IN THE COURT OF APPEAL OF NEW ZEALAND

CA308/2017
[2018] NZCA 38

BETWEEN	COMMISSIONER OF INLAND REVENUE Appellant
AND	PATTY TZU CHOU LIN Respondent

Hearing:	7 February 2018
Court:	Harrison, Cooper and Asher JJ
Counsel:	D J Goddard QC and JBY Cheng for Appellant G D Clews and S J Davies for Respondent
Judgment:	8 March 2018 at 11.30 am

JUDGMENT OF THE COURT

A The appeal is allowed.

B The declaration made in the High Court setting aside the appellant's assessments of the respondent's income tax liability for the 2005 to 2009 income years is set aside.

C The respondent's income tax liability for the 2005 to 2009 income years is to be assessed consistently with this judgment.

D The respondent must pay the appellant costs for a standard appeal on a band A basis and usual disbursements. We certify for second counsel.

E **The order made by the High Court for payment of costs by the appellant in that Court is set aside. Costs should be fixed in the High Court in accordance with this judgment.**

REASONS OF THE COURT

(Given by Harrison J)

Introduction

[1] The Commissioner of Inland Revenue's appeal from a decision of Thomas J in the High Court raises this issue:[1] is a New Zealand resident entitled to a credit against income tax liability in New Zealand for tax spared by China on income earned there by companies in which the resident has a relevant income interest?

[2] While the issue can be stated shortly, its resolution requires us to interpret relevant provisions of the double tax agreement between New Zealand and China (the China DTA)[2] and its relationship to domestic revenue legislation, in particular the Controlled Foreign Companies regime (the CFC regime) in the Income Tax Act 2007 ("the 2007 Act") and earlier versions of that legislation.[3]

Facts

[3] The parties filed an agreed statement of facts in the High Court. Those which are relevant to the issue on appeal are as follows:

(a) The respondent, Patty Lin, emigrated from Taiwan to New Zealand in late 2001 and became a New Zealand tax resident from that date.

(b) Between 2005 and 2009, the relevant tax years, Ms Lin had a 30 per cent interest in five companies which were resident in China for

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1 *Lin v Commissioner of Inland Revenue* [2017] NZHC 969, [2017] NZCCLR 24.
2 Double Taxation Relief (China) Order 1986, sch 1.
3 We discuss the CFC regime later in this judgment.

tax purposes. Each company was defined as a CFC for New Zealand purposes.

(c) As a result, the income derived by four of the five Chinese companies was attributed to Ms Lin for New Zealand tax purposes under the CFC regime. As Thomas J noted in the High Court, Ms Lin never actually received the income.[4] The Commissioner attributed to Ms Lin CFC income from the Chinese companies totalling $4,605,162.98 over the relevant period from 2005 to 2009.

(d) The New Zealand tax payable by Ms Lin on this income was about $1.796 million. The Commissioner allowed Ms Lin tax credits under New Zealand domestic law of $926,968.12. Her New Zealand tax liability on her attributed CFC income was offset by that amount for Chinese tax actually paid by the Chinese companies. In the result, the Commissioner assessed Ms Lin as liable to pay attributed tax of $869,000.

[4] The parties' point of contention arises from certain tax concessions granted to the Chinese CFCs under Chinese domestic law. The Chinese companies were spared from paying tax totalling $588,135.91 which would otherwise have been imposed on their incomes. The Commissioner refused to allow Ms Lin a further credit for New Zealand tax payable on her attributed CFC income for the Chinese tax spared.

[5] In May 2011 Ms Lin disposed of her interests in the Chinese companies and, in exchange, obtained full control of UBP Ltd (a New Zealand registered company which operates a meatworks and export business in the King Country). It was common ground, as Thomas J recited, that if Ms Lin, not the Chinese CFCs, had undertaken the relevant business activity personally in China she would have been taxed on the resulting income in New Zealand because of her residence here.[5] In that event, she

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4 *Lin v Commissioner of Inland Revenue*, above n 1, at [6].
5 At [11].

would have been entitled to credits both for the tax actually paid in China and the tax spared to her there.[6]

[6] In the High Court, Thomas J found that the Commissioner erred. She was satisfied that Ms Lin was entitled to credits both for tax paid by and tax spared to the CFCs in China.[7] She issued a declaration that the Commissioner's assessments of Ms Lin's income for the 2005 to 2009 income years were incorrect and set them aside.[8] Ms Lin's income tax liability for those years was to be assessed in accordance with the judgment.

[7] The Commissioner appeals on the ground that the Judge misconstrued critical provisions of the China DTA and their application to New Zealand domestic law.

Legislative framework

[8] Subpart BH of the 2007 Act provides for double tax agreements between New Zealand and foreign states. Such agreements come into force through declarations made by Order in Council.[9] By s BH 1(4) a double tax agreement has effect (except in the case of tax avoidance arrangements) in relation to income tax despite anything else provided in the 2007 Act and is effectively incorporated into New Zealand domestic law.

[9] The CFC regime is the starting point for our analysis. New Zealand taxes its residents on worldwide income regardless of source. One of the means of effecting that revenue precept is through the CFC regime. This was introduced in 1 April 1988[10] to prevent New Zealand residents from deferring or avoiding New Zealand tax by accumulating income in non-resident companies.[11]

[10] In summary, the CFC regime operates as follows. Income earned by a foreign company is foreign income of a non-resident of New Zealand. In the event of a

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6 At [11].
7 At [100].
8 At [105].
9 Income Tax Act 2007, s BH 1(1)(c).
10 Income Tax Amendment Act (No 5) 1988.
11 Inland Revenue Department *Tax Information Bulletin* Vol 2 No 3 (October 1990) at 10.)

distribution of profits on shares, such as by payment of a dividend, the New Zealand resident recipient is liable for tax. Without a distribution, however, the company's income stream would not be subject to New Zealand tax. The shareholder could accumulate the equivalent dividend amount, which may be reflected in a corresponding increase in share value on sale of the shares for a capital gain. In that event, New Zealand would not receive any tax on an income stream which the company had converted into capital through its deferment practices. The CFC regime foreclosed that avenue for revenue deferment or avoidance.

[11] The CFC regime applies to all taxpayers who have an income interest of greater than 10 per cent in a foreign company.[12] A New Zealand resident shareholder is subject to tax on his or her pro rata share of the CFC's profits, calculated as if the CFC were a New Zealand resident company, on a current or accrual basis irrespective of receipt.[13] This income is described as attributed CFC income.[14]

[12] Thomas J succinctly summarised the operation of the CFC rules in this way:

> [44] Broadly speaking, New Zealand's CFC regime operates as follows:
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> (a) If a foreign company is controlled by one or more New Zealand tax residents and their associates, the company is a CFC.
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> (b) The New Zealand resident will have a control interest in the CFC which is broadly equivalent to the resident's ultimate holding in the CFC.
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> (c) The profits of the CFC are notionally calculated according to New Zealand's income tax requirements.
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> (d) A percentage of the profits so calculated is attributed to the New Zealand resident in proportion to the resident's control interest and taxed at the New Zealand tax rate which would apply to the resident's personal income.
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> (e) The resident to whom income is attributed may or may not actually receive income.

12 Income Tax Act 1994, s CG 6; and Income Tax Act 2007, s CQ 2.
13 See Income Tax Act 2007, s EX 21.
14 Section CQ 2.

[13] As Thomas J also pointed out, the CFC regime was changed in December 2009 to introduce a distinction between passive and active incomes.[15] As a result, only passive income of a CFC (such as interest) is taxed to a New Zealand resident holding a control interest in the CFC. Our determination of the issue raised on appeal is thus of limited significance.

China DTA

[14] The China DTA was signed in 1986, shortly before the CFC regime came into operation. It is common ground that Chinese authorities would have been aware of New Zealand's intention to introduce the CFC regime. The treaty is entitled "Agreement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income".

[15] The China DTA is one of New Zealand's 40 bilateral DTAs. All share the same premise of revenue reciprocity: one country foregoes some of its income tax rights over source or residence taxation in return for the other country foregoing some of the same rights. The common economic purpose is to ensure that income is taxed only once.

[16] Double taxation is a term used to describe two different revenue concepts. One concept is juridical double taxation, where comparable taxes are imposed by two different states on the same taxpayer for the same subject matter and for identical periods. This residence-based approach favours capital exporters. Economic double taxation is a different concept, occurring where the same income stream including derivative income is taxed in the hands of different taxpayers. This source-based approach favours capital importers. The most obvious example of the latter is where a shareholder is taxed on dividend income which has already been taxed upstream at the level of corporate profits.

[17] Double tax treaties are generally based on one model convention or a blend of two. One is the model drafted by the Organisation for Economic Cooperation and

15 *Lin v Commissioner of Inland Revenue*, above n 1, at [46].

Development (the OECD Model) which adopts a residence-based approach favourable to capital exporters; the other is the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model) which adopts a source-based approach favourable to capital importers. The China DTA is largely based on the OECD model.

[18] This appeal centres on the proper construction of art 23 of the China DTA which states:

> **Methods for the elimination of double taxation**
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> 1 In China, double taxation shall be eliminated as follows:
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> Where a resident of China derives income from New Zealand, the amount of tax on that income payable in New Zealand, in accordance with the provisions of this Agreement, may be credited against the Chinese tax imposed on that resident. The amount of credit, however, shall not exceed the amount of the Chinese tax on that income computed in accordance with the taxation laws and regulations of China.
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> 2 In the case of New Zealand, double taxation shall be avoided as follows:
>
> (a) Subject to any provisions of the laws of New Zealand which may from time to time be in force and which relate to the allowance of a credit against New Zealand tax of tax paid in a country outside New Zealand (which shall not affect the general principle hereof), *Chinese tax paid under the laws of the People's Republic of China and consistently with this Agreement, whether directly or by deduction, in respect of income derived by a resident of New Zealand from sources in the People's Republic of China (excluding, in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid) shall be allowed as a credit against New Zealand tax payable in respect of that income*;
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> …
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> 3 For the purposes of paragraph 2(a), tax payable in the People's Republic of China by a resident of New Zealand shall be deemed to include any amount which would have been payable as Chinese tax for any year but for an exemption from, or reduction of tax granted for that year or any part thereof under any of the following provisions of Chinese law:
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> (emphasis added)

[19] The China DTA, like all double tax treaties, is to be interpreted according to the same principles applying to private contractual instruments.[16] The parties' intention is to be discerned by interpreting the ordinary meaning of the treaty's terms in context and in the light of its object and purpose.[17] The context also takes account of its contemporary background. Resort can also be made to subsequent agreement about the treaty's interpretation including, in this case, OECD commentaries.[18]

[20] It is perhaps trite to observe that each treaty is the result of a discrete round of bilateral negotiations.[19] The final instrument reflects the parties' agreement on what terms and conditions are appropriate to their particular relationship. We mention this point now, to answer briefly an argument advanced by Mr Clews for Ms Lin. He sought to pre-empt an interpretation difficulty for Ms Lin arising from the plain meaning of art 23 of the China DTA by referring to comparable provisions in double tax treaties negotiated by New Zealand with two other countries shortly after the China DTA. In Mr Clews's submission we should construe art 23 in the same way as differently worded companion provisions in the other treaties. We do not accept that submission. Each treaty must be construed discretely, in accordance with its own particular terms.

Analysis

[21] The Commissioner's case is that the plain meaning and purpose of art 23 is to provide relief from juridical double taxation alone; Mr Clews argues by reference to various provisions of the OECD Model and its updated Commentaries that art 23 is directed to relieving against both juridical and economic double taxation. His central proposition is that there is only one source of income at issue in this case. Accordingly, "the income derived" in terms of art 23(2)(a) must refer to the deemed or attributed income of the CFC, which was earned in China. The competing arguments can be distilled to a difference about whether art 23 operates on the premise of tax residence or income source.

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16 *Anson v Commissioners for Her Majesty's Revenue and Customs* [2015] UKSC 44 at [56].
17 At [56].
18 At [58].
19 *Chatfield & Co Ltd v Commissioner of Inland Revenue* [2015] NZHC 2099 at [53].

[22] As Thomas J observed, the CFC regime results in economic double taxation.[20] It subjects the CFC's profits to corporate tax in its own jurisdiction while providing for taxation of the same or derivative income in the investor's hands in New Zealand.[21] In the result, two separate legal persons in two different countries are taxed on the same income: the CFC directly in China, and the investor by attribution in New Zealand. The underlying policy of the CFC regime is to maintain New Zealand's tax base. By comparison, the purpose of tax sparing provisions such as the concessions available to the Chinese CFCs is to preserve the effect of incentives designed to attract foreign investment in a developing state. That tension is at play in this case but is immaterial to the plain meaning of art 23.

[23] The issue is best addressed by construing the text of art 23 as a sequential and related whole within its settled context. In our judgment, the meaning of the provision is clear and does not require us to resort to extraneous materials for assistance. In the High Court, Thomas J treated art 23(2) and (3) as separate provisions meriting discrete analysis, without reference to art 23(1). We are satisfied that the Judge was led into error by this approach. However, in fairness, it appears that much of the argument in the High Court followed a largely diversionary focus on extraneous materials and analogies with other legal structures, at the expense of a close textual analysis.

[24] Article 23(1) is our starting point. Mr Goddard QC, who did not appear for the Commissioner in the High Court, emphasises its plain purpose of eliminating juridical double taxation in China by limiting the entitlement of a resident of that country to a credit on tax actually paid in New Zealand on income derived here. Its focus is on residence, not source, and it is not directed to economic double taxation. Article 23(1) is the companion provision to art 23(2)(a). While there are linguistic differences between the two clauses, it would be unusual for the two countries to provide for economically asymmetrical goals. Symmetrical treatment of tax credits would be the logical common objective for both. The necessary inference, in the absence of any contrary intention, is that both relieve against juridical double taxation, allowing only credits for taxes actually paid by a domestic resident in the foreign jurisdiction.

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20 *Lin v Commissioner of Inland Revenue*, above n 1, at [67].
21 At [67].

[25] Article 23(2)(a) is directly to this effect. It entitles a New Zealand resident to a credit against tax payable in this country "for Chinese tax paid … [on] income derived by [that] resident … from sources in … China". Tax spared in China is not "Chinese tax paid" by the New Zealand resident. Ms Lin is "the resident of New Zealand" for these purposes. As Mr Goddard submits, in terms of art 23(2)(a) the "income" of the CFC was not "derived" by Ms Lin in China; and the tax paid or spared to the CFC was not payable, paid by or spared to Ms Lin. The tax imposed on two different persons is "in respect of" two different income streams. The co-extensive nature of these provisions excludes any scope for importing into the textual analysis a proposition that the "income derived" refers to the deemed or attributed income of the CFC under New Zealand legislation.

[26] Article 23(3), which Mr Goddard also emphasises, confirms the focus of art 23(2)(a) on "tax payable in … China by a resident of New Zealand." Thus a New Zealand resident who is liable to pay tax there on income derived in that country is expressly entitled to the benefit of a tax sparing provision in China in the nature of "an exemption from, or reduction of tax granted". We disagree with Thomas J's construction of art 23(3) that, when read in conjunction with art 23(2)(a), its use of the phrase "payable … by a resident of New Zealand" includes tax deemed to have been paid or payable by the New Zealand resident on income or tax deemed to have been earned or paid by the New Zealand resident through the CFC regime.[22]

[27] Mr Clews neatly summarised his contrary argument by identifying and answering two questions. First, he asks, what is the "income derived" by Ms Lin in China? It is undisputedly attributed CFC income. Second, he asks, has Ms Lin paid Chinese tax "in respect of [attributed] income"? Mr Clews says the answer must also be in the affirmative because there is only one income stream which is taxed to two different entities. One entity is the Chinese CFC, the other is the New Zealand shareholder. The "income derived" is, in all but name, Chinese income derived by Ms Lin from a source there. As we noted above, Thomas J agreed with Mr Clews that the phrase should be read broadly to incorporate the tax liability of the Chinese CFC companies.[23]

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22 At [97].
23 At [61].

[28] Mr Clews also relies particularly on the phrase "in respect of" where it first appears in art 23(2)(a). He says the words should be construed to require a connection between tax paid in China and tax payable in New Zealand. That connection, he says, is through the direct attribution regime under the CFC rules. In the High Court, Thomas J accepted this argument, finding that tax paid "in respect of income" is not necessarily only tax paid on income.

[29] We disagree. The phrase "in respect of" is amorphous and can lead to linguistic uncertainty and confusion. It is often used where one word would more accurately convey its meaning and purpose. The phrase is used in three separate places in art 23(2)(a). Mr Clews accepts the logic of consistency, of giving the same phrase the same meaning wherever it is used in the same provision. He accepts also that where the phrase "in respect of" is used in the second place ("tax paid in respect of the profits") and the third place ("tax payable in respect of that income") its meaning is synonymous with "on". The phrase refers to tax paid *on* profits out of which a dividend is paid to the New Zealand resident; and to tax payable by the New Zealand resident *on* that income — that is, the "income derived by [a New Zealand resident"] from sources in … China".

[30] We are satisfied that the phrase "in respect of" is used synonymously with "on" in all three places in art 23(2)(a). Its meaning should be consistent throughout. Contrary to the Judge's view,[24] we are satisfied that art 23(2)(a) requires the tax to have been paid by a New Zealand resident *on* income derived by him or her in China, not by a third party CFC; that is the essential precondition to a credit in New Zealand.

[31] Thomas J also placed reliance on the exclusion in art 23(2)(a) "in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid".[25] She noted that the exclusion was not included in the OECD Model.[26] She inferred that, by negating an obligation to grant a tax credit for only one type of economic double taxation in the form of dividends, the parties intended a credit to be given to counter other types of economic double taxation.[27] We disagree. The fact that the

24 At [58]–[64].
25 At [86]–[88].
26 At [86].
27 At [86]–[88].

exclusion did not appear in the OECD Model does not lead to this inference. The terms of the exclusion are specific. It relates expressly to a dividend paid on profits. It does not assist in resolving this issue.

[32] Also, Thomas J accepted Mr Clews's submission that support for Ms Lin's construction of art 23(2)(a) could be found in the OECD Commentary regarding the tax treatment of partnerships.[28] Mr Clews did not press the same argument before us. We simply record that it does not assist where the text is plain.

[33] In our judgment art 23(2)(a) relieves solely against juridical double taxation. Mr Clews's argument requires us to disregard the legal nature of the relationship between Ms Lin and the Chinese CFCs to focus instead on the substantive source of "the income derived". The fact that the ultimate source is income attributed to Ms Lin from the Chinese CFCs does not justify treating the two income streams, earned separately by the CFCs and Ms Lin, as one for revenue purposes, and ignoring the plain foundation of art 23(2)(a) on the source of "the income derived by a resident of New Zealand", Ms Lin. Mr Clews's reliance on the CFC attribution regime to circumvent the plain meaning of art 23 must fail.

Result

[34] The appeal is allowed.

[35] The declaration made in the High Court setting aside the appellant's assessments of the respondent's income tax liability for the 2005 to 2009 income years is set aside.

[36] The respondent's income tax liability for the 2005 to 2009 income years is to be assessed consistently with this judgment.

[37] The respondent must pay the appellant costs for a standard appeal on a band A basis and usual disbursements. We certify for second counsel.

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28 At [73]–[84].

[38] The order made by the High Court for payment of costs by the appellant in that Court is set aside. Costs should be fixed in the High Court in accordance with this judgment.

Solicitors:
Crown Law Office, Wellington for Appellant
Simpson Western, Auckland for Respondent