishment and Renunciation Guide <www.renunciationguide.com>.

[149] Cynthia Blum and PN Singer "A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals" (2008) 41 Vanderbilt J Transnatl L 705 at 706-707.

[150] Vivian Cheng and Neil Russ "The Foreign Account Tax Compliance Act" (paper presented to NZLS CLE Tax Conference, Auckland, September 2014) 157 at 160.

[151] *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350 at 13,356.

> concepts in the making of gains is not necessarily a sound basis for determining the scope and application of the New Zealand legislation.

Further telling of the differentiated tax net originating in the "pioneering, entrepreneurial, less static and more mobile United States"[152] is that capital gains fall within the ordinary meaning of income.[153] Richardson P's assessment is resounding: "legal rights and obligations cannot be ignored …Taxation by economic equivalence is impermissible."[154]

The Valabh Committee reiterates that the "new regime recognises that the economic substance of a trust may differ from its legal appearance".[155] It is, however, added that if the assumption of substantial settlor control does not accord with reality, New Zealand resident settlors can settle trusts on resident trustees in order to avoid a defaulting trustee's liability for income tax.[156] The assumption of control was, however, apt and particularly so when shortly after in 1992 the abolition of estate duty further retracted limits on settlor control.[157] Commentators have surmised that "settlors … exert considerable control over the trust for their own benefit without beneficially owning any of the trust assets".[158]

The reforms targeted the use of non-resident trustees in low tax environments and the Government was adamant that there be a price to pay for their continued utilisation. The settlor is the chosen "taxpayer of last resort" in this context and "liable as agent of the trustee" due to the impracticality of ascertaining beneficiaries as "their interests do not materialise until there is a distribution or vesting…mak[ing] it infeasible to tax beneficiaries on trust income".[159]

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152 At 13,356 per Richardson P.
153 *Eisner v Macomber* (1920) 252 US 189.
154 *A Taxpayer v Commissioner of Inland Revenue*, above n 151, at 13,356.
155 *International Tax Reform Full Imputation Part 1*, above n 132, at [6.3.1].
156 This consequence of settlor liability to tax as agent of the trustee is set out presently at section HC 29 of the ITA 2007.
157 To avoid estate duty, which did not apply to dispositions from trusts, under the Estate and Gift Duties Act 1955 property had to be fully alienated from the settlor as any retained control would lead to clawbacks into a notional estate: WM Patterson "When is a Trust a Trust?" (paper presented to the Legal Research Foundation Seminar "A Modern Law of Trusts", Auckland, 2009) at 4.
158 Nicola Peart, Mark Henaghan and Greg Kelly "Trusts and relationship property in New Zealand" 17(9) Trusts & Trustees 866 at 867.
159 *International Tax Reform Full Imputation Part 1*, above n 132, at [5.2.5].

In its first report the Valabh Committee acknowledged that New Zealand would not tax the foreign-sourced income of resident trustees of a trust with a non-resident settlor. Although now considered "controversial",[160] the lack of foresight of this consequence's implications is evident. This treatment was considered "appropriate…since such income has no definite connection with New Zealand apart from the existence here of the trust administrator".[161] The resident trustee's lack of beneficial interest was significant and the Valabh Committee was resigned to accept that resident trustees, if liable to tax, would resign in favour of non-resident trustees, therefore, "there is little to be gained from attempting to tax foreign-source income derived by resident trustees of non-resident trusts."[162]

Three months later in their 'Part 2' report, the previous recognition of a New Zealand connection is conspicuously absent. It is even stated that "[f]oreign trusts[163] have *no connection* with New Zealand apart from the residence here of a potential beneficiary".[164] No mention is made of the New Zealand resident trustee and John Prebble noted that the "thriving offshore trust industry in New Zealand … was certainly not the objective of the policy makers at the time."[165]

There is no explanation as to why the Valabh Committee subsequently failed to develop its previous acknowledgement that the residence of a trustee in New Zealand was a "definite" connection. The current existence of a foreign trust industry generating NZD $20 million[166] annually in fees seems to indicate that a resident trustee does represent an economic connection to New Zealand. The Valabh Committee resolved to apply the new regime to domestic and overseas trusts "with New Zealand connections",[167] nonetheless, in targeting the settlor's connection, to the exclusion of all others, the trustee's location of administration was left economically and legally unaccounted for.[168]

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[160] Craig Elliffe *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, Wellington, 2015) at [2.5.2].
[161] *International Tax Reform Full Imputation Part 1*, above n 132, at [5.2.5].
[162] At [5.2.5].
[163] This term superseded the 'non-resident trust' term used in the Part I report.
[164] (Emphasis added). *International Tax Reform Full Imputation Part 2*, above n 5, at [6.11.1].
[165] Citing his personal knowledge as a member of government advisory committees that worked on the question. See Prebble "New Zealand Taxation and Taxation Law", above n 77, at 126.
[166] International Funds Services Development Group *Exporting Financial Services* (Ministry of Economic Development, 1 February 2011) at 47.
[167] *International Tax Reform Full Imputation Part* 2, above n 5, at [6.1.2].
[168] See Appendix 2 for a table summarising the Valabh Committee's recommendations regarding settlor residence, trustee residence and New Zealand taxation.

2 *An exception to the norms of international taxation*

As highlighted by the Law Commission, the normal operation of residence-based taxation would entail that resident trustees are liable to tax on worldwide income.[169] The existence of such a noteworthy deviation from the foundational principles underlying New Zealand's general approach to taxation was justifiable on the basis of protecting the tax base from erosion within. However, the tax practices of New Zealand citizens are presently less concerning to the Government amidst a modern post-GFC climate of scrutiny and weariness surrounding the methods of international tax players.

[169] Law Commission *Second Issues Paper*, above n 88, at [3.53].

Chapter III: An International Catalyst for Change?

A Base Erosion and Profit Shifting (BEPS)

At the 2012 Summit in Los Cabos, Mexico, the G20 leaders declared the "need to prevent BEPS" in support of the OECD's ongoing work in this area.[170] BEPS subsequently formed the subject matter of a major OECD report[171] published to coincide with the 2013 St Petersburg summit. A 15-point Action Plan[172] was then formulated and published in July 2013.

New Zealand has been an "active" member of the OECD since 1973.[173] In its briefing to incoming Minister of Revenue Todd McClay, Inland Revenue highlighted New Zealand's ongoing participation in the OECD's BEPS project.[174] To illustrate the domestic impact of, and governmental responsiveness to, the OECD's work, one only has to look as far as the recently released[175] discussion document "GST: Cross-border services, intangibles and goods", of which the proposed rules align with OECD guidelines[176] developed in furtherance of its Action Item 1 'Addressing the tax challenges of the digital economy'.[177] Exploring options to collect GST on online products was one of two initiatives to ensure tax rules keep pace with the global economy in Inland Revenue's "Taxation of Multinationals" policy report: the other was reviewing the tax treatment of foreign trusts.[178]

Inland Revenue has supplemented the OECD's deliverables with its own projects on the tax policy work programme that investigate domestic law changes to help combat BEPS.[179] This

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170 "G20 Leaders Declaration: G20 Summit Communiqué: full text" (20 June 2012) The Telegraph <www.telegraph.co.uk>.
171 OECD *Addressing Base Erosion and Profit Shifting* (OECD Publishing, Paris, February 2013).
172 OECD *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, Paris, July 2013).
173 "List of OECD Member countries - Ratification of the Convention on the OECD" <www.oecd.org>.
174 "Briefing for the Incoming Minister of Revenue – 2014" (5 August 2013) Inland Revenue <www.ird.govt.nz>.
175 The discussion document was released on 18 August 2015 with submissions due 25 September 2015.
176 Policy and Strategy, Inland Revenue *GST: Cross-border services, intangibles and goods* A government discussion document (Inland Revenue, 18 August 2015) at [1.2].
177 OECD *Action Plan on Base Erosion and Profit Shifting*, above n 172, at 14; the draft guidelines, as cited in the discussion document, are available at http://www.oecd.org/ctp/consumption/discussion-draft-oecd-international-vat-gst-guidelines.pdf.
178 Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals*, above n 7, at 15.
179 "Briefing for the Incoming Minister of Revenue – 2014" (5 August 2013) Inland Revenue <www.ird.govt.nz>.

is undoubtedly in response to the OECD's call to action on countries to develop how their domestic tax laws contribute to BEPS.[180] Inland Revenue certainly does not consider itself limited by the scope of the OECD's project in addressing potential deficiencies identified internally.[181]

BEPS broadly refers to the loss of corporate revenue as a result of planning techniques aimed at shifting profits in a manner that erodes the taxable base to locations where such profits receive a more favourable tax treatment.[182] It is a newly coined adage used in the targeting of global corporates who exploit the interplay of different tax rules leading to non-taxation or instituting arrangements whereby profits are shifted away from the jurisdiction wherein the substantive economic activity takes place.[183]

Considerable media attention has been concentrated on large multinational enterprises (MNEs) whose reliance on intangibles and presence in the digital economy enable a potentially heavy involvement in the economic life of a country without the establishment of a taxable presence. Such MNEs include instantly recognisable names of the calibre of Google, Amazon, Apple and Starbucks. A 2013 BBC news article charting the rise of "tax-shaming"[184] highlights the compelled appearance of high-profile MNEs in front of the United Kingdom's Public Accounts Committee: a direct result of backlash from stories published by the Daily Telegraph, Reuters and the Guardian.[185] The reputational effect is considerable and is attributable to the impacts of public spending cuts and austerity programmes. It is inarguable that in the post-GFC era there is a wider role for public opinion and a readiness to act on any sense of unease despite the legality of various tax efficient methods.

While the shifting of profits and intellectual property rights to low tax jurisdictions does not offend the letter of the law, the morality of such business practices is being called into

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[180] OECD *Explanatory Statement* OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Paris, 2014) *www.oecd.org/tax/beps-2014-deliverables-explanatory-statement.pdf* at 4.

[181] Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals*, above n 7 at 15.

[182] OECD *Addressing Base Erosion and Profit Shifting*, above n 171, at 13.

[183] OECD *Action Plan on Base Erosion and Profit Shifting*, above n 172, at 10.

[184] Vanessa Barford and Gerry Holt "Google, Amazon, Starbucks: The rise of 'tax shaming'" *BBC News Magazine* (online ed, London, 21 May 2013).

[185] Vanessa Barford and Gerry Holt "Google, Amazon, Starbucks: The rise of 'tax shaming'", above n 184.

question.[186] The OECD is perspicuous that notwithstanding the legality of BEPS schemes, the issue is primarily one of anti-competitive effects and ultimately “an issue of fairness”.[187]

Ideals of fairness are not without potential counter-arguments. The goal of shareholder wealth maximisation (SWM) would normally require the implementation of tax minimisation techniques so as to enhance returns. Professor Avi-Yonah posits that the prevailing “nexus of contracts” view of ‘the company’, dominant among contemporary corporate scholars, provides the “most interesting debate” in terms of Corporate Social Responsibility (CSR) and tax.[188]

Under the widely held ‘web of contracts’ view, CSR is not a legitimate function: companies do not pay taxes to bolster society therein managers should engage in strategic behaviour to minimise tax pursuant to their responsibility to shareholders. Even writing in the pre-BEPS era, such an argument was held to be misguided because it would result, in the extreme, in inadequate public finances to fulfil the essential social obligations for which the government should have exclusive responsibility,[189] thus revealing an internal contradiction in Milton Friedman’s proposition that the sole social responsibility of business is to increase profits.[190]

SWM no longer holds favour in the post-GFC economic climate. The cautionary approach to government revenues and continued austerity in Europe and a lingering hostility towards the business sector are legacies of the GFC, which in turn led to the very existence of the BEPS

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186 Greg Thompson “BUDGET 2014: Time to tackle tax on multinationals” *The National Business Review* (online ed, New Zealand, 5 April 2014).

187 “BEPS - Frequently Asked Questions” OECD <www.oecd.org>.

188 RS Avi-Yonah “Corporate Social Responsibility and Strategic Tax Behavior” in Wolfgang Schön (ed) *Tax and Corporate Governance* (Berlin, Springer-Verlag, 2008) vol 3 183 at 184.

189 At 195.

190 In his 1970 article “The Social Responsibility of Business Is To Increase Its Profits” *The New York Times* (New York, 13 September 1970) Friedman notes that “[t]he imposition of taxes and the expenditure of tax proceeds are governmental functions … The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for ‘social’ purposes”.

project.[191] In a movement marked out by its politicisation it is unsurprising that CSR, not SWM, is the currency traded on to induce governmental and OECD responses.[192]

Dave Hartnett noted in 2006, with prophesying accuracy, that the unqualified assertion that tax in the UK is about the application of black letter law is no longer acceptable.[193] When a government proclaims that taxpayers must pay their 'fair share' of tax, as has happened in New Zealand,[194] one response is that 'fair' amounts to the minimum required by law. The more recent trend, however, is to value good reputation above the financial benefits of aggressive planning.

Tax should not be perceived as voluntary as this instils scepticism and a sense of injustice in taxpaying members of society. It is a fundamental constitutional principle that tax can be only levied by Parliament.[195] Nevertheless, the public perception of tax paid by companies tends to indicate a lesser understanding of the amorphous nature of tax as it exists beyond the personal income, namely salary and wages, level. The creativity of tax advisers working within the bounds of the law is seen to be unprecedented in a profession usually distinguished by its caution[196] Despite the business world's demand for such expertise, the tax advisory profession has come under fire as was seen by the "walloping"[197] of the 'Big 4' accountancy firms conducted in the UK in 2013.[198]

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[191] Casey Plunket "The BEPS Project – OECD keeps tax reform pot boiling" (2 October 2014) Chapman Tripp <www.chapmantripp.com>.

[192] The causes of politicisation have been described as "enduring global economic instability [that] has resulted in a drop in government tax revenue and a corresponding squeeze on public expenditure…[and] increased media, activist, and, generally, public awareness and criticism of the way multinational enterprises…arrange their tax affairs.": MN Kandev and Nathan Boidman "BEPS: The OECD Discovers America?" (2013) 72 *Tax Notes International* 1017.

[193] Dave Hartnett "The Link Between Taxation and Corporate Governance" in Wolfgang Schön (ed) *Tax and Corporate Governance* (Berlin, Springer-Verlag, 2008) vol 3 3 at 5.

[194] Roger Douglas' preface to the 1987 Consultative Document included the comment that "[t]o the extent that the tax base is broadened and more people pay their *fair share* of tax, rates of taxation can be lowered." More recently, John Key stated that "big multi-nationals should pay their fair share of tax. While they may be paying what is legally correct, the question is, is that ethically the right amount of tax for them to be paying?": Bernard Hickey "Key wants Multinationals like Google to pay fair share of tax" (24 February 2014) Hive News <www.hivenews.co.nz>.

[195] See Article 1 of the Bill of Rights 1688, and its continued application in New Zealand under the Imperial Laws Application Act 1988, s 3 and Schedule 1.

[196] Dave Hartnett "The Link Between Taxation and Corporate Governance", above n 193, at 4.

[197] Polly Toynbee "Accountancy's Big Four are laughing all the way to the tax office" *The Guardian* (online ed, London, 1 February 2013).

[198] Tom Bergin "MPs press accountants on tax avoidance" *Reuters* (online ed, London, 31 January 2013).

Significantly, the second introductory sentence of the OECD's BEPS report lists recent news stories attacking tax avoidance from world renowned news agencies.[199] Public perception is manifestly paramount. Indeed it is emphatically stated that despite the relative insignificance of lost corporate revenue as a proportion of total revenue, there is a "wider relevance because of its effects on the perceived integrity of the tax system."[200] The Action Plan explicitly acknowledges the evolved "tense" situation in which citizens are increasingly sensitive to tax fairness issues.[201]

The OECD's 15 point Action Plan has as its main aim the better alignment of rights to tax with economic activity[202] and notes that actions to address BEPS will restore both source and residence taxation in cases where cross-border income is untaxed or lightly taxed.[203] Action Item 5 is arguably the broadest and, therefore, most relevant in a trusts context as the OECD does not specifically target trusts. It consists of countering harmful tax practices more effectively, taking into account transparency and substance.

Actions 11, 12 and 13 - preceded by the explanatory heading "Ensuring transparency while promoting increased certainty and predictability"[204] - include reference to the progress made by the Global Forum on Transparency of Information for Tax Purposes ('the Global Forum'). The Global Forum's 2013 Peer Review Report assessed New Zealand's implementation of its international standards. In reviewing the trust as one of New Zealand's "main business structures"[205] the forum noted the lack of general obligation to register a trust with the exception of foreign trusts.[206] The foreign trust disclosure requirements were introduced in 2006 to placate the Australian Taxation Office's (ATO) concerns that foreign trusts were being used to avoid Australian tax. The ATO ruled that: [207]

[199] Such as Bloomberg's, the New York Times and Reuters: OECD *Addressing Base Erosion and Profit Shifting*, above n 171, at 13.
[200] OECD *Addressing Base Erosion and Profit Shifting*, above n 171, at 15.
[201] OECD *Action Plan on Base Erosion and Profit Shifting*, above n 172, at 8.
[202] At 11.
[203] At 11.
[204] At 21.
[205] OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: New Zealand 2013: Combined Phase 1 + Phase 2 Report, incorporating Phase 2 ratings* (OECD Publishing, Paris, November 2013) at 8.
[206] Required by section 59B of the Tax Administration Act 1994.
[207] Australian Taxation Office *Income tax: application of the Australia/New Zealand Double Tax Agreement to New Zealand Resident Trustees of New Zealand Foreign Trusts* (Australian Taxation Office, Taxation Ruling TR 2005/14, 27 July 2005).

> New Zealand foreign trusts have been marketed to Australian residents as a tax effective offshore trust structure which allows tax free accumulation of income and capital in an offshore entity.

The parallel between the alleged use of foreign trusts by Australians and the historic use by New Zealanders of offshore trusts targeted by the 1988 reforms is striking. In its 2005 double taxation agreement (DTA) negotiations, Australia stipulated that New Zealand resident trustees do not fit within the definition of a treaty resident, although this is a contentious assertion.[208] Despite highlighting uncertainty in the size of any perceived avoidance of tax via New Zealand foreign trusts (NZFTs), Inland Revenue cited the need to assuage Australian complaints and comply with OECD-developed standards as explanation for the newly introduced disclosure requirements.[209] The willingness of the New Zealand Government to bow to pressure from its trading partners is interesting. Significantly, the 2013 Peer Review Report found New Zealand to have "an excellent bilateral relationship with its major exchange of information partners, in particular with Australia" and generally to employ exchange of tax information practices of a "very high standard".[210]

Despite Inland Revenue explicitly acknowledging that New Zealand does not have tax practices considered harmful by the OECD,[211] there is discontentment with politicians and in the media[212] regarding transparency and disclosure requirements. The BEPS phenomenon is proof that attention in the political arena should be taken seriously. Although the bulk of the 15-point Action Plan is concerned with corporate income tax,[213] the OECD's initial work has provided a platform for Inland Revenue to proceed with domestic initiatives, including a review of the tax treatment of foreign trusts before the end of 2015.[214]

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208 See, for example, Jeremy Beckham and Craig Elliffe "New Zealand's foreign trust regime and the use of tax treaties" (2012) 18(9) Trusts & Trustees 833-847 which agrees with the exclusion of resident trustees from treaty benefits versus the more recent article of Geoffrey Cone "New Zealand trusts and double taxation agreements" (2014) 20(3) Trusts & Trustees 268-279 which argues such a prohibition is erroneous.

209 Inland Revenue *New Disclosure and Record-Keeping Rules for Foreign Trusts* (Inland Revenue, Tax Information Bulletin Vol 18 No 5, 2006) at 107.

210 OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews*, above n 205, at 9.

211 See the table 'Summary of BEPS actions" in Appendix 1 of Policy and Strategy, Inland Revenue *Tax policy report: BEPS progress update* (Inland Revenue, IR2014/366, August 2014).

212 For example, Tim Hunter "NZ foreign trusts among global tax havens" *Stuff* (online ed, New Zealand 22 August 2012) and Chris Barton "Taxation's black hole" *The New Zealand Herald* (online ed, Auckland, 2 November 2012).

213 Such issues include transfer pricing, hybrid mismatch arrangements and Controlled Foreign Company rules, which are not directly relevant for the purposes of this dissertation.

214 Policy and Strategy, Inland Revenue *Tax policy report: BEPS progress update*, above n 9, at 16.

This dissertation seeks to analyse the application of BEPS measures to trusts in two ways: firstly, whether the deviation from source and residence based taxation is causative of any concerning misalignment of taxation and economic substance of foreign trusts; secondly, vis-à-vis the aims of improved transparency and exchange of information, whether present disclosure requirements are adequate.

B The Development of the Foreign Trust Industry in New Zealand

As previously outlined, there was no conscious government initiative to create what has been labelled a "cottage industry"[215] of foreign trust services in New Zealand. The Valabh Committee was combatting the converse situation: New Zealanders using trusts in 'tax havens'. Although the consequence that foreign-sourced income of resident trustees would not be taxable was identified, it was paid little attention as a New Zealand trust property administrator did not attribute foreign income with a "definite connection".[216] The trustee had "no beneficial interest in the income"[217] a seemingly important factor in this context, although Inland Revenue has subsequently tended to 'pick and choose' when the trust's split title is important.

The motivation for the reforms need not be undermined by the unforeseen burgeoning of the foreign trust industry. A better question to ask is whether the taxation rules have come full circle: specifically, can New Zealand now justifiably be criticised for being just the type of 'tax haven' its 1988 reforms were designed to protect against? Is there substance to the concerns of the ATO or the claim in Inland Revenue's "Taxation of Multinationals" report that "our foreign trust rules continue to attract criticism, including claims that New Zealand is now a tax haven in respect of trusts"? It is necessary to trace the origins of the foreign trust industry in an attempt to analyse its relative significance, or lack thereof.

By exempting foreign trusts from income tax, New Zealand has a feature in common with traditional "offshore" jurisdictions such as various jurisdictions in the Channel Islands and

[215] Adam Bennett "Foreign trusts in IRD sights" *The New Zealand Herald* (online ed, Auckland, 27 November 2014).
[216] *International Tax Reform Full Imputation Part 1*, above n 132, at [5.2.5].
[217] At [5.2.5].

the Caribbean.[218] Unlike, for example, The Bahamas and the Cayman Islands, New Zealand has not legislated to incorporate wider powers for settlors.[219] Such statutory recognition has confounded the perception of a trust as a "more settlor-responsive property management device".[220] New Zealand law has not altered the nature of equity's most enduring and important legacy and the Trustee Act 1956 is largely a default piece of legislation able to be opted out of.

New Zealand's "sophisticated levels of advice from lawyers and accountants"[221] and the fact it is, to adopt the description of Inland Revenue, a stable English-speaking country with a strong rule of law and a well-developed body of trust case law,[222] as well as its good reputation as an international tax citizen[223] make it, to use the Prime Minister's own words, "a very sensible place to house a trust".[224] Several more obviously self-serving trustee services' advertisements repeat with remarkable repetition various incentives.[225]

A select number of wealth management professionals became wise to such advantages in the aftermath of the 1988 reforms. However, the "real impetus"[226] for the development of the foreign trust industry has been cited as the introduction of tax haven blacklisting by various Latin American governments in the late 1990s.[227] New Zealand has not appeared on any such

[218] Law Commission *Preferred Approach*, above n 16, at [1.18].
[219] For example, for example by specifically allowing the settlor power to consent or direct the trustee in the exercise of any of its powers.
[220] Donovan Waters "Settlor Control – What Kind of Problem is it?" (2009) Trusts & Trustees 12 at 13.
[221] Law Commission *Preferred Approach*, above n 16, at [1.18].
[222] Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals*, above n 7, at 15.
[223] "[B]ecause New Zealand is a member of the OECD and is generally regarded as having a rigorous and robust taxation regime consistent with best international tax practice…New Zealand is not on any of … 'blacklists'": Richard Taylor "Using New Zealand based foreign trusts" 22(1) Journal of International Tax, Trust and Corporate Planning 27 at 31.
[224] Matthew Backhouse "Dunne dismisses tax haven suggestions" *The New Zealand Herald* (online ed, New Zealand, 8 October 2012).
[225] See Appendix 2 for a table summary of these advertisements' touted incentives.
[226] JW Hart "New Zealand Foreign Trusts – A Vehicle for International Wealth Planning" IFC Review <www.ifcreview.com>.
[227] See the explanation in International Funds Services Development Group *Exporting Financial Services*, above n 166, at 47 that "[t]he New Zealand Foreign Trust industry has been growing steadily since tax changes were introduced on 1 April 1988, but particularly since global settlors exited blacklist jurisdictions in the 1990s".

blacklists[228] and became a viable option for advisers seeking to provide asset protection solutions to wealthy clients.

1 Deviation from source and residence based principles of taxation

New Zealand implements a measure of extra-territoriality in its taxation, beyond that of the normal residence-based paradigm, by subjecting *non*-resident trustees' foreign-sourced income to income tax in the case of a trust with a New Zealand settlor. Residence-based taxation is also excepted insofar as foreign-sourced income of *resident* trustees is not taxable. Inland Revenue was clear in 1988 that "in economic terms the residence of the settlor provided a more appropriate basis for taxing foreign-sourced trustee income than did the residence of the trustee"[229] but it is the trustee, not the settlor, who legally derives income.

In its initial 2013 BEPS the OECD notes that: [230]

> … fundamentally, a holistic approach is necessary to properly address the issue of BEPS. Government actions should be comprehensive and deal with all the different aspects of the issue … for example, the balance between source and residence taxation.

Inland Revenue clearly has such an approach in mind when it notes that, like other countries, New Zealand's starting point is the paradigmatic source and residence based taxation.[231] The OECD concern is with techniques that shift profits away from the substantive economic activity that generates them. Inland Revenue recommended "initiatives to protect the New Zealand tax base from BEPS should be a key area of focus".[232] One commentator has suggested that an underlying issue in BEPS is the primary question of who has fiscal jurisdiction to tax income: the so called 'elephant in the room' is the "demise of an internationally agreed and consistent system determining jurisdiction to tax, as a result of

[228] A state of affairs that continues to present day, see the table at page 8 of Jason Sharman and Gregory Rawlings "Deconstructing National Tax Blacklists Removing Obstacles to Cross-border Trade in Financial Services: A report prepared for the Society of Trust and Estate Practitioners" (paper presented at the 'Beyond the Level Playing Field?' Symposium, London, 19 September 2005).
[229] Inland Revenue *Explanation of Taxation of Trusts: Appendix*, above n 91, at [10.15].
[230] OECD *Addressing Base Erosion and Profit Shifting*, above n 171, at 7.
[231] Policy and Strategy, Inland Revenue *Tax Policy Report: Taxation of multinationals*, above n 7, at [15].
[232] At [21].

increasing exceptions to the rules”.[233] Professor Roy Rotaghi, an expert with extensive experience in international taxation, describes the general principle that ‘connecting’ factors give a State the right to tax by linking the taxpayer to the jurisdiction.[234]

Personal links may be residence or citizenship for individuals or the place of incorporation for legal persons. Presently, the more important idea is that in source-based taxation, it is an economic activity which is connected to the state, which then exercises its taxing rights based on a territorial link. In describing the source rule, Rotaghi elucidates that:[235]

> Limited taxation rights are granted to the country of source due to the economic attachment of persons. The country of source reserves the right to tax the income that is derived from the economic activities within its territory.

Significantly, as explained above, the trust rules represent a departure from the residence-based principle of taxation. New Zealand sourced income is still universally taxable and it is this component of orthodox international tax principles that is tied to economic activity. This outcome is coherent in the context of the 1988 reforms which targeted economic realities. Prebble reiterates that section HC 26[236] reflects governmental fiscal policy and the view that if a foreigner settles property on New Zealand resident trustees, the management of such assets is an inadequate ground for taxing the income of that property.[237] Such a view is conducive to the early 1990s era where “increasing productive investment [was] a key part of the Government’s economic strategy”.[238] The Government adhered to the general maxim that “New Zealand should reduce the taxes imposed on non-residents”.[239] It was indeed Prebble’s own arguments that legal ownership, which is “simply the form of the trustee’s controlling interest”[240] and “does not represent the substance of the position…therefore should not be

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[233] Monique van Herksen “The OECD BEPS Report: The story of the Elephant, the 800-pound Gorilla and the Tiger” (2013) International Transfer Pricing Journal (accessed online Bloomberg BNZ <www.bna.com>).
[234] Roy Rotaghi *Basic International Taxation* (2nd ed, Richmond: Richmond Law & Tax, 2005) vol 1 at 14-15.
[235] At 15.
[236] This section contains the departure from residence-based taxation.
[237] John Prebble “The New Zealand Offshore Trust Regime” (2012) 2(7) VUWLRP 28/2012 at 1.
[238] *Taxing Income Across International Borders: A Policy Framework* (New Zealand Government, Wellington, 30 July 1991) at 7.
[239] At 7.
[240] Prebble “The New Zealand Offshore Trust Regime”, above n 237, at 1.

decisive as to taxability",[241] that were successfully advanced in 1987 when he served on the Valabh Committee.[242]

To the extent that there is a concern this exception to international taxation principles is contributing to BEPS by misaligning economic activity from legal reality, there is no cause for concern. The foreign trust industry is an economic activity, but its revenues are subject to tax in the hands of New Zealand administrators in the normal way. The New Zealand Government should not consider itself responsible for tax policing the treatment of foreign beneficiaries' foreign-sourced income.

2 Issues of transparency and disclosure

As is often the case with widely used institutional terms there is no universally accepted definition of what a 'tax haven' means.[243] The most referenced 'definition' is the OECD's four indicative characteristics set out in its 1998 report addressing harmful tax practices.[244] The 1998 report was the genesis for BEPS Action Item 5. Its four key identifying factors are: no or low taxes, lack of effective exchange of information, lack of transparency, and no requirement of substantial activity.[245]

The OECD distinguished between tax havens and other non-tax haven jurisdictions that have features constituting harmful tax competition ("potentially harmful preferential tax regimes").[246] Various "other factors" are listed including, relevantly for trusts, access to a

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[241] At 1.
[242] At 4, see n 3. Prebble's reasoning is fully set out in "New Zealand Trusts in International Tax Planning" [2000] 5 BTR 554 and is essentially that trustees are economic agents because settlors transfer property to trusts to avoid future uncertainty, thus trustees administer property the way settlors would themselves were it not for intervening events such as death and other risks to property.
[243] The lack of a settled definition has been considered a "central problem in the debate on tax havens": Gary Tobin and Keith Walsh "What Makes a Country a Tax Haven? An Assessment of International Standards Shows Why Ireland Is Not a Tax Haven" (2013) 44(3) The Economic and Social Review 401 at 402.
[244] OECD *Harmful Tax Competition: An Emerging Global Issue* (OECD Publishing, Paris, 1998).
[245] At 23. The immediate mention of these factors by Jane Gravelle, Senior Specialist in Economic Policy for the US Congressional Research Service, when describing the definitional scope of tax havens in 2015 shows the weight such criteria still bears: JG Gravelle *Tax Havens: International Tax Avoidance and Evasion* (Congressional Research Service, prepared for Members and Committees of Congress, January 15 2015) at 3.
[246] At 20. Preferential tax regimes have the following four key identifying factors: no or low taxes, "ring-fencing" of regimes, lack of transparency and a lack of effective exchange of information: OECD *Harmful Tax Competition: An Emerging Global Issue*, above n 244, at 27.

wide network of tax treaties and regimes that are promoted as tax minimisation vehicles. There is explicit acknowledgement that "in many cases, the regime may have been *designed specifically* to act as a conduit for routing capital flows across borders".[247] This is decidedly not the case in New Zealand and no New Zealand regime featured in the list of "Potentially Harmful Regimes" identified in 2000.[248]

The OECD Committee on Fiscal Affairs concluded that it had fulfilled its mandate of dealing with harmful preferential tax regimes.[249] However, the work targeting preferential regimes was not left dormant for long. The OECD's desire was so stated to: [250]

> [r]evamp the work on harmful tax practices with a priority on improving transparency … and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in a BEPS context.

Could such a renewed fervour and differentiated approach mean that New Zealand's extant regimes would be reviewed with a pair of fresh 'BEPS-focussed eyes'? New Zealand appears safe thus far from scrutiny under this "key pressure area"[251] in a trusts regime context.[252] It is also perhaps telling of the broad BEPS lens that the 'substantial activity' requirement, previously a 'tax haven' indicator, is now characteristic of the preferential regimes scope. This reflects the decreasing relevance of tax haven 'blacklisting'.

The jurisdictions originally listed as tax havens by the OECD in 2000[253] have made commitments to standards of transparency and exchange of information to such an extent that

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[247] (Emphasis added). At 25.

[248] Unlike, for example, Australia's offshore banking units regime (although this was held to be 'not harmful'): see OECD *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries* (OECD Publishing, Paris, 2006) at 5.

[249] The Committee then sought to limit its role in this area to a monitoring, supervisory, as opposed to investigative function: OECD *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries*, above n 248, at 6.

[250] OECD *Action Plan on Base Erosion and Profit Shifting*, above n 172, at 18.

[251] OECD *Action Plan on Base Erosion and Profit Shifting*, above n 172, at 17. It is interesting to note the self-referential nature of why harmful tax practices are considered to be a continuing "key pressure area", namely the OECD interim report cites their inclusion in the BEPS 2013 report and Action Plan as evidence of their continued relevance.

[252] Focus is concentrated on across the board rate reductions on financial activities or the provision of intangibles: see OECD *Action Plan on Base Erosion and Profit Shifting*, above n 172, at 17.

[253] The OECD now states on its website that this list should be seen in its "historical context": "2000 Progress Report: Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices" OECD <www.oecd.org>.

by 2009 the remaining three countries were removed from its now euphemistically labelled list of "uncooperative" tax havens.[254] The emphasis has shifted from 'naming and shaming' to encouraging compliance.[255] Accordingly, the 'tax haven' label should not be used lightly.

As part of the OECD progressing its BEPS project, its 'deliverables' included a set of measures and reports released in September 2014, amongst which featured an interim report examining Action Item 5. Insofar as the interim report builds on countries' more recent commitment to strengthening substantial activities' requirements,[256] the aforementioned conclusion that the trusts regime does not ignore economic substantive activity is equally applicable.

There are three stages in identifying a harmful preferential regime.[257] First, the foreign trusts regime likely does fall within the scope of the 1998 report by applying to a geographically mobile financial services activity.[258] The regime satisfies the second filter of inquiry as it offers a tax preference compared with the general principles of taxation by exempting the income of New Zealand resident trustees: normally all residents are subject to income tax.[259] New Zealand residents, including trustees who legally derive the income of foreign trusts, have assessable income but this will not include trustees' foreign-sourced trustee income as this is 'exempt income' under section CW 54 of the ITA. Such treatment is "preferential *in comparison with the general principles of taxation in the relevant country*".[260] The third inquiry requires application of the four key factors and eight other factors.

[254] "List of Unco-operative Tax Havens" OECD <www.oecd.org>.
[255] For example, the original Global Forum, created in the early 2000s to address the risks to tax compliance posed by tax havens, was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes in 2009.
[256] OECD *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance* (OECD Publishing, Paris, September 2014) at 10.
[257] These stages are set out in the 1998 report and reproduced in the 2014 report: OECD *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency*, above n 256, at 21.
[258] A trust is mobile in this sense in that, for example, a New Zealand trust administrator can manage assets located anywhere in the world on behalf of beneficiaries similarly located anywhere in the world.
[259] Income Tax Act 2007, s BD 1(5): assessable income is all income with the exception of non-residents' foreign-sourced income. A foreign-sourced amount is income not treated as having a source in New Zealand pursuant to section YD 4 and section YA 1 of the Income Tax Act 2007.
[260] (Emphasis added). OECD *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, above n 256, at 22.

The BEPS-inspired "priority and renewed focus"[261] on requiring substantial activity is novel:[262] an absence of a substantial activity requirement suggests a jurisdiction is attempting to attract investment or transactions purely for tax reasons.[263] But there was certainly no directed government effort in 1988 to attract such investment and there has been no explicit government support since that time.[264] Additionally, the scheme of the 2014 report leaves no doubt that the real focus is on intangibles.[265]

New Zealand did not feature in the list of "Regimes other than intangible regimes" in the 2014 interim report, unlike Australia for example.[266] This undoubtedly helped form the basis for Inland Revenue's sense of security in stating in November 2014 that it is comfortable with the direction the OECD's work is taking in this area.[267] It is not plausible to accept that New Zealand "does not (or cannot) provide a legal or commercial environment or offer any economic advantages that would attract substantive business activities in the absence of the tax minimising opportunities it provides".[268] Although New Zealand was listed in 2014 as having the second most competitive tax system in the OECD[269] there are many entirely separate advantages to using a NZFT.

A 2011 Cabinet-commissioned report explored the 'major opportunity' for New Zealand to become a 'funds domicile and funds administration centre'.[270] The foreign trust industry was referenced as an example of New Zealand's aptitude in the financial services sector. The

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[261] At 27.
[262] The substantial activity requirement does, however, build on the fourth key 'tax haven' indicative factor of the 1998 *Harmful Tax Practices* report.
[263] OECD *Harmful Tax Competition: An Emerging Global Issue*, above n 244, at 23.
[264] As emphasised in International Funds Services Development Group *Exporting Financial Services*, above n 166, at 47.
[265] See, for example, "[r]egimes that provide for tax preference on income relating to intangible property raise the base eroding concerns that are the focus of the [Forum on Harmful Tax Practice's] work.": OECD *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, above n 256, at 28.
[266] Australia's conduit foreign income regime was subject to review but again it was concluded to be 'Not harmful': at 58.
[267] Policy and Strategy, Inland Revenue *Tax policy report: BEPS progress update*, above n 9, at [43]. The statements were no doubt made in anticipation of the upcoming comprehensive report on Action Item 5, to be released 5 October 2015 as part of the final package of the OECD's BEPS measures.
[268] OECD *Harmful Tax Competition: An Emerging Global Issue*, above n 244, at 24.
[269] The Tax Foundation's International Tax Competitiveness Index (ITCI) measures the degree to which the OECD countries' tax systems promote competitiveness through low tax burdens on business investment and neutrality through a well-structured tax code. The ITCI considers more than forty variables across five categories. See Kyle Pomerleau and Andrew Lundeen "International Tax Competitiveness Index" (15 September 2015) Tax Foundation <www.taxfoundation.org>.
[270] International Funds Services Development Group *Exporting Financial Services*, above n 166, at 5.

International Funds Service Development Group (IFDSG) listed New Zealand's competitive advantages as including its depth of infrastructure, good laws, good reputation, membership of the OECD, limited bureaucracy and appropriate regulation.[271]

Moreover, in the variables assessed in the International Tax Competitive Index, New Zealand performed poorly in the 'International Tax Rules' section.[272] This is understandable when one considers that the fundamental goal for which the international tax regime was overhauled in 1988 was protecting the New Zealand tax base. The regimes it instituted[273] aimed to reduce the utilisation of foreign entities to avoid New Zealand tax. The tax competitiveness of the foreign trust regime was simply an unforeseen by-product.

A second key priority of Action Item 5 is improving transparency. Since 1 October 2006 foreign trusts have been subject to disclosure requirements.[274] Resident trustees must disclose: the "name or other identifying particulars (for example, the date of settlement of the trust)" as well as the "name and contact particulars" of the resident trustees; and whether a settlor is resident in Australia.[275]

Significantly, for Australian settlors, Inland Revenue stipulated[276]at the time of enactment that it would periodically request information such as financial records, details of distributions[277] and the identity of the settlor from resident foreign trustees. There is no legal requirement to disclose settlor identity and to this extent the Commissioner would be

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[271] At 47.

[272] New Zealand ranked 22nd out of 34 member countries. Its poorly scoring international tax regulations were in part responsible: it is said that "[i]nternational tax…regulations place substantial burdens on companies and require them to shift valuable resources away from production and toward accountants and tax lawyers.": Kyle Pomerleau and Andrew Lundeen "International Tax Competitiveness Index" (15 September 2015) Tax Foundation <www.taxfoundation.org> at 25.

[273] These regimes are "a branch-equivalent regime, a foreign investment fund regime, and a revised trust regime": *International Tax Reform Full Imputation Part 2*, above n 5, at v.

[274] Tax Administration Act 1994, s 59B.

[275] If the resident trustee is a "qualifying resident foreign trustee", the name of the approved organization and the name and contact particulars of the member must be disclosed. Approved organisations are the New Zealand Law Society, the New Zealand Institute of Chartered Accountants and the New Zealand Branch of the Society of Trust and Estate Practitioners. The specified organisations are listed on the web page where taxpayers download the IR607 "Foreign trust disclosure" form. The publication of such information is excluded from Inland Revenue secrecy requirements: see section 81(4)(mb) Tax Administration Act 1994.

[276] Inland Revenue *New Disclosure and Record-Keeping Rules for Foreign Trusts*, above n 209, at 108.

[277] It should be noted that all resident foreign trustees are required to keep records sufficient to calculate the trust's income, together with records of distributions in accordance with section 22(2)(fb) of the Tax Administration Act 1994.

exercising her powers under section 17 of the Tax Administration Act 1994 (TAA). Inland Revenue provides information on a "regular basis" to the ATO. The requirement to disclose a settlor's Australian residence was considered necessary to ensure Inland Revenue could request and provide information to the ATO.[278] Interestingly, however, Inland Revenue was quick to emphasise that Australia is the "only country to which New Zealand is proposing to provide information to on this basis".[279] In respect of its 38 other DTA partners, requests will be examined on a case-by-case basis and general "fishing expeditions" will *not* be entertained.

Such specifications serve to enforce an overall reticence of Inland Revenue to disclose information to foreign tax authorities. However, this 2006 statement may no longer currently reflect the position. It was more recently observed that in order to "protect our international reputation it may be necessary to strengthen our regulatory framework for disclosure and record-keeping".[280] The potential increased costs of such disclosure, collection and reporting of information has prompted Inland Revenue to question whether the present foreign trust rules are sustainable at all. Thus the disclosure issue is seemingly pivotal.

The foreign trusts regime had attracted media and political attention prior to the BEPS project, albeit Inland Revenue's interest was piqued only after the OECD's work came to the fore. A 60 Minutes segment on 7 October 2012 asserted that New Zealand was a tax haven of the ilk of Panama.[281] The seeds of dissidence were quickly sewn. It may even have been an August 2012 Stuff article which prompted the segment, outlining as it did that "foreign trusts don't have to tell anyone what they own, how much money they make or who benefits from anything they pay out"[282] labelling this a "veil of secrecy" and highlighting the regime as "obviously advantageous to tax dodgers and criminals". The ATO had warned Australian residents in May 2012 that marketers of NZFTs might be applying DTA benefits

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[278] The rule forms the basis of the exchange of information pursuant to the New Zealand/Australia Convention for the Avoidance of Double Taxation 1995, Article 26.

[279] Inland Revenue *New Disclosure and Record-Keeping Rules for Foreign Trusts* (Inland Revenue, Tax Information Bulletin Vol 18 No 5, 2006) at 109.

[280] Policy and Strategy, Inland Revenue *Tax policy report: Taxation of multinationals*, above n 7, at 15.

[281] It should be noted that TV3 itself retracted the position advanced, highlighting that "no evidence was produced" to support its statements and indeed claims that there was a lack of transparency were "inaccurate": "Treasure Islands Response Blog" (October 2012) TV3 <www.tv3.co.nz>. The blog also set out the "correct legal and reporting position regarding New Zealand foreign trusts and New Zealand's status as a compliant and transparent country".

[282] Tim Hunter "NZ foreign trusts among global tax havens" *Stuff* (online ed, New Zealand, 22 August 2012).

inconsistently with their view of the correct approach.[283] The ATO had "identified trusts [administered in New Zealand] being settled in countries such as the Republic of Panama, Samoa, Vanuatu and Hong Kong"[284] but at no point had it been claimed that New Zealand was a tax haven. Then Minister of Revenue Peter Dunne stated shortly after the segment aired that "key identifying characteristics of tax havens are secrecy and lack of transparency…[which are] simply not factors here in New Zealand."[285]

Regarding its implementation of international standards, New Zealand's overall phase two rating by the Global Forum was 'Compliant' albeit the one area where New Zealand received the lesser 'Largely Compliant' rating was 'Ownership'.[286] There is appreciation in the media of the risk that NZFTs are "conduits for wealth located in … offshore bank account[s]"[287] with the "valid debate" centering on information collection because "one can't help wondering if Inland Revenue collected a little more information about these entities – such as the country of residence of all settlors – whether [the revenue generated in fees] might suddenly dry up." Relevantly, the Government very recently acknowledged the "reputational risks associated with conduit investment" in relation to 'look-through-companies' (LTCs), adding that by specifically addressing LTCs it was not indicating any acquiescence in conduit investment made by other structures.[288] On 18 August 2015, the High Court delivered a decision[289] concerning the worldwide freezing order made against property owned by Sergei

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283 As set down in their ruling "New Zealand Foreign Trusts in Taxation Ruling TR 2005/14" Australian Taxation Office "ATO warns people using New Zealand Foreign Trusts, but earning Australian income" (media release, 16 May 2012).

284 "Taxpayer Alert TA 2012/2 New Zealand Foreign Trust arrangements" (16 May 2012) Australian Taxation Office <www.law.ato.govt.au>.

285 The Minister also highlighted New Zealand's signature of the multilateral Convention on Mutual Administration Assistance in Tax Matters and the approval of its exchange of information and transparency standards by the Global Forum's peer review report as making a "mockery" of tax haven claims: Peter Dunne "Dunne: new agreement makes mockery of tax haven claims" (press release, 8 October 2012).

286 See 'Table 2: Jurisdictions that have undergone both Phase 1 and Phase 2 Reviews': "Global Forum on Transparency and Exchange of Information for Tax Purposes "Phase 1 and Phase 2 Reviews (as of August 2015)" (August 2015) OECD <www.oecd.org>.

287 Chris Barton "Taxation's black hole" The New Zealand Herald (online ed, Auckland, 2 November 2012).

288 Policy and Strategy, Inland Revenue and the Treasury *Closely Held Company Taxation Issues*, above n 133, at [4.20].

289 *Kea Trust Company Ltd v Pugachev* [2015] NZHC 1960. Pugachev is being chased by Russian court-appointed liquidators, whose liquidation order was recognised in the UK in 2014. On 14 August 2015 the English Court of Appeal accepted that Pugachev's interest as a discretionary beneficiary made the trusts' property amenable to the freezing order. Pugachev purported to remove the trustees (trustee companies two Auckland lawyers as directors) in favour of 4 new New Zealand trustees. The documents were purportedly signed in Nice although the High Court notes that "the last confirmed sighting of Mr Pugachev in the United Kingdom was on 23 June 2015. He is now believed to be in France."

Pugachev, a former Russian billionaire known as “Putin’s banker”,[290] which remarkably included assets owned by five New Zealand trusts. The fact that NZFTs feature in the arrangements of an ex-oligarch’s NZD $110 million fortune does lend credence to the claims warning of conduit investment.

Pursuant to an Official Information Act request, Inland Revenue provided that at the last inventory on 20 August 2015 there were:[291]

- 9940 active foreign trusts; and
- 40 active foreign trusts with Australian settlors.

Inland Revenue previously advised in 2012 that there were 7586 active foreign trusts[292] of which 126 had declared Australian settlors.[293] The dramatic decrease (approximately 70%) in the number of trusts settled by Australians could reflect either a staggered negative reaction to increased disclosure requirements or fear by Australian taxpayers induced by the ATO’s 2012 warning. Given the disclosure requirements have existed since 2006, the latter may be the more probable explanation.

The bare facts are, however, that foreign trust use has increased by 30% since 2012, but Australian foreign trusts have moved in the opposite direction. In November 2013, Dr Russel Norman, then Green Party co-leader, drafted “non-controversial legislation that … impose[s] a more rigorous registration and disclosure regime … effectively removing the secrecy provisions that make [NZFTs] so attractive to criminals and tax cheats”,[294] seemingly spurred into action by the addition of New Zealand to the TJN’s Financial Secrecy Index (FSI).[295] The 2009 FSI had identified 60 secrecy jurisdictions based on various tax haven lists,[296]

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[290] Hamish Fletcher “Kiwi link to Putin’s banker” *The New Zealand Herald* (online ed, Auckland, 4 September 2015).
[291] Inventory of Active Foreign Trusts (Obtained under Official Information Act 1982 Request to Media, Marketing & Communications, Inland Revenue).
[292] Chris Barton “Taxation’s black hole”, above n 287.
[293] Tim Hunter “NZ foreign trusts among global tax havens”, above n 282.
[294] Russel Norman “Foreign trusts earn New Zealand tax haven status” (press release, 7 November 2013).
[295] The Tax Justice Network is an independent international network launched in 2003 which describes itself as a “fast, flexible, expert-led, activist think tank…[and] not politically aligned.”: “Our Goals and Methods” Tax Justice Network <www.taxjustice.net>.
[296] International Bureau of Fiscal Documentation 1977; Charles Irish 1982, academic paper; Hines and Rice 1994, academic paper; Financial Stability Forum 2000; International Monetary Fund 2000; OECD 2000; Financial Action Task Force 2000/02; Hampton and Christensen 2005 for the Tax Justice Network;

unsurprisingly omitting New Zealand. However, the 2011 FSI report postulated that "subsequent FSIs … will include more jurisdictions needing serious scrutiny, such as New Zealand."[297] In 2013 11 jurisdictions were added.[298] New Zealand ranked 48th: its secrecy score of 52 placing it in the "lower mid-range of the secrecy scale".[299] Out of 82 jurisdictions, a 48th position[300] is not demonstrative that New Zealand's "foreign trust regime and lax company registration requirements are damaging our international reputation",[301] especially in light of New Zealand's ranking lower than similar Commonwealth countries such as Australia, Canada and the United Kingdom.

However, one of the "four broad dimensions of secrecy" adopted in the FSI's methodology is "knowledge of beneficial ownership".[302] New Zealand's deficiency in this area is arguably reflected in its lesser 'Largely Compliant' rating for 'Ownership and identity information' in the Peer Review Report.[303] The concerns that led to the 'Largely Compliant' rating, however, related exclusively to companies and records of non-resident directors.[304] Under new legislation,[305] effective 1 May 2015, director residence requirements would likely rectify this rating. As the report highlighted, New Zealand law requires the maintenance of information identifying the settlor, trustee and beneficiaries of a trust.[306] Where there are no income tax

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Zoromé 2007, academic paper for the IMF; Senator Carl Levin 2007 for the Stop Tax Haven Abuse Act in the USA; and Lowtax.Net (accessed 22-1-08), web site promoting secrecy jurisdictions: Richard Murphy "Mapping the Faultlines Where are the world's secrecy jurisdictions?" (September 2009) Financial Secrecy Index <www.financialsecrecyindex.com>.

[297] Tax Justice Network "Introducing the 2011 Financial Secrecy Index" (September 2011) <www.financialsecrecyindex.com>.

[298] New Zealand, and one other country (the Dominican Republic) were added "based on indications that secrecy services are offered" and seven others were added due to the scale of financial services exported: Tax Justice Network "Methods and Concepts" Financial Secrecy Index <www.financialsecrecyindex.com>.

[299] Tax Justice Network "Report on New Zealand" (7 November 2013) <www.financialsecrecyindex.com>.

[300] FSI ranking is calculated by multiplying the Secrecy Score and the Global Scale Weight. Hence New Zealand's Secrecy Score of 52, compared, for example, with Australia's Secrecy Score of 47, did not lead to a higher ranking because New Zealand accounts for less than 1 per cent of the global market for offshore financial services, making it a tiny player.

[301] Russel Norman "Foreign trusts earn New Zealand tax haven status", above n 294.

[302] The FSI report identifies New Zealand's lack of register of trusts and absence of company ownership records: Tax Justice Network "Secrecy Indicators" <www.financialsecrecyindex.com>.

[303] This was the only category for which it received a 'Largely Compliant' rating and it did not affect the overall 'Compliant' rating.

[304] OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews*, above n 205, at 95.

[305] Companies Amendment Act (No 4) 2014.

[306] The report does not appear to make the distinction that this requirement is in relation to foreign trusts only: Tax Administration Act 1994, s 22(2)(fb).

filing obligations "Inland Revenue has broad powers under the TAA to require a resident settlor or trustee to provide particulars".[307]

In conclusion, regarding transparency, the criticism in the media of New Zealand as a 'tax haven' is baseless and it is disappointing that Inland Revenue has attributed significance to such murmurings. New Zealand is compliant with international standards of transparency and exchange of information.[308] However, as can be seen by the decrease in Australian-settled foreign trusts, the introduction of more burdensome disclosure requirements and the use of scare tactics by a domestic revenue authority can affect the utility and popularity of NZFTs.

A European Union (EU) 'white list' produced in 2008[309] itemised countries, including New Zealand,[310] which it considered as having EU equivalent anti-money laundering/combatting the financing of terrorism (AML/CFT) systems.[311] The list's purpose was to identify countries in which transactions required less scrutiny. New Zealand, along with the Russian Federation, was removed from this list in 2012 without formal explanation.[312]

The Financial Action Task Force (FATF) is an intergovernmental organisation that works to prevent money laundering and terrorist financing; its recommendations are recognised global standards. The FATF's second follow-up report on New Zealand in 2013 assessed its implementation of 2009 recommendations, one of which required rectification of the "deficiency" that "there is no requirement to obtain, verify and retain adequate, accurate and current information on the beneficial ownership and control of trusts."[313] Although new legislation[314] imposes customer due diligence obligations and creates strengthened beneficial ownership requirements, it was held that it "cannot be determined that information on the

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[307] OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews*, above n 205, at 23.
[308] Any concern relating to ownership identity has been centred on companies.
[309] The list was produced by member states participating in the Committee on the Prevention of Money Laundering and Terrorist Financing.
[310] The other countries listed are Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, the Russian Federation, Singapore, Switzerland, South Africa and the United States.
[311] HM Treasury "Statement on Equivalence" (12 May 2008) <webarchive.nationalarchives.gov.uk>.
[312] "Common Understanding between Member States on third country equivalence under the Anti-Money Laundering Directive (Directive 2005/60/EC)" (June 2012) European Commission <www.ec.europa.eu>.
[313] 'Recommendation 34': Financial Action Task Force *Mutual Evaluation of New Zealand 2nd Follow Up Report* (OECD/FATF, Paris, October 2013) at 42.
[314] Anti-Money Laundering and Countering Financing of Terrorism Act 2009.

ultimate beneficial owners is accessible and/or up-to-date in all cases"[315] therefore the level was not yet 'largely compliant'. Given that FATF is the authoritative body on AML/CFT measures, it is perhaps unsurprising that New Zealand was not included in the 'white list' given 18 out of 24 FATF recommendations received 'non-compliant' ratings.[316]

Under Russel Norman's draft legislation,[317] trusts would only receive the 'foreign' classification if they register electronically and are up-to-date with disclosure obligations.[318] Although the political motivation behind such legislation leaves a question mark over its appropriateness,[319] increased disclosure would be an alternative course of action to changing the taxation of foreign trusts. The BEPS concerns raised by foreign trusts are insufficiently concerning to warrant questioning the sustainability of the trust rules. Even more fundamentally, recent empirical literature has shown that "the estimated magnitude of BEPS is typically much smaller than is found in earlier studies"[320] which is in contrast to widespread policy discourse. The OECD's final package of measures will be released 5 October 2015.[321] It is hoped that Inland Revenue will be measured in its response to this package and its potential furtherance of a review of foreign trusts.

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[315] Financial Action Task Force *Mutual Evaluation of New Zealand*, above n 313, at 42.

[316] It is even noted that future public evaluation reports adopted by the FATF could be cause for reviewing the list: "Common Understanding between Member States on third country equivalence under the Anti-Money Laundering Directive (Directive 2005/60/EC)" (June 2012) European Commission <www.ec.europa.eu>.

[317] Income Tax (Foreign Trusts Registration and Disclosure) Amendment Bill (Draft).

[318] Income Tax (Foreign Trusts Registration and Disclosure) Amendment Bill (Draft), s 11(3) would require a trustee to provide the name, date of birth, passport number, country of residence and tax identification for the beneficiaries, settlor and trustees of foreign trusts.

[319] The Law Commission recommended that a system of registration for trusts should not be introduced but it did propose that new legislation should set out exactly which records trustees must maintain: Law Commission *Preferred Approach*, above n 16, at [3.85] and [15.10].

[320] Dhammika Dharmapala "What Do we Know About Base Erosion and Profit Shifting? A Review of Empirical Literature" (Coase-Sandor Working Paper Series in Law and Economics Working Paper No. 702, University of Chicago Law School, 2014) at 24.

[321] "OECD to release BEPS package for reform of the international tax system to tackle tax avoidance on Monday 5 October 2015" (25 September 2015) OECD <www.oecd.org>.

Chapter IV: A Domestic Misunderstanding

A How New Zealanders See Their Trusts

Baragwanath J was prompted in *NZHB Holdings Ltd v Bartells* to make the comment that "[r]ecent experience in more than one case suggests that the concept of trust is used more often than it is understood."[322] New Zealanders' trust use has made both the Courts and the Law Commission uneasy as "many trusts have been created without a full appreciation of what trusts are and how they should properly be treated. Individuals are often treating trust assets as their own".[323] The Law Commission found that it has become difficult to distinguish between trusts and other concepts such as agency noting that "in some cases a settlor seems to be acting as a principal would in an agency".[324]

Perhaps the conduct of New Zealanders is explicable. The 1988 tax reforms were premised on the view that "the trustee is an agent for the settlor as a matter of economics rather than in law".[325] The language used by the Valabh Committee is categorical: legal appearance is seen as incongruous to the reality of settlor control or "substantial influence" over disposition of trust property and the ability to wind up.

The increasing number of claims relating to trusts in relationship property disputes is thought to be "not necessarily surprising given the fondness that New Zealanders appear to have had for trusts over the last 30 years, and their subsequent misuse".[326] The Law Commission also gained the impression that "the number of trusts has grown steadily over at least the last 20 to 30 years"[327] and pays attention to the consequences in the creditor protection and relationship property fields. But there may yet be a more elucidatory link to make in explaining why trusts became so heavily utilised in the first place.

Also thirty years ago, roughly, the taxation of trusts was reformed and replaced by the settlor-based regime. Tax drives behaviour and it could be that the perception of settlors as

[322] *NZHB Holdings Ltd v Bartells* (2005) 5 NZCPR (HC) 506 at [34].
[323] J Palmer "Sham Trusts" in A Butler (ed) *Equity and Trusts In New Zealand* (2nd, Thomson Reuters, Wellington, 2009) 393 at 394 cited in Law Commission *Second Issues Paper*, above n 88, at [1.7].
[324] Law Commission *Second Issues Paper*, above n 88, at [5.5].
[325] Craig Elliffe *International and Cross-Border Taxation in New Zealand*, above n 93, at [2.5.2].
[326] J Palmer "Sham Trusts", above n 323, at 394.
[327] Law Commission *Second Issues Paper*, above n 88, at [2.7].

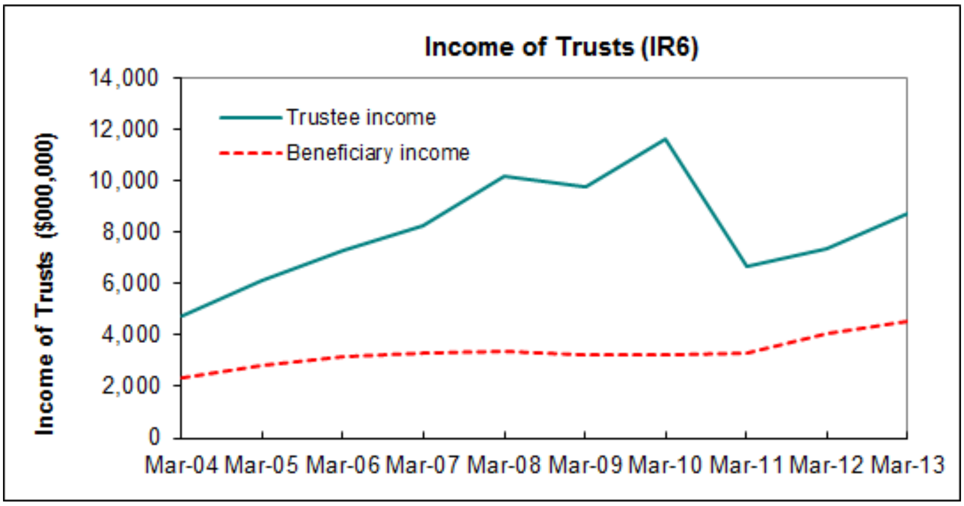
principals in an agency relationship instilled an altered understanding of the trust that prioritised economic substance at the cost of legal form and potentially the integrity of the device itself. Baragwanath J was right to acknowledge the seeming disconnect between trusts as they are used by New Zealanders and promoted by practitioners as compared with the actual legal relationship and equitable principles to which trusts owe their existence.

Despite the Law Commission's acknowledgement that the settlor-centric provisions of the ITA disregard traditional trust principles, their explanation for why New Zealanders are so partial to trusts[328] is a discursive collection of factors ranging from tax (such as estate and gift duties and the misalignment of tax rates) to relationship property statutes, social assistance, avoiding creditors and the active promotion of family trusts by advisers. Notwithstanding the irrefutable relevance of each factor separately, an economic conception of the trust driven by tax laws could provide a more persuasive explanation generally as to the frequent use of trusts and why "the law pertaining to family trusts in New Zealand has become so far removed from the accepted principles of equity as to demand investigations".[329]

The 1988 reforms ignored the legal consequences of the trust relationship, albeit for sound policy reasons. If tax law is prepared to equate trustees as agents, so too could trust practitioners acceptably advise clients that they can settle property on trust but still control it: this despite a trust being legally distinct from agency, albeit with an admitted "blurring" of the distinction in recent times.[330]

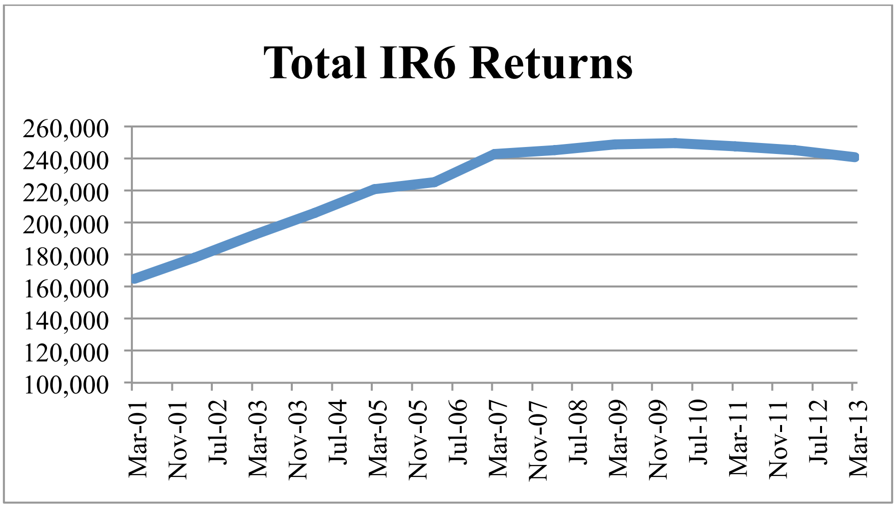
Tax drives behaviour. One only has to examine the spike (and subsequent drop) in the amount of trustee income reported on IR6 returns in the period 2000 until 2010, during which the trustee rate and highest marginal personal rate were misaligned by 6%:[331]

[328] Contained in Chapter 2: Law Commission *Second Issues Paper*, above n 88.
[329] Sue Tappenden "The family trust use in New Zealand and the claims of 'unwelcome beneficiaries'" (2009) 2 Journal of Politics and Law 17 at 17.
[330] Law Commission *Introductory Issues Paper*, above n 1, at [2.50]-[2.51] and [3.15].
[331] The highest personal tax rate increased to 39% and the trustee rate remained at 33%.



[332]

The effect of the divergence on trustee income was remarkable. The number of trust income tax returns filed in 2001 was 164,800 increasing steadily until it peaked at 249,500 in 2010.[333] In the aftermath of the realignment of tax rates on October 1 2010, the number of returns filed has plateaued in subsequent tax years:



Taxpayers and their advisers will rationally respond to the government's policy choices. Therefore, it is somewhat harsh that taxpayers have been penalised for using trusts based on an understanding that the settlor is a vital economic player able to benefit from and exert

[332] Inland Revenue "Income on Trust IR6 Returns, 2001 to 2010" (spreadsheet downloaded from Archived Tax statistics spreadsheets: 2001 to 2010-11) < http://www.ird.govt.nz/aboutir/external-stats/archives/2010/tax-statistics-archive-2010-11.html>.
[333] Inland Revenue "Income on Trust IR6 Returns, 2001 to 2010" (spreadsheet downloaded from Archived Tax statistics spreadsheets: 2001 to 2010-11) < http://www.ird.govt.nz/aboutir/external-stats/archives/2010/tax-statistics-archive-2010-11.html>.

control over settled property,[334] when this is the role that the tax regime assumed for the settlor all along.

The Law Commission is targeting trust misuse in a relationship property and creditor protection context, seeking overarching reforms, but pays less attention to how trusts are treated for tax purposes which may be the single most important connection to be made. The point was advanced that gift duty "has had a significant impact on trust practice in New Zealand".[335] But despite the abolition of gift duty and subsequent ease with which assets could be transferred to trusts being predicted to result in an increase in trust use,[336] this does not appear to have eventuated if one accepts income tax returns filed as a proxy for estimating trust use. Gifting programmes may have inculcated a culture and fondness for trust use but the abolition of gift duty has had negligible effects.

The disregard for important legal points and fine distinctions between tax and trust law seems to have been perpetuated on both sides.[337] There is no overwhelming coherence in the tax treatment of trusts, even though these two areas of the law have been historically intertwined and formative in each other's existence. It has been said that irrespective of the shared mutual objective of "Asset Protection" between the 'Tax Lawyer' and 'Trust Lawyer', there exists an "uneasy synergy between trusts and tax".[338]

It is proposed that this lack of reciprocity and understanding is due to the prioritization of economic substance over the legal principles inherent in the trust relationship. Of itself, this is an acceptable stance to adopt given the sound motivation of protecting the New Zealand tax base from erosion from which this economic outlook has flowed. However, the

[334] As seen in the well-known Supreme Court case *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95.
[335] Law Commission *Second Issues Paper*, above n 88, at [2.24]. The issue was addressed in its own separate heading in explaining New Zealanders' partiality to trusts.
[336] At [2.26], citing C MacLennan "Gifting to trusts will increase if threshold is repealed" LawNews (23 July 2010).
[337] For example, the "identification of trusts as complying, non-complying or foreign occurs for tax purposes only and has no effect for trust law purposes": Amundsen *Taxation of Trusts*, above n 89, at [2-040]. Alternatively, The proposed abolition of apportionment rules between income and capital receipts and expenses not only disregards traditional trust law principles but is also stipulated to "not alter in any way the tax status or liability that attaches to any receipt or outgoing": Law Commission *Preferred Approach*, above n 16, at [5.32].
[338] Simon Weil "NZ Domestic Trusts – Tax Issues Through the Eyes of Trust Lawyers" (paper presented to NZLS CLE Tax Conference, Auckland, September 2014) 141 at 141. The presenter attributes the uneasy synergy to the "simple fact that achieving maximum tax efficiency is not always consistent with achieving maximum Asset Protection".

recognition that New Zealand has not been formalistic or followed Montesquieu's advice to match the tax to the form of government could be welcome. The global settlor-based approach is pragmatic not principled: "referring to trustees as agents acknowledges that New Zealand tax policy for trusts is based in economic considerations rather than legal theory".[339] It provided a solution to a specific problem and formed part of a programme of reforms in which the trust was treated like any other commercial entity.

The settlor regime has not been without consequence. As herein articulated, it could have caused a perception of trusts by practitioners and clients alike akin to the 'settlor-responsive property management devices' seen in offshore jurisdictions. The misalignment of trustee and maximum personal rates illustrates that tax changes the way people act. But could it be said that tax can also change the way people think? If tax law instilled an equivocal quasi-agency relationship in its 1988 rules, it is understandable that New Zealanders began to use them as such and the concern that of the 400,000 trusts some "would not withstand close scrutiny concerning both the quality of trust deeds and the way they are administered should a dispute arise"[340] could be well-founded.

That New Zealand is a land of trusts must be accepted. Policy decisions from 1987 inadvertently created a noteworthy foreign trust industry but the 9,940 active foreign trusts pales in comparison to the estimated 400,000 strong domestic trusts' activity. Inland Revenue's desire to review the tax treatment of foreign trusts is not a severable exercise as the requirement to refer to the settlor's residence applies equally to domestic trusts.

There is limited concern that foreign trusts are contributing to BEPS and New Zealand's disclosure requirements are in accordance with international standards. A more fundamental issue might be whether such unilateral initiatives are justifiable given the high susceptibility of the 'BEPS' project to public opinion and political pressure; this is not the most informed basis upon which to examine a complex area of law.

If the 'foreign trust' reason is insufficient, is domestic trust use good cause for rethinking the way New Zealand taxes trusts? Trust law reform is being evaluated currently, as evidenced by Minister of Justice Amy Adam's establishment of the Trusts Reference Group in May

[339] John Prebble "New Zealand Trusts in International Tax Planning" [2000] 5 BTR 554 at 558.
[340] Law Commission *Second Issues Paper*, above n 88, at [5.3].

2015.[341] Although it is not submitted that there exists any glaringly obvious need to change the taxation of trusts in New Zealand, the upcoming period of reform at least provides an appropriate time to take proper account of the way trusts are treated for tax purposes.

An important aspect of domestic trust treatment is how not only practitioners but Inland Revenue and the Courts interpret and apply the rules. Inland Revenue has grappled with the trust rules and inevitably been led down some contorted definitional paths. By contrast, the 'economic substance' basis of the settlor regime is well attuned to recent tax avoidance jurisprudence. Both will be examined.

B Inland Revenue – An Example of the Tension

The taxation of trusts regime is buttressed by broad settlor definitions. In response to concerns regarding beneficiaries' 'current accounts'[342] Inland Revenue released two draft public rulings[343] in December 2014 analysing whether a beneficiary will be caught by the statutory definition of a 'settlor'.[344] The Commissioner considered that a beneficiary is a settlor per section HC 27(2) if, regarding an undistributed amount of beneficiary income, there is a loan back to the trustee on non-commercial terms.[345]

"Provide" is an essential component of the settlor definition.[346] The Commissioner posits that it "seems implicit that before a person can 'provide' … the person must be the legal

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[341] Amy Adams "Minister puts trust law reform on the agenda" (press release, 29 May 2015).

[342] The New Zealand Institute of Chartered Accountants had alerted Inland Revenue to the issue of beneficiaries' current accounts being used by a trust in submissions to the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill. NZICA requested a public item due to its implications in a working for families tax credit context. Because of the central importance of the settlor definition, and as was noted by the presenter at the NZLS Tax Conference, there are implications for foreign trusts also: Keith Turner "Topical NZ Trust Tax Issues" (paper presented to NZLS CLE Tax Conference, Auckland, September 2014) 127 at 129.

[343] Public Rulings *Income Tax – Whether a Beneficiary Will Be Treated As a Settlor Where There is No Loan (draft)* (Inland Revenue, BR Pub 14/XX); Public Rulings *Income Tax – Whether A Beneficiary Will Be Treated As a Settlor Where There is a Loan (draft)* (Inland Revenue, BR Pub 14/YY).

[344] See Appendix 1 for the full statutory definition of a 'settlor' set out at Income Tax Act 2007, s 27.

[345] Such terms are: no interest is charged; interest is charged below market rate; interest is payable on demand and no demand is made; or demand for payment of interest or principal is deferred so long that the loan is non-commercial.

[346] "Provide" is used in both the section YA 1 definition of "transfer of value" (which comprises the first limb of section HC 27(2)) and the second limb relating to the provision of "financial assistance".

owner".[347] 'Absolutely vesting' or 'paying'[348] an amount without physical transfer, regardless of any right to present or future possession, does not transfer legal ownership and beneficiaries "cannot provide what they do not have".[349]

This fixation on legal ownership is left unexplained. By contrast, in determining the appropriate basis for taxing trusts in 1988, the trustee's lack of "beneficial interest" was seemingly decisive[350] and, generally, beneficial interest is sufficient to attract taxation and could, for example, constitute an adequate property interest to use as security for a loan. Split title can sometimes be fastened upon, it would appear, to enforce a predetermined outcome.

The Commissioner correctly highlights that a trustee's declaration or resolution does not create a debtor-creditor relationship, relying on the Court of Appeal's decision in *CIR v Ward*[351] but demonstrates a lesser understanding when it is assumed that undistributed amounts are part of the same "ongoing trust relationship".[352] *Ward* is explicit that resolutions give rise to a "new title consisting of the exercise of the trustees' discretion in the infant's favour".[353] The Commissioner acknowledges in its assessment of the nature of beneficial rights that despite the case authority's confinement to infant beneficiaries "the same conclusions would apply … for adult beneficiaries".[354] However, there is a fundamental difference as infant beneficiaries cannot require the transfer of undistributed amounts whereas adult beneficiaries with a right to demand possession can. The Valabh Committee stipulated that when income vests in, or is derived in trust for, a beneficiary those amounts are taxable to the beneficiary; beneficiaries are "entitled in possession to that income because they can call on the trustees to pay it over. This is not the case with infants … since an infant

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347 Public Rulings *Commentary on Public Ruling BR Pub 14/XX and 14/YY* (Inland Revenue, 22 December 2014) at [6].
348 The rulings apply where the trustees "vest absolutely in interest an amount in a beneficiary" or "pays an amount to a beneficiary" which replicates the definition of beneficiary income under section HC 6 ITA 2007. "Vest" means obtaining a immediate right of present or future possession. "Paid" has a broad meaning, including for example, trustee declarations and resolutions crediting amounts (*Commissioner of Inland Revenue v Ward*) and encompasses the previous section OB 1 ITA 2004 caselaw regarding the "applies for the benefit" component.
349 Public Rulings *Commentary on Public Ruling BR Pub 14/XX and 14/YY*, above n 347, at [42].
350 *International Tax Reform Full Imputation Part 1*, above n 132, at [5.2.5].
351 *Commissioner of Inland Revenue v Ward* [1970] (CA) NZLR 1.
352 Public Rulings *Commentary on Public Ruling BR Pub 14/XX and 14/YY*, above n 347, at [62]. This is also evident when it is noted that "when trustees vest an amount…or pay an amount to a beneficiary without transferring possession, the trustees *continue* to be the legal owners" (at [7]) and the amounts "until possession is given [are] *still* subject to a trust relationship": at [59].
353 *Commissioner of Inland Revenue v Ward*, above n 351, at 30.
354 Public Rulings *Commentary on Public Ruling BR Pub 14/XX and 14/YY*, above n 347, at [59].

is not entitled to the possession of the income".[355] For adult beneficiaries the discretion, once exercised in a beneficiary's favour, is inhibited, arguably creating a bare trust.[356]

Again, the use of trusts in reality demonstrates a disregard for legal principle, as the "current account" concept is frequently used by accountants to record amounts vested in or "paid" to beneficiaries.[357] The Commissioner finds the term potentially 'misleading' if it implies that a beneficiary has an on demand right to possession as the right could be of "future possession only".[358] Inland Revenue seeks to align the split legal and beneficial estate distinction with the property law concepts of possession and right to immediate possession, to carve out the definitive 'legal ownership' difference. This painstaking effort is an attempt to capture the reality[359] that trustees, despite having negated their discretion, continue to use such funds as working capital. Adult beneficiaries would usually have an immediate right to present possession but allow the trustee to control and use the funds as before. Inland Revenue does not want this to constitute settlement and manufactures the legal ownership distinction to this end.

The insistence on legal ownership is somewhat arbitrary and forces an interesting process of deduction when the Commissioner determines that a beneficiary is a settlor 'where there is a loan':[360] how can beneficiaries obtain legal title without any transfer in possession? This is achievable under a set-off[361] which allows "two people with payment obligations to each

[355] *International Tax Reform Full Imputation Part 2*, above n 5, at [6.2.5].
[356] A bare trustee holds property in trust for the absolute benefit and at the absolute disposal of other persons who are of full age and sui juris in respect of it, and has no present beneficial interest in it and no duties to perform except to convey or transfer it, see *Halsbury's Laws of England (Online ed)* (LexisNexis UK, England, 2014) at [195].
[357] Public Rulings *Commentary on Public Ruling BR Pub 14/XX and 14/YY*, above n 347, at [67].
[358] At [67]. Although it is true that infant beneficiaries may have a right to future possession only, adult beneficiaries would usually have an immediate right to present possession once a trustee has exercised discretion to vest or pay amounts to them.
[359] This was eluded to at the 2014 Tax Conference where it was noted that beneficiary income constituted "personal funds" and if the trustee "then goes on to use them as working capital" without paying for that use, this should attract the settlor definition as should "a foreign trust using a beneficiary's current account as part of its investment activities": Keith Turner "Topical NZ Trust Tax Issues", above n 342, at 129.
[360] Whether a beneficiary has loaned a vested or paid amount back to the trust will be a factual enquiry and does not have to be in writing but may be established from the surrounding circumstances: Public Rulings *Commentary on Public Ruling BR Pub 14/XX and 14/YY*, above n 347, at [93]-[95].
[361] At [76].

other to discharge … those obligations without the need for a physical payment."[362] The trustees have a payment obligation to the beneficiary of the undistributed amount and the beneficiary has a contractual obligation to repay the loan principal. But a step seems to be missing: these so-called "reciprocal payment obligations", if they attach as they must to legal ownership, do not co-exist simultaneously as the beneficiary does not obtain a legal title to loan back, creating a contractual obligation, in the first place. Despite the conclusion that the character of the relationship is now purely contractual[363] and governed by the loan agreement's terms[364] one cannot help but imagine that realistically the trustee will continue to behave in the same manner (the amounts never actually change hands), administering the property in accordance with the trust deed and his or her fiduciary obligations. This is fine until a dispute arises and equity is seemingly excluded from providing redress. A wider issue is that the settlor definition's important taxation consequences may be attracted by inadvertent 'contamination' of foreign trusts by non-commercial lending from New Zealand residents.[365]

Taxing trusts can give rise to occasional awkwardness, and this is true of New Zealand's settlor-based regime. Due to domestic trust practices and their intermittent disconnect from legal principles, Inland Revenue is obliged to accommodate the fluid use of current accounts. However, the wide settlor definitions can make this is a less than self-evident exercise.

C Tax Avoidance – A Closer Alignment

> Every man is entitled … to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be … This so called doctrine of the "substance" seems to me to be … an attempt to make a man pay notwithstanding that … the amount of tax sought from him is not legally claimable.[366]

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[362] The Commissioner cites the *Laws of New Zealand* (Online ed, LexisNexis, accessed 24 November 2014) at [296] which describes the forms of payment of contractual promises as including "a settlement of accounts by which items on one side are agreed to be set-off against items on the other side" and notes that the Court of Appeal in *Trans Otway Ltd v Shephard* [2005] 3 NZLR 679 accepted set-off as 'payment' discharging contractual obligations.
[363] Public Rulings Unit *Commentary on Public Ruling BR Pub 14/XX and 14/YY*, above n 347, at [83].
[364] At [81].
[365] Craig Elliffe *International and Cross-Border Taxation in New Zealand*, above n 93, at [2.7.2].
[366] *Duke of Westminster v Commissioners of Inland Revenue* [1935] All ER 259 H.L.

The above statement is no longer representative[367] of recent tax avoidance jurisprudence which is focussed on the "substance". The situation has indeed involved since the 1970 Privy Council observation that "tax avoidance has not been part of the New Zealand way of life".[368] Intriguingly, "[tax avoidance] consideration by the Courts began in the 1960s"[369] and did so in the context of trusts.[370] To the extent that trusts are taxed with a view to capturing the economic reality of benefits and residence, recent tax avoidance jurisprudence operates on a similar level. Ironically, the tax rules that, as it has been argued, encouraged acceptance of settlor control, have led to arrangements which may fall within the purview of the section BG 1 GAAR and its wide economic and substantive scope.

The relationship between specific statutory provisions and section BG 1 was settled by the Supreme Court in *Ben Nevis*.[371] The second stage of the posited test[372] is whether the arrangement is within Parliament's contemplation,[373] which must be assessed "in light of the commercial reality and economic effect".[374] In *Penny and Hooper*, although the badges of "artificiality" and "contrivance" (so telling in *Ben Nevis*) had no application to the "entirely lawful and unremarkable"[375] trust and corporate structures, it was the setting of "artificially low"[376] salaries that would constitute avoidance if "influenced in a more than incidental way by a consideration of the impact of taxation",[377] namely the 6% rate differential between the

[367] Inland Revenue commented that the "law has clearly moved on" from the *Duke of Westminster* decision: Public Rulings Unit *Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007* (Inland Revenue, IS 12/01, 13 June 2013) at [393].
[368] *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 at 601.
[369] At 601.
[370] Specifically, 'paddock trusts': see *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 and *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279.
[371] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115.
[372] First, the specific provision must be used within its intended scope as determined by the ordinary meaning of the words and in light of its purpose (in deference to section 5 of the Interpretation Act 1999). The second stage is the only stage if no specific provision is in question: see, for example, the situation which "differs from *Ben Nevis*" in this respect: *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95 at [33].
[373] Although the Supreme Court in *Ben Nevis* (at [107]) refers to "within the contemplation and purpose of Parliament", reference to purpose is later omitted in *Penny and Hooper* (at [33]). This could reflect the fact that Parliament acts with purpose when it enacts legislation but where the facts do not involve a specific provision it is less easy to analyse 'purpose'.
[374] *Ben Nevis*, above n 371, at [109] per Tipping J and McGrath JJ.
[375] *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95 at [33] per Blanchard J.
[376] At [33] and [46] per Blanchard J.
[377] At [34] per Blanchard J.

trustee (33%) and top personal (39%) tax rates. Setting low salaries is otherwise acceptable.[378]

The ITA's silence provides a seemingly blank canvas for determining Parliamentary contemplation. Despite the existence of trustee "discretion" the Supreme Court was less concerned with trust law and this power's nature because the taxpayers could "naturally expect" to benefit, and do so without the impost of the 39% tax rate.[379] The more than "merely incidental purpose" of avoiding tax is a requisite component of the section YA 1 "tax avoidance arrangement" definition, which is tested by Parliamentary contemplation. However, the Supreme Court tautologically submits that Parliamentary contemplation extends only to tax advantages that are "merely incidental".[380] At this point the taxpayers had already lost because the trust structures and increase in personal rates were no coincidence. The real unspoken answer, however, seems to be that the Supreme Court does not approve of taxpayers personally benefitting from funds without paying the highest rate, despite what the law allows. This represents a remarkable shift from previous comments approved by the Privy Council that "moral precepts are not applicable to the interpretation of revenue statutes".[381] A post hoc determination of Parliamentary contemplation on an unlegislated issue was concerning enough to taxpayers that a "Revenue Alert" was released stating that Inland Revenue would not investigate structures where salaries paid are at least 80% of total returns.[382]

It is interesting to hypothesise the Courts' approach to a practice that Parliament irrefutably must have contemplated but still leads to arrangements adopted for more than "merely incidental" tax advantages. One such example could be the allocation of income to beneficiaries aged 16 and above so as to avoid the minor beneficiaries' rule[383] and corresponding 33% tax rate, and secure a lesser rate due to the presumably low income of young persons who are often still dependent on parental support. Under *Penny and Hooper* logic, this would constitute tax avoidance but is it genuinely outside Parliament's

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[378] For example, a salary may still be low but absorb all profits, retained funds may be needed for capital expenditure or a company may be experiencing financial difficulties: *Penny and Hooper*, above n 375, at [34].
[379] At [35] per Blanchard J.
[380] At [49] per Blanchard J.
[381] Per Rowlatt J in *Cape Brandy Syndicate v Inland Revenue Commissioners* [1921] 1 KB 64 at 71 approved in *Mangin v Commissioner of Inland Revenue* 70 ATC 6001 at 6003.
[382] "Revenue Alert RA 11/02" (1 September 2011) Inland Revenue <wwww.ird.govt.nz>.
[383] Income Tax Act 2007, s HC 35.

contemplation? Trusts are one of Inland Revenue's stated "Key Focus Areas" for compliance in 2015[384] thus practitioners and clients alike should be live to the issue.

The Supreme Court has adhered to its intuitive assessment of the 'economic reality' of a situation which was readily comprehensive in a case like *Ben Nevis*, but perhaps less so in *Penny and Hooper*. As this latter shows, ordinary trust structures may be transformed into extraordinary tax avoidance on the simple premise that Parliament would not intend tax advantages to form more than an incidental purpose of trust use. Given the known tax benefits of using trusts, and the obvious behavioural effects tax policy has, it is perhaps an interesting intention to impute, even more so when one considers that the 1988 reforms were intended to treat the settlor as an essential economic actor in the trust relationship.

Inland Revenue and the Courts are charged with applying this difficult intersecting area of tax and trust law. What the tensions do reveal is that the unique settlor regime requires careful consideration at times. However, contribution to BEPS, in any meaningful sense, is not a failing of these rules and it must be remembered that their original raison d'être was the protection of New Zealand's tax base.

[384] Inland Revenue will look for structures that "don't seem to make commercial sense" or "deliver unusually favourable tax advantages": Inland Revenue *Our Compliance Focus 2014-2015* (Inland Revenue, IR 969, November 2011) at 11.

Conclusion

To conclude this inquiry into the taxation of trusts in New Zealand, the Australian experience may be used by way of example. In Australia, the "default treatment is that tax is imposed on beneficiaries rather than in the trust".[385] The complexity and uncertainty of Australia's taxation of trusts[386] is frequently criticised. The Treasury's 2015 "Re:think tax discussion paper" drew attention to several "longstanding issues with the legal framework"[387] which had been brought out in the 2010 High Court of Australia decision known as *Bamford*.[388]

Such comments were, however, far from ground-breaking: since 2006 there have been at least six different "poorly co-ordinated [taxation of] trust reform projects",[389] such that the "current state of play is confusing even for those who might wish to follow it closely" and the probability of a coherent regime emerging is decidedly "small".[390] Of the various key drivers of reform, namely ATO initiative, electoral politics and industry lobbying, sound policy has not been a dominant factor and the end-product has been described as "overlap, redundancy and rehearsing old debates".[391] One might take comfort in the fact that the most recent reform effort culminated in a 2012 proposal[392] outlining, as an alternative to the current system, the 'economic benefits model' which is based on New Zealand's own.[393] However, the latest comment in 2015 that "wider reform has not occurred"[394] shows yet again that the movement has languished.

Thus it becomes more readily comprehensible as to why, notwithstanding the undeniably important link between tax and trusts, the Law Commission's trust law reform discussion has

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385 The Australian Government the Treasury *Re:think Tax Discussion Paper* (Department of the Treasury (Australia), Discussion Paper, March 2015) at 112.
386 To adopt a heavily simplified description of the taxation of trust rules, beneficiaries are assessed on a proportionate amount of the trust's taxable income which is calculated by reference to their share of the trust's distributable income.
387 The Australian Government the Treasury *Re:think Tax Discussion Paper*, above n 385, at 112.
388 *Commissioner of Taxation v Bamford* (2010) 240 CLR 481.
389 GS Cooper "Reforming the Taxation of Trusts: Piecing Together the Mosaic" (2013) 35 Syd LR 187 at 190.
390 At 235.
391 At 235.
392 The Australian Government the Treasury *Taxing trust income – options for reform* (The Treasury, Policy Options Paper, October 2012).
393 The Australian Government the Treasury *Modernising the taxation of trust income – options for reform* (The Treasury, Consultation Paper, November 2011) at 39.
394 The Australian Government the Treasury *Re:think Tax Discussion Paper*, above n 385, at 112.

steered relatively clear of any deeper investigation into the ‘how and why’ of New Zealand’s settlor regime.

Reform should not be lightly undertaken, or without a sound policy basis, and the recent BEPS-driven focus on foreign trusts is not a sufficiently principled ground. For want of a better expression, ‘if it ain’t broke don’t fix it’ and New Zealand’s settlor regime is functioning at an acceptable level. The prioritisation of “micro-economics and substance [over] legal principle”,[395] it has been here argued, may have played an integral role in the extensive trust use observed today but also achieved the important goal of protecting the New Zealand tax base. Ultimately:[396]

> …the availability of the trust as an organizational form requires the government to adopt tax rules adequate to prevent use of the trust form to avoid the government’s desired pattern of taxation and – owing to the necessary incompleteness of any such set of rules – necessarily gives private parties more control over the tax treatment of their transactions then would be available without the trust.

New Zealanders certainly appreciate that increased control and the Government’s response in 1988, while by no means perfect, is justifiable and effective in its application to this ‘protean’ instrument.

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[395] Prebble “New Zealand Trusts in International Tax Planning”, above n 339, at 556.
[396] Henry Hansmann and Ugo Mattei “The Functions of Trust Law: A Comparative Legal and Economic Analysis” (1998) 73 NYUL L Rev 434 at 478.

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Appendix 1: Relevant Sections of the Income Tax Act 2007

1. Section HC 6 provides:

Beneficiary income

Meaning

(1) An amount of income derived in an income year by a trustee of a trust is beneficiary income to the extent to which—

(a) it vests absolutely in interest in a beneficiary of the trust in the income year; or

(b) it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B).

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.

Exclusions

(2) Beneficiary income does not include—

(a) an amount of income derived by a trustee of a trust in an income year in which the trust is a superannuation fund; or

(b) an amount of income derived by a trustee that is income to which sections CC 3(2) (Financial arrangements) and EW 50 (Income when debt forgiven to trustee) apply.

Deriving beneficiary income in same year

(3) When an amount derived by a trustee in an income year is also beneficiary income, the beneficiary is treated as having derived the income in the same tax year as that corresponding to the trustee's income year.

2. Section HC 27 provides that:

Who is a settlor?

When this section applies

(1) This section applies for the purposes of—

(a) the trust rules; and

(b) the consolidation rules; and

(c) section CW 59 (New Zealand companies operating in Niue); and

(cb) section MB 7 (Family scheme income of settlor of trust); and

(d) section YA 1 (Definitions), the definition of **settlement**; and

(e) subpart YB (Associated persons and nominees) as modified by section YB 10 (Who is a settlor?).

Meaning of settlor

(2) A **settlor** of a trust is a person who, at any time,—

(a) transfers value—

(i) to the trust; or

(ii) for the benefit of the trust; or

(iii) on terms of the trust:

(b) provides financial assistance to the trust or for the benefit of the trust with an obligation to pay on demand, and the right to demand is not exercised or is deferred:

(c) is treated as a settlor under section HC 28.

Trusts for retirement benefits for employees

(3) Despite subsection (2), a person resident in New Zealand who makes a settlement on a trust as an employer for the benefit of 1 or more employees is not a settlor of the trust if the following circumstances apply:

(a) the trust is established or created mainly to provide retirement benefits to natural persons; and

(b) the trust is neither a foreign superannuation scheme nor a superannuation fund.

Employee share purchase agreements

(3B) Despite subsection (2), an employer is not a settlor for the purposes of the trust rules in relation to a payment made by them to the trustee of an employee share purchase agreement if—

(a) some or all of the payment is used by the trustee to acquire shares under the terms of the employee share purchase agreement; and

(b) an amount that is less than or equal to the payment used by the trustee would be income of an employee under section CE 1(1)(d) (Amounts derived in connection with employment).

Contributions to foreign superannuation scheme

(3C) Despite subsection (2), a person who makes a contribution to a trust that is a foreign superannuation scheme is not a settlor of the trust.

Indirect settlement

(4) A person may make the transfer or provision in subsection (2) directly or indirectly, or by 1 transaction or a number of transactions, whether connected or otherwise.

Nil value of beneficiary relationship

(5) The fact that a person is, or will become, a beneficiary of a trust does not constitute the giving or receiving of value.

Appendix 2: Table Summaries

1. Trust Use in Commonwealth Countries

	New Zealand	**Australia**	**UK**	**Canada***
Returns filed (2012/2013 tax year)	240,300	780,105[397]	160,500[398]	212,620[399]
Population (2013 estimate)	4,470,000	23,295,400[400]	64,105,700[401]	34,500,000[402]
Trusts per capita ("1 trust for every…")	18.60 New Zealanders	29.86 Australians	399.41 British	162.26 Canadians
*Data based on 2011/2012 tax year and 2012 population estimate due to availability of statistics.				

2. The Valabh Committee's Recommendations Regarding Settlor Residence, Trustee Residence and New Zealand Taxation with Current ITA Legislative Provisions

	Resident settlor Resident trustee	**Resident settlor Non-resident trustee**	**Non-resident settlor Resident trustee**
Foreign-sourced income	Trustee liable: ss BD 1(5) and HC 7	Trustee liable: ss BD 1(4)(c) and HC 25(2) Settlor liable in default: s HC 29	Trustee not liable: s HC 26
New Zealand-sourced income	Trustee liable: ss BD 1(5) and HC 7	Trustee liable: ss BD 1(5) and HC 7 Settlor liable in default: s HC 29	Trustee liable: ss BD 1(5) and HC 7

397 "Partnership and Trusts Tables" (4 May 2015) Australian Taxation Office <https://www.ato.gov.au>.
398 "Trusts Statistics" (30 January 2015) United Kingdom HM Revenue & Customs <www.gov.uk/government/organisations/hm-revenue-customs>.
399 "Number of Trusts by Jurisdiction, 2007 to 2011" (11 December 2013) Canada Revenue Agency <www.cra-arc.gc.ca/menu-eng.html>.
400 "Australian Demographic Statistics, Dec 2014" (25 June 2015) Australian Bureau of Statistics <http://www.abs.gov.au>.
401 "Population Estimates for UK, England and Wales, Scotland and Northern Ireland, Mid-2014" (25 June 2015) Office for National Statistics <http://www.ons.gov.uk/>.
402 "Population and Demography" (20 December 2012) Statistics Canada <http://www.statcan.gc.ca>.

3. *Categorisation of Trusts for the Purposes of Distributing Accumulated Trustee Income*[403]

	Accumulated trustee income	**Capital gains**	**Corpus**
Complying trust	Not taxable: ss HC 20 and CW 53	Not taxable: ss HC 20 and CW 53	Not taxable: ss HC 20 and CW 53
Foreign trust	Taxable distribution: s HC 15(4); at marginal rate: s HC 18	Not taxable due to s HC 15 definition of 'taxable distribution'	Not taxable due to s HC 15 definition of 'taxable distribution'
Non-complying trust	Taxable distribution: s HC 15(2); at penal rate of 45%: s HC 34	Taxable distribution: s HC 15(2); at penal rate of 45%: s HC 34	Not taxable due to s HC 15 definition of 'taxable distribution'

[403] Adapted from OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: New Zealand 2013: Combined Phase 1 + Phase 2 Report, incorporating Phase 2 ratings* (OECD Publishing, Paris, November 2013) at 43.

4. Summary of Various Trustee Service Providers' Advertisements

Incentive	Trustee service advertisement
International reputation	New Zealand is a respected OECD member with a solid commercial, professional and judicial framework.[404]
Advanced understanding of trusts	New Zealand is a common law country with a longstanding and mature trust and foreign trust industry.[405]
Good 'image'	A NZFT can "operate as an offshore trust without the negative stigma that is often associated with Offshore Entities";[406] "New Zealand is not a tax haven"[407] and an NZFT may "project a better image than a trust established in a tax haven."[408] This is in part due to the lack of "contrived legislative framework" or "deliberate tax concession".[409]
Privacy and confidentiality	Provided the settlor is not an Australian resident there are minimal disclosure requirements for NZFTs.[410] There is no central registry offering a degree of privacy and secrecy.[411]
Tax treaty benefits	"[a]s if the tax-free status in New Zealand were not enough, the New Zealand trust may also claim tax benefits in other countries too".[412] New Zealand has an extensive network of DTAs (39 in total).[413]

404 Henry Brandts-Giesen TEP "New Zealand Trusts for International Wealth Structuring" (18 August 2009) Low Tax Global and Business Portal <www.lowtax.net>. See also New Zealand is an "OECD member country with sound legal, regulatory, political and economic system, thus becoming a viable alternative to offshore jurisdictions": "Preferential NZ Tax Regimes – New Zealand Foreign Trusts (NZFT's)" (2013) Covisory Partners <www.covisory.com>.
405 "Preferential NZ Tax Regimes – New Zealand Foreign Trusts (NZFT's)" (2013) Covisory Partners <www.covisory.com>.
406 "Preferential NZ Tax Regimes – New Zealand Foreign Trusts (NZFT's)" (2013) Covisory Partners <www.covisory.com>.
407 "New Zealand as an Offshore Centre" Trust New Zealand: Establish a New Zealand Foreign Trust to Protect you Assets <http://www.trust-nz.com>.
408 "New Zealand Law trust" (2011) Intertrust Group <www.intertrustgroup.com>.
409 "Preferential NZ Tax Regimes – New Zealand Foreign Trusts (NZFT's)" (2013) Covisory Partners <www.covisory.com>.
410 "New Zealand Foreign Trust – Overview" Atrium Associates LLC Tax Consultors <www.atrium-incorporators.com>.
411 "Preferential NZ Tax Regimes – New Zealand Foreign Trusts (NZFT's)" (2013) Covisory Partners <www.covisory.com>.
412 Peter Macfarlane and John Allcard "Trusting Trusts: The New Zealand Offshore Asset Protection Trust" (2013) Q Wealth Report <www.qwealthreport.com>.
413 Inland Revenue "Tax treaties" Inland Revenue Tax Policy <http://taxpolicy.ird.govt.nz>.