IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV-2015-404-2267
[2017] NZHC 969

IN THE MATTER	of Part VIIA, Tax Administration Act 1994
BETWEEN	PATTY TZU CHOU LIN Plaintiff
AND	THE COMMISSIONER OF INLAND REVENUE Defendant

Hearing:	7–9 November 2016
Further submissions:	16 February 2017
Counsel:	G D Clews and S J Davies for Plaintiff M Deligiannis and J Cheng for Defendant
Judgment:	12 May 2017

JUDGMENT OF THOMAS J

This judgment was delivered by me on 12 May 2017 at 4.00 pm pursuant to Rule 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Date:………………………….

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Introduction

[1] This case concerns an investment held in five companies established in China (the Chinese Companies) and the tax consequences to the plaintiff, Ms Lin, of that investment. Ms Lin is a New Zealand resident.

[2] Ms Lin was assessed by attribution for New Zealand tax on a 30 per cent share of the income derived by the Chinese Companies. Ms Lin contends that, in assessing her, the defendant, the Commissioner of Inland Revenue (the Commissioner), failed to allow her the full tax credits to which she was entitled under the double tax agreement (DTA) between New Zealand and China (the China DTA)[1] and under the related New Zealand domestic law. Ms Lin says that she is

[1] The text of the double tax agreement between China and New Zealand is set out in Schedule 1 to the Double Taxation Relief (China) Order 1986.

entitled to a credit for tax "spared" (ie foregone) by the Chinese government to the Chinese Companies.

[3] The Commissioner says Ms Lin is not entitled to tax credits for tax spared to the Chinese Companies under the China DTA and that New Zealand's domestic legislation regarding tax credits cannot be read in the manner Ms Lin contends.

Factual background

[4] Ms Lin is a New Zealand tax resident. As such, her income is subject to New Zealand tax, regardless of where it is sourced.

[5] The present case concerns income attributed to Ms Lin in the 2005 to 2009 tax years (the tax years in dispute). During those years, Ms Lin held a 30 per cent stake in two companies, Prime Hill Ltd and Great Well Ltd, each of which was registered in the British Virgin Islands. Prime Hill and Great Well owned a number of subsidiaries, including the Chinese Companies.

[6] Because of her shareholdings in Prime Hill and Great Well, Ms Lin was considered to hold a control interest in the Chinese Companies. Each of the Chinese Companies was accordingly defined as a Controlled Foreign Corporation (CFC) for New Zealand purposes. The income derived by the Chinese Companies was therefore attributed to Ms Lin for New Zealand purposes under the regime pertaining to CFCs. Ms Lin never actually received the income.

[7] Over the course of the tax years in dispute, Ms Lin was attributed with personal income from the Chinese Companies totalling $4.605 million. The New Zealand tax due on this income was approximately $1.796 million. The Commissioner allowed tax credits from China of $926,968 to offset Ms Lin's New Zealand tax liability on her attributed CFC income for Chinese tax paid by the Chinese Companies in relation to that income, leaving some $869,000 due from Ms Lin.

[8] Under Chinese domestic tax law, tax concessions were available to the Chinese Companies, so they were relieved of Chinese tax which would otherwise

have been imposed on their incomes (tax spared). The amount of Chinese tax spared to the Chinese Companies totalled $588,135. If credited against her New Zealand liability, as she asserts should be the case, Ms Lin's tax liability would have been reduced to just under $281,000. However, the Commissioner refused to allow any credit in respect of tax spared to the Chinese Companies.

[9] Ms Lin has refused to pay New Zealand tax on the portion of her CFC income which is derived from tax spared to the Chinese Companies. In July 2015, the Commissioner imposed shortfall penalties of $50,438.27.

[10] Ms Lin disposed of her interests in the Chinese Companies in May 2011 in exchange for full control of UBP Ltd, a company registered in New Zealand.

[11] Had Ms Lin been undertaking business activity personally in China, Ms Lin would have been taxed on the resulting income in New Zealand because of her residence here, and would have been entitled to a tax credit both for tax actually paid in China and for tax spared to her in China.

Issues

[12] The outcome of this case turns upon the interpretation of Article 23 of the China DTA and specifically, its application in the context of income derived from a CFC. Article 23(2)(a) of the China DTA provides:

> 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;

There is no dispute that CFC income derived from the Chinese Companies is "income derived by a resident of New Zealand from sources in the People's Republic of China" within the terms of Article 23(2)(a).

[13] Article 23(3) further provides:

> 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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> …

[14] This means that China may forego tax (or "spare" the local taxpayer the obligation to pay it) but the tax spared will still be treated as payable for the purposes of the DTA.

[15] The issues which this Court must determine in respect of Article 23 can be expressed as follows:

(a) Does "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand" include Chinese tax paid by the CFC itself, as opposed to tax which is paid directly by the New Zealand resident?

(b) If the answer to (a) is "Yes", is the New Zealand resident also entitled to a credit for tax spared to the CFC under Article 23(3)?

(c) If the answer to (b) is "Yes", what is the effect of Article 23 upon the assessment of CFC income under New Zealand's domestic income tax legislation?

[16] If Ms Lin fails to prove her case, the Court must also consider whether it is appropriate to impose shortfall penalties in respect of her unpaid tax.

Expert evidence

[17] Each of the parties to the case engaged an expert witness who provided evidence in support of the party's submissions.

[18] Professor Craig Elliffe gave expert evidence for Ms Lin. Professor Elliffe is a professor of law at the University of Auckland, following 14 years as a tax partner at an internationally recognised tax advisory firm and eight years as a tax partner in a large commercial law firm. He will shortly be awarded a Doctorate from Cambridge University and is the director of the Masters in Taxation Studies programme at the University of Auckland. He is an expert in the field of international taxation, having lectured and written extensively on the subject, including the leading textbook *International and Cross-Border Taxation in New Zealand*.[2]

[19] Robin Oliver gave evidence for the Commissioner. Mr Oliver is a tax advisor and a director of a chartered accountancy firm specialising in taxation advisory services. He has had extensive experience providing advice on tax policy and tax law for over thirty years. He was employed in the tax policy section of the New Zealand Treasury from 1984 to 1987 and, from 1995 to 2011, was Deputy Commissioner of Inland Revenue in charge of providing advice to the Government on tax policy. He was New Zealand's representative on the tax committee of the Organisation for Economic Co-operation and Development (OECD) Committee on Fiscal Affairs and Deputy Chair of that Committee from 2004 to 2009. He was the head of the New Zealand delegation for the negotiation of all New Zealand DTAs and protocols to New Zealand's DTAs from 1996 to 2012. Mr Oliver also chaired the sub-committee which produced in 2011 the update to the United Nations (UN) Model Convention.

Approach

[20] Although the issue is a relatively narrow one of interpretation, it requires a brief explanation of the CFC regime and an analysis of relevant aspects of New Zealand's international tax policy and approach to DTAs, including the role of

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2 Craig Elliffe *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, Wellington, 2015).

Model Conventions and Commentaries. The differences between juridical and economic double taxation must be understood before addressing how the China DTA deals with economic double taxation and tax sparing.

[21] Part I of this decision addresses the general background to the case. Part II then addresses, against that background, the issues identified at [15] above.

PART I

Double Taxation Agreements

[22] New Zealand has a network of 40 bilateral DTAs intended, inter alia, to regulate the taxing rights of the signatory countries when the income of a person may be subject to tax in both countries – in other words, when the income of a person may be subject to double taxation.

[23] Under a DTA one country gives up some of its income taxation rights over source or residence taxation in return for which the other country gives up some of its own income taxation rights in an effort to ensure that income is taxed only once (and in some cases, to ensure it is taxed at least once).

[24] DTAs are unusual amongst New Zealand's international treaties because they have direct effect in New Zealand domestic law by virtue of s BH 1(4) of the Income Tax Act 2007. The practical effect of this provision is, if a New Zealand taxpayer is entitled to a benefit under any DTA, then the taxpayer is entitled to enforce that benefit in a New Zealand court, despite any contradictory provision within the Income Tax Act itself.[3]

Model Conventions and Commentaries

[25] The differing objectives of countries in entering into DTAs are reflected in the two different Model Conventions upon which most DTAs are based. The OECD Model Convention (OECD Model) is seen as favouring a residence-based approach favourable to capital exporters. The UN Model Convention (UN Model) was

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[3] See *Commissioner of Inland Revenue v ER Squibb & Sons (New Zealand) Ltd* (1992) 14 NZTC 9,146 (CA) at 9,154.

developed as an alternative to the OECD Model and is seen as favouring a more source-based approach favourable to capital importers.

[26] New Zealand is a member of the OECD and generally adopts the OECD Model's provisions but also adopts aspects of the UN Model.

[27] The OECD Model has a Model Commentary (Commentary) which in effect is an explanation of the Model. It is important as guidance and is widely used. The Commentary is prepared by the Committee of Fiscal Affairs, which is part of the OECD and includes revenue officials from member countries. The UN Model also has a Model Commentary.

[28] The latest version of the OECD Model and Commentary was released in 2014, and a new version is expected in 2017. Models and Commentaries are generally released in two or three yearly cycles.

Tax sparing

[29] Many DTAs include "tax sparing" provisions, whereby a contracting country agrees to grant relief from residence tax by way of foreign tax credits with respect to source taxes which have not actually been paid (taxes which have been "spared") because of source taxation concessions provided by the other contracting country.

[30] In the absence of tax sparing provisions, an investor who takes advantage of, in this case Chinese tax concessions, reduces its tax in China but loses its foreign tax credits (in its New Zealand tax return) and pays more tax in New Zealand. The Chinese tax concessions, instead of encouraging investment in China, effectively transfer tax revenue from China to New Zealand. A tax sparing provision deems Chinese tax to have been paid as if no Chinese tax concessions existed so the investor, not the New Zealand government, gets the benefit of the Chinese tax concessions and the investment incentive stays in place.

[31] Typically, a tax sparing clause will be included in a DTA when the country offering to forego tax has a developing economy and tax incentives are important to support growth. The Commentary to Article 23 of the UN Model strongly supports

the adoption of tax sparing where the other contracting country relieves double taxation by providing foreign tax credits. The Commentary states:[4]

> It is of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital exporting countries using the foreign tax credit system. This undesirable result is to some extent avoided in bilateral treaties through a “tax sparing” credit, by which a developed country grants a credit not only for the tax paid but also for the tax spared by incentive legislation in the developing country.

[32] The OECD by contrast does not suggest the inclusion of tax sparing provisions. In fact, the OECD Model Commentary on Articles 23A and 23B states that tax sparing provisions constitute a departure from Articles 23A and 23B.[5] In a 1998 report titled *Tax Sparing: A Reconsideration*, the OECD argues against the inclusion of such provisions or, if they are included, suggests their application be limited.[6]

The New Zealand approach

[33] Mr Oliver gave evidence about the general context of negotiating a DTA and in particular, the political environment and its impact on a principled approach. That is, while New Zealand might approach a negotiation on the basis of its preferred approach, it shifts its ideal position as a result of negotiation and political imperatives.

[34] Mr Oliver outlined New Zealand’s preferred strategy as follows:

(a) Taxing income of a New Zealand resident from direct investment offshore as it accrues and allowing, as DTAs require, a credit for foreign tax paid by the New Zealand resident on the accrued income. However, that credit for foreign tax does not qualify for an imputation credit, and so it is effectively clawed back when the foreign company pays a dividend to shareholders.

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4 Article 23 Commentary in *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2001) [UN Commentary] at para 4.

5 Commentary on Articles 23A and 23B in OECD *Model Tax Convention on Income and on Capital (Full Version)* (OECD Publishing, Paris, 2015) [OECD Commentary] at para 78.1.

6 OECD *Tax Sparing: A Reconsideration* (OECD Publishing, Paris, 1998) at 41–43.

(b) Taxing income earned on indirect investment offshore as it accrues under CFC or Foreign Investment Fund (FIF) rules. The CFC rules calculate the CFC income to the New Zealand resident on the same basis as if it were a branch (hence labelled the Branch Equivalent Method). New Zealand tax on the New Zealand resident's CFC income can be offset by a credit for foreign tax paid.

(c) Taxing dividends derived offshore with a credit for foreign withholding taxes levied on the New Zealand investor (as required by DTAs) and a credit for New Zealand tax paid on CFC income through the Branch Equivalent Tax Account (BETA), but no underlying foreign tax credit for foreign taxes paid by the CFC, even though a credit for such taxes was provided when determining New Zealand tax on CFC income. This is consistent with the strategy of allowing credits but treating them as a tax concession to be clawed back at the earliest opportunity when dividends are taxed on repatriation.

(d) Taxing the dividends of a New Zealand resident company paid to its shareholders to the extent such dividends are paid out of income sheltered from New Zealand tax because of credits received for foreign tax paid.

[35] Mr Oliver described New Zealand's underlying policy framework for international tax as "national welfare maximisation". This approach means New Zealand's domestic tax rules should apply the same rate of domestic tax regardless of whether the investment is made onshore or offshore. This best ensures investments are made (and resources are allocated) where they make the highest return to New Zealand. However, New Zealand recognises its ability to deny foreign tax credits (ie treating foreign taxes as deductible, rather than providing a credit for foreign tax) is severely constrained by DTAs and other international practical and political considerations. The granting of credits for foreign tax is the international norm and a political necessity, rather than a desirable policy outcome as far as New Zealand is concerned. New Zealand effectively foregoes taxation on New Zealand residents who have been subject to foreign tax because it expects, on a

reciprocal basis, that foreign jurisdictions will provide their own foreign tax credit for New Zealand tax paid on New Zealand-sourced income to non-New Zealand residents investing in New Zealand.

[36] Mr Oliver discussed the process involved in the negotiation of DTAs. New Zealand's negotiating team is always led by the Inland Revenue Department. Countries research each other's tax system, treaty policy and record of treaty negotiations. Each country is likely to have a model treaty (based on the OECD and/or UN Models). New Zealand follows the OECD Model but introduces more protection for source taxation than the OECD Model allows.

[37] Mr Oliver described each Article of a DTA as being negotiated separately because each deals with a different income stream based on its legal form. Precedents are very important, he said, and, once a deviation from national policy is agreed to with one country, it is hard to resist providing the same concession to other negotiating partners. Furthermore, a provision might have no practical effect but might be necessary for political or other reasons.

[38] It was clear from his evidence that a decision to conclude a DTA is determined by more than tax administration or policy considerations. It involves political considerations and takes account of New Zealand's wider commercial, trade and diplomatic objectives.

The China DTA

[39] At the time the China DTA came into effect in 1986, New Zealand did not have a CFC regime. However, both Professor Elliffe and Mr Oliver agreed it was likely China would have been aware at the time of negotiations that New Zealand was considering implementing a CFC regime. At the time China was also renegotiating treaties with other countries which had CFC rules, for example Canada and the United Kingdom.

[40] China had a firm policy of requiring tax sparing provisions in DTAs, reflecting its position as a developing economy, its adherence to the UN Model, and its global positioning as a "leader of the third world". Mr Oliver's evidence was that

New Zealand has a long-standing policy against the inclusion of tax sparing provisions in DTAs. However, by the time the China DTA was being negotiated, New Zealand had already incorporated tax sparing provisions in agreements with Singapore (1972), Malaysia (1976), Fiji (1976), the Philippines (1980), Korea (1981) and India (October 1986). It was, therefore, not in a position to refuse a tax sparing agreement with China. In Mr Oliver's opinion, New Zealand would have sought a provision which was as restricted in its application as possible.

CFCs and attribution

[41] New Zealand's statutory CFC regime came into effect from 1 April 1988, with the objective of reducing opportunities for New Zealand residents to avoid or defer New Zealand tax through the accumulation of income in foreign non-resident companies.[7]

[42] Prior to that, the income of a foreign company would only have been recognised for tax purposes in New Zealand when the company declared a dividend to its New Zealand resident shareholder. This led to income being "rolled up" in foreign companies for many years without ever being taxed in New Zealand to the owners of the companies. However, under the CFC regime, that income is taxable in New Zealand by attributing it to the New Zealand resident owner. The Consultative Committee on International Tax Reform explained the rationale for the regime as follows:[8]

> As commercial transactions have become more sophisticated, both the accounting and income tax concepts of income have of necessity been extended in many areas to include not only income received but income which can be said with reasonable certainty to have accrued. It is fully consistent with this extended definition of income to tax residents on the undistributed income of non-resident entities that can reasonably be assumed to have accrued to them.

[43] The OECD Commentary states that CFC rules which tax "residents on income attributable to their participation in certain foreign entities" are "internationally recognised as a legitimate instrument to protect the domestic tax

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7 IRD "Appendix: Controlled Foreign Companies" (1990) 2(3) *Tax Information Bulletin* 10 at 10.
8 Arthur Valabh and others *International Tax Reform Part 1: Report of the Consultative Committee* (March 1988) at 7.

base".[9] Consistency between such rules and the Articles of the OECD and UN Models is confirmed in the Commentaries.[10]

[44] Broadly speaking, New Zealand's CFC regime operates as follows:

(a) If a foreign company is controlled by one or more New Zealand tax residents and their associates, the company is a CFC.

(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.

(c) The profits of the CFC are notionally calculated according to New Zealand's income tax requirements.

(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.

(e) The resident to whom income is attributed may or may not actually receive income.

[45] There is no dispute that the CFC regime applied to Ms Lin. She had the necessary control and income interests through her ownership of shares in Prime Hill. In this case none of the Chinese Companies ever distributed a dividend to Ms Lin.

[46] There was a change to the CFC regime in December 2009 whereby a distinction between passive and active income was introduced. Under the current CFC rules, only the passive income (for example, interest) of a CFC is taxed to a New Zealand resident holding a control interest in the CFC. However, the CFC rules

9 OECD Commentary on Article 1at para 23.
10 See, for example, OECD Commentary on Article 7 at para 14 and Article 10; at para 37 UN Commentary to Article 1 at para 74.

as they applied to the tax years in dispute did not have this distinction. The issue in this case therefore has limited application.

PART II

[47] As noted at [15] above, this case raises three principal issues:

(a) Does "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand" include Chinese tax paid by the CFC itself, as opposed to tax which is paid directly by the New Zealand resident?

(b) If the answer to (a) is "Yes", is the New Zealand resident also entitled to a credit for tax spared to the CFC under Article 23(3)?

(c) If the answer to (b) is "Yes", what is the effect of Article 23 upon the assessment of CFC income under New Zealand's domestic income tax legislation?

[48] I address each of these in turn. Before doing so, however, it is useful to briefly discuss the principles of treaty interpretation. These principles are particularly relevant to the first and second issues above.

The principles governing treaty interpretation

[49] The Vienna Convention on the Law of Treaties 1969 (Vienna Convention) applies to DTAs. Article 31 contains the general rule of interpretation and relevantly provides:

> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
>
> …
>
> 3. There shall be taken into account, together with the context:
>
>   a. Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

b. Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

c. Any relevant rules of international law applicable in the relations between the parties.

[50] In interpreting the DTA between the United Kingdom and the United States of America in *Anson v Commissioner for Her Majesty's Revenue and Custom,* Lord Reed said:[11]

> [56] Put shortly, the aim of interpretation of a treaty is therefore to establish, by objective and rational means, the common intention which can be ascribed to the parties. That intention is ascertained by considering the ordinary meaning of the terms of the treaty in their context and in light of the treaty's object and purpose. Subsequent agreement as to the interpretation of the treaty, and subsequent practice which establishes agreement between the parties, are also to be taken into account, together with any relevant rules of international law which apply in the relations between the parties. Recourse may also be had to a broader range of references in order to confirm the meaning arrived at on that approach, or if that approach leaves the meaning ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable.
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> …
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> [58] The contemporary background of a treaty, including the legal position preceding its conclusion, can legitimately be taken into account as part of the context relevant to the interpretation of its terms ...

[51] Therefore, while the ordinary meaning of the terms of a DTA is the starting point, it is also mandatory to consider the context, object and purpose of the DTA. This broad and purposive approach has been adopted by New Zealand courts, notably by McCarthy P in *Commissioner of Inland Revenue v United Dominions Trust Ltd*.[12]

[52] Where the treaty in question is a DTA based wholly or in part upon the OECD or UN Models, the Commentaries will be highly relevant in determining the correct interpretation of the treaty. Although the Commentaries are not legally binding, they are regarded as "a source from which courts of different states can seek

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[11] *Anson v Commissioner for Her Majesty's Revenue and Customs* [2015] UKSC 44, [2015] 4 All ER 288.

[12] *Commissioner of Inland Revenue v United Dominions Trust Ltd* [1973] 2 NZLR 555 (CA).

a common interpretation".[13] New Zealand courts have used them for this purpose as discussed by Richardson J in *Commissioner of Inland Revenue v JFP Energy*:[14]

> The OECD Convention rules have an international currency used as they are by and in countries throughout the world and accordingly the language of the rules should be construed on broad principles of general acceptation and having appropriate regard to the Commentary or to any *travauz preparatoires.*

[53] The Canadian Federal Court of Appeal in *R v Prevost Car Inc* summarises this as follows:[15]

> [10] The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the Commentaries on the provisions of the OECD Model Convention a widely accepted guide to the interpretation and application of the provisions of existing bilateral conventions…

[54] The same may be said with respect to later Commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries.[16]

The meaning of "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand"

[55] The outcome of this issue turns almost exclusively upon the meaning of the phrase "in respect of". Ms Lin contends that tax which is paid by a CFC is "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand". The Commissioner, on the other hand, submits that "Chinese tax paid … in respect of [CFC] income derived by a resident of New Zealand" must mean tax which has been paid by the New Zealand resident herself, therefore excluding tax paid by the CFC.

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13 Klaus Vogel *Doppelbesteuerungsabkommen* (2nd ed, CH Beck, Munich, 1990) (translated ed: John Marin (translator) Klaus Vogel *Klaus Vogel on Double Taxation Conventions* (Kluwer, Deventer, 1991) at [79].

14 *Commissioner of Inland Revenue v JFP Energy* [1990] 3 NZLR 536 (CA) at 540.

15 *R v Provost Car Inc* [2009] FCA 57, [2010] 2 FCR 65.

16 See *Chatfield & Co Ltd v Commissioner of Inland Revenue* [2015] NZHC 2099, (2015) 27 NZTC 22-024 at [62].

[56] In accordance with the principles of treaty interpretation set out above, the first step is to consider the ordinary meaning of Article 23(2)(a). I will then consider the relevant provisions of the Commentary and any other relevant matters.

The ordinary meaning of Article 23(2)(a)

[57] Article 23(2)(a) provides as follows:

> 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;

[58] On its face, Article 23(2)(a) of the China DTA does not require the tax to have been paid by the same person. It simply requires that there be:

(a) Chinese tax paid, either directly or by deduction;

(b) in respect of income derived by a New Zealand tax resident;

(c) from sources in China.

[59] There is no dispute that the ordinary meaning of "income derived by a New Zealand tax resident" includes income of a New Zealand resident which is assessed by attribution. Further, there is no dispute that income which accrues in a Chinese CFC and is subsequently attributed to a New Zealand resident is income "from sources in China", within the ordinary meaning of that phrase.

[60] However, there is a significant dispute regarding the meaning of the phrase "in respect of". In the submission of Ms Deligiannis, who appeared for the Commissioner, the CFC regime has created a different income stream which is not

business income but is an income stream derived by the New Zealand owner in respect of which the New Zealand owner has not paid tax in China. Mr Clews, who appeared for Ms Lin, submitted the proper construction of Article 23(2)(a) is to focus on the *tax* not the *payer* and the proper construction is much wider than the approach taken by the Commissioner.

[61] In my view, the phrase "in respect of" suggests that a more expansive interpretation, such as that favoured by Ms Lin, may be appropriate. Parliament itself appears to have adopted this approach in the past. Section LC 4 of the Income Tax Act 2004 provides that:

> (1) Subject to this section, a person who has attributed CFC income for an income year in respect of an income interest in a controlled foreign company is allowed a credit against the person's income tax liability for—
>
> (a) income tax paid or payable in New Zealand or another country or territory by the controlled foreign company *in respect of the attributed CFC income*.
>
> (emphasis added)

[62] The substance of that subsection is not particularly important for present purposes. What is relevant is that the legislation uses the phrase "tax paid … in respect of the attributed CFC income" to refer to tax which is paid by the CFC, rather than the New Zealand resident.

[63] The Income Tax Act 2007 similarly provides in s LK 1 that:

> (1) A person who has an amount of attributed CFC income for an income year has a tax credit for the tax year corresponding to the income year equal to the following *amounts paid or payable in relation to the attributed CFC income*:
>
> (a) an amount of *income tax paid by the CFC* from which the income is derived:
>
> (b) an amount of tax withheld and paid on behalf of the CFC from which the income is derived:
>
> (c) the amount of *foreign income tax paid by the CFC* from which the income is derived:
>
> (d) the amount of foreign income tax paid by the person in relation to the CFC from which the income is derived:

> (e) the amount of foreign tax paid, under the legislation of another country or territory that is equivalent of the international tax rules, by a foreign company in relation to income derived by the CFC.
>
> (emphasis added)

So, s LK 1(1) refers to "foreign income tax paid by the CFC" as being an amount "paid or payable in relation to the attributed CFC income". The terminology is slightly different from that used in Article 23(2)(a) – "in relation to" rather than "in respect of" – but the effect of the words is the same.[17]

[64] The manner in which these phrases are used in the Income Tax Act 2004 and Income Tax Act 2007 would tend to support Ms Lin's interpretation of Article 23(2)(a). In this case Chinese tax has been paid by the CFC in China. It is "in respect of" income treated as having been derived by Ms Lin as a New Zealand resident. Tax paid in respect of income is not necessarily only tax paid *on* income.

The Model Commentary

[65] Much of the expert evidence and legal argument at the hearing before me was dedicated to the interpretation and application of the OECD Model. The discussion on this point can be separated into two related sub-issues:

(a) Does Article 23 apply to relieve both juridical and economic double taxation; or does Article 23 relieve juridical double taxation only?

(b) What is the relevance of the partnerships discussion at para 69 of the OECD Commentary on Article 23?

[66] The debate regarding juridical versus economic double taxation arises in large part from the wording of para 1 of the OECD Commentary on Articles 23A and 23B, which states:

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17 In fact, the Oxford English Dictionary defines "in relation to" to mean "in respect of": "relation, *n.*" *Oxford English Dictionary* (Oxford University Press, 2017, online edition).

> A. The scope of the Articles
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> 1. These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State.
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> 2. This case has to be distinguished especially from the so-called economic double taxation, *i.e.* where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

[67] Under the CFC regime the profits of the CFC are subject to corporate tax in the home jurisdiction of the CFC whilst the same or derivative income is taxed in the hands of investors in the resident state. Two separate legal persons are taxed on the same income – one directly, the company in China, and one by attribution, the investor in New Zealand. In this way, it can be said that the CFC regime results in economic double taxation. Both parties approached this issue on this basis.

[68] Mr Clews argued that subsequent developments had overtaken para 1 and that Article 23 now applied to eliminate economic as well as juridical double taxation. Ms Deligiannis, consistent with her interpretation of the words "in respect of" in Article 23(2)(a), said no Chinese tax has been paid by Ms Lin on attributed CFC income which is a separate stream of income from the income derived by the Chinese Companies as a matter of legal form. That, in her contention, meant para 1 continued to have effect and precluded an interpretation of Article 23(2)(a) which would require states to grant relief in respect of economic double taxation.

[69] The position taken by the Commissioner, as articulated by Ms Deligiannis, would mean that Article 23 could never apply to CFC attributed income. I note however that para 38 of the OECD Commentary on Article 10 observes that CFC legislation or rules with similar effect "may, however, complicate the application of Article 23". This suggests the Commentary does not preclude the application of Article 23 to CFCs.

[70] Paragraph 3 of the OECD Commentary on Articles 23A and 23B describes international juridical double taxation as arising in three cases as follows:

> 3. International juridical double taxation may arise in three cases:
>
> *a)* where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax, see paragraph 4 below);
>
> *b)* where a person is a resident of a Contracting State (R) and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital (see paragraph 5 below);
>
> *c)* where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability, see paragraph 11 below).

[71] This expanded definition of juridical double taxation is helpful to the CFC analysis because CFC attributed income can be considered as falling into category 3(b), that is, income is derived from, in this case, China and both China and New Zealand impose tax on that income. I attach some significance to the fact category 3(b) refers to a person who *derives* income from the other contracting state.

[72] Analysed in this way, taxation of CFC attributed income can be considered to fall within the definition of or be deemed to be juridical double taxation and covered by Article 23.

[73] Further support for this interpretation is found in the discussion in the OECD Commentary on Articles 23A and 23B regarding the tax treatment of partnerships. That discussion is of some significance and is worth setting out in full:

> 69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State of source treats a partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of source may, subject to the applicable provisions of the Convention, tax the partnership on its income when that income is realised and, subject to the limitations of paragraph 2 of Article 10, may also tax the distribution of profits by the partnership to its non-resident partners. The State of residence, however, will only tax the partner on his share of the partnership's income when that income is realised by the partnership.
>
> 69.2 The first issue that arises in this case is whether the State of residence, which taxes the partner on his share in the partnership's income, is

> obliged, under the Convention, to give credit for the tax that is levied in the State of source on the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that the State of residence flows through the income of the partnership to the partner for the purpose of taxing him, it must adopt a coherent approach and flow through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for the purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.
>
> 69.3 A second issue that arises in this case is the extent to which the State of residence must provide credit for the tax levied by the State of source on the distribution, which is not taxed in the State of residence. The answer to that question lies in that last fact. Since the distribution is not taxed in the State of residence, there is simply no tax in the State of residence against which to credit the tax levied by the State of source upon the distribution. A clear distinction must be made between the generation of profits and the distribution of those profits and the State of residence should not be expected to credit the tax levied by the State of source upon the distribution against its own tax levied upon generation (see the first sentence of paragraph 64 above).

[74] Mr Clews submitted that the simultaneous taxation of a partnership and its partners was economic double taxation. If that position were accepted, he said, it followed that Article 23 now requires DTA partners to eliminate economic double taxation, even though the tax in one state is paid by a different legal person from the one who pays tax in the other state.

[75] Ms Deligiannis took the position that taxing of partners and partnerships was not economic double taxation. Rather, she submitted, the partnerships discussion in the OECD Commentary on Articles 23A and 23B merely clarified the legal status of partnership structures – “legal form”, as the Commissioner would have it.

[76] The interpretation of the partnerships discussion is critical to the interpretation of Article 23 generally.

[77] One option would be for this Court to interpret the partnerships discussion narrowly so that the principles espoused in the discussion apply in respect of partnerships only. Mr Oliver in his evidence supported this approach. He explained that the measures described in para 69 had been introduced to deal with specific practical problems and were not intended to represent a philosophical widening of

the ambit of Article 23. He said it took a number of years to reach agreement on the issue of partnerships and amendments to the Commentary were deliberately limited to partnerships. His evidence on this point is borne out to some degree by the text of the OECD Commentary on Article 1, which reads as follows:

> **COMMENTARY ON ARTICLE 1**
>
> **CONCERNING THE PERSONS COVERED BY THE CONVENTION**
>
> 1. …
>
> **Application of the Convention to partnerships**
>
> 2. Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships. These difficulties are analysed in the report by the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships", the conclusions of which have been incorporated below and in the Commentary on various other provisions of the Model Tax Convention.
>
> …

[78] The OECD Commentary then goes on to summarise the difficulties presented by the application of the OECD Model to partnerships by reference to the various Articles of the OECD Model. It is clear, therefore, that the application of the OECD Model to partnerships was subject to detailed analysis which then resulted in the various references to partnerships throughout the OECD Commentary.

[79] On the other hand, the text of the partnerships discussion would appear to support a broader interpretation and application of those principles. Paragraph 69.1 of the OECD Commentary on Articles 23A and 23B states that "[p]roblems may arise where Contracting States treat *entities such as partnerships* in a different way."[18] By the reference to "entities such as partnerships", the OECD Commentary arguably has opened up the ambit of Article 23 to entities other than partnerships, being entities which are treated by Contracting States in a different way.

[80] Paragraph 69.2 then discusses an issue which may arise as a result of the different treatment of partnerships by the state of residence and the state of source. It explains that, if the state of residence flows through the partnership income to the

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18 Emphasis added.

partner for tax purposes, it must be consistent and flow through to the partner the tax paid by the partnership to eliminate double taxation arising from taxation of the partner. Importantly, it explains that, if the corporate status given to the partnership by the state of source is ignored by the state of residence for the purposes of taxing the partner on his income, it should likewise be ignored for the purposes of calculating the foreign tax credit.

[81] Does this mean that the partnerships discussion extends the scope of Article 23 to cover some forms of economic double taxation? The double taxation of partnerships and partners can be conceptualised as a form of juridical double taxation which arises because the existence of the corporate entity in the state of source is ignored and the individual taxpayer is deemed to have paid tax in both the state of source and the state of residence. The conceptualisation is consistent with the general statement in para 1 of the Commentary on Articles 23A and 23B that "[t]hese Articles deal with … so-called juridical double taxation" and obviates the need to ignore or adopt a contorted interpretation of that paragraph.

[82] Returning to the subject of the present case, the next question is whether the principles espoused in the partnerships discussion can be extended, by analogy, to CFCs. In my view, that analogy is available. The problems that Ms Lin faces in the present case arise because the contracting states, here China and New Zealand, treat CFCs in a different way. China treats CFCs as corporate entities with separate legal personality. New Zealand treats CFCs as fiscally transparent entities under the CFC rules. On this basis, CFCs can be considered to be entities "such as partnerships".

[83] The analogy between partnerships and CFCs can also be demonstrated by re-writing para 69.2 of the OECD Commentary, substituting terms as appropriate:

> The first issue that arises in this case is whether [New Zealand], which taxes the [owner] on his share in the [CFC's] income, is obliged, under the Convention, to give credit for the tax that is levied in [China] on the [CFC], which [China] treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that [New Zealand] flows through the income of the [CFC] to the [owner] for the purpose of taxing him, it must adopt a coherent approach and flow-through to the [owner] the tax paid by the [CFC] for the purpose of eliminating double taxation arising from its taxation of the [owner]. In other words, if the corporate status given to the [CFC] by [China] is ignored by New Zealand for purposes of taxing the

> [owner] on his share of the income, it should likewise be ignored for the purposes of the foreign tax credit.

[84] Paragraph 69.3 then addresses the second issue which arises when the state of source imposes a separate tax on the distribution/dividend but the state of residence does not because the state of residence does not recognise that a second distribution has occurred. This issue does not arise in relation to CFCs, because both China and New Zealand recognise that a second distribution (in the form of a dividend) has occurred. However, the fact that the CFC regime does not lead to the *same* issues as the taxation of partnerships does not necessarily undermine the analogy.

[85] In my view, the OECD Commentary extends Article 23 to partnerships and entities which, like partnerships, are treated in different ways by contracting states, and this can properly include CFCs.

[86] Even if I am wrong in this analysis, however, there is another point which operates in favour of Ms Lin. Paragraph 2 to the OECD Commentary on Articles 23A and 23B states that "[i]f two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations". The China DTA *is* the result of bilateral negotiations. Article 23(2)(a) of the China DTA states that it applies "excluding, in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid". This exclusion is not included in the OECD Model, from which it can be inferred it was intentionally included by the parties to the China DTA. By negating an obligation to grant a tax credit for only one type of economic double taxation (dividends) a strong inference arises that the parties intended a credit must be given to counter other types of economic double taxation.

[87] The Commissioner says the specific reference to dividends is very important:

> New Zealand provides a foreign tax credit under Art 23 to a New Zealand resident deriving a dividend sourced from China for Chinese tax paid by that taxpayer on that dividend (that is, the Chinese non-resident withholding tax paid on dividends). However, the explicit exclusion in Art 23 means that New Zealand does not provide a foreign tax credit for Chinese tax paid *by the Chinese company* on the profits of the Chinese company funding the dividend. If New Zealand were to provide foreign tax credits for Chinese tax paid by the Chinese company on its profits, New Zealand would be providing foreign tax credits for underlying foreign tax paid (underlying foreign tax credits (UFTCs)).

[88] However, if Article 23 is limited to juridical double taxation in the way contended by the Commissioner, then the words which exclude "tax paid in respect of profits out of which the dividend is paid" are simply not required. The Commissioner's argument about the significance of reference to the dividend is inconsistent with the other arguments put forward on her behalf.

Interpretation of Article 23(2)(a)

[89] I am satisfied that "Chinese tax paid … in respect of income derived by a resident of New Zealand from sources in the People's Republic of China" includes Chinese tax paid by the CFC itself. The effect of Article 23(2)(a) of the China DTA is therefore that Chinese tax paid by a CFC must be allowed as a credit against New Zealand tax payable by Ms Lin on her CFC income.

The application of tax sparing provisions to CFC income

[90] The second issue which must be determined is whether Ms Lin is entitled to a credit for tax spared to her CFCs in China, as well as tax paid by the CFCs. Tax sparing is governed by Article 23(3) of the China DTA, which provides:[19]

> 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:
>
> …

[91] Unlike Article 23(2)(a), Article 23(3) refers specifically to "tax payable … *by a resident of New Zealand*". The question is whether Article 23(3) therefore precludes a New Zealand resident from obtaining any tax credit in respect of tax spared to a CFC.

[92] The Commissioner says that, as the tax is payable in China by the CFC and not by the New Zealand resident, Article 23(3) cannot apply so as to entitle the New Zealand resident to a credit for tax spared. Ms Lin says that "tax payable … by

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19 The phrase "tax payable in the People's Republic of China" does not appear in Article 23(2)(a), which refers instead to "Chinese tax paid". However, both parties agreed that the correct approach was to treat both terms as referring to the same thing.

a resident" must be read to include tax which is deemed to have been paid by a New Zealand resident under Article 23(2)(a), even though that tax may in reality have been paid by the CFC.

[93] Mr Oliver's evidence was that the tax sparing provision was only intended to apply in a very limited way in circumstances where a New Zealand resident itself invested in China on its own account (a branch operation) and where the New Zealand resident would have been liable to pay tax in China on its Chinese-sourced income, but for a Chinese tax exemption. In support of that he referred to a Tax Information Bulletin published in 1997, in which the Commissioner answered a question regarding tax sparing in the context of Fijian tax credits:[20]

> A tax sparing credit is not available under the controlled foreign company (CFC) regime in relation to a tax concession of a foreign country utilised by a CFC. This is because a New Zealand resident taxpayer is allowed a credit under section LC 4 … for income tax actually paid or payable by a CFC only, and the benefit of a tax sparing provision in a DTA is not extended to the CFC. A DTA allows a credit for tax paid (or deemed to be paid under a tax sparing provision) by a New Zealand resident only.

[94] While the Commissioner's opinion is to be accorded respectful consideration, this statement merely reflects the Commissioner's view that a tax sparing provision in a DTA can never apply to CFC attributed income because the taxpaying entity is different. Further, I note it predates the adoption of the report by the Committee on Fiscal Affairs on the application of the OECD Model to partnerships.

[95] The *International Tax Reform Part 1: Report of the Consultative Committee* was produced in March 1988 for the purpose of introducing new international tax reforms into New Zealand for the CFC rules. It said:[21]

> A number of submissions argued that the claw back of foreign tax preferences would be inconsistent with a number of New Zealand's tax treaties which include tax sparing provisions. These provisions generally apply only to branches of New Zealand companies in the tax treaty country and, since foreign branches are not affected by the present reforms, tax sparing would not be withdrawn or diminished. We are satisfied that the BE regime does not breach a tax treaty obligation. The tax sparing provisions were, however, entered into before the introduction of the present proposal and may now appear to be inconsistent with the thrust of the reforms.

20 IRD "Tax sparing – Fijian tax credits" (1997) 9(1) *Tax Information Bulletin* 6.
21 Valabh and others, above n 8, at 22.

[96] Although the report noted that tax sparing provisions *generally* only apply to branches, it did not specify that tax sparing rules did not apply to the CFC regime.

[97] Article 23(3) must be read in light of Article 23(2)(a). I have found that under the CFC rules, the income of the CFC is deemed to have been earned by the owner, and so the tax paid by the CFC is deemed to have been paid by the owner (the New Zealand resident). When this analysis is extended to Article 23(3), the only logical conclusion is that tax paid or payable by a New Zealand resident includes tax which is deemed to have been paid or to be payable by the New Zealand resident for the purpose of Article 23(2)(a). In this way Article 23(2) and (3) can be read consistently.

[98] I have considered all the material to which I have been referred. The academic analyses referred to in evidence which can be considered contrary to the conclusion that a tax sparing credit is available were all written prior to the addition in the OECD Commentary of the provision on entities such as partnerships. As Ellis J recently observed in *Chatfield & Co Ltd v Commissioner of Inland Revenue*:[22]

> On that approach, any changes to the Commentaries (where there has been no relevant substantive change to the Model Convention) are to be viewed not as recording an agreement about a new meaning but as reflecting a common view as to what the meaning is and always has been.

[99] I acknowledge the evidence from Mr Oliver as to his opinion of New Zealand's intentions. However, his evidence is one factor only to take into account. As outlined above, DTAs must be interpreted in accordance with the Vienna Convention, with appropriate regard to the Commentary and taking a purposive approach.

[100] For these reasons I am satisfied a New Zealand resident is entitled to a credit for tax spared in China to the CFC. This enables Article 23 to be read in a principled way, giving effect to its purpose of relieving double taxation.

[101] This interpretation is underscored by the evidence about the way in which DTAs are negotiated, the research done by each country into the other's tax systems

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[22] *Chatfield & Co Ltd v Commissioner of Inland Revenue*, above n 16, at [62].

and policy and the irresistible inference, acknowledged by Mr Oliver, that both parties would have known at the time of entering into the China DTA that New Zealand intended to implement a CFC regime in the near future.

[102] This interpretation of Article 23(3) also respects the purpose of the tax sparing provision in the China DTA to encourage investment in China, by ensuring that the benefit of the Chinese tax concessions remains with investors, rather than New Zealand tax collectors.

The effect of Article 23 on New Zealand's domestic income tax legislation

[103] The China DTA has direct effect in New Zealand and therefore pursuant to the China DTA Ms Lin is entitled to credits for tax paid by and tax spared to the CFCs. New Zealand's domestic legislation must be interpreted consistently with and give effect to New Zealand's obligations under the China DTA. The relevant provisions are ss LC 4(1) of the Income Tax Act 1994, LC 4(1) of the Income Tax Act 2004 and LK 1 of the Income Tax Act 2007. They set out the relevant foreign tax credit provisions relating to attributed CFC income and reference in them to "tax paid or payable" must therefore include tax spared to CFCs.

Shortfall penalty

[104] Given my decision, the question of shortfall penalties does not arise.

Result

[105] For the reasons set out above, judgment is given for Ms Lin. I make a declaration pursuant to s 138P of the Tax Administration Act 1994 that the Commissioner's assessments and default assessments in respect of Ms Lin's income tax for the 2005, 2006, 2007, 2008 and 2009 income years are incorrect to the extent affected by this judgment and Ms Lin's income tax positions for those years are to be assessed consistently with this judgment.

[106] Any costs submissions from the plaintiff are to be filed and served within two weeks of the date of this decision, with any reply on behalf of the Commissioner seven days thereafter.

Thomas J

Solicitors:
Simpson Western, Auckland for Plaintiff
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