Chapter 25

Controlled Foreign Company Legislation in New Zealand

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25.1. Characteristics of New Zealand's CFC legislation

New Zealand enacted controlled foreign company (CFC) legislation in 1988 along with complementary legislation covering the taxation of foreign investment funds (FIFs) and offshore trusts. The CFC rules came into effect in several stages with the first part targeting companies resident in a list of nil or low-tax jurisdictions from 1 April 1988, while, for companies resident in other states, from 1 April 1993.

The initial impetus for the introduction of the CFC legislation was significant avoidance arising through the use of offshore companies located in low- and nil tax jurisdictions after New Zealand removed long-standing foreign exchange controls in 1985. These exchange controls had been in place since 1933 and prevented New Zealand residents from converting local currency into foreign exchange for offshore investments (equity shares and real estate) except in certain limited circumstances. Once these controls were suddenly lifted in 1985, New Zealand companies and high net-worth individuals were quick to put in place tax avoidance arrangements involving companies and trusts located in offshore tax havens such as the Cook Islands (a former New Zealand dependent territory), Hong Kong and the Channel Islands, among others. In the 1987 Budget[1] delivered on 18 June 1987, it was announced that CFC rules would be introduced as an "anti-tax haven" measure. At this stage, it appeared such rules would target New Zealand residents who held controlling interests in companies in low- or nil tax jurisdictions in respect of passive income only. The drafting of the CFC rules was referred to a consultative committee for further advice.

In December 1987, the government released a consultative document[2] on its proposed international tax reforms as part of a wide-reaching economic statement.[3] The international tax proposals contained in this document were

1. R. Douglas; *1987 Budget,* Government Print Wellington, June 1987.
2. R. Douglas, *Consultative Document on International Tax Reform,* Wellington, Dec. 1987.
3. R. Douglas, *Government Economic Statement*, 17 Dec. 1987.

much broader than initially proposed and the CFC rules that were proposed were no longer targeted just at passive income derived by companies in tax havens through companies in tax havens, but to eliminate deferral of New Zealand tax on income earned by all offshore entities controlled by New Zealand residents. These rules were to be supplemented by FIF rules which would apply to interests in offshore portfolio entities and revised tax rules applying to offshore trusts. Thus, the policy objectives underpinning the CFC rules underwent a significant shift from when they were announced in the 1987 Budget until the release of the consultative document from being a targeted anti-avoidance provision to one that extended residence-based taxation to holdings in all offshore entities eliminating any deferral. This extension of a proposal into something much broader and comprehensive was a trend in New Zealand's tax reform programme throughout the 1980s and 1990s. It is open to speculation that this was a deliberate manipulation by public officials to get the government committed to undertake a tax reform (i.e. to deal with tax avoidance using tax havens), which appeared perfectly reasonable and necessary, then manipulate the reform process to achieve something much broader that may not have been sellable to the government in the first instance. The resulting CFC rules that were enacted were part of a much wider package (including complementary FIF rules for which there were non-controlling interests in non-resident entities and for offshore trusts) which also involved the introduction of dividend imputation[4] and the taxation of intercompany dividends from foreign companies when previously they had been exempt.

From when the New Zealand CFC rules were first introduced, New Zealand has attributed income of offshore companies to their New Zealand shareholders as if they had earned income directly under what is termed a "branch equivalent" basis.[5] This effectively is the same as if the veil of incorporation of the CFC was lifted.

4. One key objective sought from the introduction of dividend imputation (which was part of the series of international tax reforms) was to create an incentive for companies to pay tax in New Zealand instead of offshore. Under the dividend imputation rules, any foreign tax credits that a New Zealand company receives in respect of any foreign-sourced income they derive cannot be passed on to shareholders as imputation credits.
5. Note that New Zealand does not exempt the income of any offshore branch (i.e. PE) and it has always been included as part of a resident's worldwide income.

A "controlled foreign company" is defined[6] as a foreign company[7] for which there is either:

(a) a group of five or fewer New Zealand residents whose total control interests in a foreign (non-resident) company are more than 50% in any one of four tests; or
(b) a single New Zealand resident holds a control interest of 40% or more unless, at the same time, the person's control interest is less than or equal to a control interest in the same category held by another person; and that other person is not a New Zealand tax resident and not associated with the single New Zealand shareholder; or
(c) there is a group of five or fewer New Zealand residents who can control the exercise of shareholder decision-making rights for the company and, as a result, control the company's affairs.

Thus, the concept of a "control interest" is central to the definition of a CFC. It is defined in section EX 2(1) and (2) as one that arises in each of four separate categories:

(a) shareholdings in the foreign company; or
(b) shareholder decision-making rights for the foreign company; or
(c) rights to receive income from the foreign company; or
(d) rights to receive distributions of the company's net assets.

The calculation of "control interests" is explained in section EX 3(1) as the direct control interests held by the taxpayer and persons associated with the taxpayer (whether resident or not)[8] plus indirect control interests held by the taxpayer and persons associated with them (again whether a New Zealand resident or not). Indirect control interests arise when the interests in the target CFC are held through a chain of companies. When a person has direct control interests of more than 50% in an intermediate company for determining the control interests of the final company, the direct control interests of the intermediate company are attributed to the final shareholders.

A company will be treated as a CFC for the whole accounting period if any one of the control tests is met on any day in the accounting period. This will not result in excessive attribution of income if the shareholder has only held shares in the CFC for part of the accounting period as the period

6. NZ: Income Tax Act 2007, sec. EX(1) [hereinafter ITA 2007], Primary Sources IBFD.
7. A "foreign company" is defined in section YA 1 of the ITA 2007 as a non-resident company or a resident company that is treated as a non-resident company under a double tax agreement.
8. *See* sec. EX 4 ITA 2007.

of ownership is taken into account when the amount of CFC income to be attributed to the shareholder is calculated.[9]

The New Zealand CFC rules are applied individually to interests in each non-resident company including lower-tier subsidiaries of CFCs. They apply not only to New Zealand companies with offshore subsidiaries but also to individuals with direct interests in non-resident companies. When interests in non-resident companies and other entities do not fall within the definition of a CFC (or are below the 10% threshold for income attribution), the FIF rules apply. These are explained in section 25.3.

Once a CFC exists, income from that CFC interest will be attributed to the New Zealand resident shareholders according to each resident shareholder's income interest.[10] Income interests are defined in a similar way to control interests with the key difference being that the income of CFC shareholdings held indirectly are calculated by multiplying through the chain of companies without the step-up for 50% of more interests in intermediate companies, which is done with the control interests test.[11] The interests of associated persons are not included as they will be taxed separately in respect of their CFC interests.

The New Zealand CFC rules have never defined a CFC on the basis of the tax rates applying to the CFC, although offshore company tax rates were partly considered in 1992 when revising which countries would be placed on the "grey list" of non-attributing CFCs. CFCs have always been defined using the control interest concept. When the CFC rules were first introduced, there were very few exemptions from the requirement to attribute CFC income. The only exemption offered was for CFCs resident in one of seven countries, namely, Australia, Canada, France, Germany, Japan, the United Kingdom and the United States that were known as "grey-list" countries.[12] The justification for this "grey list" was compliance cost grounds. These states had similar rates of tax to New Zealand's and had already adopted similar base protection measures so that, after the granting of foreign tax credits, very little additional income tax would be payable in New Zealand.

9. *See* sec. EX 17 ITA 2007.

10. *See* secs. EX 8 and EX 9 ITA 2007. Non-resident shareholders that were aggregated as associated persons under the control test do not have income attributed to them in respect of the CFC interests – sec. EX 16(2) ITA 2007.

11. *See* sec. EX 10 ITA 2007.

12. After the "grey list" was introduced, it was later revised by removing France and adding Norway and Spain; the latter two countries entered protests at being left off the list on the grounds that their tax regimes were not sufficiently robust against international tax avoidance.

Hence, there was little point in imposing significant compliance costs on New Zealand shareholders if little tax would be collected. No exemption was provided for active income earned by CFCs in any other country, which placed New Zealand-based companies at a significant disadvantage compared to their foreign competitors in respect of foreign operations.

The CFC rules underwent a substantial revision in 2009 when an active income exemption was introduced that is comparable to the one provided in Australia's CFC rules. However, at the same time, the "grey list" of countries where CFCs were not subject to income attribution was reduced to just one country, namely, Australia.[13] Thus, CFCs in countries such as the United States, the United Kingdom and Canada are now potentially subject to income attribution in respect of any passive income derived if they do not meet the active income exemption.

To qualify for an active income exemption, the CFC (termed a "non-attributing active CFC") must derive less than 5% of its total gross income from passive sources (interest, royalties, dividends, rental and lease income). This test can be applied using accounts prepared using IFRS or, in other circumstances, foreign tax accounts with some adjustments (such as for capital gains) to reflect New Zealand tax accounting rules.[14] It is important to note that this exemption hinges on the categories of incomes that are defined as passive; any other amounts of income are assumed to be active.

The second exemption from the requirement to attribute CFC income is for "non-attributing Australian CFCs", which are defined in section EX 22(1) of the ITA 2007. They are Australian companies which, at all times during the accounting period, are:

(a) tax residents of Australia (under Australian law and not treated as non-resident under any Australian double tax agreement (DTA)) and subject to income tax on their income; and
(b) their income tax liability has not been reduced by either an exemption from or in respect of income derived from business activities carried on outside Australia or any relief or allowance in respect of offshore banking units; and
(c) is not a unit trust unless it is one taxed as a company.

Broadly, if a CFC is resident and subject to tax in Australia, it is a non-attributing Australian CFC and is exempt from attribution under the New

13. *See* sec. EX 22 ITA 2007.
14. *See* secs. EX 21C-21E ITA 2007.

Zealand CFC rules if the New Zealand shareholders have an income interest of 10% or more.[15] If the Australian exemption does not apply, then one needs to determine whether to use tax measures of income or accounting measures of income to check if the CFC qualifies for the active business exemption. However, even if a non-attributing Australian CFC exists, the New Zealand shareholders may still have attributed CFC income or attributed CFC loss if the CFC derives personal services income.[16] Such income is always attributable.

For an Australian CFC to be "subject to tax", it requires one of two things. Firstly, the CFC can itself be subject to Australian income tax. Alternatively, the CFC can be part of a consolidated group for Australian tax purposes if that consolidated group (through the "head company") is itself subject to Australian income tax. Importantly, it is not sufficient for a person with an income interest in the CFC to be subject to Australian tax on the CFC's income.

An Australian CFC will not qualify to be a non-attributing one for New Zealand tax purposes if its liability for Australian income tax has been reduced by an exemption from or reduction of income tax for certain offshore business income. In these circumstances, the Australian CFC will be subject to an income attribution on the same basis as a CFC resident in other countries and still be eligible for the active income exemption if their passive income is below the 5% threshold. If ineligible for the active income exemption, all passive income derived by the CFC must be attributed. If a non-attributing Australian CFC holds an interest in another CFC, the Australian exemption will not automatically apply to that other CFC. This is because the other CFC is effectively treated as being held by the resident holders of interests in the first CFC rather than by the first CFC.[17] The eligibility of the other CFC for the New Zealand CFC exemption must be separately assessed.

If a non-attributing Australian CFC holds an interest in a FIF, the Australian exemption will not automatically apply to that other FIF. Again, this is because the FIF is effectively treated as being held by the resident holders of interests in the CFC rather than by the CFC itself.[18]

15. *See* sec. EX 22 ITA 2007.
16. *See* sec. EX 20B(3)(h) ITA 2007.
17. *See* secs. EX 10 and EX 21(13)(c) ITA 2007.
18. *See* sec. EX 58 ITA 2007.

If a CFC is ineligible for either the active income or Australian company exemptions, income must be attributed to New Zealand resident shareholders but only in respect of the passive income earned by the CFC. For income attribution to occur, the person must have an income interest of 10% or more in a CFC.[19] Under section EX 18, a person's attributed CFC income for an accounting period is defined to be:

income interest x net attributable CFC income or loss

Income interests are to be calculated on a quarterly basis although taxpayers have an option to use a weighted-average basis which is likely to be more attractive if there have been variations in their shareholding within a quarter.[20]

The attributable CFC income or loss is calculated under section EX 20B. It is a complex calculation taking into account the passive income of the CFC with adjustments for funding costs. Additionally, there is an interest allocation rule that applies under sections EX 20C and EX 20D to allocate interest expense against the CFC's income and the New Zealand shareholder's income.[21]

In calculating the tax payable by a New Zealand resident shareholder in respect of attributed CFC income, a foreign tax credit is allowed for income tax paid by the CFC when it derives that income including any withholding taxes. However, any credits arising under tax sparing provisions of a DTA will not be granted to the New Zealand shareholder on attributed CFC income.[22] The country in which the foreign tax has been paid and which a foreign tax credit is sought must be the same country from which the attributable CFC income is derived. This restriction is consistent with the New Zealand foreign tax credit rules whereby foreign tax credits are calculated on a source-by-source, country-by-country basis.[23] The amount of the foreign tax credit cannot exceed the New Zealand tax payable by the New

19. If their income interest is less than 10%, while no attribution occurs under the CFC rules, they are subject to income attribution under the FIF rules – refer to section 25.3.
20. *See* sec. EX 17 ITA 2007.
21. Under section DB 8 of the ITA 2007, New Zealand companies are entitled to a deduction for financing costs of acquiring shares in a subsidiary company provided there is at least 66% or greater common ownership. No nexus is required to be established between the interest expense of any income produced by the subsidiary and, in any case, intercompany dividends from non-resident companies are exempt from New Zealand tax.
22. Refer to NZ: Court of Appeal [NZCA], 8 Mar. 2018, *Lin v. Commissioner of Inland Revenue*, [2018] NZCA 38, (2018) 28 NZTC 23-052. *See also* NZ: NZCA, 8 Mar. 2018, *Lin v. Commissioner of Inland Revenue*, Tax Treaty Case Law IBFD.
23. *See* subpart LJ ITA 2007.

Zealand shareholder on their attributed CFC income. If there are excess foreign tax credits in respect of attributed CFC income, they can be carried forward to the next income year subject to a shareholding continuity test if the New Zealand shareholder is a company.[24] This is the only instance for which excess foreign tax credits can be carried forward under the ITA 2007; for other types of foreign-sourced income, any excess foreign tax credits are forfeited. The original reason for this carry-forward was to allow for timing differences when there was no active income exemption prior to 2009 and the active income of most CFCs had to be attributed.

Any loss derived by a CFC for which income attribution would otherwise occur is attributable to the New Zealand resident shareholders according to the fraction of their income interest but cannot be directly offset against their other sources of income. Instead, it can be only offset against attributed CFC income from other CFCs (and certain FIF interests) in the same jurisdiction in the same year. Otherwise, the attributed CFC losses must be carried forward to future income years subject to a minimum of 49% shareholding continuity being maintained in the CFC. Given that the CFC income is attributable on a "branch-equivalent" basis, it is inconsistent and inequitable for losses to be quarantined on this basis when losses derived by a New Zealand resident from an ordinary offshore branch (or PE) can be directly offset against other income.

The New Zealand CFC rules are applied individually to interests in each non-resident company including lower-tier subsidiaries of CFCs. They apply not only to New Zealand companies with offshore subsidiaries but also to individuals with direct interests in non-resident companies. When interests in non-resident companies and other entities do not fall within the definition of a CFC (or are below the 10% threshold for income attribution), the FIF rules apply. These are explained in section 25.3.

25.2. Implementation of Articles 7 and 8 of the Anti-Tax Avoidance Directive

As New Zealand is not an EU country, these articles of the Anti-Tax Avoidance Directive are not relevant.

24. This continuity requirement is the same as for the carry-forward of company tax losses – namely, 49% or greater continuity of shareholding.

25.3. Special CFC rules

New Zealand's CFC rules apply to all non-resident companies that meet the control tests explained in the first section of this chapter. There are no special rules for particular types of CFCs apart from the non-attribution of income from certain Australian CFCs. One notable feature of the New Zealand CFC rules are the complementary FIF rules.[25] They apply to all interests held by New Zealand residents in offshore entities that fall outside the CFC rules because one of the control tests is not met (even if the investor's income interest is above 10%) or in respect of CFCs when a resident's income interest is below 10%.

A FIF is an offshore investment that is:[26]
– a foreign company;
– a foreign unit trust;
– a foreign superannuation scheme (prior to 1 April 2014);
– a FIF superannuation interest; or
– an insurer under a foreign life insurance policy.

One of the major issues for attributing income from a FIF is that the New Zealand investor usually has limited scope to obtain detailed information from the FIF about its earnings in order to undertake income attribution in a way that is comparable to CFCs. Therefore, proxies are adopted to attribute FIF income in the absence of such detailed information. Five methods are potentially available to investors to determine the amount of FIF income to be attributed:[27]
(i) attributable FIF method;
(ii) comparable value method ("mark-to-market");
(iii) deemed rate of return method;
(iv) fair dividend rate method; and
(v) cost method.

Under all of the five above methods, any dividends or cash distributions received are ignored for tax purposes.

Investors do not necessarily have an unfettered choice among the five methods as not all methods can be used in all situations. The attributable FIF method is only available to non-portfolio holdings (interests of 10% or

25. *See* secs. EX 28-EX 73 ITA 2007.
26. *See* sec. YA 1 ITA 2007.
27. *See* sec. EX 44 ITA 2007.

more) and provides an active income exemption similar to the one offered under the CFC rules when the offshore company does not qualify as a CFC. The calculation of income under this option is extremely complex.[28]

The comparative value is "mark-to-market" and can only be applied when there are reliable market values available such as with listed companies. This method taxes unrealized capital gains and is the least attractive of the five methods, especially since New Zealand does not comprehensively tax capital gains on a realized basis for interests in New Zealand resident companies.[29]

The deemed rate of return method can only be used in rare circumstances after 2011 to interests in "certain non-ordinary shares" such as fixed rate shares and non-participating redeemable shares.[30]

The fair dividend method deems a 5% return on the market value of an investment at the beginning of each income year that starts on 1 April. If the investment was acquired during the year, no income is attributed in the first year unless sold within the same income year, which requires complex calculations. For individuals and family trusts, if the actual return (dividends plus capital gains realized and unrealized) is below 5%, the actual return is subject to tax. Managed funds are taxed on the deemed 5% return with no option for a lower amount if actual returns are low or negative.[31] While this method is the most commonly adopted for accounting for FIF interests, it can produce unusual outcomes. No taxable income is derived during the year an investment is acquired as there is a nil value at the start of the year. However, income is deemed to arise during the year an investment is sold.

The cost method is a variation on the fair dividend method and applies when there are no readily available market values. In this case, the cost of the investment is used with a 5% uplift each year (compounding) on the assumption that the real value of the investment will increase each year. A 5% deemed return is the FIF attributed income on the compounding cost figure each year.[32]

There are a range of exemptions from income attribution under the FIF rules with the most important being in respect of interests in most ASX listed

28. *See* sec. EX 50 ITA 2007.
29. *See* sec. EX 51 ITA 2007.
30. *See* sec. EX 55 ITA 2007.
31. *See* secs. EX 52-54 ITA 2007.
32. *See* sec. EX 56 ITA 2007.

Australian resident companies. Another is a *de minimis* exemption for FIF interests that have a cost in aggregate less than NZD 50,000.[33] There are further exemptions for certain listed Australian unit trusts, certain venture capital companies migrating to specified countries and interests in foreign superannuation schemes.

A second series of special rules concern portfolio investment entities (PIEs) that are vehicles for collective investments. These entities include managed funds that invest the contributions from investors in different types of investments. PIEs came into existence on 1 October 2007. PIEs cannot use the active income exemption for their foreign investments as, if they could, then there would be no New Zealand tax when PIEs distributed active income to their shareholders. Consequently, all CFC interests held by a PIE are deemed not to be CFC interests.[34] However, the foreign company will continue to be CFC, but the PIE will use the FIF rules as opposed to the CFC rules. Other persons with CFC interests in the CFC will continue to use the CFC rules.

In addition to the CFC and FIF rules, a third set of rules exist when the income is from a foreign trust.[35] A trust will be a foreign trust if none of its settlors have been resident in New Zealand since the later of these dates:
– 17 December 1987; *or*
– the date the trust was first settled.

A trust will cease to be a foreign trust if it makes any distribution after a settlor becomes a New Zealand resident or if a New Zealand resident makes a settlement on the trust. Foreign-sourced income derived by a New Zealand resident trustee is exempt income if certain criteria are met.[36] The amendments that apply from 27 February 2017 ensure that the foreign trust must comply with the increased disclosure obligations in order to be eligible for this tax exemption.[37] Further discussion of this regime is beyond the scope of this report.

One further area where special rules exist relates to new migrants. If a person becomes a tax resident in New Zealand, they may qualify for a

33. Once the NZD 50,000 threshold is exceeded, the FIF rules apply to all FIF interests from the first dollar.
34. *See* secs. EX 14 and EX 34 ITA 2007.
35. For further details on New Zealand’s foreign trust regime, *see* subpart HH of the ITA 2007 and section 147.
36. *See* secs. CW 54 and HC 26 ITA 2007.
37. *See* NZ: Tax Administration Act 1994, secs. 59B-59E [hereinafter TAA 1994], Primary Sources IBFD.

temporary tax exemption on some of their foreign income.[38] This exemption (which can only be granted once in a lifetime) is available to those who:
- qualify as a tax resident in New Zealand on or after 1 April 2006; and
- are new migrants or returning New Zealanders who have not been resident for tax purposes in New Zealand for at least 10 years prior to qualifying as a tax resident in New Zealand (transitional residents).

The temporary tax exemption for foreign income is for 4 calendar years (up to 49 months). It starts on the first calendar day of the month you qualify as a tax resident in New Zealand and ends on the last calendar day of that month 4 years later. The types of foreign income that are temporarily exempt from tax in New Zealand incorporates (italics added):[39]
- *CFC income that is attributed under New Zealand's CFC rules*;
- FIF income that is attributed under New Zealand FIF rules (including foreign superannuation);
- foreign income subject to non-resident withholding tax or the approved issuer (e.g. interest payable on offshore mortgages);
- accrual income (from foreign financial arrangements);
- income from foreign trusts;
- income derived from rental of offshore property;
- foreign dividends, interest and royalties;
- income connected with employment performed overseas before coming to New Zealand, such as bonus payments and from the exercise of foreign employee share options;
- gains on the sale of property derived offshore (held on revenue account); and
- offshore business income (that is not related to the performance of services).

25.4. CFC legislation and other anti-abuse provisions

The New Zealand CFC rules are legislatively complex, which reflects that they are a comprehensive taxing code for all interests New Zealand residents have in non-resident companies and similar entities. The revised trust taxation rules, which came into effect at the same time that the CFC rules did, are part of a comprehensive tax reform package including FIF rules. They are designed to prevent any substantial deferral of income earned by any offshore entity which, from an economic perspective, is owned by a New

38. *See* sec. HR 8 ITA 2007.
39. *See* sec. HR 8 ITA 2007.

Zealand tax resident. Consequently, the CFC, FIF and trust taxation rules all contain a large number of anti-avoidance provisions (found in sections GB 7 to GB 16 of the ITA 2007, among others) aimed at specific types of tax avoidance strategies that could allow taxpayers to circumvent these three sets of rules.

The New Zealand ITA 2007 has a wide-reaching general anti-avoidance rule (GAAR) in section BG 1.[40] It was held by the Privy Council in *Commissioner of Inland Revenue v Challenge Corporation Ltd*[41] that an arrangement that exploited deficiencies in the company tax loss carry-forward rules did not preclude the application of the GAAR to negate the advantages sought from that arrangement. Thus, compliance with any specific anti-avoidance provision in the ITA 2007 will not prevent the subsequent application of the GAAR, which is almost certain to be the case with the CFC (and related) rules. Therefore, the GAAR potentially applies to New Zealand resident's interests in any offshore entity and any arrangement that seeks to obtain an unintended tax advantage that was not in the contemplation of the New Zealand Parliament.[42]

25.5. CFC legislation and tax treaties

It is not proposed to traverse the role of DTAs generally and how they operate to reduce double taxation. It is well established that their interpretation in part follows the guidance in the Vienna Convention[43] as well other approaches to interpretation provided, for example, through the Commentaries to the OECD Model[44] (assuming this forms the basis of the negotiated DTA).[45]

40. For more information on the New Zealand GAAR, refer to C. Elliffe & A.M.C. Smith, *Chapter 22: New Zealand* in *GAARs – A Key Element of Tax Systems in the Post-BEPS Tax World* (M. Lang et al. eds., IBFD 2016), Books IBFD.
41. UK: PC, 20 Oct. 1986, *Commissioner of Inland Revenue v. Challenge Corp. Ltd.*, [1986] NZPC 1.
42. The judicial test that must be applied in considering whether the GAAR applies to an arrangement is known as the "parliamentary contemplation test". This test was established by the Supreme Court in *Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue*, [2009] 2 NZLR 289, and requires a consideration of "whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose" (at 109).
43. Vienna Convention on the Law of Treaties (1969) [hereinafter VCLT].
44. *OECD Model Tax Convention on Income and on Capital* (2017) and Commentaries on the Articles of the OECD Model Tax Convention (2017).
45. *See further* M. Lang et al., *General Report* in *CFC Legislation: Domestic Provisions, Tax Treaties and EC Law* pp. 28-38 (Linde 2004).

What is of interest is the interplay between the CFC rules and DTAs, especially with regard to judicial interpretation of this interplay. Until recently, the relationship between the CFC rules and tax treaties was reasonably clear in New Zealand. Tax treaties could limit the application of the CFC rules but in a limited manner. It is unclear how the new Article 1(3) of the OECD Model may change this approach. In this regard, it should be noted that New Zealand has adopted Article 11 of the Multilateral Instrument (MLI) in respect of all of its covered tax agreements that confirm the right of a party to tax its own residents, which presumably includes CFC rules. CFC rules are not listed as one of the exclusions in subsections (a) to (j) of Article 11 of the MLI.

The interaction between one of New Zealand's DTAs and the CFC regime was the subject of the High Court's decision in *Lin v Commissioner of Inland Revenue*,[46] overturned on appeal by the Court of Appeal.[47] Of significance is the fact that the relevant CFC rules in this case were those before the introduction of the active income exemption in 2009.

The High Court found that tax relief under the China-New Zealand Double Tax Agreement (China DTA)[48] is available for tax payable under the CFC regime. It also found that New Zealand tax credits are available for tax paid by a CFC in China and also for tax spared in China. If this decision stood, it would be of wider interest as New Zealand has tax sparing arrangements not only with China but also in its DTAs with Fiji, India, Korea, Malaysia, Papua New Guinea, Singapore and Vietnam.[49] The decision would provide guidance on how New Zealand resident taxpayers could qualify for foreign tax credits for tax spared in those countries.

The facts concern Ms Lin who was a New Zealand tax resident during the period 2005 to 2009 and indirectly held controlling interests in five Chinese companies. Under the New Zealand CFC rules, income earned by the Chinese companies was attributed to Ms Lin so she was liable for

46. NZ: High Court [NZHC], 12 May 2017, *Lin v. Commissioner of Inland Revenue*, Tax Treaty Case Law IBFD; [2017] NZHC 969, (2017) 28 NZTC 23-016.
47. *Lin* (2018), [2018] NZCA 38, (2018) 28 NZTC 23-052.
48. *Agreement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (1986, as amended through 1997)*, Treaties & Models IBFD.
49. *See* Art. 20(3) *Fiji-NZ DTA* (1977); Art. 23(3) *India-NZ DTA* (1986); Art. 23(4) *Kor. Rep.-NZ DTA* (1983); Art. 20(3) *Malay.-NZ DTA* (1976); Art. 22(3) and (4) *NZ-Papua N. Guin. DTA* (2013); Art. 21(3) *NZ-Sing. DTA* (2013) (in force until 2020 only) and Art. 22(3) *NZ-Viet. DTA* (2014).

New Zealand tax on this income. This attribution occurred notwithstanding that she never actually received any cash income from the CFCs. The income amounted to NZD 4.605 million for which the Commissioner of Inland Revenue (CIR) allowed tax credits of NZD 926,968 for tax paid in China by the companies. Under Chinese tax law, these companies were also relieved of tax totalling NZD 588,135 (referred to as "tax spared"). If this amount was credited against her New Zealand tax liability, Ms Lin's tax liability would have been reduced to approximately NZD 281,000. The Commissioner would not allow Ms Lin to claim any tax credits for the tax spared. The dispute came before the High Court.

Thomas J, in the High Court, held that the China DTA allows a credit against New Zealand tax payable by Ms Lin on her CFC income for Chinese tax paid by a CFC and that tax payable in China includes any tax spared amount. This decision, if it stood, would reduce Ms Lin's liability and ensure that no penalties would apply. The High Court decision in *Lin v. CIR* would suggest that the courts take a broad pragmatic approach in interpreting tax sparing provisions thereby enabling taxpayers to have the opportunity to utilize foreign tax credits and reduce their income tax liability accordingly.

On appeal, the Court of Appeal (Harrison, Cooper and Asher JJ) reviewed the application and interpretation of Article 23 of the China DTA. In applying a literal approach to its interpretation of Article 23, the Court of Appeal found that the High Court had misconstrued the meaning of the article by inferring that the tax relief provided in it extended to both juridical and economic double taxation. The Court of Appeal's decision confirms that New Zealand residents will not be entitled to a credit against income tax liability in New Zealand for tax spared by China on income earned there by companies in which the resident has a relevant income interest.

Specifically, the Court of Appeal reached its decision as follows. The starting point was the CFC regime. This regime was introduced to prevent New Zealand residents from deferring or avoiding New Zealand tax by accumulating income in non-resident companies. The Court of Appeal then observed that the purpose of the China DTA is to produce revenue reciprocity. That is, one country foregoes some of its income tax rights over source or residence taxation in return for the other country foregoing some of the same rights. The common economic purpose being to ensure that income is taxed only once. The Court of Appeal then considered that the issue should be approached by construing the text of Article 23 as a "sequential and related whole within its settled context".

The Court of Appeal agreed with the CIR's submission that Article 23(1) had the plain purpose of eliminating juridical double taxation in China by limiting the entitlement of a resident of that country to a credit on tax actually paid in New Zealand on income derived there. The Court of Appeal went on to note that, while there are linguistic differences between Article 23(1) and its companion provision (Article 23(2)(a)), the necessary inference in the absence of any contrary intention is that both relieve against juridical double taxation. This means that they allow only credits for taxes actually paid by a domestic resident in the foreign jurisdiction.

The Court of Appeal agreed with the CIR's submission that, in terms of Article 23(2)(a), the "income" of the CFC was not "derived" by Ms Lin in China and the tax paid or spared to the CFC was not payable, paid by or spared to Ms Lin. Furthermore, the Court of Appeal found that there was no scope to import a proposition that the "income derived" refers to the deemed or attributed income of the CFC under New Zealand legislation.

The Court of Appeal disagreed with the High Court's construction of Article 23(3). The High Court determined, that, when read in conjunction with Article 23(2)(a), the phrase "payable … by a resident of New Zealand" includes tax deemed to have been paid or payable by the New Zealand resident on income or tax deemed to have been earned or paid by the New Zealand resident through the CFC regime. Rather, the Court of Appeal viewed Article 23(3) as confirming the focus of Article 23(2)(a) as being on "tax payable in … China by a resident of New Zealand."

Ms Lin's argument relied on the phrase "in respect of" where it first appears in Article 23(2)(a) and stated that it should be construed as requiring a connection between tax paid in China and tax payable in New Zealand. The Court of Appeal disagreed and said that the phrase "in respect of" is synonymous with "on". The Court of Appeal was satisfied that Article 23(2)(a) requires the tax to have been paid by a New Zealand resident on income derived by him in China, not by a third-party CFC.

The Court of Appeal concluded that Article 23(2)(a) relieves solely against juridical double taxation. Ms Lin's argument required the Court to disregard the legal nature of the relationship between her and the CFCs. The fact that the ultimate source is income attributed to Ms Lin from the Chinese CFCs does not justify treating the two income streams (earned separately by her and the CFCs) as one for revenue purposes and ignoring the plain foundation of Article 23(2)(a) on the source of "the income derived by a resident of New Zealand".

The Supreme Court (New Zealand's highest appellate court) declined to grant leave for appeal, being of the view that the arguments were not points of sufficient importance to justify the grant of leave and there would be no risk of a miscarriage of justice.[50] The Court held that the change to the CFC regime in 2009 that required the attribution only of the passive income to a New Zealand shareholder of a CFC but not the active income significantly affected Ms Lin's case. This meant that it was unlikely that a CFC would ever benefit in the future from a tax sparing provision in relation to income attributed to it in New Zealand. Furthermore, the Supreme Court also noted that there were ongoing negotiations for a new China-New Zealand DTA. The Court noted that, even if the new DTA were to allow for tax sparing provisions, it anticipated it would be clear what credit should be available to a New Zealand tax resident.

The Court of Appeal's decision thus remains the final statement on the matter. Of particular note is that its approach to interpretation of DTAs differs in part from that applied in earlier New Zealand decisions and by international courts when interpreting international instruments such as DTAs and other tax treaties.[51] Specifically, the court has opted for a more literal approach, suggesting that DTAs are to be interpreted according to the same principles as those that apply to private contractual instruments and that each DTA "must be construed discretely, in accordance with its own particular terms".[52] This approach limits the precedential value of its decision to other New Zealand DTAs that contain tax sparing provisions.

The Court of Appeal's decision confirms that extraneous materials such as the OECD and United Nations Commentaries do not have the status of legislation. Furthermore, the decision does not directly consider other international tax agreements such as tax information exchange agreements (TIEAs) with low-tax jurisdictions and the Multilateral Convention regarding information exchange.[53]

50. NZ: NZSC, *Lin v Commissioner of Inland Revenue*, [2018] NZSC 54, (2018) 28 NZTC 23-061.

51. For example: NZ: NZCA, 14 June 1990, *Commissioner of Inland Revenue v. JFP Energy Inc*, Tax Treaty Case Law IBFD; [1990] 3 NZLR 536; CA: FCA, 26 Feb. 2009, *Prevost Car Inc. v. Her Majesty the Queen*, Tax Treaty Case Law IBFD; [2009] FCA 57, [2010] 2 FCR 65; AU: High Court of Australia, 22 Aug. 1990, *Thiel v. Federal Commissioner of* Taxation, Tax Treaty Case Law IBFD; 88 ATC 4094 (FCA); and NZ: NZHC, 9 June 2016, *Chatfield & Co Ltd v. Commissioner of Inland Revenue*, Tax Treaty Case Law IBFD; [2015] NZHC 2099, (2015) 18 ITLR 392, (2015) 27 NZTC 22-024.

52. *Lim* (CA), at para. [20].

53. *See* Double Tax Agreements (Mutual Administrative Assistance) Order 2013.

25.6. CFC legislation and constitutional law/EU law

New Zealand is not a member of the European Union and thus any EU law or directives are not applicable. New Zealand does not have a written constitution (similar to the United Kingdom), and thus there are no explicit constraints on the New Zealand legislature in enacting tax legislation. None of New Zealand's free trade agreements contain any significant restriction on how it may tax its residents unless some measure has been designed to be protectionist and to obstruct foreign trade.

25.7. Improving the current rules

The current CFC rules are a substantial improvement from when they were first introduced in 1988 with the introduction of the active income exemption in 2009 along with further changes to the complementary FIF rules in 2011. They are still complex, however, and give rise to substantial compliance costs for affected taxpayers that were made worse by the elimination of all countries except Australia from the "grey list". There is a case to restore the grey list to what it was in the 1990s as they included the countries where New Zealand businesses were most likely to have set up offshore subsidiaries and the amount of New Zealand tax collectible after granting foreign tax credits is low.

A more substantial issue is whether the underlying policy objective of the CFC rules should be revised to just target offshore tax avoidance arrangements rather than eliminating deferral on all offshore income. This would require a significant revision to the accompanying FIF rules. As the CFC (and FIF) rules are seen by politicians to be highly technical and largely the domain of public officials, these officials have had undue influence in the drafting of them. It would have been ideal if their own views have been more influential on the design of these rules. There is little taxpayer pressure to review the rules and thus no political appetite to revisit them after much controversy in their initial enactments (especially with the FIF rules).

25.8. Outlook: The future of CFC legislation

New Zealand itself is of the view that it has robust CFC rules and this is something that other jurisdictions should have as well. New Zealand does not appear to have a view on whether there should be a global minimum tax. Revenue collected from the operation of New Zealand's CFC legislation is not in itself likely to be significant, but the absence of such rules would see widespread avoidance and, in all likelihood, a significant reduction in tax revenue. The deterrent effect that comes with the CFC rules is important.

New Zealand is of the view that its GAAR is effective for tackling artificial shifting of income to other countries. In part, this is reflected in the CIR's success in litigating cross-border transactions and CFCs, as shown in the *Lin* case and in the *Alesco* case.[54]

In some respects, the outlook in terms of CFC legislation in New Zealand is one of "wait and see". In its response to base erosion and profit shifting (BEPS),[55] the New Zealand government's view (as advised by officials) was that New Zealand had robust CFC rules and no changes were necessary to accommodate the BEPS Action Plan. Should this prove to be wrong, then implementation of necessary legislation would ensue. As at the time of writing, the New Zealand government and officials have not identified any deficiencies. That said, officials will be monitoring developments from the OECD in the light of the implementation of BEPS.

From a judicial interpretation of treaties' perspectives, the *Lin* decision, if left as it stands, shows that the New Zealand courts have moved some distance from their well-established position to one in which the interpretation of each DTA needs to occur in isolation of any other DTA. In this regard, prior judicial decisions will not serve to the same degree as precedents. This divergence in approach, in the authors' view, is unhelpful to New Zealand taxpayers seeking to reply on DTAs when it comes to tax sparing (and potentially other provisions in the DTAs).

54. NZ: NZCA, 5 Mar. 2013, *Alesco NZ v. Commissioner of Inland Revenue*, [2013] NZCA 40, [2013] 2 NZLR 175, (2013) 26 NZTC 21-003.
55. *See*, for example, A. Sawyer & R. McGill, *The Adoption of BEPS in New Zealand*, in *Tax Design and Administration in a Post-BEPS World: A Study of Key Reform Measures in 18 Jurisdictions* Chap. 2, pp. 211-228 (Kerrie Sadiq, A. Sawyer and B. McCredie, eds., Fiscal Publications 2019).

Appendix: Article 23 of the China-New Zealand DTA

Article 23

Methods for the elimination of double taxation

1. In China, double taxation shall be eliminated as follows:

   Where a resident of China derives income from New Zealand, the amount of tax on that income payable in New Zealand, in accordance with the provisions of this Agreement, may be credited against the Chinese tax imposed on that resident. The amount of credit, however, shall not exceed the amount of the Chinese tax on that income computed in accordance with the taxation laws and regulations of China.

2. In the case of New Zealand, double taxation shall be avoided as follows:

   a) Subject to any provisions of the laws of New Zealand which may from time to time be in force and which relate to the allowance of a credit against New Zealand tax of tax paid in a country outside New Zealand (which shall not affect the general principle hereof), Chinese tax paid under the laws of the People's Republic of China and consistently with this Agreement, whether directly or by deduction, in respect of income derived by a resident of New Zealand from sources in the People's Republic of China (excluding, in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid) shall be allowed as a credit against New Zealand tax payable in respect of that income;

   b) For the purposes of this Article, income of a resident of New Zealand which in accordance with the provisions of this Agreement may be taxed in the People's Republic of China shall be deemed to arise from sources in the People's Republic of China.

3. For the purposes of paragraph 2(a), tax payable in the People's Republic of China by a resident of New Zealand shall be deemed to include any amount which would have been payable as Chinese tax for any year but for an exemption from, or reduction of tax granted for that year or any part thereof under any of the following provisions of Chinese law:

   a) Articles 5 and 6 of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign

Investment and Article 3 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment;

b) Articles 4 and 5 of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises;
c) Articles I, II, III, IV and X of Part I, Articles I, II, III and IV of Part II and Articles I, II and III of Part III of the interim provisions of the State Council of the People's Republic of China concerning reduction or exemption from enterprise income tax in special economic zones and coastal cities;

so far as they were in force on, and have not been modified since, the date of signature of this Agreement, or have been modified only in minor respects so as not to affect their general character; or

d) any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.