NEW ZEALAND DOUBLE TAX TREATY POLICY AND PRACTICE, 1987-2004: A PRELIMINARY ASSESSMENT

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1. Introduction

Despite criticism by economists, lawyers and others for all of its life, the bilateral tax treaty continues to be the predominant way governments coordinate the income tax world. Indeed, each year, the total number of bilateral tax treaties grows as many governments negotiate more of them. In an income tax world that is continually changing, the bilateral tax treaty provides one stable reference point. A bilateral tax treaty today would be instantly recognised by tax practitioners of forty years ago: slim documents of about twenty pages, containing around thirty articles, starting with their scope, the taxes covered and general definitions and ending with territorial extension, entry into force and termination. Many domestic income taxes today, however, have changed markedly from those in the 1960s. Many tax a much wider definition of income, particularly income across borders. Many are much larger in volume. Some have been, or are in the process of being, restructured and rewritten.

Something that is increasingly used over more than forty years of testing change must still be considered of value by governments. Yet the critics continue to attack. From the first efforts of the League of Nations to develop a model tax treaty in the 1920s, the double tax treaty has been criticised as being inefficient. More recently, it has been criticised as also being increasingly irrelevant and inflexible[2], unfair[3] and ineffective[4].

Just occasionally, a government decides to review the usefulness of this instrument of coordination. In 1991 the New Zealand Government outlined a policy framework for taxing income across international borders.[5] That document emphasised the primacy of domestic tax rules in relieving undesirable double taxation and dealing with international tax problems. It argued that double tax treaties played a secondary role. It said the government was considering instigating an ongoing review of each of New Zealand's 24 existing double tax agreements (DTAs)[6]. It set out criteria for assessing whether to negotiate a new agreement or to renegotiate in existing one. It stated that New Zealand would seek to renegotiate double tax agreements that had fallen out of line with current policy. The document concluded:

> *"The same criteria that are used to assess proposed changes to domestic tax laws will be used to assess proposed DTAs.*

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[2] Vann, Richard, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)", (1991) 45 *Bulletin for International Fiscal Documentation* 99-111.

[3] Dagan, T, "The Tax Treaties Myth", (2000) 32 *New York University Journal of International Law & Politics* 939-996.

[4] Blonigen, B.A. and R.B. Davies, "The Effects of Bilateral Tax Treaties on U.S. FDI Activity" (2004) 11 *International Tax and Public Finance* 601-22.

[5] Richardson, Hon Ruth, and Hon Wyatt Creech, *Taxing Income Across International Borders - A Policy Framework*, (Wellington: July 1991).

[6] As New Zealand and Australian treaty practice is to refer to these instruments as 'agreements', this paper generally refers to specific examples of a tax treaty as a 'tax agreement'. The paper generally refers to these instruments as 'tax treaties' in general references as this is a more descriptive term.

> *Within these constraints, New Zealand will continue to use DTAs where they can provide a positive effect on investment and trade."*[7]

Between 1987 and 1994 New Zealand did not negotiate any new double tax agreements. To be precise, the suspension period began on 25 March 1987 with the signing of the double tax agreement with Indonesia (which came into force one year later in 1988). The period ended on 21 February 1994 with the first round of talks to re-negotiate the double tax agreement with Australia. The appendix arranges in chronological order all 29 of New Zealand's current double tax agreements, according to the date each agreement came into force. Twenty-three came into force between 1963 and 1988. Six came into force between 1995 and now. In addition, one agreement has been signed since 1995 but has not yet come into force.

This period from 1987 to 1994, in which New Zealand did not negotiate any new double tax agreements, is also the time in which New Zealand extensively reformed the way that its domestic rules taxed income across its borders: rules defining residence, taxes on the foreign-source income of residents and the local-source income of non-residents. The 1991 policy framework document expressed the direction for New Zealand's international tax reform in these terms:

> *"The New Zealand Government has decided in principle that it will move to limit the taxes on income from capital it imposes on non-residents, while maintaining a comprehensive system for taxing residents on their worldwide income. In line with this general tax policy, it will seek to minimise the compliance costs of that regime.*
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> *Little change is envisaged in relation to the taxation of labour income.*
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> *In reaching this view, the Government has balanced the need to raise revenue, its desire to make New Zealand an attractive investment destination, its policy of securing low interest rates and the compliance costs that the various taxation options involve."* [8]

In short, the government would apply its general tax policy of raising revenue at lowest net cost and fairly. At the border, this would aim at comprehensive taxation of residents' worldwide income and limited taxation of non-residents' income from capital.

At a time that the government was moving its domestic rules away from source taxation towards residence taxation, it made sense to review its tax agreement policy and practice to see whether they were consistent with this change in direction. New Zealand's double tax agreements are based on an international model tax treaty that comprehensively covers the taxation of income across borders. Further, the New Zealand legislative authority to incorporate double tax agreements into domestic law provides that the tax agreements operate notwithstanding anything to the contrary in the Income Tax Act or any other enactment.[9]

This is an initial scoping paper for a research project about the extent to which it is feasible for a country that has a network of double tax treaties to apply the same criteria that are used to assess proposed changes to domestic tax laws to assess double tax treaties. The research project focuses on New Zealand's experience from 1987 onwards.

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[7] Richardson, Hon Ruth, and Hon Wyatt Creech, *Taxing Income Across International Borders - A Policy Framework*, (Wellington: July 1991) 36.
[8] Id., at 12.
[9] Income Tax Act 2004, section BH 1(4), NZ.

Section 2 places bilateral double tax treaties in a model of tax co-operation between nations. Double tax treaties may not be the only means of international tax co-operation but this research project is important because almost all income tax co-operation between nations currently takes place using this bilateral tax treaty instrument. Section 3 briefly surveys the evaluative literature on double tax treaties, particularly focusing on the weaknesses in the OECD Model Tax Convention on Income and on Capital. The following section provides background by describing how New Zealand double tax agreements are negotiated and by giving further detail on the New Zealand double tax agreement review in the early 1990s. Section five discusses the various methods that could be used to analyse the extent to which it is feasible for a country that has a network of double tax treaties to apply the same criteria that are used to assess proposed changes to domestic tax laws to assess double tax treaties. Section six notes the limited differences between New Zealand's 1972 tax agreement with Australia, negotiated well before the New Zealand double tax treaty policy review in the early 1990s, and New Zealand's 1995 tax agreement with Australia, which was the first tax agreement negotiated after the review. The paper finishes with preliminary conclusions and implications for international tax reform, both in New Zealand and in other countries.

2. A model of tax co-operation between nations

The object of this research project is to analyse the feasibility of using general tax policy criteria in relation to one international co-operative option for responding to international income tax issues: the double tax treaty. That instrument is the predominant coordinating mechanism for cross-border income tax issues. As the keeper of the Model Double Tax Convention that is, directly or indirectly, followed by almost all 1700 or more bilateral comprehensive DTAs in the world, the OECD is the main multilateral lawmaking body for international income tax. The UN Model Double Taxation Convention between Developed and Developing Countries draws heavily on the OECD Model with some limited by significant exceptions.[10] The OECD recommends to members that they negotiate bilateral DTAs based upon its Model DTA that provides a detailed commentary and a mechanism for members to make reservations to the Model.[11] In the past, the OECD Model DTA has been amended relatively infrequently. More recently, however, the OECD has changed to a more helpful amendment process that is progressive.

The intellectual underpinning of the OECD Model, however, was laid in the 1920s. In the subsequent period, economists, lawyers and others have continued to think about how to devise an international tax system that creates minimal distortions and meets other tax policy objectives.[12] There is, however, no sign of a multilateral instrument along the lines of the WTO instruments being developed.[13] To the

[10] Kosters, Bart, "The United Nations Model Tax Convention and Its Recent Developments" (2004) 9 *Asia-Pacific Tax Bulletin* 4-11, at 5-7. See also Willem F.G. Wijnen and Marco Magenta, "The UN Model in Practice" (1997) 51 *Bulletin for International Fiscal Documentation* 574-585 for a study of the extent to which provisions of the UN Model have been included in more than 800 tax treaties concluded between 1 January 1980 and 1 April 1997.

[11] OECD, *OECD Model Tax Convention on Income and on Capital* (Paris: OECD, loose leaf).

[12] Gordon, Roger H. and Hines, James Rodger, "International Taxation" (April 2002), NBER Working Paper No. W8854, available at <http://ssrn.com/abstract=305598>. Desai, Mihir A. and Hines, James Rodger, "Evaluating International Tax Reform" (July 2003), Harvard NOM Working Paper No. 03-48, available at <http://ssrn.com/abstract=425943>. Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003). Professor Michael Graetz has recently published an excellent collection of multidisciplinary readings that, among other things, deal with many broad international income tax policy issues, albeit with a US focus – Graetz, Michael, *Foundations of International Income Taxation* (New York: Foundation Press, 2003). See also the Symposium on International Tax Policy in the New Millennium introduced in Victor Zonana, "International Tax Policy in the New Millennium: Developing An Agenda" (2001) 26 *Brooklyn Journal of International Law* 1253. See also Reuven S. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification" (1996) 74 Texas Law Review 1301.

[13] The Head of Fiscal Affairs Division, OECD, has questioned the desirability of replacing the existing bilateral DTA network with several multilateral treaties and doubted whether countries would find this acceptable. He has proposed several measures to improve the present arrangements. Owens, J, "Globalisation: The Implications for Tax Policies" (1993) 14 *Fiscal Studies* 21-44, at 43. On the other hand, a former director of the Fiscal Affairs Department of the IMF has argued that perhaps it is time to establish a "world institution with the responsibility to establish desirable rules for taxation and with

extent that individual agreements follow the Model, there is a multilateral aspect to the international tax law world. Negotiators of these agreements, however, still tend to regard them as bilateral bargains. In essence, the international income tax law world remains a bilateral world.

The other main player on international tax is the IMF but it does not have an international rule or standard making function. Its traditional role has been to provide advice to developing countries and analysis of tax problems.[14]

The GATT/WTO has ventured into the income tax field with panels making findings about aspects of the US and three European company tax systems in the 1970s and more recently.[15] With the Uruguay Round agreements, however, the WTO is moving into the investment area. The overlap between the work of the WTO and the OECD on investment issues may grow. The possibility of the WTO considering income tax issues may increase. Towards the end of the Uruguay Round, the DTA negotiators became aware of the potential conflict between the GATS and the OECD Model DTA. The income tax treaty negotiators seem to have ensured that their OECD Model DTA came out on top. But there is still a battle over how disagreements about the respective jurisdictions of the OECD and GATS dispute resolution mechanisms should be resolved.[16]

Double tax treaties may currently be the predominant co-operative response of most governments to international tax issues, and these treaties may themselves operate at different levels of co-operation, but they are not the only way that governments can co-operate. The model of international tax co-operation[17] in Table 1 helps tease out the different ways that double tax treaties work and also puts double tax treaties into a broader context. As this research project compares two of New Zealand's double tax agreements with Australia in the main, this section also uses Australasian examples, wherever possible. The model can also be applied at a regional or multilateral level, for example to the work of the OECD, which is responsible for the most influential international model double tax convention.[18]

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enough clout to induce countries to follow those rules." Tanzi, V, *Taxation in an Integrating World* (Washington, D.C.: The Brookings Institution, 1995) 140. Similar calls for an international institution on tax have been made by lawyers, like Vann, R J ("A Model Tax Treaty for the Asian-Pacific Region? (Part II)" (April 1991) 45 *Bulletin for International Fiscal Documentation* 151-63 at 160) and economists, like Slemrod, J ("Tax Principles in an International Economy" in Boskin, M J, and McLure, C E Jr (eds), *World Tax Reform - Case Studies of Developed and Developing Countries* (San Francisco: ICS Press, 1990) 11-23).

[14] Goode, Richard, *Economic Assistance to Developing Countries through the IMF* (Washington: The Brookings Institution, 1985). Goode, Richard, "Tax Advice to Developing Countries: An Historical Survey", (1993) 21 *World Development* 37-53; IMF, "Technical Assistance on Tax Policy: A Review", 1993, *IMF Working Paper* 93/65. Vito Tanzi and Howell Zee, "Tax Policy for Emerging Markets: Developing Countries," (2000) 53 *National Tax Journal* 299-322. Miranda Stewart and Sunita Jogarajan, "The International Monetary Fund and Tax Reform" (2004) *British Tax Review* 146-175.

[15] For a recent article on these issues, see Paul R. McDaniel, "The David R. Tillinghast Lecture: Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions," (2004) 57 *Tax Law Review* 275-300.

[16] Article XXII of the GATS provides that WTO Members may bring these jurisdictional disputes before the Council for Trade in Services and the Council shall refer the matter to binding arbitration (the trade negotiator's solution). An additional paragraph has been added to the Commentary to Article 25 of the OECD Model DTA for Member countries who wish to ensure that the dispute resolution mechanism of a bilateral income tax treaty (the income-tax-treaty negotiator's solution) will always prevail over the dispute resolution mechanism in the GATS agreement.

[17] This section draws heavily on part of chapter 1 in the author's doctoral dissertation, "Trans-Tasman Company Tax Horizons" (Faculty of Law, University of Sydney, March 1997).

[18] This tax co-operation model may also be applied at the multilateral level to the work of the OECD Committee on Fiscal Affairs. Working Party No. 2 on Tax Analysis and Tax Statistics operates at levels one, two and three (information exchange and consultation). Working Party No. 1 on Double Taxation and Related Questions operates at level four in its work on the OECD Model Tax Convention. The Working Party on the Taxation of Multinational Enterprises in its work on transfer pricing guidelines is working at marginal co-operation level four. Finally, the Committee on Fiscal Affairs now has a mandate to monitor implementation of the transfer pricing guidelines by OECD members and non-members, including by peer review of member-country practices.[18] In carrying out this mandate, this Committee will be carrying out deep co-operation at levels five (convergence) and, maybe, six (approximation).

International tax co-operation can be broken down into a rough hierarchy of eight levels of co-operation to reinforce the point that there are a range of co-operative options, each with different implications for freedom of national policymaking and possible effects on each nation's welfare. This categorisation of eight levels of co-operation can, in turn, be divided into three: 'shallow', 'marginal', and 'deep'[19] (see Table 1). Imagine a small coral atoll in the South Pacific. First, there is a 'shallow' lagoon that is bordered by coral reef. Secondly, there is the reef itself, which, in a sense, is the outer 'margin' of the atoll. Thirdly, there is the drop down to the 'deep' ocean floor.

Table 1[20]*: Levels of Tax Co-operation Between Nations*

	Shallow co-operation
1	Exchange information on *existing* policy and practice
2	Exchange information on *proposed* policy and practice
3	Analyse and discuss policy and legislative issues together (consultation)
	Marginal co-operation
4	Integrate national policies at the margins (co-ordination)
	Deep co-operation
5	Adapt rules so that they are increasingly similar (convergence)
6	Adopt rules that have similar effect (approximation)
7	Adopt the same rules (unification)
8	Set up a common institution to administer the same or similar rules

The first three levels of co-operation are termed 'shallow' because they require no commitment on a government's part to make changes to its tax law. By agreeing to exchange information or consult, however, governments may minimise the chance of misunderstandings and improve the coherence of national policies. An example of level one co-operation between the two Tasman countries can be found in Article 2 (2) of the Australia-New Zealand Double Tax Agreement 1995. New Zealand and Australia are each obliged to notify the other about any significant changes made in their income and fringe benefit tax, and, for Australia, resource rental tax law.

Level two co-operation, involving information exchange on proposed policy and practice, may occur informally between officials in the two countries. Some writers have suggested that there should be more trans-Tasman co-operation at this level, involving business representatives too.[21]

Australia and New Zealand has co-operated at least three times at level three: analysing and discussing policy and legislative issues together. In the early 1990s, in 1996-97, and in the recent triangular tax reforms, the joint analysis concerned the merits of integrating the company and individual income tax systems of the two countries.[22]

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[19] Lawrence uses the terms 'shallow' and 'deeper' in relation to economic integration in a slightly different sense. By 'shallow integration' he means trade liberalisation and by 'deeper integration' he means "integration that moves beyond the removal of border barriers ... ." See Lawrence R Z, *Regionalism, Multilateralism, and Deeper Integration* (Washington D.C.: The Brookings Institution, 1996) 8.

[20] Table 1 substantially modifies and tabulates, for the purpose of tax, an idea expressed in Cooper, R N, "International Economic Co-operation: Overview and a Glimpse of the Future" in OECD*, Interdependence and Co-operation in Tomorrow's World* (Paris: OECD, 1987) 180-94 at 183.

[21] Hamilton, R, "Tax Systems: Do the Differences Distort the Market and What Can be Done About it?" a paper delivered at a seminar "Asking the Hard Questions" held by the Australia-New Zealand Business Council in Sydney in May 1990, mimeo, 14 (suggesting the establishment of a joint technical committee comprising tax officials and tax representatives from business to take submissions on tax impediments, review the DTA and recommend reform to Governments). A call for greater international policy dialogue in general has been made in Waincymer, J, *Australian Income Tax: Principles and Policy* (Sydney: Butterworths, 2nd ed, 1993) 63.

[22] For the joint discussion document released by the two governments on the most recent example of level three trans-Tasman co-operation, see Hon Peter Costello and Hon Dr Michael Cullen, *Trans-Tasman Triangular Tax: An Australian and New Zealand Government Discussion Document*, available at <http://www.taxpolicy.ird.govt.nz/publications/files/html/transtasman/> (6 December 2004).

The fourth level of co-operation is described as 'marginal' as it merely requires co-operation at the margins of national policy. In some areas of economic policy this may mean literally making adjustments at national borders, for instance, on cross-border flows of goods, services or income. In other cases, it may mean making small adjustments to aspects of national policy. Double tax treaties are a good example of 'marginal' co-ordination, in both of the above senses of the word. In about twenty pages these treaties can adjust only the margins of two - often huge - income tax acts, for cross-border investment between two countries. One writer has conservatively estimated that the Australian Income Tax Assessment Act is over 5,000 pages, excluding fringe benefit tax legislation and international tax agreements.[23] The New Zealand income tax legislation is considerably shorter but is still the largest statute in that country.

Another example of marginal co-operation is Article 26 of the Australia-New Zealand DTA. This article authorises certain exchange of information between the competent authorities in the two countries, for example in administering the DTA. Further, a 1995 Memorandum of Understanding formalises the existing close working arrangements between the New Zealand and Australian tax offices, for example, to promote sharing of information about tax-avoidance and evasion schemes and their promoters. As the exchanges of information under the DTA and Memorandum of Understanding deal with the tax affairs of specific taxpayers and are designed to ensure compliance with national tax law in each country, they are better classified as level four co-operation rather than level one co-operation.

Once policy co-operation moves to levels five to eight, however, the issues become much more complex. The recent New Zealand legislation that seeks to allow Australian companies to join New Zealand's imputation credit rules and the recent Australian legislation that seeks to allow New Zealand companies to join Australia's franking credit rules, as part of a joint exercise to reduce the double taxation of some trans-Tasman investments, fit more into category six than four. Here, the economic activity that is taxed at the company level occurs in the same country in which some shareholders are resident. It is merely because a company resident in the other Tasman country sits between the economic activity and some of its shareholders that neither Tasman imputation system initially gave a credit for this company tax paid in its own jurisdiction.[24] The two pieces of domestic legislation allow a proportion of this company tax paid in one Tasman country to be imputed to shareholders resident in the same Tasman country. This has been a complex exercise of co-operation that officials first discussed over 12 years ago. It is likely to require monitoring to ensure it achieves its policy objectives.

In addition, New Zealand and Australia have, over the years, been exhorted to co-operate at levels five to eight on other tax issues. As the two countries are currently rewriting their income tax laws, one writer has proposed that they choose several drafting projects to work on together to achieve some standardisation, but not harmonisation, of their tax law.[25] Writers have suggested that the tax laws in the two countries should be approximated.[26] And, of some relevance to level eight, a

[23] Vann, R J, "Improving Tax Law Improvement: An International Perspective" (1995) 12 *Australian Tax Forum* 193-246, at 225.

[24] Take the following simple example calculated assuming full payment of statutory tax and ignoring exchange rate conversions: New Zealand subsidiary taxable income of $100, less New Zealand company tax of $33, is a cash dividend of $67 to Australian parent company (supplementary dividend under the foreign investor tax credit regime in effect discharges the New Zealand non-resident withholding tax), has $10 deducted as Australian NRWT (15% deducted as the dividend has no Australian franking credits attached), is a cash dividend of $57, New Zealand gives 10% NRWT credit, the dividend is grossed up to $67 again, 33% New Zealand personal income tax on that is $22, leaving $45 to the New Zealand shareholder. The overall statutory tax rate on this trans-Tasman equity investment where profit has been repatriated across the Tasman to Australia by dividend is 55%: New Zealand has collected 45% and Australia 10%.

[25] Vann, R J, "Improving Tax Law Improvement: An International Perspective" (1995) 12 *Australian Tax Forum* 193-246, at 208-9.

[26] For example, Marsh, C, "Taxation Impediments to Transnational Investments: Lessons from Europe" (1993) 10 *Australian Tax Forum* 357-84, at 384.

prominent New Zealand tax lawyer ended one article asking, "Might the place to begin an Australasian Court be in the area of taxation?"[27]

In terms of the international tax co-operation model in Table 1, then, this project is about the feasibility of New Zealand using its general tax policy criteria to assess marginal co-operation at level four in its proposed double tax agreements. The question is important because almost all tax co-operation between nations currently takes place at this level using this instrument. Tax co-operation at levels five to eight represents a very small percentage of tax co-operation between nations. Take New Zealand for example. New Zealand currently has 29 double tax agreements that are typically negotiated in one or two short negotiating sessions over 18 or so months. New Zealand has one instance of tax co-operation at levels five to eight and that has been the result of long, but intermittent, negotiations over more than 12 years.

3. The literature

There is a huge literature on the longstanding institution. Much of it pragmatically writes about double tax treaties because, like a mountain range, they are there - a key feature of the landscape. These writers neither argue for nor against the double tax treaty. They describe and they analyse one of the more enduring features of their subject. Most of the writing on New Zealand's double tax agreements, for example, is of this type.

The evaluative literature on the double tax treaty draws on economics, political science, law and other disciplines. It is often critical. It is sometimes trenchant. From the outset, wise heads warned that using different rules for different types of income would create problems for national income taxes. "We hold out no hopes of this proving to be a smooth and practical arrangement," they said in 1923.[28] The recent evidence suggests that global competition, technological developments and the current rules, both national and international, for taxing income are causing increasing problems for national income tax systems.[29]

There has been little evaluative writing of New Zealand's double tax agreements. As the New Zealand double tax agreements are so closely patterned on the OECD Model Convention, however, the broad criticisms of the way that the OECD Model Convention break tax policy principles provide a good basis for this analysis.

The main tax policy criticism of the OECD Model is that it is not efficient or fair to apply different source-country tax rates to different categories of income, especially for direct investors who control

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[27] Congreve, R L, "Trans Tasman Taxation" in Congreve, R L, Burnett, R, and Eagles, I, (eds) *CER - The Business and Law Essentials, Part II* (Auckland: Legal Research Foundation, 1983) 2-27, at 27. The commentator on this paper did not agree, retorting 'Vive la différence'. "The reason for this, of course, is that tax advisors in both jurisdictions are only too pleased to play-off the differences between the rules of one jurisdiction and those of the other to the benefit of their clients. This notwithstanding the Double Tax Convention between the two countries." See Brannigan, P, in Congreve, R L, Burnett, R, and Eagles, I, eds., *CER - The Business and Law Essentials, Part III* (Auckland: Legal Research Foundation, 1983) 50-74, at 51-2 and 58. There is already one example of a trans-Tasman cross-border regulatory body. From July 1996 a joint system for setting food standards has been operating. The Australia New Zealand Food Authority is jointly funded and has offices in each country. See *CER: Key Documents, Speeches & Statements 1995* (Wellington: Ministry of Foreign Affairs and Trade, 1995) 29-61, 71-2, 105-6.

[28] League of Nations, *Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations*, League of Nations document no F. 212 (Geneva: League of Nations, 1925) reprinted in United States, Joint Committee on Internal Revenue, *Legislative History of United States Tax Conventions*, vol. 4 (Washington, DC.: US Government Printing Office, 1962), 4049.

[29] Mintz, Jack M, "National Tax Policy and Global Competition*",* (2001) 26 *Brooklyn Journal of International Law* 1285; Vito Tanzi, "Globalization, Technological Developments, and the Work of Fiscal Termites", (2001) 26 *Brooklyn Journal of International Law* 1261.

their investment.[30] It is inefficient to encourage direct investors to recharacterise their income into tax-favoured categories. They may, for example, minimise or eliminate source taxation by paying high royalties to an associated company offshore and deducting this expense from source business income. They may do it by paying high interest to an associate offshore to reduce source business income. It is not fair in that it treats two investors with the same level of well-being differently depending upon whether they control their investment or not.

A second tax policy criticism of the OECD Model is that it is inefficient to apply the arm's length method for transactions between associates, especially in relation to intangibles. Company groups can often shift income and deductions between countries to achieve lower worldwide taxation through how they price transactions between related companies, or between a head office and a permanent establishment, especially in relation to intangibles for which there is often no arm's length comparable price.[31]

A third tax policy criticism of the OECD Model is that it causes overly complex company group structures and transactions by encouraging taxpayers to use conduit companies in third countries specifically to take advantage of favourable terms in a tax treaty of that country.[32]

4. New Zealand double tax treaty review and treaty making

This section provides background on the New Zealand double tax agreement review in the 1990s and the New Zealand double tax agreement programme. It also describes how New Zealand's double tax agreements are negotiated: essential background in determining the best methodology to use in this research project.

New Zealand has a smaller network of double tax agreements than many other OECD countries. Its network currently consists of 29 double tax agreements with its main trading and investment partners. In addition, New Zealand has signed a further double tax agreement that has not yet come into force. The appendix to this paper lists the 29 current agreements and the dates on which they came into force, as well as the new agreement that has merely been signed.

While New Zealand was debating and enacting extensive new domestic rules on international tax in the late 1980s and the early 1990s, it suspended its double tax agreement negotiation programme. Twenty-three of the current double tax agreements date from this period.

In 1991 the New Zealand Government announced the review of its double tax agreements and said it was considering instigating an ongoing review of each of New Zealand's 24 existing double tax agreements. It set out criteria for assessing whether to negotiate a new agreement or to renegotiate in existing one and stated that New Zealand would seek to renegotiate double tax agreements that had fallen out of line with current policy. In fact, the only pre-1991 New Zealand tax agreement that has been renegotiated since 1994 is the one with Australia. In the New Zealand Government's 1991 policy framework document, New Zealand announced that in devising possible solutions to trans-

[30] Musgrave, Peggy "The OECD Model Tax Treaty: Problems and Prospects", (1975) *Columbia Journal of World Business*, 29-39 in Musgrave, Peggy, ed., *Tax Policy in the Global Economy: Selected Essays of Peggy B. Musgrave* (Northampton, MA: Edward Elgar, 2002) at 357.

[31] See, for example, Vann, Richard, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)", (1991) 45 *Bulletin for International Fiscal Documentation* 99-111, at 104-7. Rigby, Michael. "A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism", (1991) 8 *Australian Tax Forum* 301-427, at 357-373.

[32] For an excellent account of the 'messy, and therefore manipulable, status quo' in the country that has tried to do most about treaty shopping (the US), see David R. Tillinghast, "Tax Treaty Issues", (1996) 50 *University of Miami Law Review* 455-482.

Tasman tax problems through a tax agreement or reciprocal legislation, it would keep in mind its 'tax design criteria of efficiency, fairness and simplicity'.[33]

No public announcement has been made about the outcome of that review of the New Zealand double tax treaty policy. The government simply recommenced its treaty negotiating programme. It first renegotiated the double tax agreement with Australia. A further five new agreements were negotiated and have come into force. Another agreement has been signed but not yet come into force.

In addition to negotiating new agreements, an Inland Revenue Department briefing to the incoming government in 1999 explains that much of their work consists of maintenance:

> *"A large part of our treaty team's DTA work involves negotiating remedial amendments to our existing treaties, at either our request, or the request of our treaty partners. For example, we have recently negotiated protocols to revise existing DTAs with China, India and Korea. These protocols removed the ability of investors to exploit tax sparing provisions in those treaties in an unintended manner. The protocol with India also reduced the withholding rates faced by New Zealand investors into India, which has positive benefits for our business community. A number of other protocols are awaiting finalisation or are being negotiated."* [34]

The 1991 New Zealand policy framework document set out the criteria that the government proposed to use in assessing double tax agreements in these terms:

> *In addressing international tax matters, the Government will first identify any taxation problems before going on to identify the possible solutions and, importantly, their cost.*
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> *If New Zealand is considering a new DTA, or is re-negotiating in existing DTA, it should ask:*
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> - *What are the tax problems that the DTA will overcome?*
> - *How will a DTA correct these problems?*
> - *What will be the fiscal cost of the DTA?*
> - *What are the risks to the New Zealand tax base of the DTA?*
> - *What will be the benefits* ***to New Zealand as a whole*** *from the DTA?*
> - *What alternative solutions exist to solve the tax problems the DTA will correct, and what are the costs and benefits of those alternatives?*
>
> *Once it has answered these questions, the final decision will be based on an assessment of the relative costs and benefits of the available options.*[35]

This describes a 'blank sheet of paper' approach to problem solving: identify the particular tax problems between the New Zealand income tax system and one other country's tax system, identify the reform options and choose the optimal solution using cost benefit basis. It assumes the other country is willing to do the same.

In fact, in the author's limited experience, double tax treaty negotiations are far from being problem-solving exercises of this type. They are highly constrained exercises. Each country has its own model double taxation convention, usually with a commentary. A country model tax treaty will be closely

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[33] Richardson, Hon Ruth, and Hon Wyatt Creech, *Taxing Income Across International Borders - A Policy Framework*, (Wellington: July 1991) 37.

[34] New Zealand Inland Revenue Department, *Supplementary Briefing Papers, Vol. 1, Tax Policy* (Wellington: November 1999) 32.

[35] Richardson, Hon Ruth, and Hon Wyatt Creech, *Taxing Income Across International Borders - A Policy Framework* (Wellington: July 1991) 35.

based on one of the international models: the OECD Model, the UN Model or a regional model. Whichever international model tax treaty is used as a base for a country model, the structure and order of the articles of the agreement, and even the wording of particular articles, will be very similar. A country model tax treaty may be slightly adapted to take into account particular features of a country's national income tax system. In preparing for a particular negotiation, a country will usually research the main features of the other country's national income tax system and its existing double tax agreements. As a result of this research, a country may make some changes to its national model tax treaty that it uses in the negotiation.

At the outset of negotiations, the two delegations agree on which country model tax treaty will be used as the basis for the negotiations. After a brief introduction, the two delegations then discuss the articles one by one. If the wording in the two country model tax treaties is the same, it is accepted. If the wording is different, each delegation explains the reason for their choice of wording. This explanation may relate to the policy or wording of national legislation, a domestic court decision on the meaning of certain words, tax avoidance concerns, or consistency with other national double tax treaties.

In this conservative legal negotiating environment, 'precedents' are very important. Governments are very wary of deviating from what they have negotiated with other countries in the past. Once they have made a new concession to one country, they know that new negotiating partners are likely to ask for the same concession and that existing treaty partners may do the same when the treaty is re-negotiated. In some cases, a government may have agreed to renegotiate aspects of a double tax treaty should it subsequently grant other countries more favourable treatment. Although the concept of a particular fiscal advantage granted to one country, in a context of one negotiation having to be conceded automatically to many other treaty partners, is largely a foreign one in the international tax world,[36] New Zealand is one country that has conceded most-favoured-nation clauses in DTA negotiations. Whether there is a most-favoured-nation undertaking or not, a concession that may be relatively costless in relation to one country (residents of that country may earn few royalties from the other country, for example), may be very expensive in relation to another or, more importantly, in relation to most of a country's treaty partners.

If the two delegations agree that the wording in one of the model tax treaties is better, then it is accepted. If there is no agreement, square brackets are put around the language and the issue is discussed later. To get agreement on a single text, the two delegations often trade off sets of square bracketed language: "We'll agree to lift the square brackets in Article X so that you get the wording you want, if you agree to lift the square brackets in Article Y so that we get the wording we want."

In summary, double tax treaty negotiations are at the other end of the spectrum from 'blank sheet of paper' problem solving: identifying particular tax problems, reform options and choosing the optimal solution using cost benefit basis.

5. Methodology

There are four possible ways to test to what extent New Zealand has used its general tax policy criteria to assess its double tax agreements since it resumed negotiating double tax agreements in February 1994.

[36] In the special context of the European Union (EU), however, there has been a debate between Vogel, who opposes applying the most-favoured-nation standard in the EU and Radler, who argues for the most-favoured-nation approach so that that all privileged treatment is extended "automatically to all individuals and companies resident within the Union who are taxpayers." Vogel, K, "Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law" (1995/4) *Intertax* 264-5 cf. Radler, A J, "Most-Favoured-Nation Clause in European Tax Law?" (1995/2) *Intertax* 66-7, at 67.

First, one might analyse the government's review of New Zealand double tax treaty policy and practice in the early 1990s and the review recommendations to discover to what extent the new double tax treaty policy objectives align with the government's general tax policy criteria. Unfortunately, the New Zealand Government has not released this document to the public, and is unlikely to do so, as it might compromise future negotiations with other governments.

Secondly, one might analyse the changes to the revised New Zealand Model double tax agreement that resulted from the government's review of New Zealand double tax agreement policy and practice in the early 1990s. As discussed above, the United States is one government that does make its model tax treaty available to the public. Unfortunately, neither the New Zealand nor the Australian governments do. Once the New Zealand government has negotiated a number of treaties using a new model tax treaty, a pattern may sufficiently emerge to discern a change in policy. Of course, this depends on the New Zealand government persuading sufficient governments to agree to make a particular change in the bilateral treaty with them. The more radical the change in the post-1994 New Zealand model tax treaty, the less likely it is that New Zealand will be successful in achieving this repeatedly, in what is a very conservative negotiating environment.

Thirdly, one might analyse the results of New Zealand's double tax agreement negotiations from 1994 onwards. To do this, it is necessary to compare these new treaties against a base. What is likely to be the best base? We do not have access to the old New Zealand model tax treaty. We do, however, have 23 pre-review treaties. It would be best to compare the text of the treaties negotiated with the same country before and after the review. Fortunately, there is one such country: New Zealand's near neighbour, Australia. The first double tax agreement negotiation after the review was a renegotiation of the 1972 agreement with Australia. The main unknown variable that we need to adjust for in making this comparison are changes in the Australian model double tax treaty from 1972 to 1994.

In addition, there is one backup comparison that could be made to support any conclusions reached in respect of the renegotiated Australia-New Zealand agreement. New Zealand negotiated a double tax agreement with one ASEAN country in 1987 (Indonesia), immediately before the suspension of New Zealand double tax treaty negotiations, and a double tax agreement with another ASEAN country in 1998 (Thailand), after the review. ASEAN members have worked together on tax matters, including double tax policy and practice. They agreed that the intra-ASEAN Model Double Taxation Convention 1987, with its confidential administrative notes, would be a guide for ASEAN countries negotiating with third countries.[37]

A less helpful comparison could be made between the double tax agreement negotiated with Ireland in 1986, before the suspension of New Zealand double tax treaty negotiations, and the agreement negotiated will the Russian Federation in 2003, well after the review. There is less reason to believe, however, that the Irish and Russian Federation model tax agreements are sufficiently similar to allow helpful observations to be made about New Zealand double tax treaty policy.

In this project, the main method of testing to what extent New Zealand has used its general tax policy criteria to assess its double tax agreements since it resumed negotiating double tax agreements in February 1994, will be to compare the New Zealand double tax agreements with Australia of 1972 and 1995. A subsequent paper will undertake a more detailed comparison of these two Australia-New Zealand agreements, in addition to comparing New Zealand double tax agreements with Indonesia and Thailand.

[37] The Joint Communique of the Third ASEAN Heads of Government Meeting held in Manila, 14-15 December 1987 at paragraph 35 noted that this initiative had been taken. See <http://www.aseansec.org/5107.htm>.

6. Assessing subsequent New Zealand treaty practice

As a first step in this research project, this section makes a preliminary comparison of the New Zealand double tax agreements with Australia of 1972 and 1995. It begins with an observation. It then briefly examines the 1995 double tax agreement to see whether it addresses any of the major tax policy criticisms of the OECD Model. Finally, it examines some new features of the 1995 double tax agreement to see whether they create a more efficient, fair or simple 'trans-Tasman income tax system'.

The observation is that this renegotiation of the 1972 double tax agreement took place within a year. The first round of negotiations was held in Wellington from 21 to 25 February 1994. The second, and final, round of negotiations was held in Canberra from 21 to 25 November 1994. To a certain extent, this expeditious negotiating can be explained by the preliminary talks that the two countries had held in the early 1990s, exploring mutual recognition of imputation credits and trans-Tasman tax issues in general. The speed of the negotiations, however, also indicates that the two countries had decided to negotiate a relatively standard double tax agreement, using the general approach to double tax treaty negotiations outlined in section five above.

Secondly, this section briefly examines the 1995 double tax agreement to see whether it addresses any of the major tax policy criticisms of the OECD Model outlined in section three above. The 1995 double tax agreement does not address the main tax policy criticism of double tax treaties. It applies different source-country tax rates to different categories of income. The maximum withholding tax to be charged on dividends, for example, is fifteen percent of the gross amount of the dividends (Article 10). The maximum withholding tax to be charged on interest is ten percent of the gross amount of the interest (Article 11). The maximum withholding tax to be charged on royalties is ten percent of the gross amount of the royalties (Article 12). This is inefficient for company groups, encouraging them to recharacterise their cross-border income as interest or royalties.

The 1995 double tax agreement does not address the second major tax policy criticism of double tax treaties. It applies the arm's length method for transactions between associates (Article 9).

The 1995 double tax agreement is a slight improvement over the 1972 agreement in relation to the third major tax policy criticism of double tax treaties. The drafting of the 1995 double tax agreement strengthens the hands of the tax authorities in relation to exchange of information (Article 24), for example. It does not, however, include explicit anti-treaty shopping provisions, as the United States includes in its treaties, for example, in an attempt to stop taxpayers using conduit companies in a jurisdiction specifically to take advantage of favourable terms in a tax treaty. The effectiveness of these United States anti-treaty-shopping provisions, however, is doubtful.[38]

To sum up, the 1995 Australia-New Zealand double tax agreement does not address the main two tax policy criticisms of the OECD Model. It has made a minor improvement in relation to the third tax policy criticism of the OECD Model.

Finally, this section contains a preliminary assessment of the extent to which some major new features of the 1995 double tax agreement are better explained by general tax policy principles or by other factors (the Article references below are to Articles in the 1995 agreement).

- Business profits (Article 7) – the 'force of attraction' rule no longer applies in the 1995 agreement, a change that is better explained as a rejection of a UN Model 'force of attraction'

[38] Tillinghast, David R., "Tax Treaty Issues", (1996) 50 *University of Miami Law Review* 455-482.

provision and the adoption of OECD Model language rather than as an application of tax policy criteria;

- Dividends (Article 10) – the presence of a special life insurance maximum dividend withholding tax of 5% in certain circumstances was designed to give equivalent tax treatment to two ways that an Australian insurance company can invest in New Zealand, although it seems that New Zealand has been overly generous and has not achieved that result;[39]

- Interest (Article 11) - the ten percent maximum withholding rate of tax on interest did not previously apply to payments made to associate companies but, consistent with the OECD Model, that maximum rate now does apply to such payments made to associated companies, with a consequence that the new 1995 Australia-New Zealand DTA is less efficient and fair than the 1972 agreement (see the main tax policy criticism of the OECD Model discussed in section three above);

- Royalties (Article 12) – in the 1995 agreement the definition of royalties has been updated to include developments such as satellite and cable transmissions but the maximum rate of withholding tax on royalties has been reduced from 15% to 10%, with a consequence that the new 1995 Australia-New Zealand DTA is less efficient and fair than the 1972 agreement (see the main tax policy criticism of the OECD Model discussed in section three above).

7. Conclusions and Implications

In 1991 the New Zealand Government announced that it would apply general tax policy principles to assessing its double tax agreements. It said that it was reviewing its participation in double tax treaty making. In 1994 it appears to have proceeded to negotiate tax agreements in much the same way that it had previously. With the exception of the double tax negotiations with Japan, which started in 1986 and still have not been completed, most negotiations have been completed expeditiously in two rounds. There is no evidence there that New Zealand is prolonging negotiations in an attempt to produce double tax agreements that are more efficient, more fair or raise revenue at less net cost. Further, the initial results of a comparison of the double tax agreement negotiations with Australia in the 1990s to the results of 1970s negotiations before the review suggest that, in important respects, the 1995 agreement is less efficient and fair than the 1972 agreement.

On this evidence, the pragmatists seem to be right. The OECD Model Convention is a dominant part of the landscape that is relatively easily avoided, especially by the well advised. For a New Zealander, it brings to mind the magnificent Southern Alps that run 550 kilometres down the length of the South Island. Originally, the land was flat, just above sea level. Now, the Southern Alps rise to a height of 3754 metres. Formed by the Pacific tectonic plate overriding the Australian tectonic plate, they are still being uplifted.[40] Notwithstanding the way that they dominate the whole South Island, they can be avoided by an end-run at the north and south and over a few mountain passes. Still, it is difficult to envisage anything, short of something cataclysmic, changing that reality. So it is with the OECD Model Convention. The bilateral strands of more than 1700 bilateral double tax treaties are now so

[39] Green, Mark and Greg Lewis, "Practitioner Article: Double Tax Agreement between Australia and New Zealand" in CCH, *Australian International Tax Agreements*, loose leaf, paragraph 80-114 at p. 84-008.

[40] See generally, Aitken, JJ, *Plate Tectonics for Curious Kiwis* (Lower Hutt: New Zealand Institute of Geological and Nuclear Sciences, 1996) and Aitken, JJ, *Rocked and Ruptured: Geological Faults in New Zealand* (Lower Hutt: New Zealand Institute of Geological and Nuclear Sciences, 1999).

strong and entrenched that it is difficult to see how, in the normal course of events, a new mode of international tax co-operation may supplant this flawed instrument. The one time that New Zealand moved from international tax co-operation at level four to level six in the model of tax co-operation between nations in Table 1, it took long, but intermittent, negotiations for more than 12 years to produce a solution that has been scorned by tax specialists[41] and criticized by writers suggesting that alternative self-help strategies will continue to be employed by trans-Tasman companies.[42]

Even if it is tax treaty business as usual, and there is restricted room for applying tax policy principles to this exercise, the New Zealand Government's international treaty examination process, which does now apply to double tax agreements and will require a national interest analysis to be prepared by officials for Cabinet and a parliamentary select committee, is to be welcomed.[43]

If it is tax treaty business as usual, and there is restricted room for applying tax policy principles to this exercise, there are important implications for domestic rulemaking, especially for taxing income across borders. Where double tax treaties govern a huge proportion of cross-border investment, as is the case for New Zealand, it means that policymakers are operating in a highly constrained environment, not on a blank sheet of paper. It means that more attention needs to be paid to understanding the typical double tax treaty rules that bind a country when formulating options to address a cross-border tax problem. Where typical double tax treaty rules offer a better policy outcome to existing domestic rules, the treaty rules should be adopted in domestic law.[44] Where typical double tax treaty rules offer a poor policy outcome, it may require a lot more work and ingenuity to devise domestic rules that are not inconsistent with the double tax provisions and that continue to operate in spite of the double tax provisions.

Finally, if it is tax treaty business as usual and double tax treaties govern most cross-border investment, there are important implications for domestic tax law drafting. The drafting of international tax rules should take more account of the international consensus in the double tax treaty. The drafting of the domestic legal rules could more explicitly take into account the usual double tax provisions found in a country's double tax treaties. There should be very good reasons for using different terms than those used in double tax treaties (for example, the use of the term 'fixed establishment' instead of 'permanent establishment' in New Zealand's domestic income tax law).

[41] *The National Business Review*, 21 February 2003, 5.
[42] Dunbar, D. and H. Tat. "Trans-Tasman Triangular Taxation Relief: an Exercise in Political Futility", 2004, available at <http://pandora.nla.gov.au/tep/23524> (6 December 2004).
[43] See <http://www.clerk.parliament.govt.nz/Content/SelectCommitteeReports/feitetaxation.pdf> (6 December 2004).
[44] A senior Australian academic, for example, has suggested that Australia should adopt in its domestic law the concept of 'profits attributable to a permanent establishment' from the OECD Model Convention in place of Australia's existing source rules. See Magney, Tom, "Australia's Double Taxation Agreements: Does the OECD Model Serve Australia's Interests?", chapter three in Richard Krever and Yuri Grbich, editors, *Australian International Tax Recent Developments and Future Directions ATAX Research Series No 1 (Sydney: Law Book Company, 1994) 25-71, at 47-8*. Like Australia, New Zealand has announced, but not completed, a review of its source rules. This proposal by Magney is worth considering by New Zealand too.

Appendix: New Zealand's Current Double Tax Agreements

	Year Agreement in Force	*Year Protocols in Force*
Japan	1963	1967
Singapore	1973	1993
Malaysia	1976	1996
Fiji	1977	1986, 1995
Germany	1980	
Sweden	1980	
France	1981	
Italy	1983	
Philippines	1980	Protocol signed 2002
Canada	1981	
Denmark	1981	1985
Netherlands	1981	Protocol signed 2001
Switzerland	1981	
Belgium	1983	
Korea	1983	1997
Norway	1983	1998
USA	1983	
Finland	1984	1988
UK	1984	Protocol signed 2003
China	1986	1997
India	1986	1997, 1999
Indonesia	1988	
Ireland	1988	

March 1987 to February 1994 - Suspension of Double Tax Agreement negotiations

Australia	1995
Taiwan	1997
Thailand	1998
Russian Federation	2003
South Africa	2004
United Arab Emirates	2004
Chile	2003 signed

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