International tax planning for individuals and small businesses

John Prebble*

In New Zealand, international tax planning tends to be left to large corporations with extensive connexions abroad. In fact, there are many situations where individuals and small companies can usefully consider and plan for the trans-national tax implications of their business and investment decisions. This article introduces some basic concepts and techniques of international tax planning, and discusses three examples of international tax planning in practice.

I. INTRODUCTION

International tax planning tends to be neglected by many professional advisers, for a number of reasons. It is often thought to be too expensive, or not worthwhile for the smaller business; or it is thought that New Zealand's exchange control is so strict that there is very limited scope for international tax planning. There is only an element of truth in these beliefs. International tax advice does tend to be costly, but at the same time it is calculated to pay for itself many times over. Even small companies can often benefit, especially if they are engaged in international trade. New Zealand exchange control is, admittedly, an inhibiting factor. Most of the more dazzling off-shore investment schemes run for North Americans and Europeans can have no place here. But New Zealand has a high level of international trade; and people, and therefore money, are always moving in and out. Legitimate movements of funds across borders are the foundation for a good deal of international tax planning. Moreover, it must be borne in mind that many New Zealanders own property overseas which is exempt from New

* Senior Lecturer in Law, Victoria University of Wellington.
This article is a revision of a paper presented by the author at the 1981 New Zealand Law Conference, held in Dunedin, New Zealand. The author gratefully acknowledges the suggestions and comments of the conference audience and, particularly, of the chairman and official commentators, his Honour Mr Justice Thorp of the New Zealand High Court, his Honour Mr Justice Aiken of the High Court of Australia, and E. J. Chronican Esq. F.C.A. of Dunedin, recently a member of the committee on international taxation of Messrs Coopers and Lybrand. Responsibility for the final version rests with the author.

Zealand exchange control. Such property and its income are often particularly apt subjects for tax planning.

Just as domestic tax planning adds a whole dimension to most commercial or investment decisions, so is international tax planning likely to be relevant across an extensive range of activities with any kind of offshore connexion. The difficulty is to recognise an opportunity and, having seen it, to know what to do about it. Rather than try to cover every topic lightly, this article considers three fairly specific examples of the type of situation where international tax planning can be relevant, and outlines plans that could be adopted in each case. An example is taken from each of international trade, foreign investment, and overseas employment.

Most things involved in international tax planning are familiar enough in onshore commercial dealings, but three matters, tax havens, treaties for the reduction of double taxation, and other measures for the reduction of double taxation, require preliminary consideration.

A. *Tax havens*

Much international tax planning involves the use of companies or trusts in countries which have no, or low, taxes, either generally, or on off-shore income. These countries are known as tax havens. Sometimes, a company will set up business in a tax haven. An example is the Syntex Corporation, a Panamanian company that has about half the United States market for contraceptive pills. Its headquarters are in Mexico, but it has a major manufacturing plant in Freeport, on Grand Bahama.

Perhaps more frequently, a tax haven will be a useful stepping stone between two high tax countries. For example, a New Zealand company wanting to exploit a patent by licensing manufacturers in several countries would, generally speaking, find it profitable to establish a master licencee in, say the Netherlands. This second company would then license manufacturers in North America and Europe. The Netherlands' excellent network of tax treaties, combined with its generous tax treatment of foreign royalties, would effect a significant saving in tax.

B. *Tax treaties and tax credits*

By section 242 of the Income Tax Act 1976, New Zealand taxes not only New Zealand source income, but also world-wide income of all New Zealand residents. This approach is common enough in other countries too. Consequently, off-shore income is frequently liable to double taxation. Many countries, including New Zealand by section 293 of the Act, allow a credit for foreign tax paid, but this credit is invariably confined to the domestic tax assessable on the foreign income in question. The credit is not like a deduction. It cannot be carried forward from a year of loss, for example.

The situation is further regulated by bilateral tax treaties between governments. Typically, a treaty will exempt certain business income from tax levied by one of the signatory countries. Ordinarily, one signatory will agree not to tax the business income of a resident of the other, even though that income has a source within the

jurisdiction of the first country. A major exception occurs where the income in question arises from a "permanent establishment" maintained by a foreign resident within the jurisdiction of the first country.[1] Fairly elaborate rules lay down which state has the right to tax which income. Non-business income, such as dividends, royalties, and interest, is usually treated differently. Ordinarily, the country of source is permitted to levy a tax of up to a certain fraction of the gross payment, often 15 per cent. The country of receipt gives its taxpayer a credit for the foreign tax paid. An example of the way in which a tax treaty operates is discussed in Part III A.3 of this article.

Generall speaking, where the taxpayer's business involves the passage of interest, dividends, or royalties between countries, he will be better off if the countries he chooses are linked by a treaty reducing the tax charged on those payments. On the other hand, where the taxpayer so organises his business that a discrete part of it can be carried on entirely within a tax haven, the existence of a tax treaty with that haven becomes less significant. An example is considered in Part II A. and following. In point of fact, most tax havens have no tax treaties at all. This is partly because, charging no taxes, they have no quid pro quo to offer in negotiations with a high tax country, and partly because tax treaties usually contain clauses authorising the exchange of information between the revenue services of the governments concerned. Tax havens generally prefer to preserve confidentiality in respect of the affairs of people resorting to them.

II. INTERNATIONAL TRADE

Inevitably, trading involves expenses — insurance, financing charges, shipping charges, and, of course, the cost of trading stock. All these items are legitimate deductions in calculating one's assessable income. The higher the expenses, the lower the assessable income, and, therefore, the lower the tax in respect of any particular trade. But, ordinarily, the corollary of low assessable income is low profits. Consequently, generally speaking, the interests of the taxpayer and the Commissioner to some extent coincide. To maximise profits, expenses should be kept low, but higher profits mean higher taxes.

Where a business is organised in such a way that expenses benefit the owner, rather than an outside supplier of goods and services, the motivation to reduce expenses is not so strong. Thus, a one-man company will often inflate the salary and expenses of the governing director. When it is a case of foreign trade, the opportunities for tax planning take on another dimension. Thus, a vertically integrated multi-national company will adjust its intra-group pricing policies in an endeavour to incur its highest expenses in high tax jurisdictions, and to derive its greatest profits in tax havens. In New Zealand, the best known examples are found in *Commissioner of Inland Revenue* v. *Europa Oil (N.Z.) Ltd.* (Europa No. 1.)[2] and *Europa Oil (N.Z.) Ltd.* v. *Commissioner of Inland Revenue* (Europa

1 E.g. the Canada-New Zealand Double Tax Convention, reproduced in the Schedule to the Double Taxation Relief (Canada) Order 1981, S.R. 1981/86, article 7(1).
2 [1971] N.Z.L.R. 641 (P.C.).

No. 2.).[3] However, multinationals and other corporations are by no means the only taxpayers to go in for international tax planning. One may take as an example a simple reinvoicing scheme, whereby deductons for the cost of trading stock are increased, with a consequent reduction in the assessable profits derived in a high tax jurisdiction.

A. *Reinvoicing: an example*

In *Federal Commissioner of Taxation* v. *Isherwood & Dreyfus Pty. Ltd.*,[4] the taxpayer was an Australian company importing goods from China. The company established a wholly-owned subsidiary in Hong Kong, Isherwood & Dreyfus (H.K.) Pty. Ltd. Thenceforth, the Hong Kong company bought goods from China at the normal export prices, added 10 per cent, and reinvoiced the goods to the Australian company. Since the Australian company now had to pay 10 per cent more for its imports, the mark-up by the Hong Kong company had the effect of reducing the profits of the Australian company by the same amount.

The Federal Commissioner of Taxation disallowed as a deductible business expense that portion of the purchase price paid by the Australian taxpayer that represented the Hong Kong mark-up. However, the Federal Court disagreed, and allowed the taxpayer to deduct the full price paid. The case depended on a finding in a lower court that the payments were made for one purpose only, namely the acquisition of trading stock. Consequently, the High Court decision in *Cecil Bros. Pty. Ltd.* v. *Federal Commissioner of Taxation*,[5] which was approved by the Privy Council in both *Europa* cases, applied. The *Cecil Bros.* case holds that where a payment is in fact made for trading stosk, the revenue rannot attack the wisdom or the amount of the payment. One infers from the judgments in the *Isherwood* case that it would have been open on the facts for there to have been a finding at first instances that the payments by the taxpayer had a dual purpose, the second purpose being to make profits in Hong Kong which would eventually accrue to the taxpayer as dividends. Such a finding would, presumably, have brought the case within the ambit of *Europa No. 1* where, in circumstances fundamentally similar to the *Isherwood* case, the Privy Council disallowed a portion of the cost of trading stock, because the reason for the payment of the disallowed portion was to derive tax-free dividends from a tax haven subsidiary, rather than to acquire stock.

B. *More elaborate steps in reinvoicing arrangements*

Australia, like England, the United States, and several other jurisdictions, now has specific legislation aimed at reinvoicing like that carried out in the *Isherwood* case. In New Zealand, the relevant provision is section 22 of the Income Tax Act 1976. Section 99, the general anti-avoidance provision, is also in point.

3 [1976] 1 N.Z.L.R. 546 (P.C.).
4 (1979) 9 A.T.R. 473.
5 (1964) 111 C.L.R. 430.

From its title section 22 appears to apply only to businesses "controlled by non-residents", but subsection (3) expressly extends the operation of section 22 to a business that "is carried on by persons having control of a company not resident in New Zealand". Section 22 applies when such a business produces no taxable income, or less taxable income than might be expected to arise from that business. In such circumstances, the Commissioner can "determine" the taxable income of the business, and levy tax accordingly.

Section 22 would catch a New Zealand company that carried out a scheme exactly like that adopted by Isherwood & Dreyfus Pty. Ltd.: the company is a "person" carrying on business and "having control of a company not resident in New Zealand", to wit its subsidiary company in Hong Kong. However, relatively slight modifications of the arrangements made would take such a company outside the scope of section 22.

The possible application of section 99 of the Income Tax Act 1976 to an arrangement like that in the *Isherwood* case is considered in Part II C. In any event, it is thought unlikely that New Zealand tax advisers would these days recommend a scheme quite as transparently ingenuous as the one adopted by Isherwood & Dreyfus Pty. Ltd. Even assuming that an arrangement like that would survive an attack under section 99, there are several ways in which it might be improved, both generally and in the light of section 22, though not all of them would necessarily have been available to the taxpayer in the circumstances of the *Isherwood* case. These include:

1. If only for cosmetic reasons, it seems unfortunate to have named the Kong Kong stepping stone company Isherwood & Dreyfus (H.K.) Pty. Ltd.
2. The Hong Kong company should not have been a subsidiary of the Australian importer, and, preferably, not even an associate company owned by the same shareholders. However, at least in the latter case, the taxpayer could have relied on *Europa No. 2,* where the fact that the tax haven reinvoicing company was not a subsidiary of the New Zealand taxpayer was very significant in distinguishing the case from *Europa No. 1.* Consequently, in *Europa No. 2,* the court allowed the full cost of trading stock to be deducted.
3. From the report, it seems likely that Isherwood & Dreyfus (H.K.) Pty. Ltd. would have paid Hong Kong tax at 17 per cent on its profits. This Hong Kong tax could well have been avoided with a slightly more elaborate arrangement.
4. Repatriating profits from a tax haven is a relatively simple process if effected by means of corporate dividends, and this method was successful in *Europa No. 2.* Nevertheless, it is probably not a method that would usually be recommended in a fairly clear reinvoicing case lke *Isherwood & Dreyfus Pty. Ltd.* v. *Federal Commissioner of Taxation.* Also, there is the disadvantage that the Hong Kong profits wind up inside the Australian company, able to be extracted only at the cost of tax on dividends declared.

C. *Reinvoicing and section 99*

Is a clear reinvoicing arrangement like that in *Isherwood & Dreyfus Pty. Ltd.* v. *Federal Commissioner of Taxation* vulnerable to attack under section 99 of the

New Zealand Income Tax Act 1976? On the authority of *Europa No. 2,* it appears that where a deduction for the purchase of trading stock survives an attack under section 104, the general deductions provision of the Act, the Commissioner cannot turn to section 99 as an alternative weapon. This is because the deduction having been found to be authorised by the Act, the general provisions of section 99 are over-ridden by the specific authority of section 104. Indeed, it appears that a parallel proposition must have been accepted by the Australian revenue in the *Isherwood* case, because section 260 of the Australian Act, the equivalent of section 99, seems not even to have been raised there. Be that as it may, were a New Zealand taxpayer to decide to adopt an arrangement along the general lines of the *Isherwood* case, it would be only prudent to take precautions against the possible application of section 99. One precaution would be to attempt to arrange matters so that the trade in goods purchased from Hong Kong could be considered to be a new source of income. [6] To this end, it might be advisable to establish a new importing company in New Zealand, with no previous history of this type of business, assuming, of course, that any import licensing requirements could be complied with.

D. *Customs duties*

It would be ironical if an importer, having paid an inflated price for goods to a tax haven associate, found his siphoned profits reclaimed by the revenue in the form of extra duties on the higher price paid for the goods. In fact, this does not happen.

Typically, customs duties are calculated on the value of goods in their country of origin. In the New Zealand Customs Act 1966, this is described in section 136 as the "current domestic value", meaning the fair market value of the goods when sold for cash in the ordinary course of business for home consumption in the principal market of the country of export, at the time of export.

Ordinarily, acting under authority conferred by section 140 of the Customs Act, the Collector may take the invoice relating to the goods as evidence of their current domestic value.

Where goods are imported otherwise than on a sale from their country of origin, the consignor issues a separate invoice under section 188(1)(b), stating their current domestic value. By section 144(1), goods exported to New Zealand from any country, but passing through any other country on their voyage to New Zealand (whether transhipped or not) are valued for duty as if they were imported directly from the first-mentioned country.

A reinvoicing transaction like that in *Federal Commissioner of Taxation* v. *Isherwood & Dreyfus Pty. Ltd.* will not usually involve shipping goods through a third country at all, let alone transhipping. The goods will be sent directly from their country of origin to their destination, though title and payment pass through a third party in a tax haven. The Customs Act 1966, with its emphasis on the

6 Cf. *Halliwell* v. *Commissioner of Inland Revenue* [1978] 1 N.Z.L.R. 363.

physical act of "importation", as opposed to purchas, of goods, does not concern itself with the passage of title to goods. Thus, the charge to duty depends on where goods come from in fact, rather than how they may have been dealt with on the way.

III. FOREIGN INVESTMENTS OWNED BY NEW ZEALANDERS

Many New Zealanders own property in foreign countries. Some people left property behind when they immigrated to New Zealand. Other people have acquired foreign property by inheritance, or by working abroad for some time, or perhaps as the fruit of a successfully-executed tax plan. Take, for instance, the case of X, a domiciled New Zealand resident who inherits a portfolio of shares in English listed companies. He is liable to income tax on the dividends in both New Zealand and England, and potentially, to New Zealand estate duty and English capital transfer tax. What should X do?

A. *Example of a tax plan*

The ways in which X could arrange his affairs are infinitely various. One possible plan is set out below. This plan has been chosen because it illustrates the stepping-stone technique of planning, using havens, both with and without tax treaties with high tax countries, rather than because of particular merit in the scheme itself. In fact, it is open to a number of criticisms, some of which are discussed in Part III E. The steps of the plan are:

(a) establish a company incorporated, managed, and controlled in Cyprus, with local directors:

(b) transfer the English shares to the Cyprus company in return for shares issued by the Cyprus company to X;

(c) establish a trust in Hong Kong, administered by a Hong Kong trustee corporation;

(d) sell the Cyprus company shares to the Hong Kong trustee, leaving the price owing, and payable on demand;

(e) progressively forgive the debt owed by the trustee to X;

(f) the Hong Kong trustee should hold the trust funds on discretionary trusts for beneficiaries who include the members of X's family in New Zealand;

(g) the Hong Kong trustee places the dividends received from the Cyprus company on an interest-bearing deposit account with a Singapore bank;

(h) the trustee advances funds to the beneficiaries as needed.

These transactions will have the following effects on the various relevant taxes:

1. *United Kingdom capital gains tax*

There is no effect as far as capital gains tax is concerned, as this tax is not imposed on gains by non-residents, even though the property in respect of which

a gain has been realised in situated in the United Kingdom. Thus, X is not liable to capital gains tax in any event, whether or not be adopts the plan suggested.

2. *United Kingdom capital transfer tax*

Capital transfer tax is chargeable on all United Kingdom property and on world-wide property of a United Kingdom domiciliary transferred for inadequate consideration. The threshold of capital transfer tax was lifted by section 85(1) of the Finance Act 1980 to £50,000 of accumulated lifetime transfers by the same person. However, it cannot be assumed that a future government would leave the capital transfer tax table in its present relatively generous form. In the last ten years England has seen a number of major changes in the taxation of capital gains and transfers: more, even, than New Zealand and Australia. It should not be assumed that this period of upheaval has finished.

The current rates of capital transfer tax are set out below. The first table covers transfers on death or within three years before death; the second table applies to other inter vivos transfers. In each case, the particular property transferred is valued, and then added to previous transfers by the same individual, to determine which slice that transfer falls into. Tax is then assessed at the appropriate rate.

Rates of capital transfer tax

TABLE ONE			TABLE TWO		
Portion of value		Rate of tax	Portion of value		Rate of tax
Lower limit £	Upper limit £	Percent	Upper limit £	Lower limit £	Percent
0	5,000	Nil	50,000	0	Nil
50,000	60,000	30	60,000	50,000	15
60,000	70,000	35	70,000	60,000	17½
70.000	90,000	40	90,000	70,000	20
90,000	110,000	45	110,000	90,000	22½
110,000	130,000	50	130,000	110,000	27½
130,000	160,000	55	160,000	130,000	35
160,000	510,000	60	210,000	160,000	42½
510,000	1,010,000	65	260,000	210,000	50
1,010,000	2,010,000	70	310,000	260,000	55
2,010,000	—	75	510,000	310,000	60
			1,010,000	510,000	65
			2,010,000	1,010,000	70
			—	2,010,000	75

The share exchange between X and the Cyprus company would not be subject to capital transfer tax, because there is no inadequacy of consideration. X receives Cyprus shares of equivalent value to his United Kingdom shares. The gradual forgiveness by X of the price owed to him by the Kong Kong trustee is not caught, because the property transferred, the debt, is not situated in the United Kingdom.

It may be that X could safely sell his English shares to the Cyprus company, and then progressively forgive the price. This is the pattern commonly adopted in

New Zealand estate planning with the sale of, say, a farm to a trust. In the present case, this course would have the advantage that X's wealth would not be locked into the Cyprus company in the form of shares, but could be paid out as capital dividends as the occasion arose. However, the capital transfer tax legislation contains in section 20 and section 44 of the Finance Act 1975 provisions calculated to catch transfers of wealth by a "series of transactions" or by "associated operations". whether these sections, which has no parallel in the New Zealand Estate and Gift Duties Act 1968, would in fact catch sales and subsequent forgiveness of a foreign debt is not clear, but the risk might not seem to be worth running.

The share exchange technique is commonly adopted by English solicitors for a second reason; a share sale results in an immediate taxable capital gain, but on an exchange of assets the taxpayer is entitled to roll over his gains, and tax liability does not crystallise. In the case of X, this consideration is not important because not being an English resident, X is not liable to United Kingdom capital gains tax anyway.

3. *United Kingdom income tax*

Under article VI of the United Kingdom-New Zealand Double Tax Agreement,[7] the United Kingdom tax on X's dividends from his English shares is limited to 15 per cent of the gross payments. Under article XVIII, and by section 293 of the New Zealand Income Tax Act 1976, that tax is allowed as a credit against X's New Zealand tax on the same dividends. Consequently, assuming X suffers at least a moderately high tax rate on his overall income, the total New Zealand and English tax on the dividends will not be more than if they had been derived from New Zealand companies. It should be noted that, like all foreign tax credits, this credit is allowed against tax on the United Kingdom dividends only. Thus, if X suffers a loss in any year in New Zealand he will have no New Zealand tax to set the credit against, and he is not permitted to carry the credit forward to a subsequent year, even against later tax on the United Kingdom dividends.

Under the plan as proposed, tax on the English dividends will continue to be limited to 15 per cent, pursuant to article 11 of the Cyprus-United Kingdom Double Tax Convention 1974.[8] It is for this reason that Cyprus was chosen as the residence of the holding company, rather than another tax haven. There are not many tax treaties between the United Kingdom and tax havens. Those that exist often do not give relief in respect of dividends. Examples of such include the treaties of 1952 with Jersey and Guernsey. Were it not for the Cyprus-United Kingdom treaty, withholding tax would be charged on the gross amounts of the dividends at the full rate. This is currently 30 per cent in the United Kingdom, but has been 35 per cent in the past.[9]

4. *Cyprus income tax*

Ordinarily, Cyprus is not a low-tax country. Company profits are usually taxed at 42.5 per cent. However, qualifying Cyprus-registered offshore companies are

7 Double Taxation Relief (United Kingdom) Order 1966, S.R. 1966/119.
8 *Simon's Taxes* (3rd ed., Butterworths, London, 1976) Division F4.5, 867.
9 On choice of tax treaties, see further Part III E.

taxed at 10 per cent of the standard rate, that is 4.25 per cent. This privilege is available to, inter alia, Cyprus-registered companies whose shares belong exclusively to aliens, and whose income comes from sources outside Cyprus. It is not essential that directors, management, or control be in Cyprus, but if that is the case, it will not be possible to suggest that a company, although incorporated in Cyprus, is in fact resident somewhere else, such as England or New Zealand. It is for this reason that Cypriot directors are suggested for X's company. Moreover, the company must have some directors, and Cyprus directors are likely to be as economical as most.

Cyprus companies qualifying for the 10 per cent tax rate are not granted a credit for foreign tax paid. Otherwise, the credit would almost certainly eliminate any Cyprus tax. However, the foreign tax is deductible in calculating Cyprus taxable income. Consequently, X will pay 4.25 per cent tax on at most 85 per cent of the gross value of the English dividends received. In practice, deductible expenses for administration would usually reduce the 85 per cent figure a little further.

Because the Cyprus corporation is a qualifying offshore company, there is no Cyprus income tax on the dividends from Cyprus to the Hong Kong trustee.[10]

5. *Cyprus capital taxes*

Shares held in a Cyprus offshore company are not liable to Cyprus estate duty. There is no Cyprus capital gains tax. Consequently, neither the capital assets of the company nor its shares, if sold, are liable to any tax. There is no Cyprus tax on capital transfers, apart from the estate duty.

6. *Hong Kong income tax*

Hong Kong taxes most income arising in the colony at a standard rate of 16½ per cent. However, there is no Hong Kong tax on foreign-source income, even if remitted within the jurisdiction. Thus, the dividends derived by the Hong Kong trustee from Cyprus are not taxable in Hong Kong, in the hands of either the trustee or the beneficiaries. On the other hand, bank interest arising in Hong Kong is taxed at 15 per cent. This is the reason for banking in Singapore, which does not tax interest paid by banks to non-residents. This type of concession is, in fact, quite common, even in countries which can by no stretch of the imagination be called tax havens. Israel and the United States of America are other examples. The reason is to encourage capital inflow.

7. *Hong Kong capital taxes*

Hong Kong imposes an estate duty of up to 18 per cent on assets within the colony. X's trust will probably be drawn in such a way that none of the New Zealand beneficiaries can be said to have a dutiable interest in the corpus, but, if they do, the total liability would be unlikely to exceed the New Zealand duty

10 See generally, C. Demetriades, *Cyprus in International Tax Planning* (Kluwer, England, 1980).

in respect of the same assets, because of the foreign duty credit in section 40 of the Estate and Gift Duties Act 1968. Hong Kong has no gift duty.

8. *New Zealand estate duty*

X's estate is chargeable with the value of the debt still owed to him by the trustee at his death, if anything, together with the value of any of the debt forgiven in the previous three years. Even if none of the debt is forgiven, New Zealand estate duty will be reduced, since the property in X's estate representing the English shares he used to own is pegged at the price at which X sells the Cyprus shares to the trustee, notwithstanding any subsequent rise in value of the English shares, and, consequently, of the Cyprus shares. Of course, this particular result owes nothing to the international flavour of X's tax plan. The same effect could be achieved by transferring the Cyprus shares, or, indeed, the English shares, to a New Zealand trustee. However, a transfer to a New Zealand trustee would not have the income tax benefits outlined elsewhere in this article.

9. *New Zealand gift duty*

There is no gift, and therefore no gift duty, on the sale of the Cyprus shares to the trustee, because the sale is at full value. It is assumed that the price would be left owing on demand without interest, in the standard manner generally adopted in New Zealand estate planning. Since X is domiciled in New Zealand, each forgiveness of debt to the trustee is a dutiable gift, assuming it is of sufficient value. The more thinly the programme of debt forgiveness can be spread over future years, the lower the aggregate gift duty. This contrasts with the capital transfer tax legislation in the United Kingdom, by which lifetime transfers are aggregated to calculate the appropriate rate of tax.

10. *New Zealand income tax*

Once the plan has been put into effect, X owns neither the English shares nor the Cyprus shares. Moreover, he is not a beneficiary of the Hong Kong trust. Consequently, X has no liability for New Zealand income tax on the dividends on the English shares at any stage of their journey through the various entities of the arrangements that have been made. The Cyprus company, clearly, is not liable to New Zealand income tax.

It will be recalled that the trust suggested for X's family is fully discretionary. Thus, when income is received by the trustee it may be paid out or accumulated. If accumulated, it may be paid out in a subsequent year.

Sections 226 to 233 of the New Zealand Income Tax Act 1976 divide trust income into two categories: trustees' income and beneficiaries' income. Broadly speaking, income that is accumulated is taxed as trustees' income, and income that is paid out to a beneficiary as beneficiaries' income. The trustee is taxed on trustees' income under sections 228 and 230, and he is also taxable on beneficiaries' income as the beneficiaries' agent under section 227. Moreover, the beneficiary is jointly and severally liable for tax on this income, by virtue of section 268.

In respect of income accumulated by the Hong Kong trustee, there is no case for the assessment of New Zealand income tax, as both the income and the recipient trustee are foreign. If the trustee pays out income to a New Zealand resident beneficiary in the year in which the trustee derives the income himself, the beneficiary is assessable in respect of that income pursuant to section 227. Technically, the trustee is also taxable as the beneficiary's agent, but this liability could not be enforced in Hong Kong by the New Zealand revenue. In any income year, if all the trust income is accumulated, there is no liability for New Zealand tax. Likewise, there is no liability for New Zealand tax on income distributed to a beneficiary at any time when the beneficiary is not a resident of New Zealand.

11. *Distributions to beneficiaries of previously-accumulated income*

The difficult question is whether the beneficiary while resident in New Zealand can be assessable in respect of distributions of income made after the year in which the income was derived by the trustee. This question has recently been considered relatively briefly by the author,[11] and in the future will be the subject of rather more detailed treatment.[12] In these articles, it is argued that there is no liability for New Zealand income tax on the beneficiary in the circumstances now under consideration. Shortly, the reasons are as follows:

(a) (i) The beneficiary is not liable under section 227 because that section charges income only if the beneficiary becomes entitled to it in the same year in which it is derived by the trustee.

(ii) The beneficiary is not liable under any general charging provision of the Act, because sections 226 to 233 furnish a code of tax liability for all income derived by a trustee. There is no scope for the operation of other sections of the Act. Sections 226 to 233 are mandatory. There is no authority for the Commissioner to assess the taxpayer under some alternative provision of the Act.[13]

(b) (i) The Income Tax Act 1976 treats and taxes income on an annual basis. Income is taxed in the year in which it arises. Consequently, if income arises in year one, it cannot be taxed in year two or year three.

(ii) The Act treats the income of a trust as one income, not a separate income for trustee and beneficiary.[14] Therefore, when income is paid out to a beneficiary in a year subsequent to that in which it was derived by the trustee, it is not assessable to the beneficiary.[15]

(c) It is believed that the points made under (a) and (b) apply equally whether accumulated funds are paid out in a regular fashion, to meet

11 Prebble, "The taxation of trusts" (1980-1981) 25 *N.Z. Current Taxation* 109, 134, 168, especially at 168-173; Prebble, "Taxation of trusts: the scope of sections 226-233 of the New Zealand Income Tax Act 1976", (1981) 11 V.U.W.L.R. 195.

12 Prebble, "Taxation in the hands of beneficiaries of payments from trust capital under English and New Zealand law" (not yet published).

13 Cf. *Commissioner of Taxes* v. *Luttrell* [1949] N.Z.L.R. 823 (C.A.).

14 Idem.

15 Idem; cf. *Stanley* v. *Inland Revenue Commissioners* [1944] 1 K.B. 255.

income purposes of a beneficiary, or in irregular lump sums for reasons of advancement or some other capital purpose. However, where sums are paid out in a manner that makes them look like income, it might appear from the case of *Tillard* v. *Commissioner of Taxes*[16] that they are taxable as income. It is thought that *Tillard* v. *Commissioner of Taxes* cannot stand with the subsequent Court of Appeal decision in *Commissioner of Taxes* v. *Luttrell*.[17] But, as a precaution, it would be advisable for the Hong Kong trustee to: (i) resolve in writing to accumulate devidends as they arise from Cyprus, and to add them to the trust capital, and (ii) make distributions to beneficiaries in capital-like forms.

B. *New Zealand exchange control*

At first sight, X's exchange of the English company shares for Cyprus shares, and the sale of the Cyprus shares to the Hong Kong, is a breach of the Exchange Control Regulations 1978. Regulation 8 forbids the transfer or sale of any foreign asset without the consent of the Reserve Bank. However, regulation 12 of the Exchange Control Exemption Notice 1978 virtually negates regulation 8 by exempting from its application all assets except those owned by trading banks. X's assets are therefore exempt, X not being a trading bank. This exemption preserves the position substantially as it has been since 1965. The Exchange Control Regulations 1978 and Exemption Notice of that year contained a similar blanket prohibition, followed by an exemption, though the exemption then applied only to securities situated in the sterling area, as defined in the notice.

C. *Costs and expenses*

Clearly, a plan like that outlined for X would entail reasonably significant costs. Offshore costs and disbursements to establish the Cyprus company and the Hong Kong trust might total about $2,000. Annual maintenance costs might be perhaps $1,500. Further, there is the problem of adequately managing the portfolio of English shares. All things considered, a plan of this nature might be thought to be worthwhile for income from English investments of $10,000 or more annually.

D. *Offshore mutual funds*

Many of the advantages of the Cyprus-Hong Kong plan could be achieved more simply by the client selling the shares and replacing them with investments in an offshore mutual fund which invests not only in the United Kingdom but wherever the capital market is most attractive The companies running these funds are generally resident in tax havens, often havens with treaties reducing withholding tax on some forms of investment income derived from countries where their investments are made. The legislation of such havens usually permits these funds to be open-ended. That is, they are allowed to buy back their own shares.

16 [1938] N.Z.L.R. 795.

17 Supra n. 13.

Nowadays, most tax havens which are at all attractive as bases for offshore funds have quite strict requirements to prevent fraud or other abuses by fund operators. It seems unlikely that another scandal like the I.O.S.-Vesco debacle will occur. In any event, many funds are under the umbrella of large financial groups of impeccable reputation, and appear to be secure investments. Examples include the various Unicorn Funds run by offshoots of Barclay's Bank. Generally speaking, offshore funds do not seem to have had startlingly successful investment records, but one could reasonably expect the better ones at least to keep up with the market average in the countries where they invest. This might wll be better than X could manage by himself, trying to supervise an English portfolio from New Zealand.

The simple switch of investment from English shares to an offshore fund would take X beyond the reach of English capital transfer tax, though his total assets in the United Kingdom may of course be below the £50,000 threshold. On the other hand, he would partially lose the effect of his credit against New Zealand tax in respect of English income tax paid, because, assuming he keeps the mutual fund shares in his own name, his income would now come from the fund rather than from the English companies in which he was previously a shareholder. The English tax withheld would become a sort of deduction, rather than a tax credit, in that it would reduce the profits of the fund, and thus X's dividends. This result might not be significant if it suited X to invest in a growth-oriented rather than income-oriented fund. Also, it should be borne in mind that a mutual fund seeking income would probably place a good portion of its fund on the international loan market, rather than into equities, because it is relatively easy to arrange for interest to be paid free of tax, as explained in Part III E.

Investment in an offshore mutual fund could be combined with a trust, used to accumulate income, or to alleviate the problems of probate in the manner discussed in Part III F.

E. *Criticism of the Cyprus-Hong Kong plan*

While a plan using Cyprus and Hong Kong illustrates several of the techniques of tax planning, it has certain shortcomings. The first relates to security. Cyprus is still half occupied by the Turkish army. Probably, safety features could be built into the plan to prevent loss to the client's family if war broke out. But there might remain a nagging doubt. Most clients would prefer their funds to be invested in a more stable jurisdiction, like Jersey, for example.

The criticism in Part III A.3 of the Channel Islands as a possible haven for the present arrangements is slightly misdirected, because it assumes that the client's funds would remain invested in income-producing equities. In those circumstances the United Kingdom-Cyprus Double Tax Agreement makes Cyprus more attractive than Jersey. But, in fact, it is unlikely that one would leave this type of portfolio concentrated in equities producing significant income. If an investor wants income, and he is in a position to invest offshore, he can obtain a far better return on the international loan market. He can obtain the best international rates of interest

for the amount of money he has available, and the market is such that without difficulty he can ensure that these rates are paid without the deduction of any tax, to any one of a number of havens, including Jersey.

On the other hand, if capital growth is required, the investor is generally best advised to put his funds into equities, or possibly into a property-based mutual fund, producing relatively little income. Although that income would suffer withholding tax at 30 per cent on the way from the United Kingdom to Jersey, rather than the 15 per cent on dividends going to Cyprus, the extra exaction might be worth paying, for the security of being based in the Channel Islands. Moreover, the income can be accumulated there. It need not be paid over directly or immediately to New Zealand. Thus, the loss of the New Zealand credit for United Kingdom tax withheld against the dividends may not be serious.

F. *Probate and administration*

Leaving aside taxes on income and capital transfers, the presence of overseas property in a deceased estate can of itself cause a good deal of trouble and expense, much of which can be avoided with a little foresight. The problem is the necessity to have the equivalent of a fresh grant of probate in each jurisdiction where property is owned. There are arrangements between Commonwealth countries that somewhat simplify the procedures involved; nevertheless, the whole business can be time-consuming and expense. Among the ways to avoid this problem are the following:

(a) Liquidation and transfer to New Zealand of foreign assets. If the assets are relatively modest in value, there may be little point in leaving them abroad, particularly where an elderly person is involved. Alternatively, if the client is unlikely to have any personal need for foreign funds, such property is an obvious candidate to be high up on a programme of giving away assets to descendants, in order to reduce New Zealand estate and gift duties.

(b) Execution of separate wills, with local executors, for each jurisdiction where the client owns property.

(c) Settlement of foreign property on a revocable trust for members of the family of the client, including himself. On the client's death, there is no passing of the legal estate in his foreign property, and consequently no need for an administration in respect of that property. On the other hand, during his lifetime the settlor's power of revocation, practically speaking, gives him virtually the rights of an owner of the settled property. If necessary, his position can be further strengthened by clauses requiring his consent to any significant action by the trustees.

Naturally, none of these techniques apart from giving property away has any effect on the liability of a deceased New Zealand domiciliary for New Zealand estate duty. Nor, apart from (a), would they be likely to affect the incidence of any overseas capital taxation. From the point of view of the New Zealand Estate and Gift Duties Act 1968, property owned by a domiciliary is nonetheless dutiable

when it is disposed of by a foreign will, and property settled on a revocable trust is caught by section 12(1)(c) of the Act.

Two further practical points should be made about (b) and (c). First, in respect of (b), having separate wills in each jurisdiction where property is owned will clearly not relieve the estate of a deceased person of the necessity to obtain probate in each of these jurisdictions. Rather, it will often be found simpler for local executors to get probate of a local will, starting from scratch, than for copies of the New Zealand grant to be extracted, sent abroad, and authenticated locally, by whatever may be the appropriate procedure. Secondly, in respect of (c), it should be noted that the revocable trust technique is not confined in its application to offshore estates. A revocable trust can be used in New Zealand to take some of the assets of a testator outside the estate that passes to his administrators. Estate duty liability remains the same, but the administration of the estate may be simplified in some cases. This technique is quite common in some states of the United States of America, where obtaining probate and administering an estate under the supervision of a surrogate's court can be slow and expensive.

IV. OVERSEAS EMPLOYMENT

The performance of personal services offers taxpayers from high-tax jurisdictions a unique opportunity to minimise their tax liability. Generally speaking, this result is not unreasonable, because, being temporarily in another country, their demands on the state are probably less than those of permanent residents. Moreover, their service abroad often helps their own country by promoting exports or otherwise helping the acquisition of overseas funds.

By virtue of section 241 of the Income Tax Act 1976, as amended by the Income Tax Amendment Act 1980, a New Zealander is ordinarily deemed to be non-resident in New Zealand if he is absent overseas for twelve months or more. This provision applies from 1 April 1980, though the twelve-month period can have started before that.

The salary of such a New Zealander, working for a New Zealand employer, is not deemed to have a New Zealand source, even though it may be paid directly by the New Zealand employer, perhaps into a New Zealand bank account. The reason is that the source of personal services income is, at least generally speaking, the place where the services are performed. The place of contracting and the place of performance are regarded as subsidiary matters, as was held in *Geothermal Energy N.Z. Ltd.* v. *Commissioner of Inland Revenue.*[18]

While this rule might at first sight appear rather generous to, say A, a New Zealand employee working in London on a tour of duty for eighteen months, and paid from New Zealand, its justice becomes apparent when one considers another case. Take B, always domiciled and resident in England, who is recruited as a receptionist to work at the London branch of the New Zealand company, C Ltd. Notwithstanding that B is paid out of money sent to London for the purpose by

18 [1979] 2 N.Z.L.R. 324.

C Ltd., it would be surprising to find that B's wages were taxable in New Zealand. Fundamentally, A is in the same position as B. They are both non-residents of New Zealand, being paid for personal services performed outside New Zealand.

As a result, if A is abroad for over twelve months, and always works in a no-tax haven, he should pay no income tax. However, practically speaking, it is more likely that A will be employed somewhere like England, or another relatively advanced, high tax country. Consequently, he will probably have some income that has its source in a high tax jurisdiction, and he may well wind up being resident there also, and thus assessable on his world-wide income, as he would if resident in New Zealand.

Depending on the requirements of A's job, he may be able to establish residence in a tax haven or, at least, in a country that does not tax foreign-source personal services income. For example, a New Zealand sales director with responsibility for Northern Europe might well settle in Jersey, which taxes residents on world-wide income, but at only 20 per cent. Of course, there are many other possibilities.

One relatively simple example may be taken, of a New Zealander seconded to the London office of his employer, a new Zealand company. Take, again, A, sent to London by his New Zealand employer, C Ltd. First, it will be advantageous if A has a tour of duty of at least one year. In this fashion, he becomes non-resident in New Zealand, and not subject to New Zealand tax on salary or wages earned abroad, as explained in the previous paragraphs.

On the other hand, people present in England for six months or more of a financial year are treated as resident there and, in any event, A will be taxable in England on his remuneration for services performed there. In this connexion, there is no need to seek for an authority parallel to *Geothermal Energy N.Z. Ltd. v. Commissioner of Inland Revenue,* discussed above, because Schedule E, Case II of the United Kingdom rules specifically taxes emoluments in respect of duties performed within the jurisdiction.

However, although A is clearly taxable in England on his salary from C Ltd., there are very substantial allowances available to him in respect of what are defined as "foreign emoluments". In appropriate cases, these allowances make the United Kingdom virtually a tax haven for the foreign-based employee.

By section 181 of the Income and Corporation Taxes Act 1970 (U.K.), the term "foreign emoluments" includes emoluments of a person not domiciled in the United Kingdom (although he may be resident there) from an employer resident outside, and not resident inside, the United Kingdom. (This double qualification in respect of the employer is necessary because of the possibility of dual residence.). Where foreign emoluments are for duties performed wholly or partly in the United Kingdom, the amount of the foreign emoluments is reduced by 50 per cent, so that A would be taxable on only half of his salary. The reduction is only 25 per cent if and when A has been resident in the United Kingdom for nine of the previous ten years.[19] The deduction is cumulative on any other reliefs and allow-

19 Finance Act 1974, Schedule 2, para. 3 (U.K.).

ances to which the taxpayer is entitled. Since this allowance operates as a deduction, rather than a rebate, even quite highly paid employees are thrown entirely into the broad band of basic rate tax. Consequently, their total tax saving can be considerably more than half, and their effective rate is often under 15 per cent on their whole salary.

The difficulty is, of course, that for A's salary to qualify it must be paid by a non-resident employer. For many reasons, C Ltd. may prefer to establish a United Kingdom subsidiary, rather than operate through a branch, and it may well be that the subsidiary will be resident in the United Kingdom. Unlike the position in New Zealand,[20] incorporation in the United Kingdom alone is not sufficient to render a company resident there.

In these circumstances, the appropriate course is for C Ltd. to establish a management or services company, possibly in the Channel Islands, for whom A and similarly placed colleagues can work. Their services are provided to the United Kingdom subsidiary of C Ltd. for a fee. A will thus qualify for the foreign emoluments deduction. This type of arrangement is common enough in England, and not objectionable to the revenue authorities there.

The rules considered above relate to emoluments for services performed in the United Kingdom. Where A, being a resident of the United Kingdom, derives "foreign emoluments" for services performed wholly outside the United Kingdom, he is taxable on them only if they are paid in or remitted to the United Kingdom. The value of an offshore management company to pay A's salary in respect of his work outside the United Kingdom is plain. If the company were resident in Jersey, the salary should be paid somewhere else, in order to avoid Jersey tax. This is because foreign-source employment income of a non-resident is taxed if received in Jersey.

V. CONCLUSION

International tax planning is now a fact of economic life, and will continue to be so for the foreseeable future. The industry is growing. The first international "Tax Havens Fair" is due to be held in London in 1981, with stalls reserved by tax haven governments, trust companies and banks. From the examples given in this article, it may be seen that the objectives of much international tax planning are by no means confined to the avoidance of tax in the country of the client concerned; foreign taxes are often significant.

From the point of view of New Zealand as a whole, it might be thought that minimisation of foreign taxes on New Zealand controlled investments or businesses would by and large be for the benefit of the country generally. The Income Tax Act 1976 perhaps adopts this philosophy; it is at least neutral as far as foreign tax is concerned. Section 99, the general anti-avoidance provision, applies to New Zealand income tax only. On a similar point relating to the interests of the

20 Income Tax Act 1976, s.241(2)(a).

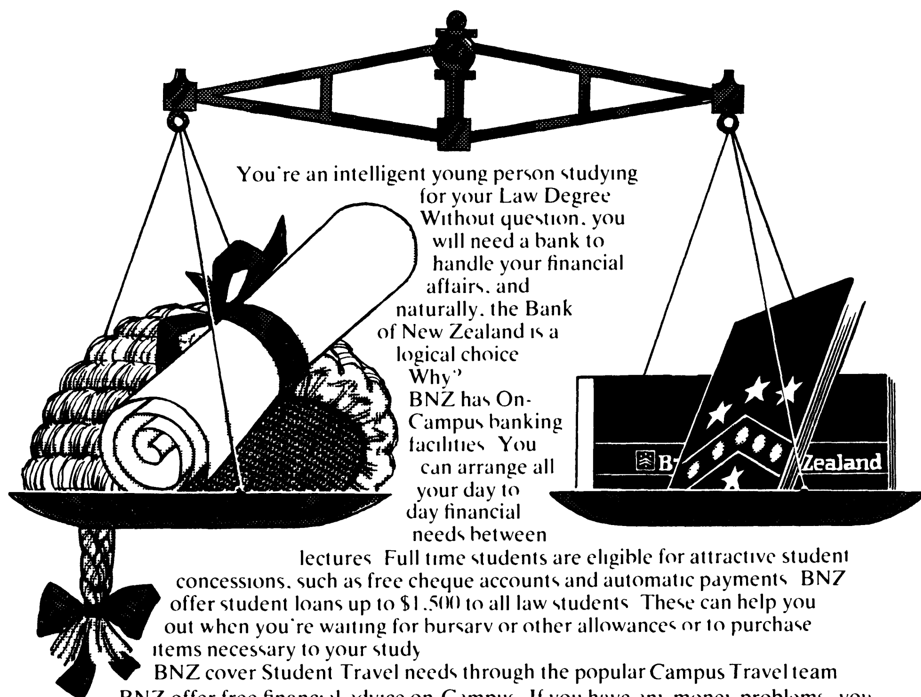
United Kingdom, Edwardes-Ker mentions in *International Tax Strategy*[21] that British Petroleum pays considerably more tax to the United States of America than necessary. If B.P. held its Alaska oil interests via a Netherlands holding company, it seems that the withholding tax levied on profits flowing from North America to the United Kingdom would be 9.75 per cent instead of the 15 per cent that is charged on a direct transfer.

Tax planning can have significant effects in respect of nearly all transactions with an international flavour. It can make the difference in trading and investment decisions on the question of whether a particular project is feasible or not, as was, indeed, the case in *Geothermal Energy N.Z. Ltd.* v. *Commissioner of Inland Revenue,*[22] according to evidence led on behalf of the taxpayer.

One of the more significant applications of international tax planning not discussed here relates to royalty payments for patents, knowhow, intellectual property in general, and the right to make, use, or sell things. The tax haven stepping stone technique is frequently used in this context. Other applications of international tax planning occur in respect of emigration by the taxpayer from one country to another, the borrowing of money, the use of captive insurance companies, and in international leasing, where some particularly arresting schemes have been devised. Depending on the jurisdictions involved, it is occasionally possible for both the lessor and the lessee to take depreciation deductions in respect of the same asset.

21 (In-Depth Publishing, Dublin, 1980) Ch. 12, p.5
22 Supra n. 18.

Prudent Student Jurisprudence with Bank of New Zealand



You're an intelligent young person studying for your Law Degree. Without question, you will need a bank to handle your financial affairs, and naturally, the Bank of New Zealand is a logical choice. Why? BNZ has On-Campus banking facilities. You can arrange all your day to day financial needs between lectures. Full time students are eligible for attractive student concessions, such as free cheque accounts and automatic payments. BNZ offer student loans up to $1,500 to all law students. These can help you out when you're waiting for bursary or other allowances or to purchase items necessary to your study.

BNZ cover Student Travel needs through the popular Campus Travel team.

BNZ offer free financial advice on-Campus. If you have any money problems you can talk it over with the friendly BNZ On-Campus Staff. And BNZ have other services available to you including Nationwide and VISA. All you have to do is drop in to your On-Campus Branch of BNZ to find out all we offer and what you are eligible for.

So why not choose Bank of New Zealand? We rest our case.

Bank of New Zealand

Here when you need us - on campus