New Zealand Foreign Trusts and relief under Double Tax Treaties

In their article in this issue Professor Craig Elliffe and Mr Jeremy Beckham suggest that New Zealand’s favourable tax treatment of foreign source income may have the unexpected result that a New Zealand trustee of a foreign trust (one with a non-resident settlor) may be subject to higher rates of withholding tax on foreign source income. He will not be able to avail himself of the lower rates of withholding tax applicable to foreign income provided for by double tax treaties. This is because of the residency article based on Article 4 of the OECD Model Convention.

The authors point out that some treaties—such as the one with the UK—contain a differently worded residency article, and do not present the same problem.

Article 4 of the OECD Model Convention refers to:

liable to tax...by reason of his domicile, residence, place of management or any other criterion of a similar nature.

There will be no New Zealand tax on such foreign source income, because of the exemption found in section HC 26 of the Income Tax Act 2007. The authors refer to the Canadian Supreme Court in Crown Forest Industries Ltd v Canada, which considered that payments to a company incorporated in The Bahamas, called Norsk Pacific Steamship Company Limited (‘Norsk’), which operated a business in the United States, were subject to withholding at the rate of 25% applicable to non-residents, rather than the 10% rate provided for under the Canada/United States Income Tax Convention. This was because Norsk was not resident in the United States for treaty purposes. The Canada/United States Income Tax Convention contained a residency provision similar to the OECD Model. Under section 882 of the Internal Revenue Code, Norsk was liable for tax on income which was ‘connected’ with its trade in the United States. Iacobucci J explained this was not enough because

Under Article IV it must be shown that the liability to taxation operates by reason of one of the listed grounds [being domicile, residence, place of management, place of incorporation or other criterion of a similar nature]. This connotes the existence of some sort of causal connection or, in the least, some relationship of proximity. In my opinion, the fact that Norsk’s place of management is in the U.S. is not causally or even proximately connected to the basis of Norsk’s tax liability in the U.S. Quite the contrary: in my mind, the reason why Norsk was liable to taxation in the U.S. was because of the income flowing from the business or trade it conducted that was connected to the United States.

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2. Ibid at [25].

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doi:10.1093/tandt/tts116
Advance Access publication 29 September 2012
The fact that Norsk was liable to US tax on US source income (but not worldwide income) was insufficient. Iacobucci J explained:

I agree with the appellant [the tax authority] that the most similar element among the enumerated criteria is that, standing alone, they would each constitute a basis on which states generally impose full tax liability on world-wide income.... In this respect, the criteria for determining residence in Article IV, paragraph 1 involve more than simply being liable to taxation on some portion of income (source liability); they entail being subject to as comprehensive a tax liability as is imposed by a state. In the United States and Canada, such comprehensive taxation is taxation on world-wide income. However, tax liability for the income effectively connected to a business engaged in the U.S., pursuant to s. 882 of the Internal Revenue Code, amounts simply to source liability. Consequently, the ‘engaged in a business in the U.S.’ criterion is not of a similar nature to the enumerated grounds since it is but a basis for source taxation.... I accept the appellant and intervener’s [the US tax authority] submission that, since the application of the Convention is to be limited to taxpayers bearing full tax liability in one of the contracting parties, then Norsk cannot benefit from the Convention and is consequently not to be characterized as a resident under Article IV, paragraph 1.3

And

The commentaries to the OECD Model Convention as well as academic sources indicate that generally the domestic laws of the contracting states employ residence to apply on ‘full-tax liability’: paragraphs 3 and 8 to the commentary to Article IV; Nathan Boidman, L. Frank Chopin and Alan W. Granwell, ‘Tax Effects for Canadians of the New U.S. Code and Treaty Residency Rules (Part Two)’.... So, too, does the American Law Institute, Federal Income Tax Project—International Aspects of U.S. Income Taxation II—Proposals on U.S. Income Tax Treaties, at pages 127–28: ‘Under prevailing practice, a country entering into an income tax treaty extends the benefits of the treaty to a person or entity that is a “resident of (the other) contracting state”. “Residence”, in turn, is defined in terms of taxing jurisdiction. A person or entity is considered resident in a country if that country asserts an unlimited right to tax his or its income—that is, a right based upon the taxpayer’s personal connection with the country (as opposed to the source of the income or other income- or asset- related factors). The test of residence requires that the person or entity claiming treaty benefits be ‘fully taxable’ in the residence country, in the sense of being fully subject to its plenary taxing jurisdiction. Full tax liability is not satisfied in a case where an entity is liable to tax in a jurisdiction only on a part of its income. (Emphasis in original.)

John Avery Jones5 suggests there must be limits to the principle that only full tax liability will qualify. What about charities and pension funds? Or UK’s treatment of resident non-domiciliaries? Do tax exemptions mean they are to be treated—like Norsk—as non-residents for the purposes of Article 4 and unable to claim treaty relief? John Avery Jones suggests the right answer is as follows:

If a person’s connecting characteristics with a state are the same as those of persons who are fully liable and actually subject to tax, that person can be said to be liable to tax even though he is not subject to tax on part or all of his income by virtue of special provisions in the domestic legislation of the state of his residence.

On this basis, a New Zealand Trustee of foreign trust would be said to be liable to tax, despite the provisions of section HC 26. Professor Elliffe and Mr Beckman accept that the position is unclear and it remains to be seen how New Zealand’s treaty partners will interpret and apply Article 4 to New Zealand

3. Ibid at [40] and [45].
4. Ibid at [57].
trustees of foreign trusts. They quote from guidance published by the Australian Tax Office, which supports their construction of Article 4. Given its thriving trust industry, we very much doubt this is the last word on this subject and hope this interesting contribution sparks debate on the subject.

**Garron**

Residence, for treaty purposes, and for the purposes of the Income Tax Act, has been considered by the Supreme Court of Canada in the recent decisions in *St Michael Trust Corp v R; Re Fundy Settlement; St Michael Trust Corp v R; Re Summersby Settlement*. The court at first instance applied the central management and control test applicable to companies, because “[t]he development of a test of trust residence in Canada has been left by Parliament to the courts. If courts decide to develop a totally different test of residence for trusts than they have for corporations, there should be good reasons for doing so. I am not satisfied that there are good reasons. I conclude, then, that the judge-made test of residence that has been established for corporations should also apply to trusts, with such modifications as are appropriate. That test is “where the central management and control actually abides”’.

The Court concluded, on the basis of the facts that the trusts were Canadian resident. These facts are described in two articles in this issue (by Howard Carr and Mary Anne Bueschkens and Lucinda E Main). They illustrate the dangers of passive trusteeship and makes one wonder why the Canadian Revenue Authority did not suggest the trusts were shams.

A trust is not a legal entity, but is deemed to be a ‘person’ by section 104(2) of Canadian Income Tax Act 1972. John Avery Jones and Angelo Nikolakakis explain in their helpful commentary on the decision, published in the International Tax Law Reports:

In contrast UK tax law refers to the trustee and never to a trust. As soon as one talks about a trust being the taxable person, even though one knows that it is not legally a person, one is drawn to thinking of it as an entity (and it is the same with partnerships). Looking for the trust’s central management and control seems to be to be a natural consequence of thinking in this way, whereas in the UK the legislation talks about the trustee and so the question is one of the residence of the trustee, which fortunately the statute deals with, but if it had not it is very doubtful that the courts would have come up with central management and control. The different way of viewing the question affects the answer…

The courts below considered the implications for the Barbados-Canada Treaty of the finding that the trust was Canadian resident, but the Supreme Court ducked this. John Avery Jones and Angelo Nikolakakis explain:

Assuming that the trust (or trustee) is resident in Barbados, the decision means that the trust is dual resident, in which case the treaty provides that ‘the competent authorities shall by mutual agreement endeavour to settle the question and to determine the mode of application of this Agreement’. We can safely assume that Canada will not ‘settle the question’ by relinquishing treaty residence to Barbados which does not tax the gain

Given these conclusions, the court did not consider it necessary to consider the tax authority’s alternative submission, based on section 245 of the Income Tax Act, which contains a General Anti Avoidance Rule.

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6. 2012 SCC 14 reported at 14 ITLR 1090 which includes a very helpful commentary by John Avery Jones and Angelo Nikolakakis.
7. 12 ITLR 79 at [161] and [162].
8. Taxed as an individual. A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person’s own income tax, be deemed to be in respect of the trust property an individual…. Lebel J concluded that this ‘separates the trust from the trustee in respect of trust property’.
UK’s GAAR

In his evocatively titled article:

putting lipstick on a pig: the rewrite that will continue to foster the continued hegemony of the culture that has already caused the collapse of the UK economy

co-editor Tony Molloy QC noted that:

Hong Kong’s income tax legislation is ‘strikingly simple, and the entire substantive law and administrative machinery on the subject are contained in about 200 pages’: about one-fifteenth of the size of the New Zealand Statute, and an even smaller fraction of the sizes of each of the US statute and the UK Rewrite.

Similarly, Mr Molloy observed that:

the New Zealand definition section is longer than the entire taxation legislation of each of Singapore, Malaysia, and Hong Kong.

The result of this is that:

businessmen of Hong Kong and of Singapore do not waste their time mucking around with structures off the balance sheet, or out of sight of the tax system. They appear reluctant to waste hard-earned money paying lawyers and accountants to concoct schemes to defeat regulation and to avoid tax. They sensibly prefer, instead, to plough that money back into their businesses. So there seems to be no developed tax avoidance industry or culture.

GAAR is the subject of an article by Charles Gothard and James Austen. They explain that it hinges on a concept of abusiveness. The authors explain that:

[u]nfortunately, the concept of ‘abusiveness’, which seems so clear to politicians, activists and columnists, is near-impossible to define satisfactorily in the context of the UK tax code. As a result, the section is fatally flawed, making the GAAR as a whole profoundly concerning.

We can only hope that HMRC will wake up to the futility of attempting to cure foolishly labyrinthine legislation by enlarging the labyrinth: and that it will take note that Hong Kong has proved that a short, sharp, tax Act is the only way to create a commercial environment in which business concentrates on making real trading profits instead of phoney ‘profits’ from gaming the system.

North Shore

Judging from the following, it sounds as if Nevis trustees–Jirehouse Resettlement Foundation—took a passive approach to their trusteeship, leaving the settlors, and one time beneficiaries, Messrs Fomichev and Peganov, to run the show:

The circumstances surrounding the appointment and behaviour of the trustees were undoubtedly suspicious. For a wealthy man (or in this case two wealthy men acting simultaneously) to make himself a pauper, with the genuine intention of disposing of his money down to his last dollar irrevocably and with no ability to control what was to happen to it, is an unlikely scenario. Family trusts are a well known possible device for trying to place assets ostensibly beyond the reach of creditors, and the timing of the simultaneous creation of the trusts fits such a pattern. Suspicion that these were not entirely arm’s length arrangements is heightened by the later steps taken

by the trustees, for example, in seeking to prevent cross examination of the Appellants in the English proceedings and in apparently removing the Appellants from even being discretionary beneficiaries for reasons and in circumstances which are unexplained. The circumstantial evidence gave reasonable ground to infer that there was in truth some understanding or arrangement between the Appellants and the trustees by which they were to shelter the Appellants’ assets, consistent with the Appellants’ real aim, and that the nature of that understanding and arrangement was such that the trustees would take whatever steps the Appellants wished in the administration of the trusts.\footnote{North Shore Ventures v Anstead Holdings Inc [2012] EWCA 11 at [38] per Toulson LJ.}

Paul Sinclair, barrister for North Shore at both first instance and on appeal urged the judge at first instance to consider the reality:

In real life they [Messrs Fomichev and Peganov] will have access to these documents. They can ask their wives, their children, they can ask the trustees, in real life, and, my Lord, I would ask that they shall provide those trust documents. If they do not and they breach the order then they will have to explain what exactly has happened.\footnote{ibid, at [19].}

The judge agreed:

I think Mr Sinclair is right that in practice if such an order is made it is reasonable to suppose that Mr Fomichev and Mr Peganov will be able to comply with it. I am told that the beneficiaries of the trust are their wives and their children. If that is the position then it seems to me to be wholly unrealistic to suppose that if Mr Fomichev does not keep copies of these documents himself then there is no way in which he would be able to obtain copies\footnote{ibid, at [20].}

The acid test suggested by the House of Lords in Lonrho v Shell\footnote{[1980] 1 WLR 627.} was whether a beneficiary had a presently enforceable right to disclosure of trust documents without the need to obtain the consent of a third party. This test has become difficult after Schmidt, which shows that disclosure is a matter of discretion and that no beneficiary has any rights or entitlement to require disclosure of particular documents. The implications of this are still being worked through—this case suggests pragmatism will prevail over principle.

### Curtis v Pulbrook

Messrs Formichev and Peganov were not the only ones to find courts unsympathetic to those who seek to make themselves judgment proof—by alienating assets—to protect against their judgment creditors. Mr Pulbrook had done something similar—by making gifts to his wife and daughter—backdating the transfer to make it appear that it had taken place before the claim was intimated. The Claimant, Curtis, obtained a charging order over the shares. Pulbrook claimed to have parted with ownership. The judgment in Curtis v Pulbrook\footnote{[2011] EWCH 167.} followed a trial to determine whether Mr Pulbrook really had parted with ownership. Briggs J held that Mr Pulbrook failed to pass legal title to shares in a company (because the company had not authorized the transfers to his wife and daughter). The question was whether the wife and daughters acquired an equitable interest—considered by the Court of Appeal in Pennington v Waine\footnote{[2002] EWCA 227.}—where Arden LJ cautioned against ‘frustrating the clear and continuing intention of the donor’ and identified three
routes by which equity might assist. Briggs J considered that none of these applied. The donor had not taken all necessary steps to transfer the shares. His Lordship therefore held that:

Apart from the considerations arising from section 423 [of the Insolvency Act 1986] (which, as Arden LJ points out, have nothing to do with the policy behind the purely equitable rules) I might have been straining to find a way in which to give effect to the attempted gifts in the present case. Nonetheless, I have been unable to do so, within the constraints of the equitable rules as laid down in the two most recent authorities to which I have referred. 16

These matters are considered by Tracey Angus QC, counsel who represented Curtis at the trial.

**Two party rule**

St Michael Trust Corporation and Jirehouse were so lackadaisical that they might well have breached the two party rule—that the same person cannot be on both sides of a transaction. *Lewin* explains:

A purchase or other similar transaction will generally have two aspects, namely contract and transfer of title. It takes two to make a contract. A purported purchase by a person from himself is ineffective because there is no contract 17

It was applied in the Court of Appeal (Millett LJ dissenting) in *Ingram v IRC*, 18 the headnote explains:

It was clear that a nominee could not contract with his principal so as to create rights and obligations in relation to the subject of the nomineeship. From that it followed that a nominee could not grant a lease to his principal, at any rate one which was not a bare term containing no covenants by either party. Accordingly, the leases to Lady Ingram were a nullity

Lord Upjohn in *Boardman v Phipps* 19 commented:

There is no general rule that information learnt by a trustee during the course of his duties is property of the trust and cannot be used by him. If this was to be the rule it would put the Public Trustee and other corporate trustees out of business and make it difficult for private trustees to be trustees of more than one trust. This would be the greatest possible pity for corporate trustees and others may have much information which they may initially acquire in connection with some particular trust but, without prejudice to that trust, can make it readily available to other trusts to the great advantage of those other trusts.

It is probably for these reasons that the two party rule has been reversed by section 82 of the Law of Property Act 1925 which provides:

any covenant, whether express or implied, or agreement entered into by a person with himself and one or more other persons shall be construed and be capable of being enforced in like manner as if the covenant or agreement had been entered into with the other person or persons alone.

The fifth amendment to the Trusts (Jersey) Law 1984 includes the following proposed amendment to Article 31 (which relates to a trustee acting in more than one capacity):

(3) Subject to this Law (including in particular Articles 21 and 23), but despite any other enactment or rule of law to the contrary, a person may in the capacity of a trustee of one trust enter into a contract or other arrangement with himself or herself in the

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16. ibid, at [47].
person’s capacity as a trustee of one or more other trusts.

A paper published by the States of Jersey\textsuperscript{20} makes clear that:

Its effect is to allow a trustee to make a contract with himself, or with herself, in the trustee’s separate capacities in respect of 2 or more trusts. He or she will in respect of each trust be subject to all the duties of a trustee, including in particular those in Articles 21 and 23.

The paper contains no explanation for the reason for the amendment; one infers that trustees have come a cropper on this technicality. These—and related matters—are considered in an article by Paul Adams, published in this issue.

**Rule against perpetuities**

Another rule which has been the subject to recent legislative amendment is the rule against perpetuities. We have previously\textsuperscript{21} noted a study conducted by Sitkoff and Schanzenbach which suggested that:

roughly $100 billion in trust assets have moved as a result of the Rule’s abolition.

It might also reduce the risk of claims against lawyers practicing in those jurisdictions, though the Californian Supreme Court, in 1961, in the case of *Lucas v Hamm*\textsuperscript{22} held that because the rule was difficult to properly apply, it was not negligent for an attorney to draft a will that inadvertently violated it. Trusts created in the 1960s and 1970s might be getting towards the mid-point of their lives. The end date might not be looming but some trustees are beginning to think about it. It is a particular issue where the trust assets are sizeable and the class of beneficiaries is small and where the settlor wanted trustees to meet beneficiaries reasonable needs—and did not want them to go beyond this—for all the usual reasons. But if there is a fixed date—on which the trust terminates—and everything must be distributed at that time—then the lucky beneficiary who happens to be around at the time gets a windfall—even though he or she may be hopelessly irresponsible with money. This seems contrary to everything the settlor wanted. In these situations, trustees might think about a perpetual trust.

The Bahamas has joined those that have abolished the rule against perpetuities. Section 1 of its Rule Against Perpetuities (Abolition) Act, 2011 simply provides ‘The rule against perpetuities is abolished’. The Act defines the ‘rule against perpetuities’ as to the rules against remoteness of vesting and the rule against excessive accumulations. The difficulty with such a change is the position of existing trusts. Vested interests would be affected if such changes were retrospective. It is for this reason that the Bahamian legislation is prospective (the Act came into force on 31 December 2011) but section 4 grants the court power to apply the provisions of the Act to existing dispositions.\textsuperscript{23} Dr Earl Cash from one of the leading firms in The Bahamas, Higgs & Johnson, provides a summary of the new legislation.

Before leaving the subject, it is worth mentioning that perpetual trusts are not without their detractors. The American Law Institute recently expressed its support for the policy concerns underpinning the rule against perpetuities. As stated in the


\textsuperscript{21} Editorial ’Thousand Year Trusts?’ (2009) 15 (9) Trusts & Trustees 710–713.

\textsuperscript{22} 56 Cal 2d 583, 15 Cal Rptr 821, 364 P2d 685.

\textsuperscript{23} In relation to any disposition of an interest in property in trust made before the commencement day the court may, on an application made by the trustee of the trust, make an order, on such terms as it thinks fit, declaring that this Act shall apply to the disposition.
Restatement (Third) of Property: Wills and Other Donative Transfers, Introductory Note to Chapter 27 (2011):

It is the considered judgment of The American Law Institute that the recent statutory movement allowing the creation of perpetual or near-perpetual trusts is ill advised. . . . A rule against perpetuities that curbs excessive dead-hand control is deeply rooted in this nation’s history and tradition, and for good reason. . . . An important reason for maintaining a reasonable limit on dead-hand control is that the limit forces control of encumbered property to be shifted periodically to the living, free of restrictions imposed by the original transferor. The living can then use the property as they wish, including transferring it to new trusts with up-to-date provisions.

Dr Cash notes:

the Act does nothing to prevent [settlers] . . . from limiting the duration of their inter vivos or testamentary trusts. Accordingly, dispositions made after the Act could still have a limit that could be for any definite number of years or any fixed period of time. Such limit would be a voluntary one imposed by such settlers or testators, not by common law or statute.

Formalities required by settlor

Another elephant trap—which prevents the valid exercise of a power—is a failure to comply with formalities required by the settlor. Lewin explains that:

[i]t is open to a settlor to require a power to be executed with whatever formalities or subject to whatever preconditions he may choose. It is common to require that execution should be by deed or by writing. (It is also common for such requirements to be overlooked.) Whatever the requirements are—indeed however odd or unreasonable they are—they have to be observed according to their terms and there is no valid execution if they are not. Hence if a power is expressed to be exercisable by deed during the donee’s lifetime it cannot be exercised by will, and vice versa. If it is expressed to be exercisable by ‘writing effected under hand’ it cannot be exercised by unsigned writing. 24

There is a limited discretion to aid the defective exercise of a power, provided the holder of the power was subject to a natural or moral obligation to provide for the person whom he sought to benefit by the exercise of the power. This power was employed by the Jersey Royal Court in the Matter of the Shinovic Trust25 to rescue a defective exercise of the power to add a long standing partner of the holder of the power to the class of beneficiaries of the trust. The decision expands the category of those in whose favour equity will assist. The decision is considered in a case note prepared by Lisa Springate and Tim Wright published in this issue.

Pateras

Forced heirship—a feature of succession laws of civil law jurisdictions—in essence provides that particular heirs should receive proportionate shares of a deceased’s estate. This was recognized—at an early stage—as a threat to offshore discretionary trusts. The Cayman Islands were the first to introduce so-called firewall legislation,26 by conferring jurisdiction on the courts of the Cayman Islands, providing that they have exclusive competence to decide validity questions and providing that the orders of other courts will not be recognized. This has been taken up by other jurisdictions. There have been surprisingly few reported decisions concerning validity challenges based on forced heirship principles. The main one is Lemos and another v Coutts & Company (Cayman)
Limited and others,\textsuperscript{27} which predated the introduction of firewall legislation. There are of course several decisions of the Royal Court of Jersey on Article 9 of Trusts (Jersey) Law 1984 (as amended)—considering enforcement of ancillary relief orders of the English family division—where the firewall was ineffective at protecting the trust from foreign interference. The decision of Guernsey’s Royal Court in \textit{Re Rothschild Trust Guernsey Limited v Pateras}\textsuperscript{28} is the first to consider firewalls found in section 14 of the Trusts (Guernsey) Law 2007 in the context of a forced heirship claim. The validity challenge was brought before Full Member Court of Athens. The judgment describes the claim as follows:

the Defendants claim that during their father’s lifetime the shares in the Company [owned by the trust] belonged to him and that following his death ownership passed to the Defendants as his intestate heirs. They also claim that a meeting of the shareholders of the Company convened to authorise the sale of the estate was not valid because it was not attended by the Defendants who, they claim, were the legitimate shareholders, not the Trustee. They challenge the validity of decisions taken at the meeting, including the validity of a Power of Attorney appointing Mr Ward and a Mr Page as the attorneys of the company to complete the sale of the estate.

The trustee sought a declaration from the Royal Court that the trust was valid. Although they were validly served, the heirs declined to participate in the Guernsey proceedings. Perhaps unsurprisingly in these circumstances the declaration sought was made. The judgment simply records:

It is not known whether the Defendants are seeking to assert a rule of forced heirship under Greek Law but even if they are, the 1995 Trust would be regarded as valid under Guernsey law by virtue of section 11A of the 1989 Law as amended. Section 14 of the 2007 Law provides that all questions of validity are to be determined in accordance with Guernsey law. Accordingly, I am satisfied on the evidence before me that the 1995 Trust is validly constituted according to the laws of Guernsey.

This issue features a case note, by Alison Ozanne, the trustees’ advocate in the case.

\textbf{Guernsey Foundations}

The Consultation Document published by Guernsey’s commerce and employment department dated 11 April 2011 explains:

One of the key goals of the Department is to create legislation which would be treated as a foundation in a civil law jurisdiction. There has been academic criticism of foundations legislation in some competitor jurisdictions as being too similar to companies to be viewed as genuine foundations by a civil law court. That creates a risk that these entities could be treated as companies rather than as foundations in some civil law jurisdiction which would create uncertainty and undermine the rationale for using a Guernsey foundation.

Presumably such differences would make it impossible to redomicile an existing foundation to Jersey. Guernsey sought to learn from these experiences and worked with civilian lawyers to formulate a foundation law, which is compatible to its civilian progenitor. On 25 July 2012, the Guernsey parliament approved The Foundations (Guernsey) Law, 2012, which is considered in an article in this issue by Russell Clark.

\textsuperscript{27} CILR 1992–93.
\textsuperscript{28} 3 May 2011.