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SUBMISSIONS TO THE GOVERNMENT INQUIRY INTO FOREIGN TRUST DISCLOSURE RULES

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INTRODUCTION

1. I am a Professor of Law at the University of Auckland Law School. My principal field of expertise is tax law and tax policy, including international tax, tax planning and tax avoidance. I have published extensively in these areas both in New Zealand and in other countries. I am a fulltime academic but I have also from time to time provided advice to business interests and to the governments of several countries. I make these submissions in my personal capacity.

2. On 19 April 2016 the government established an Inquiry into the Foreign Trust Disclosure Rules and on the same day it appointed John Shewan to conduct this Inquiry. Also on that day, a notice of the establishment of the Inquiry and its terms of reference were published in the New Zealand Gazette, available at: https://gazette.govt.nz/notice/id/2016-go2253. Mr Shewan has suggested that submissions to the Inquiry might address five particular questions which have been formulated by him and which broadly reflect the terms of reference; see email from John Shewan to interested parties, 20 April 2016. This submission adopts that suggestion and responds to the five questions in the order in which Mr Shewan has posed them.

3. .Coincidentally over the last 18 months or so I have been working on an analysis of the foreign trust disclosure rules, the risk that they pose to New Zealand's reputation and what, if anything, should be done about them. The current state of that analysis is set out in a paper called "Using New Zealand as a Tax Haven: How is it Done? Could it be Stopped? Should it be Stopped?" The paper is annexed to this submission and available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2761993. Earlier versions of it were presented at meetings of the New Zealand Branch of the International Fiscal Association (IFA) on 13 March 2015, the Law and Economics Association of New Zealand (LEANZ) on 30 April 2015, the University of Auckland Law School on 25 August 2015, the Association of Certified Anti-Money Laundering Specialists (ACAMS) on 30 November 2015 and the New Zealand Police Asset Recovery Unit on 17 December 2015.

4. I would like to put on record at the outset that in my view the various criticisms that have been made of Mr Shewan's appointment are misconceived. It might have been better for the government, given that what it wants is legal advice, to have appointed a lawyer rather than an accountant. But there is no reason to regard Mr Shewan as anything other than highly competent and entirely principled. There is also much to be said for engaging a poacher as gamekeeper. It might be added, however, that the establishment of the Inquiry was and is unnecessary and a waste of money. The reason is that there is plenty of expertise within the Inland Revenue Department; if the government wanted advice as to the law relating to foreign trusts, all it had to do was ask the Department.

5. The five questions posed by Mr Shewan and my responses to them are as follows.

THE FIVE QUESTIONS

Question 1: [Do] you consider the existing foreign trust disclosure rules are adequate to ensure that New Zealand's reputation as a country that cooperates with other jurisdictions to deter abusive tax practices [is maintained]?

6. The answer to this question is "No". It is obvious and not plausibly deniable that New Zealand's reputation "as a country that cooperates with other jurisdictions to deter abusive tax practices" has already suffered as a result of the recent publicity given to the laxity of the foreign trust disclosure rules. It seems inevitable also that the country's reputation will suffer further damage unless the law is changed.

Question 2: Concerns have been raised that foreign trusts may be used as vehicles to hide investments that might not have a legitimate source. Do you consider that the existing anti-money laundering/countering foreign terrorism legislation is able and sufficient to address such concerns?

7. I have no comment on this aspect of the Inquiry.

Question 3: If no to either of the above questions, is this because the law is not adequate or because the enforcement is not sufficiently rigorous?

8. The reason New Zealand's reputation has suffered is that the law (meaning mainly the relevant provisions in the Income Tax Act 2007 and the Tax Administration Act 1994) allows the country to be used as a tax haven. By this I mean simply that New Zealand law allows people resident in other countries to use New Zealand as a means of avoiding some of the tax that they would otherwise have to pay in their home country. In particular, New Zealand law allows non-residents to use trusts established in New Zealand to avoid the tax they would otherwise have to pay in their home country. How this works is explained in the paper annexed to this submission.

9. There has been much debate recently, almost all of it ill informed, as to whether or not New Zealand is a tax haven. In particular, if "tax haven" is defined as meaning "a jurisdiction that does not tax incomes", then plainly New Zealand is not a tax haven. A more meaningful definition, however, is that a tax haven is "a jurisdiction that allows itself to be used by non-residents as a means of avoiding the tax that they would otherwise have to pay in their home countries". By this definition, New Zealand is plainly a tax haven.

10. The suggestion (raised by the Inquiry's terms of reference) that "enforcement is not sufficiently rigorous" implies that the damage that has been done to New Zealand's reputation is the fault of the Inland Revenue Department. This is unfair; it is obviously not the Department's fault that the law allows the country to be used as a tax haven. Moreover, it would appear that the Department some time ago (in 2013) alerted the government to the fact that the law allowed the country to be used as a tax haven and that this posed a risk to the country's reputation; yet the government chose to leave the law as it was.

Question 4: What changes to the foreign trust disclosure rules or their enforcement do you recommend?

Preliminary Points

11. If the New Zealand government wanted to stop foreigners from using the country as a tax haven, it would be technically straightforward for it to do so. Before suggesting how that might be done, however, it is necessary to make several preliminary points.

12. First, whilst the current law relating to foreign trusts is such as to have attracted considerable adverse publicity, it does not necessarily follow that the law should be changed. The reason is that the adverse publicity might be a price worth paying for the advantages that might be obtained by leaving the law as it is. In particular, setting up and administering trusts for foreigners generates economic activity in New Zealand; and the firms that do that work employ staff, pay taxes and so on.

13. Secondly, whether the adverse publicity that comes with allowing the country to function as a tax haven is a price worth paying for the economic benefits is a question that is not susceptible to a technical answer. For that reason neither I nor Mr Shewan nor any other expert is any better placed to answer it than anyone else.

14. Thirdly, there seem to be a considerable number of people who believe that as a matter of principle the New Zealand government should not allow the country to be used as a tax haven, even if the economic benefits of doing so outweigh the reputational damage. Again, however, this is a question that is not susceptible to a technical answer. That is, neither I nor Mr Shewan nor any other expert is any better placed than anyone else to express an opinion as to whether, as a matter of principle, the government should allow the country to be used as a tax haven.

15. Fourthly, it seems that some members of the public are under the impression that the New Zealand foreign trust regime is somehow being used by New Zealand residents to avoid or evade tax. That is, of course, incorrect. The problem, if it is a problem, is that non-residents might be using New Zealand trusts to avoid or evade the taxes that they would otherwise pay *in their home countries*. In other words, it is only other countries whose taxes might be avoided or evaded; the New Zealand government's own revenues are not at risk. On the contrary, the New Zealand government gains by taxing the firms that carry on business in New Zealand setting up and administering trusts for non-residents.

16. Fifthly, whilst the New Zealand government could easily stop non-residents using the country as a tax haven if it wanted to, it is virtually certain that that would make no difference to the overall amount of tax avoidance and evasion going on in the world. The reason is that there are many other jurisdictions that can be used, and are being used, as tax havens. If the New Zealand government were to tighten up the rules relating to foreign trusts, the virtually

certain consequence would be that people currently using this country as a tax haven would use some other jurisdiction instead – for example, Hong Kong.

17. Sixthly, whilst it is probable that New Zealand is being used as a tax haven, it seems unlikely that this is, by the standards of the rest of the world, a significant problem. Of all the tax avoidance and evasion going on in the world, it seems probable that the part of it that involves New Zealand is a small fraction of one per cent.

What Changes to the Foreign Trust Disclosure Rules Might be Appropriate?

18. If the New Zealand government would prefer not to allow the country to be used as a tax haven, the remedy would be straightforward. All that would be required would be to strengthen the disclosure requirements.

19. Under the current law, a person or company who is resident in New Zealand and who is the trustee of a foreign trust is obliged to inform the Inland Revenue Department of "the name or other identifying particulars (for example, the date of the settlement on the trust) that relate to the foreign trust": Tax Administration Act 1994, section 59B. If the settlor is resident in Australia, the New Zealand-resident trustee is obliged to supply certain other information also. But if the settlor is resident anywhere other than Australia, the trustee is not obliged to supply anything other than *the name or other identifying particulars (for example, the date of the settlement on the trust) that relate to the foreign trust*. Moreover, even this is only a one-off requirement. That is, once the trustee has advised the Department of "the name or other identifying particulars (for example, the date of the settlement on the trust) that relate to the foreign trust", no annual (or any other) updating is required.

20. This is inadequate to prevent foreigners from using New Zealand as a tax haven. In particular, under the current law, the Department generally does not even know who the settlor and the beneficiaries are, let alone which country or countries they are resident in – so it does not know which countries' taxes they might be avoiding or evading. For this reason, the current disclosure requirement is almost completely useless.

21. It would be possible to prevent the kind of tax avoidance and evasion that is currently of concern (that is, non-residents using New Zealand trusts to avoid or evade the tax they would otherwise have to pay in their home countries) by amending the law (specifically section 59B of Tax Administration Act 1994) so as to require every person who is a New Zealand resident trustee of a foreign trust to disclose annually to the Inland Revenue Department more information than is currently required as to the settlor, the beneficiaries, the trust's assets, its income and the distributions made to the beneficiaries.

22. Every such trustee would also have to be required to update this information annually, so as to take into account changes in the identity of the beneficiaries, the beneficiaries' countries of residence, the financial affairs of the trust and so on.

23. More specifically, to prevent the kind of tax avoidance and evasion that is currently of concern the law would have to be amended so as to require every person who is a New Zealand resident trustee of a foreign trust to disclose annually to the Inland Revenue Department the following information (which the Department would then be able to supply to the foreign governments whose taxes were being avoided).

23.1 The identity of the settlor or settlors (meaning any person who has at any time settled property on the trust or otherwise transferred value to it). This information is needed to enable the IRD to determine who it is that might be avoiding or evading tax. It would have to be an annual requirement because otherwise it would be possible to avoid disclosure by arranging for one person to establish a trust and for another to settle further assets on it at a later date.

23.2 The country of residence of the settlor (or settlors). This information is needed so as to enable the IRD: (a) to identify the settlor adequately; (b) to determine which country's or countries' taxes are at risk of avoidance or evasion; and (c) to determine also therefore which country's or countries' tax authorities might be interested in receiving information about the trust.

23.3 The identity of the beneficiaries. As with the settlor, this information is needed so as to enable the IRD to determine who it is that might be avoiding or evading tax. It would have to be an annual requirement because otherwise it would be possible to avoid disclosure by establishing a trust and then adding further beneficiaries at a later date.

23.4 The country of residence of the beneficiaries. As with the settlor, this information is needed so as to enable the IRD: (a) to identify the beneficiaries adequately; (b) to determine which country's or countries' taxes are at risk of being avoided or evaded; and (c) to determine also therefore which country's or countries' tax authorities might be interested in receiving information about the trust. This, too, would have to be an annual requirement because of the possibility that beneficiaries might move from one country to another.

23.5 The nature of the assets held by the trust (and any further information required to make it possible to identify the assets). This information is needed because without it the country or countries that might have an interest in taxing the income (if any) produced by the assets would be unable to determine whether their laws are being complied with. Again, this requirement and the other requirements relating to the financial affairs of the trust (see below) would have to be an annual requirement to enable the New Zealand Inland Revenue Department to supply up-to-date information to other governments having a legitimate interest in it.

23.6 The country in which the assets are situated. Again, this information is needed because without it the country or countries that might have an interest in taxing the income (if any) produced by the assets would be unable to determine whether their laws are being complied with.

23.7 The value of the assets. Again, this information is needed because without it the country or countries that might have an interest in taxing the income (if any) produced by the assets would be unable to determine whether their laws are being complied with.

23.8 The amount of income received by or accruing to the trustee. Again, this information is needed because without it the country or countries that might have an interest in taxing the income produced by the assets would be unable to determine whether their laws are being complied with.

23.9 The identity of any person to whom the trustee transfers value (by distribution, licence to use, or otherwise). This requirement is worded as it is because it is possible for trustees to transfer value to beneficiaries not only by straightforward payments but also by other means. For example, instead of distributing cash to a beneficiary, the trustee could either (a) lend money interest-free to the beneficiary and not require repayment or (b) buy a house and allow the beneficiary, or a family-member of the beneficiary, to live in it. Such arrangements might or might not entail tax consequences for the beneficiary, depending on the law of the beneficiary's country of residence. But the tax authorities of the countries concerned will need to know about such arrangements so as to determine their tax consequences (if any).

23.10 The means by which any such transfer of value is effected. Again, the tax authorities of the countries concerned will need to know how such transfers are effected so as to determine their tax consequences (if any).

24. If the New Zealand IRD were to be supplied with this information it would be able, in turn, to supply it to whichever other government or governments it regarded as having a legitimate interest in it – assuming the requisite information exchange arrangements to be in place under a Double Tax Agreement (DTA) or a Tax Information Exchange Agreement (TIEA) or otherwise (for example under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters). Typically that would be the country of residence of the settlor and the country or countries of residence of the beneficiaries (and perhaps also the country or countries in which the assets are situated, though that is likely to be less important because governments are generally able to identify assets situated within their jurisdiction). Then, if the tax authorities in that country (or those countries) wished to do so, they could determine whether the settlor and the beneficiaries were complying with the relevant tax laws.

Enforcement

25. There appears to be no reason to suppose that the Inland Revenue has been anything other than exemplary in its administration of the existing law.

26. If the law were to be changed as discussed above (that is, by strengthening the disclosure requirements), the consequences would include increased administration and compliance costs. New Zealand-resident trustees of foreign trusts would have to supply more information to the Department than is currently required. Moreover, this would be an annual requirement, rather than one-off. As for the Department, it would be obliged, every year, to receive this information, store it, analyse it, decide whether to forward it to the relevant foreign government (or governments) and, where appropriate, forward it to that government (or those governments).

27. Under the current law, New Zealand resident trustees of foreign trusts are generally not taxed in New Zealand: see Income Tax Act 2007, sections CW 54 and HC 26(1). It might therefore be desirable to keep their compliance costs low. What is more important is that the costs incurred by the Department in monitoring foreign trusts should be kept as low as possible. The reason is that these trusts will generally not be subject to New Zealand tax, so the monitoring undertaken by the New Zealand IRD will be entirely for the benefit of *other countries'* tax departments.

28. The additional administrative and compliance costs resulting from strengthening the disclosure requirements would, however, be minimal. In particular, New Zealand-resident trustees of foreign trusts should already be keeping records of information of most of the kinds referred to above; see Tax Administration Act 1994 sections 22(2)(fb), 22(7)(d) and 22(2C). Consequently, strengthened disclosure requirements would entail little more than that the trustee would have to make available to the Department information already in its (the trustee's) possession. As for the Department, as indicated above, it would have to receive the information, store it, analyse it, decide whether to forward it to the relevant foreign government and, where appropriate, forward it to that government. This would not seem to be terribly burdensome. Moreover, it seems likely that the consequences of strengthening the disclose requirements would include that some foreign trusts would be relocated to some other jurisdiction (so as to retain their confidentiality). If that were to happen, it would lessen the administrative burden on the New Zealand IRD.

Question 5: What other actions might be taken?

29. An alternative course of action would be simply to repeal sections CW 54 and HC 26(1) of the Income Tax Act 2007. The effect of that would be to impose tax on New Zealand-resident trustees of foreign trusts. That is, if the exemption provided for by those sections were to be withdrawn, New Zealand-resident trustees of foreign trusts would be subject to the general rule – that persons resident in New Zealand are subject to New Zealand tax on their worldwide income (with allowance generally for foreign taxes, so as to provide relief from double taxation). The effect of imposing tax on New

Zealand-resident trustees of foreign trusts would probably be that most of them, if not all of them, would leave New Zealand or be wound up (most if not all such trustees presumably being companies incorporated for the purpose).

30. In some respects, this would be a desirable outcome. In particular, it would make plain that New Zealand does not allow itself to be used for this kind of tax avoidance and it would minimise the administrative burden on the IRD. But it might also be a harsher measure than is warranted. In particular, some commentators have suggested that at least some of those who have set up foreign trusts in New Zealand have done so for legitimate reasons; that is, they have claimed that these trusts are not being used to avoid tax or for any other illicit purpose. To the extent that this claim is sound, it might be said that the industry of setting up and administering foreign trusts is harmless, even beneficial; that there is no reason in principle to tax such trusts (because there is no reason, in principle, for New Zealand to tax income derived from outside New Zealand for the benefit of persons who are not resident in New Zealand); and that such income therefore ought not to be taxed in New Zealand. It might also be politically easier to strengthen the disclosure requirements than to repeal sections CW 54 and HC 26(1) – and the result would probably be much the same (that is, most or all of these trusts would emigrate or be wound up).

31. I would be happy to elaborate on these submissions and to answer questions about them.

Michael Littlewood

13 May 2016

USING NEW ZEALAND AS A TAX HAVEN: HOW IS IT DONE? COULD IT BE STOPPED? SHOULD IT BE STOPPED?

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ABSTRACT

The New Zealand tax system is so structured as to allow the country to be used as a tax haven. Specifically, it allows non-residents to use trusts established in New Zealand to avoid the tax they would otherwise have to pay in their home country. This article explains how this works, and asks whether New Zealand law should be changed so as to prevent tax avoidance of this kind or, at least, to make it easier for other governments to prevent it.

INTRODUCTION

The question this article seeks to address is whether, as a matter of policy, New Zealand should allow itself to be used as a tax haven. The article is not about the avoidance of New Zealand taxes. Rather, it is about non-residents using New Zealand as a means of escaping the taxes they would otherwise have to pay in other countries. More specifically, it is about non-residents using trusts established in New Zealand to reduce their liability to tax in their country of residence.

Take, for example, the case of a person who is resident in Portugal and owns a forest in Indonesia; and who generates income by arranging for the trees to be chopped down and sold. Or it could equally be a Mexican who owns a chain of fast food

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[1] University of Auckland Law School. I am grateful to all those who contributed observations on drafts of this article at meetings of the New Zealand Branch of the International Fiscal Association (IFA) on 13 March 2015, the Law and Economics Association of New Zealand (LEANZ) on 30 April 2015, the University of Auckland Law School on 25 August 2015, the Association of Certified Anti-Money Laundering Specialists (ACAMS) on 30 November 2015 and the New Zealand Police Asset Recovery Unit on 17 December 2015. I am especially grateful to Robin Oliver, John Hart, John Bassett, Andy Archer, Susan St John, Gary Hughes, Tim Goldrick and Jeng Chen (none of whom, however, should be taken as agreeing with any of the conclusions advanced here). I am grateful also to Ana Lenard for helping with the research upon which the article is based.

outlets in several South American countries or a resident of the UK who owns a block of flats in Hong Kong – but the Portuguese with the forest in Indonesia is as good an example as any. The income derived from the forest will be taxable in Indonesia, albeit at a relatively low rate.[2] It will also be taxable in Portugal, at a relatively high rate. There will not be any double tax, because the taxpayer will be entitled to a tax credit in Portugal for the tax paid in Indonesia. That is, he (or she; but the owners of income-producing offshore assets are mostly men) will be able to set off against his liability to tax in Portugal the tax that he paid in Indonesia, so in Portugal he will pay the difference between the Portuguese rate of tax and the Indonesian rate of tax. The end result will be that his overall rate of tax will be the same as if he were simply paying tax in Portugal at his marginal rate of tax; and since ownership of income-generating offshore assets correlates with income, he is likely to pay tax in Portugal at the highest rate.

It is commonly possible, however, for persons in such circumstances to substantially reduce their liability to tax by using a trust set up in New Zealand.[3] This will typically be arranged by an advisor resident in New Zealand. The adviser might be a law firm, an accounting firm or a firm having no professional qualifications at all – for it appears that there is no law requiring any kind of professional certification of persons supplying advice as to the setting up and administering of trusts. In any event, the firm incorporates a company, owned by itself or by some other entity controlled by it. The taxpayer then transfers the forest in Indonesia to the company to hold on trust for himself or for members of his family. The firm provides whatever is required in the way of administering the trust in accordance with the wishes of the settlor.

The result is that the profits derived from the forest are still taxable in Indonesia, as before. But no tax is payable in Portugal and no tax is payable in New Zealand. No tax is payable in Portugal because the income is no longer the income of anyone resident in Portugal. Rather, it is the income of the company; and the company is resident in New Zealand, not Portugal. And no tax is payable in New Zealand because, whilst a person resident in New Zealand is generally taxable on his or her worldwide income,[4] no liability arises where (a) the person deriving the income is a trustee; and (b) the settlor (that is, the Portuguese) is not resident in New Zealand; and (c) the asset producing the income is situated somewhere other than New Zealand; and (d) the beneficiaries are not resident in New Zealand.[5]

If the trustee simply distributes the income to the beneficiaries in Portugal, then they will be liable to tax in Portugal. But it is typically possible for the trustee to get the money to the beneficiaries in some other way. For example, the trustee might accumulate the income for a few years and *then* distribute it to the beneficiaries; and that way it might count as a non-taxable capital distribution, rather than as taxable income. Or the trustee might *lend* the money to the beneficiary; and then some years

[2] The point of this article is to show how New Zealand can be used as a tax haven. The other countries referred to – Portugal, Indonesia and so on – are merely used to illustrate the operation of New Zealand law. Thus, whilst authority (generally statutory) is cited for propositions of New Zealand law, it would seem unhelpful to burden the article with authority for general statements as to how other countries' tax laws operate.

[3] John Prebble has written extensively about the New Zealand tax treatment of foreign trusts. See for example John Prebble "New Zealand Trusts in International Tax Planning" [2000] British Tax Review 554.

[4] Income Tax Act 2007, s BD 1(5).

[5] Income Tax Act 2007, ss CW 54 and HC 26(1).

later forgive the loan. Or the trustee might purchase a house in Lisbon and allow the beneficiary to live in it rent-free. Or the trustee might use the funds to acquire further income-producing assets. Thus the relatively low amount of tax paid in Indonesia constitutes the whole of the burden. From Portugal's point of view, New Zealand has functioned as a tax haven.

The argument in favour of allowing New Zealand to function as a tax haven in this way is as follows. First, supplying tax-haven services to non-residents generates economic activity. That is, it generates work for the firms that carry on business in New Zealand setting up and administering trusts for non-resident clients. It is a small industry, but growing. Moreover, given that its clients are ex hypothesi non-resident, it generates foreign exchange. The scale of the industry is difficult to gauge because the firms that undertake this work do not necessarily advertise; and even if they advertise, they do not publish any data as to the scale of their business. Discussions with people working in the field, both those doing the work and officers of the Inland Revenue Department (Department or IRD), suggest that the industry generates somewhere between $25 million and $50 million per year. The rumour among tax-advisers is that the industry is about the same as the avocado export industry. The Revenue has also advised that the number of such trusts is currently about 11,000. It has not published any data as to the value of the assets held in those 11,000 trusts. One reason for that appears to be that the Department itself has no idea what the value of the assets is, but it seems reasonable to suppose that it is several billion dollars. Beyond that, however, information is hard to come by. It would be useful to know in which countries the settlors and the beneficiaries are resident; what sorts of assets the trustees hold; in which countries the assets are situated; the value of the assets; and the amount of income generated by the assets. How much data of these kinds the Department holds is unclear. It is possible that the answer is "very little". In any event, the Department has not published any such data and has declined to supply any on request.

In the short term, at least, New Zealand seems to benefit from functioning as a tax haven. Most of the benefit goes to the lawyers and accountants and others who provide these services, but they employ people and pay rent and consume goods and services and so on. It seems clear, therefore, that the industry benefits the economy generally. And it is only *other* countries' taxes that are being avoided, so this kind of tax avoidance costs the New Zealand government nothing. In fact the government *benefits* because the advisors providing the services pay tax on their incomes and GST on their consumption. Moreover, if income is derived from outside New Zealand for the benefit of a person not resident in New Zealand, it might be said that as a matter of principle it should not be taxed in New Zealand. Moreover, it is not as if New Zealand is the only country operating as a tax haven; there are plenty of others. So if New Zealand were to cease functioning as a tax haven, that would not reduce the amount of tax avoidance going on in the world. Rather, if New Zealand were to cease offering this service, the tax avoiders would simply go elsewhere.

On the other hand, the New Zealand government likes to portray itself as a reputable member of the international community. It even denies that New Zealand is a tax haven, though the denial is implausible. There is no agreed definition of "tax haven" but a workable definition for present purposes is that a tax haven is any country that wilfully allows itself to be used as a means of avoiding other countries' taxes (meaning a fortiori that any country that deliberately sets out to allow itself to be used as a means of avoiding other countries' taxes is also a tax haven). By this definition, New Zealand is plainly a tax haven. The New Zealand government's claim that the country is not a tax haven assumes a definition of the term so narrow as to be misleading – for example, that a tax haven is a country that does not impose any taxes on income.

In any event, it may be that in the medium term New Zealand loses as a result of the foreign trust regime, because perhaps the short-term gains made by the tax avoidance industry are less than the longer-term losses resulting from the damage to the country's reputation. It might also be argued that the question is not simply a matter of direct self-interest and that it is simply wrong in principle for a country to allow itself to be used to undermine other countries' tax systems – especially if it does so deliberately. Further, whilst there are plenty of other tax havens in the world, it would seem that there are no other members of the OECD that permit this particular form of tax avoidance. Therefore, if New Zealand were to tighten up its foreign trust regime, the tax avoiders would have to resort to some less reputable jurisdiction.

The article consists of two main parts. Part I examines the law and explains how it is possible to use New Zealand as a tax haven. That is, it explains how it is possible for persons resident in other countries to use New Zealand as a tax haven – in other words, how it is possible for persons resident elsewhere to use a New Zealand trust to escape, to some degree, the tax they would otherwise have to pay in their home country. It also explains how the law got to be as it is. The second explains what it would be possible for the New Zealand government to do about it, if it were to decide that it would rather not allow the country to be used as a tax haven.

THE LAW

It is necessary to begin by outlining the relevant provisions of the New Zealand tax system – that is, first, the rules defining the system's jurisdictional scope and, second, those governing the tax treatment of trusts.

Jurisdiction: Residence and Source

Like most tax systems, New Zealand's is based on the twin jurisdictional pillars of residence and source. The *residence* principle is that a person who is resident in New Zealand is obliged to pay New Zealand tax on his worldwide income, meaning both income derived from New Zealand and also income derived from anywhere outside New Zealand. The *source* principle is that income derived from New Zealand is subject to New Zealand tax, even if the person by whom it is derived is non-resident.[6]

If a person resident in New Zealand derives income from outside New Zealand, he will typically be exposed, prima facie, to double tax, because the income will be taxable both in the country from which it is derived (referred to as the source country) and in New Zealand (referred to in this instance as the residence country). Income derived from New Zealand by a person resident in some other country will likewise typically be exposed, prima facie, to double tax, because it will be taxable both in New Zealand (in this instance the source country) and also in the residence country (the country in which the taxpayer resides). Usually such problems of double taxation are eliminated by one or other or both of the two countries involved providing some

[6] Income Tax Act 2007, s BD 1(5).

form of relief;[7] but the income is nonetheless within the basic scope of both countries' tax systems.

The Basic Tax Treatment of Trusts

The basic problem in the tax treatment of trusts is that the trustees might distribute a trust's income to the beneficiaries as they receive it, or they might accumulate the income with a view to distributing it to the beneficiaries at some later date. The solution provided for by the current income tax legislation (the Income Tax Act 2007) is that if the trustees distribute the trust's income to the beneficiaries as they (the trustees) receive it, then the beneficiaries are taxed on it; and if the trustees do not distribute the trust's income to the beneficiaries (in other words, if the trustees accumulate the income), then they, the trustees, are taxed on it.[8] The Act achieves this by distinguishing between "beneficiary income" and "trustee income". "Beneficiary income" is defined as meaning essentially income which is received by trustees and distributed by them to the beneficiaries during the year in which they (the trustees) received it, or within a further six months of the end of the year;[9] and "trustee income" is defined as meaning essentially income which is received by trustees and retained by them for at least that long – that is, for at least six months after the end of the year in which it is received by the trustees.[10] Thus it is not determined whether income received by a trustee is beneficiary income or trustee income until either (a) the trustee distributes the income to a beneficiary within the year plus six months (in which case it will at that point become beneficiary income) or (b) the income remains undistributed six months after the end of the year (in which case it will at that point become trustee income).

Beneficiary income is taxable in the hands of the beneficiary, at the beneficiary's rates of tax. That is, to the extent that the trustee distributes the trust's income to a beneficiary within the year in which he (the trustee) received it or within a further six months, the beneficiary is obliged to combine that income with whatever other income he or she has received from other sources and pay tax on the total.[11] Thus, depending on how much income (including beneficiary income) the beneficiary has, the rate of tax applicable to his or her beneficiary income will be 10.5 per cent, 17.5 per cent, 30 per cent or 33 per cent (or 28 per cent if the beneficiary is a company, which is possible but unusual).[12] As an administrative matter, the tax on beneficiary income is collected from the trustee as agent of the beneficiary, rather than from the beneficiary directly.[13] But that is simply a withholding requirement – the income is regarded as the beneficiary's income, not the trustee's income; and the amount of tax is calculated at the beneficiary's rate of tax.

Trustee income, conversely, is taxable in the hands of the trustee at a flat rate, currently 33 per cent (irrespective of whether the trustee is a natural person or a

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[7] New Zealand is currently a party to about three dozen bilateral double tax treaties, and the number is increasing at a rate of about one or two a year. These treaties all provide for relief from double taxation where a resident of one of the signatory countries derives income from the other. See below at n 27. In the absence of a treaty, unilateral relief is generally available; see Income Tax Act 2007, subpart LJ.

[8] Income Tax Act 2007, subpart HC.

[9] Income Tax Act 2007, s HC 6.

[10] Income Tax Act 2007, s HC 7.

[11] Income Tax Act 2007, ss HC 17 and CV 13(a).

[12] Income Tax Act 2007, Schedule 1, Part A, cl 1.

[13] Income Tax Act 2007, s HC 32(3).

company).[14] In other words, to the extent that the trustee retains the trust's income until the end of the year in which he receives it and for a further six months, he is obliged to pay tax on it at 33 per cent. The tax on trustee income is a final liability; if the trustee subsequently distributes such income to a beneficiary, no further tax is payable on it.[15]

Using Offshore Companies to Avoid New Zealand Tax: Pre-1988

Prior to 1988, it was easy for New Zealanders to avoid tax on offshore income by accumulating it in an offshore company. If a New Zealand resident received offshore income directly, he was liable to pay tax on it – because New Zealand residents were (as they are still) obliged to pay New Zealand tax on their worldwide incomes. But if he incorporated a company in some other country (typically a tax haven) and arranged for the income to be received by the company, rather than by himself, the income was not subject to New Zealand tax, the reason being that (a) the income was derived from outside New Zealand and (b) the person receiving the income (that is, the company) was not resident in New Zealand. If the company paid a dividend to a New Zealand-resident shareholder, the shareholder would generally be chargeable to New Zealand tax on it. But for that reason, the New Zealand-resident owners of the company would generally arrange for the company not to pay any dividends. Instead, they would get their hands on the money in some other way. For example, they might accumulate the income in the company and then sell the shares for a tax-free capital gain.

In 1988 Parliament enacted legislation designed to prevent this kind of abuse. The legislation contained rules referred to as the Controlled Foreign Company Rules (or CFC rules).[16] These rules are complex but their general effect is to impose tax where income is accumulated in a controlled foreign company, meaning a company controlled by five or fewer persons resident in New Zealand. The rules provide for the undistributed income of the company to be attributed to the shareholders. Thus, if the company pays a dividend, the shareholders are taxed on it under the general rule that persons resident in New Zealand are taxed on their worldwide incomes; and if the company does not pay dividends (that is, if it simply accumulates its profits), the shareholders are taxed under the CFC rules.

At the same time Parliament enacted another set of rules referred to as the Foreign Investment Fund (or FIF) rules, which were designed to fill two gaps in the CFC rules.[17] First, the CFC rules apply only to *controlled* foreign companies – meaning generally companies controlled by five or fewer New Zealand-resident shareholders. They therefore left open the possibility that a New Zealand resident might avoid tax by accumulating offshore income in a company not so controlled (that is, a company with a more diverse shareholding). Secondly, the CFC rules apply only to companies; they therefore left open the possibility that a New Zealand resident might avoid tax by accumulating offshore income in some entity other than a company (such as a superannuation fund). The FIF rules preclude those possibilities by taxing New Zealand residents on income accumulated in offshore funds whether incorporated or not and whether controlled by New Zealand residents or not. They do not render the CFC rules redundant because, although their scope is broader, the method for

[14] Income Tax Act 2007, s HC 24(1) and Schedule 1, Part A, cl 3.
[15] Income Tax Act 2007, ss HC 20 and CW 53.
[16] See, now, Income Tax Act 2007, subparts CQ, DN, EX, GB, IQ and LK.
[17] See, now, Income Tax Act 2007, s CD 36 and subparts CQ, DN, EX, GB and IQ.

calculating the amount of income attributed to the New Zealand-resident investor is different (for technical reasons not germane to this article).

Using Foreign Trusts to Avoid New Zealand Tax: Pre-1988

The CFC rules and the FIF rules made it impossible to escape New Zealand tax on offshore income by the simple expedient of accumulating it in an offshore company or fund. They did not, however, entirely resolve the problem because they left open the possibility that taxpayers would use trusts to achieve much the same result. Applying the basic "residence" and "source" rules (outlined above) to income received by trustees would produce the result that income derived by a trustee is subject to New Zealand tax where either (a) the trustee is resident in New Zealand or (b) the income is derived from New Zealand (even if the trustee is not resident in New Zealand). Prior to 1988, that is indeed the basis upon which the New Zealand tax system operated. That was unsatisfactory, however, because it left a large hole in the tax system. Some affluent New Zealand residents took advantage of this in the following manner. First, the New Zealand resident established a trust by settling assets on a non-resident trustee. That could be achieved, for example, by the New Zealand-resident settlor transferring funds to the non-resident trustee. The trustee could then use the funds to acquire an income-producing asset located in a country other than New Zealand. For example the trustee could use the funds to buy land or securities or even simply leave the funds in an interest-bearing bank account. Alternatively, if the New Zealand-resident settlor already owned assets outside New Zealand, he could transfer them to the trust.

The trustee would then receive whatever income the assets produced. The income was not taxable in New Zealand because (a) the trustee was not resident in New Zealand and (b) the income was not derived from New Zealand. If the trustee distributed the income to a New Zealand-resident beneficiary as beneficiary income (that is, within the year in which the trustee received it or a further six months), then the income would be subject to New Zealand tax. That is, the beneficiary would be obliged to pay New Zealand tax on it. But if the trustee retained the income until the end of the year in which he received it and for a further six months and *then* distributed it to a New Zealand-resident beneficiary, it would not be subject to New Zealand tax at all. It would not be subject to New Zealand tax as trustee income (because, although it was possible to classify it as trustee income, it was derived from outside New Zealand; and the trustee was not resident in New Zealand); and it would not be subject to New Zealand tax as beneficiary income either (it was not beneficiary income because it was not distributed to the beneficiary within the requisite year and six months).

The "Resident-Settlor" Rule

Prior to 1988 it was possible to avoid New Zealand tax in this way (that is, by using an offshore trust), but it seems not to have been common. The reason was that it was simpler to use an offshore company (as explained above) rather than a trust. But the enactment of the CFC rules and the FIF rules in 1988 largely precluded the use of offshore companies as a tax avoidance device. It was easily foreseeable, then, that the use of offshore trusts would proliferate, unless specifically legislated against. Together with the CFC rules and the FIF rules, Parliament therefore introduced what is called the "resident-settlor" rule, which is as follows: if the *settlor* of a trust is resident in New Zealand, then all the trustee income is subject to New Zealand tax – even if the trustees are not resident in New Zealand and even if the income is derived from outside New Zealand.[18] This is currently provided for by s HC 25, which applies where (a) the settlor of a trust is a New Zealand resident;[19] and (b) the trustees are non-residents;[20] and (c) the trustees derive income from outside New Zealand.[21] In such circumstances, the income is assessable to New Zealand tax in the hands of the trustees.[22] Moreover, not only are the trustees liable to pay tax on the income but so, too, is the settlor. As the Act puts it, in these circumstances "the settlor is liable as agent of the trustee for income tax payable by the trustee."[23] Generally it might be that the trustees will pay the tax; but it is necessary for the Revenue to be able to collect it from the settlor, since in the circumstances in which the rule applies it is likely to be impossible to collect it from the trustees if they fail to pay (because the trustees will be non-resident and typically own no assets in New Zealand).

The word "settlor" is widely defined, covering any person who "transfers value" to a trust.[24] The usual means of settling property on trustees is simply to give it to them (or to sell it to them and then forgive the debt), but the definition of "settlor" is much wider than that. For example, it covers where a person sells property to a trust at less than market value; where a person buys property from a trust at more than market value; where a person performs services for a trust either for no payment or for less than the services are worth; where a person lends money to a trust at a rate of interest below the market rate or without charging interest at all; and so on. The Act provides also that a person is a settlor of a trust if he indirectly transfers value to it – for example, by arranging for someone else to do it.[25] The reason for defining "settlor" so broadly is that if it were possible to transfer value to a trust without constituting oneself a settlor, it would be possible to escape the "resident settlor" principle – and thus avoid tax. The resident settlor principle seems to be peculiar to New Zealand. Many other countries have adopted rules aimed at preventing taxpayers from using offshore trusts to avoid tax, but they have used other mechanisms rather than simply basing liability on the residence of the settlor.

Using New Zealand as a Tax Haven

When Parliament enacted the resident-settlor rule, it did not simply graft it onto to the existing legislation. Instead, it simultaneously enacted a provision whereby a trustee who is resident in New Zealand is not chargeable to tax on income derived from outside New Zealand, if the settlor is not resident in New Zealand. This exemption is currently provided for by ss CW 54 and HC 26(1) of the Income Tax Act 2007. It only applies to offshore income; income derived from New Zealand is assessable to tax in the hands of the trustees, in accordance with the source principle. Also, the exemption only applies to trustees; it does not apply to beneficiaries. Thus, if a non-resident settles property on a trustee resident in New Zealand, the income derived from outside New Zealand is not taxable in the hands of the trustee; but if the trustee distributes the income to a beneficiary resident in New Zealand, it will be assessable in the hands of the beneficiary. If the trustee distributes the income during the year in which he receives it or within a further six months, it will be taxable as beneficiary

[18] Income Tax Act 2007, s HC 25.
[19] Income Tax Act 2007, s HC 25(2)(a).
[20] Income Tax Act 2007, s HC 25(1).
[21] Income Tax Act 2007, s HC 25(1).
[22] Income Tax Act 2007, s HC 25(2).
[23] Income Tax Act 2007, s HC 29(2).
[24] Income Tax Act 2007, s HC 27(2).
[25] Income Tax Act 2007, s HC 28.

income (at the beneficiary's marginal rate); if he distributes it after that period, it will be taxable as a "taxable distribution" (again at the beneficiary's marginal rate).[26]

Why Parliament enacted this exemption is unclear. It would seem, however, that the rationale is several-fold. First, it might be said that it is appropriate for New Zealand (in accordance with the residence principle) to tax persons resident within the jurisdiction on their worldwide incomes; and also (in accordance with the source principle) to tax income derived from New Zealand, even where the person deriving it is not resident; but that it would be inappropriate for New Zealand to tax income derived from outside New Zealand for the benefit of persons not resident in New Zealand. In other words, it might be said that as a matter of policy there is no reason to tax New Zealand-resident trustees on income derived from outside New Zealand for the benefit of non-resident beneficiaries. Secondly, it might be said also that it would be futile for New Zealand to attempt to tax income derived by a New Zealand-resident trustee from outside New Zealand for the benefit of a non-resident beneficiary, because the settlor could easily escape the liability by arranging for the trust property to be held by a trustee resident elsewhere. Therefore, the exemption costs the New Zealand government nothing.

But whatever Parliament's reasons for enacting it, it is this exemption that makes possible the kind of tax avoidance with which this article is concerned. To return to the example with which the article began, it is this exemption that makes it possible for the Portuguese to settle his forest in Indonesia on a New Zealand-resident trustee and so escape the tax he would otherwise have to pay in Portugal on the income derived from the forest. In other words, it is this exemption that makes it possible for persons resident in other countries to use New Zealand as a tax haven.

As indicated above, tax avoidance of this kind costs the New Zealand government nothing – the reason being that it is foreign tax (for example, Portuguese tax), not New Zealand tax, that is being avoided. Indeed, the New Zealand government will tend to *gain* from allowing the country to be used as a tax haven because the firms setting up and administering trusts for foreign clients charge fees (so the New Zealand economy benefits) and pay tax (so the government benefits).

It is obvious that the exemption provided for by ss CW 54 and HC 26(1) permits persons resident in other countries to use New Zealand as a tax haven; and it is obvious that New Zealand benefits from providing this service (leaving aside the harm that might result from the country's being stigmatised as a tax haven). Presumably, then, the exemption was enacted with that in mind. That is, the government's aim, when it procured the enactment of the rules now provided for by ss CW 54 and HC 26, was presumably to promote the use of the country as a tax haven. It is conceivable that it was not done deliberately. That is, it is conceivable that the New Zealand Parliament's enactment of a law effectively allowing the country to be used as a tax haven was inadvertent – though it seems unlikely. But whether it was deliberate or inadvertent, other countries' governments are likely to regard it as unsatisfactory for New Zealand to allow itself to be used to undermine other countries' tax systems.

[26] Income Tax Act 2007, ss HC 18 and CV 13(c).

Treaty Benefits

It is also possible that an arrangement of this kind might produce treaty benefits. There are in the world 3,000 or so bilateral double tax treaties, commonly referred to as double tax agreements or DTAs.[27] New Zealand has a DTA with most of the countries with which there is significant cross-border trade and investment – Australia, the United States, Canada, Mexico, most large European countries, and many countries in Asia. New Zealand is currently party to about 40 DTAs and has recently entered into new DTAs at a rate of about one per year. Almost all DTAs (including all of New Zealand's) are quite closely based on a Model Treaty produced by the OECD, though if any two DTAs are compared there are almost always differences in the wording.

DTAs have two main functions: providing relief from double taxation and making it easier for governments to detect and prevent tax avoidance and evasion. Double taxation is likely wherever income is derived from one of the contracting states by a person resident in the other. DTAs generally resolve that problem by providing that in some circumstances the *source* state will waive the tax that it would otherwise charge (or impose tax at a lower rate than it would otherwise charge); and in other circumstances the *residence* state will waive the tax, or part of the tax, that it would otherwise charge. For example, DTAs generally provide that each contracting state can impose a withholding tax on dividends, interest and royalties paid to a resident of the other contracting state, but that the tax cannot exceed a stipulated rate. For instance, the New Zealand/Australia DTA provides that the withholding tax imposed on interest paid by a resident of one state to a resident of the other generally cannot exceed 10 per cent.[28] For this system to work it is of course necessary for the DTA to override domestic law – in this instance, the New Zealand and Australian taxing statutes imposing withholding taxes at more than 10 percent. For that reason it is invariably the case that DTAs override domestic law, even in countries, such as New Zealand, in which treaties generally do not override domestic law.[29]

The global network of DTAs is complex and provides endless opportunities for tax planning and tax avoidance, including some that are available to trusts established in New Zealand by non-residents. For example, the DTA between Indonesia and New Zealand might provide for lower rates of withholding tax than the DTA between Indonesia and Portugal. Thus, if an asset in Indonesia is owned by a person resident in New Zealand, the income derived from it might be taxed at a lower rate than if it is owned by a person resident in Portugal. That in turn would mean that the advantages obtained by the Portuguese resident by settling the asset on a New Zealand-resident trustee might be twofold. First, less tax would be payable in Indonesia and, second, no tax would be payable in Portugal (or New Zealand).

The Advantage of There *Not* Being a Treaty

As indicated above, one of the aims of DTAs is to make it easier for governments to detect and prevent tax avoidance and evasion. DTAs generally do that by providing

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[27] See generally Craig Elliffe *International and Cross Border Taxation in New Zealand* (Thomson Reuters, Wellington, 2015).

[28] Convention between Australia and New Zealand for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion, art 11(2).

[29] See Income Tax Act 2007 s BH 1(4) and, for example, Double Taxation Relief (Australia) Order 2010 (which together provide, in effect, for the New Zealand/Australia DTA to override New Zealand law).

for the tax authorities of the two states that are party to a DTA to exchange information about taxpayers. Even in the absence of such a provision it might be possible for tax authorities to exchange information, though tax authorities, including the New Zealand IRD,[30] are typically subject to stringent confidentiality obligations. In any event, in the absence of some formal arrangement, such is provided for by a DTA, it is unusual for one country's tax authority to supply information to another country's tax authority.[31] For that reason a person seeking to hide income in another country is likely to choose a country that does not have a DTA with his country of residence. For example, there is currently no DTA between New Zealand and Portugal, so there is no established procedure for the Portuguese tax authority to ask the New Zealand IRD for information about a Portuguese resident's financial affairs in New Zealand; nor any procedure by which the IRD could make such information available to the Portuguese authority. A resident of Portuguese establishing a trust in New Zealand could therefore be reasonably confident that the Portuguese tax authority would never find out about it, unless he chose to disclose it himself.

The Disclosure Requirements

As explained above, New Zealand gains by allowing itself to be used as a tax haven. Other countries, however, suffer. For example, Portugal suffers if its residents are able to escape Portuguese tax by using trusts established in New Zealand – and the same is true of almost all other governments also. It appears that in the 1990s and early 2000s a significant number of Australians were using New Zealand trusts to escape Australian tax; that the Australian government had become concerned about it; and that it persuaded the New Zealand government to effect a remedy. That came in the form of s 59B of the Tax Administration Act 1994, which was enacted in 2006.

Section 59B provides that a New Zealand-resident trustee of a foreign trust must supply certain information to the Commissioner of Inland Revenue. The principal requirement is that the trustee must disclose to the Commissioner "the name or other identifying particulars (for example, the date of the settlement on the trust) that relate to the foreign trust". This is so badly drafted that one suspects it was deliberate. If Parliament's intention had been to require the trustee to disclose the name of the *settlor*, it could easily have said so – but it did not. Presumably, then, Parliament did not intend to require the trustee to disclose the name of the settlor. For example, the settlor might be John Smith and he might call his trust the Abracadabra Trust. If the trustee discloses to the Commissioner that it is the trustee of the Abracadabra Trust, and nothing more, that would appear to satisfy s 59B. Another example: the trust might be established by Jack, who settles $100 on the trustee. Jill then settles a further

[30] See Tax Administration Act 1994, Part 4.

[31] For an unusual exception, see the *Ben Nevis* litigation, in which the New Zealand Serious Fraud Office obtained documents from the British Virgin Islands (with which New Zealand had not entered into a DTA) and made them available to the New Zealand IRD. The documents related to the affairs of a company established in the British Virgin Islands by persons resident in New Zealand. See *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19,027 (HC) at [230]-[237]; *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 231 at [1] and *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115 at [145]. This litigation involved a number of taxpayers but after the documents were made available to the IRD, Accent Management (the taxpayer initially named first) withdrew and settled with the IRD and the proceedings were continued in the name of Ben Nevis (one of the other taxpayers). How the Serious Fraud Office obtained the documents in the British Virgin Islands is unclear.

$25 million on the trustee. The trustee discloses to the IRD that it is the trustee of a trust established by John. Again, that would seem to satisfy s 59B.

All the trustee is obliged to supply is *the name or other identifying particulars (for example, the date of the settlement on the trust) that relate to the foreign trust*.[32] The trustee is generally not required to supply any information at all as to the following:

1. the name of the settlor;
2. the country of residence of the settlor;
3. the names of the beneficiaries;
4. the country of residence of the beneficiaries;
5. the assets held by the trust;
6. the country in which the assets are situated;
7. the value of the assets;
8. the amount of income generated by the assets;
9. to whom, if anyone, the income is distributed.

A more stringent rule applies where the settlor is resident in Australia. Specifically, if the settlor is resident in Australia, the trustee is obliged to inform the Department of that fact.[33] It would appear that the IRD's practice, where a person discloses that he is a trustee of a trust settled by a person resident in Australia, is in turn to supply that information to the Australian Tax Office (ATO). It appears, too, that the IRD does that spontaneously – that is, without waiting for the ATO to ask for it. Even so, it is notable that the information supplied to the ATO is a long way short of what the ATO might find useful. Obviously the IRD is only able to supply to the ATO the information that the trustee has supplied to the IRD; and all the trustee is obliged to supply to the IRD is "the name or other identifying particulars" of the trust.[34] As indicated above, the trustee is not obliged to supply the IRD with any information at all as to the settlor, the beneficiaries, the assets or the income. Presumably if the ATO is interested in whatever information it receives from the IRD, it asks for further information of those kinds and presumably the IRD then goes out and obtains the information and relays it to the ATO. Typically the IRD does not already hold such information (because it has no bearing on any person's liability to New Zealand tax), so obtains it solely in order to supply it to the ATO. This procedure presumably enables the ATO to foil most attempts made by Australian residents to use New Zealand trusts to escape Australian tax. It seems safe to assume also, therefore, that not many Australian residents have established trusts in New Zealand since 2006, when these disclosure requirements were introduced.

If the settlor is resident anywhere other than Australia, however, none of that happens. The trustee is obliged to notify the IRD of the trust's existence wherever the settlor is resident; but it is only where the settlor is resident in Australia that the trustee is obliged to notify the IRD of the settlor's country of residence. Consequently, if the settlor is resident anywhere other than Australia, the IRD generally have no idea of who the settlor is or of the country in which he resides. The IRD is therefore not able

[32] Tax Administration Act 1994, s 59B.
[33] Tax Administration Act 1994, s 59B(1)(c).
[34] Tax Administration Act 1994, s 59B.

to inform that country's revenue authority that one of their residents has set up a trust in New Zealand. And, of course, the other country's tax authority is unlikely to ask, because it is unlikely to know that its resident is setting up a trust in another jurisdiction; even if it knows that, it is unlikely to know that that jurisdiction is New Zealand; and even if it knows that the trustee is a New Zealand resident, it is unlikely to know the name of the trust. In other words, the disclosure requirements would appear to be utterly ineffective, except where the settlor is resident in Australia – so all the world can still use New Zealand as a tax haven, except for Australia.

Record-Keeping Requirements

Although the disclosure requirement is inadequate (for the reasons given above), the Tax Administration Act also imposes record-keeping obligations on any person who is (a) resident in New Zealand and (b) a trustee of a trust established by a non-resident. Specifically, s 22 of the Tax Administration Act provides, among other things, that:[35]

> [E]very person…who…is a resident foreign trustee of a foreign trust…shall keep sufficient records to enable the ascertainment readily by the Commissioner, or any officer authorised by the Commissioner in that behalf, of…the financial position of the foreign trust and shall retain all such records for a period of at least 7 years….

The section also provides that the records to be kept by the trustee must include the following:[36]

(i) documents that evidence the creation and constitution of the foreign trust; and
(ii) particulars of settlements made on, and distributions made by, the foreign trust, including the date of the settlement or distribution, the name and address (if known) of the settlor of the settlement, the name and address (if known) of the recipient of the distribution; and
(iii) a record of—
  (A) the assets and liabilities of the foreign trust; and
  (B) all entries from day to day of all sums of money received and expended by the trustee in relation to the foreign trust and the matters in respect of which the receipt and expenditure takes place; and
  (C) if the trust carries on a business, the charts and codes of accounts, the accounting instruction manuals, and the system and programme documentation which describes the accounting system used in each income year in the administration of the trust[.]

These requirements are quite stringent and appear to cover most of what a foreign tax authority would like to see (leaving aside the curious wording of paragraph ii, which appears to envisage that the trustee might distribute trust monies to a beneficiary without knowing who the beneficiary is). And of course the Commissioner's general

[35] Tax Administration Act, s 22(2)(fb) and (m). See also s 2, definition of "resident foreign trustee". The term "foreign trust" is not defined in the Tax Administration Act. It is defined in the Income Tax Act 2007 as meaning generally any trust in respect of which the settlor is not resident in New Zealand: Income Tax Act 2007, ss YA 1 and HC 11. Presumably Parliament intended this definition to apply not only to the Income Tax Act but also to the Tax Administration Act, though the drafting is not as clear in this respect as would have been desirable. See in particular the opening words of s YA 1 ("In this Act unless the context requires otherwise….").

[36] Tax Administration Act 1994, s 22(7)(d). See also s 22(2C).

powers are ample to enable her to inspect the records kept by the trustee, to copy them, and, at least where there is a treaty between New Zealand and the other country, to supply to foreign tax authorities the information obtained. Thus, the Tax Administration Act requires resident trustees of foreign trusts to keep more or less adequate records of the trust's affairs; but it does not require them to disclose any meaningful information at all to the Commissioner, unless the Commissioner asks for it.

Tax Information Exchange Agreements and the Multilateral Convention

As is explained above, DTAs generally provide for information exchange; and governments are also free (subject to their obligations of confidentiality) to exchange information even in the absence of prearranged procedures as to how such exchanges are to be effected. But two other mechanisms also are relevant to the exchange of information, namely (1) the global network of tax Information Exchange Agreements (TIEAs) and (2) a multilateral treaty called the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

Most countries have entered into bilateral DTAs with most of the other countries with which they have significant cross-border trade and investment – the reason being simply that governments are most motivated to establish mechanisms to provide for relief from double taxation where cross-border trade and investment is significant. Consequently, since DTAs almost invariably provide for information exchange, most countries routinely exchange information with their major trading partners. Most governments, however, have traditionally taken the position that there is no point in entering into DTAs with tax havens, for the equally simple reason that cross-border trade and investment with tax havens seldom gives rise to double tax.[37] That means, however, that whilst information exchange is a powerful mechanism, it is unavailable where it is needed most – that is, where taxpayers have entered into arrangements with affiliates in tax havens.

To rectify this very large deficiency, the OECD some years ago promulgated a standard form instrument referred to as a Tax Information Exchange Agreement or TIEA. As its name suggests, it provides only for information exchange. The idea is that TIEAs will be entered into by, on the one hand, countries that are not tax havens (whether members of the OECD or not) and, on the other, tax havens; and this will enable countries that are not tax havens to obtain tax-relevant information from tax havens. This manoeuvre has made very considerable progress, for the OECD and its member states have succeeded in persuading most tax havens to enter into numerous TIEAs. Of course in this context the word "exchange" is a euphemism; the idea is that the tax havens will supply information to their treaty partners – it is unlikely that any information will ever flow in the other direction.

As for the multilateral treaty, it was promoted by the OECD and has been joined by a large number of countries, including a significant number of tax havens. It was signed by New Zealand in 2012 and became operative for New Zealand on 1 January 2015. The Convention provides for three forms of cooperation, namely (1) the exchange of information relating to taxation, (2) assistance in recovery of unpaid taxes and (3) service of documents relating to taxation. The basic point of the convention is that it

[37] There are, however, many exceptions. See for example Michael Littlewood and Kyle Rainsford "Hong Kong's Treaty Network: Are the US, Germany and Australia Sensibly Standing Aloof? Or Sadly Missing Out?" [2014] British Tax Review 72.

provides a mechanism for information exchange even in the absence of a bilateral treaty.

WHAT SHOULD BE DONE?

One theory is that the status quo is unproblematic. Foreigners can use the country as a tax haven, but why does that matter? The current law results in no revenue loss to New Zealand. On the contrary, at least in the short term New Zealand gains because professional service firms are able to profit by setting up and administering trusts for people resident in other countries. And the New Zealand government gains because it taxes those firms' profits. Other countries, of course, might suffer, in that their residents are avoiding tax. But, the theory is, why is that a matter of concern for New Zealand? If other countries' tax systems are so structured that their residents are able to escape tax by using trusts in New Zealand, that is their problem; if they are concerned about it, they could legislate accordingly.

The alternative view is that for the New Zealand government to allow the country to be used as a tax haven is not in the national interest. The reasoning is that countries generally, including New Zealand, benefit from behaving as responsible members of the international community of nations. If New Zealand allows itself to be used as a tax haven, it will alienate the countries whose taxes are being avoided and its reputation as a responsible member of the international community will suffer. It will to some degree earn the disreputable and stigmatising label of "tax haven".

Moreover, the suggestion that the countries whose taxes are being avoided should legislate is facile. The basic problem is that they lack information. They are aware, no doubt, that some of their residents are avoiding tax by the use of offshore arrangements – for all governments can safely assume that some of their residents are doing that. But they generally find it very difficult to obtain reliable information as to exactly which of their residents are doing it and how. They might suspect that a person is hiding assets and income offshore, but they might have no idea of the nature of the assets, their value, the jurisdiction in which they are being hidden, the amount of income they generate, or how the income is being used. And no amount of legislation will rectify that lack of information. Whichever jurisdiction is being used as a tax haven, however, is uniquely placed to obtain the information. If New Zealand is being used as a tax haven, the New Zealand government is uniquely placed to obtain information as to how that is being done.

What, then, might be done? If it is accepted that the current state of affairs is unsatisfactory, there are two possible solutions. The first would be simply to withdraw the exemption – that is, to impose tax on income derived by New Zealand-resident trustees from outside New Zealand. The second would be to beef up the disclosure requirements – that is, to require New Zealand-resident trustees of foreign trusts to supply more useful data to the IRD, so that the IRD, in turn, could supply it to other governments.

Withdrawing the Exemption

As explained above, prior to 1988 a New Zealand-resident trustee was chargeable to New Zealand tax on income derived from outside New Zealand. That is, the exemption now provided for by ss CW 54 and HC 26(1) of the Income Tax Act 2007 had not been introduced. That was in accordance with the basic jurisdictional scope of the tax system – specifically that persons resident in New Zealand were (and are) subject to New Zealand tax on their worldwide incomes. The resident settlor rule, introduced in 1988, extended the system to catch income derived by a non-resident trustee from outside New Zealand where the settlor was resident in New Zealand. At the same time, the exemption was introduced; that is, a New Zealand-resident trustee was exempted from tax on income derived from outside New Zealand, so long as the income was not distributed to a New Zealand-resident beneficiary. But the exemption is not a necessary corollary of the resident settlor rule. It would be possible, indeed straightforward, to withdraw the exemption while leaving the rule unchanged.

That could be done by simply repealing ss CW 54 and HC 26 of the Income Tax Act 2007. The result would be that a New Zealand-resident trustee would be subject to tax on income derived from outside New Zealand, even where the income was distributed to a non-resident beneficiary. That would effectively bring the problem to an end. It would be almost certainly not raise any revenue, because those affected would rearrange their affairs. Most likely they would appoint a new trustee in some more amenable tax haven and arrange for the New Zealand trustee to transfer the assets to them. Moreover, extending the tax system in this way would lead to a decrease in revenue, because the firms currently profiting by setting up and running trusts for foreigners would lose that line of work. But that might be a price worth paying for protecting the country's reputation.

Beefing Up the Disclosure Requirements

The alternative remedy would be to beef up the disclosure requirements. As currently provided for, they are woefully inadequate – so inadequate, as indicated above, that it seems more likely that the inadequacy was deliberate than that it was inadvertent. Rectifying the inadequacy, however, would be straightforward – technically, at least, if not politically. All that would be required would be to amend s 59B of the Tax Administration Act in two respects. First, the section should require a New Zealand-resident trustee of a foreign trust to supply to the IRD the following information:

1. the identity of the settlor;
2. the country of residence of the settlor;
3. the identity of the beneficiaries;
4. the country of residence of the beneficiaries;
5. the nature of the assets held by the trust;
6. the country in which the assets are situated;
7. the value of the assets;
8. the amount of income received by or accruing to the trustee;
9. the identity of any person to whom the trustee transfers value (by distribution, licence to use, or otherwise); and
10. the means by which any such transfer of value is effected.

Secondly, the trustee's obligation to supply this information should not be a one-off requirement, as currently. Rather, trustees should be required to supply the information annually.

If the disclosure requirements were extended in this way, the information obtained by the IRD would be useful and the IRD could supply it to whichever governments it thought might be interested (subject to its obligations of confidentiality). Extending the rules in this way would impose an increased compliance burden. But the increase would be trivial because the trustee would presumably be in possession of the relevant information already. Also, it seems likely that non-residents go to the trouble of setting up a trust in New Zealand only where the value of the assets is considerable; so the burden of compliance would be easily tolerable.

Strengthening the disclosure requirements would probably also add significantly to the burden on the IRD because the Department would be obliged to process the information received from trustees. Moreover, some trustees would no doubt fail to comply fully with their obligation to supply information and the Department would be obliged to pursue them. This would be an unwelcome function for the IRD because it is presumably reluctant to allocate its resources to activities that do not generate any revenue – and resident trustees of foreign trusts, by definition, are not obliged to pay any tax.

CONCLUSION

The resident settlor rule was introduced in 1988 to stop New Zealand residents from using offshore trusts to avoid their liability to New Zealand tax. It has served that purpose well, effectively bringing to an end that form of tax avoidance. The rule did not preclude the possibility of *evasion*, because any taxpayer prepared to lie to the IRD could still escape his liability to New Zealand tax by using an offshore trust and withholding from the IRD the relevant information. But that is a criminal offence; and the rule did prevent *avoidance*.

Also in 1988, at the same time as the resident settlor rule was introduced, the legislation was amended by the introduction of the exemption for resident trustees of foreign trusts. That was the change that opened the door for people in other countries to use New Zealand as a tax haven in this manner – and for New Zealand advisors to profit by helping them to do so. Considerable use has been made of that possibility so that, as indicated above, the number of such trusts is now about 11,000.

In 2005, the legislation was amended again, so as to require resident foreign trustees to disclose to the IRD the fact that they were a trustee – and also, if the settlor of the trust was an Australian resident, of that fact. That was enough, at the time, to enable the New Zealand government to maintain plausibly that New Zealand was not a tax haven. In particular, it presumably brought to an end the possibility that an Australian might use a New Zealand trust to escape Australian tax. And it perhaps brought some measure of reassurance to governments elsewhere.

For the reasons given in this article, however, the 2005 amendments were wholly inadequate to prevent foreigners (other than Australians) using New Zealand as a tax haven. In 2005, that was unproblematic, especially as the amendments at least indicated a willingness on the part of the New Zealand government to take steps to prevent the country's being used as a tax haven. Since then, however, things have changed. In particular, most governments are even more concerned than before about tax avoidance – a concern manifest in the OECD's project against "base erosion and profit shifting" (essentially euphemistic jargon for tax avoidance).[38] More particularly still, countries (and other jurisdictions) perceived as tax havens have come in for increasing opprobrium. Over the same period the OECD and its member countries

[38] OECD, *Addressing Base Erosion and Profit Shifting*, 2013; OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013; and OECD/G20, *Base Erosion and Profit Shifting Project: 2015 Final Reports*, 2015.

have incrementally ratcheted up their expectations of "information exchange" and "transparency". Previously, it was possible for governments to refrain from sharing information with other governments; and the individual's supposed right to confidentiality was even accorded the status of a kind of basic human right; but that is no longer so. Rather, the OECD has successfully elevated its own preference for information exchange and transparency into generally accepted international norms.

Most recently, journalists in various countries have somehow obtained copies of the so-called "Panama papers" – 11 million documents apparently belonging to the Panamanian law firm Mossack Fonseca and its clients and dealing with the arrangements used by these clients to escape tax.[39] The consequences have included that considerable publicity has been given, both in New Zealand and elsewhere, to the proposition that New Zealand is a tax haven. The government's response, at the time of writing, remains to be seen.

13 May 2016

[39] Juliette Garside, Holly Watt and David Pegg "The Panama Papers: how the world's rich and famous hide their money offshore", The Guardian, 3 April 2016; Isaac Davison "Panama Papers: Key defends offshore banking comments", New Zealand Herald, 6 April 2016; Tim Hunter "Shame of Panama Papers may force government action", National Business Review, 4 April 2016.