

Discretionary Trusts and Taxation of Immigrants Under the Controlled Foreign Companies Regime

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I: INTRODUCTION

This article addresses the ambit and operation of the Controlled Foreign Companies ("CFC") regime in New Zealand, as contained in s 245A-Q of the Income Tax Act 1976 ("the Act"). Under this regime, a New Zealand resident taxpayer is liable to be assessed for income tax purposes on any attributed foreign income or loss derived by that resident merely on account of holding an *interest* in a closely-held foreign corporation, irrespective of whether any distribution will be, or in fact has been, received on account of such interest. This regime poses a particular problem for wealthy immigrants seeking to migrate to New Zealand who possess substantial and valuable overseas holdings in foreign corporations in which they might have a predominant interest, and yet be unlikely to receive regular distributions.

A common example of this phenomenon is the family-oriented private company favoured by many Asian business people, which is often used as a consolidation vehicle for grouping a diverse range of other business interests in the context of the traditional asset protection advantages of limited liability. Should a major shareholder in that company, or a group of shareholders that together possess a predominant interest in the company, choose to migrate to New Zealand, they risk a potentially substantial income tax liability on the basis of their interests in that company, regardless of whether they either have, or will, receive a distribution from it.

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This article proposes a potential scheme for the minimisation of such tax liability under the CFC regime for immigrants planning to move to New Zealand. The scheme is based upon the interpositioning of a non-exhaustive discretionary trust between the immigrant and any foreign corporate interests held by that person, which must be first divested to a separate company formed in a tax haven jurisdiction.

The utility and validity of such an arrangement is analysed in terms of a detailed hypothetical example outlined in this article, which concerns a Japanese businessman who chooses to migrate to New Zealand for what are principally business reasons. This article refers to the law as it stood at 31 January 1994.

II: THE OPERATION OF THE CONTROLLED FOREIGN COMPANIES REGIME

The CFC regime¹ attributes the income of a foreign company, not resident in New Zealand under domestic tax law or a double tax treaty, to its New Zealand owners on the basis of two tests. The first is a control interest test which is used to effectively determine the ownership of the company. The second is an income interest test which is used to calculate an individual's attributed income or attributed loss from the relevant CFC.

The regime is effectively founded upon the branch equivalent method of taxation because CFCs are taxed as if they are foreign branches of New Zealand companies.

1. The Control Test: What is a Controlled Foreign Company?

Section 245C(1) of the Act provides detailed control criteria to determine whether a company is a controlled foreign company. A foreign company will generally constitute a CFC where :

- (i) five or fewer New Zealand residents the aggregate of whose control interests in the foreign company, taking into account both direct and indirect control, are greater than 50 percent;² or
- (ii) a single New Zealand resident holds a control interest in a foreign company of at least 40 percent, unless at that time a person who is not a New Zealand resident, nor is associated with one, has a control interest

1 Contained in s 245A-Q of the Income Tax Act 1976 ("ITA"), as amended by the Income Tax Amendment Act ("ITAA") (No 5) 1988 and ITAA (No 2) 1993.

2 Section 245C(1)(a). Prior to the ITAA (No 2) 1993, the CFC regime was activated by aggregate control interests *equal to or greater than 50 percent*.

in the company equal to or greater than the control interest held by the single person resident in New Zealand;³ or

- (iii) a group of five or fewer New Zealand residents have the power to ensure the affairs of the foreign company are conducted in accordance with their wishes by controlling the exercise of shareholder decision-making rights.⁴

Both tests (ii) and (iii) are de facto control tests. The latter in particular is unique in New Zealand since it does not rely on the *ownership* of shares, usually referred to as de jure control.

In order to determine the degree of control held by the taxpayer in a foreign company, both direct and indirect control interests must be taken into account.

(a) Direct control interest

Section 245C(4) provides that a direct control interest in a foreign company is equal to each percentage of the following things which that person holds or is entitled to acquire at that time:

- (i) the percentage of the total paid-up capital of the foreign company;
- (ii) the percentage of the total nominal capital of the foreign company;
- (iii) the percentage of the total rights to vote or participate in any decisions specified;⁵ if the percentage of the total rights to vote or participate differs as between the differing types of decisions, the highest percentage prevails;
- (iv) the percentage of the income of the foreign company;
- (v) the percentage of the value of the net assets of the foreign company.

(b) Indirect control interest

Indirect control interests are defined in s 245C(5) as those direct control interests held in a foreign company ("the underlying company") by a *controlled*

³ Section 245C(1)(b)(i).

⁴ Section 245C(1)(b)(ii). See s 8B of the Act for the definition of "shareholder decision-making rights".

⁵ The specified decisions are the same as those defined in s 8B as "[s]hareholder decision-making rights".

foreign company (“the first tier controlled foreign company”). Additionally, s 245C(5) provides detailed rules to ensure that the “qualified control interests”⁶ of the first tier controlled foreign company are also taken into account when determining whether the underlying company will be a CFC.

(c) Aggregation of control interests

To decide whether the company is a CFC, it is necessary to combine the relevant direct and indirect control interests. This procedure is regulated by s 245C(3) which defines the control interest as the aggregate of:

- (a) Any direct control interest held by that person in that foreign company; and
- (b) Any direct control interest or interests held in that foreign company by persons associated with that person, whether those associated persons are resident in New Zealand or not; and
- (c) Any indirect control interest or interests held by that person in that foreign company; and
- (d) Any indirect control interest or interests held in that foreign company by persons associated with that person, whether those associated persons are resident in New Zealand or not.

In each case the same interest should be counted only once in relation to any group of five or fewer persons.⁷ However, it may be that the control interest held by associated persons would be eligible for counting more than once in any particular case.

Presuming that the aggregation of interests determines that a particular company is a controlled foreign company for the purpose of the legislation, the next step is to calculate either the income or loss that can be attributed to the New Zealand resident taxpayer on account of that individual’s shareholding in the controlled foreign company.

2. The Income Interest Test

Pursuant to s 65(2)(ea) of the Act, the assessable income of any person for taxation purposes includes “all attributed foreign income”.⁸ Such foreign income from a CFC will be calculated on the basis of a New Zealand resident’s income interest in that company.

⁶ Section 245C(6) defines “qualified control interests” to include any direct interests held by the first tier controlled foreign company in the underlying company, as well as any direct control interests held in the underlying company by any persons *associated* with the first tier controlled foreign company.

⁷ Section 245C(8).

⁸ Section 245A(1) defines this term by assigning it the meaning given in s 245G.

(a) Section 245D

To determine the income interest of a New Zealand resident taxpayer derived from a shareholding in a CFC, s 245D of the Act uses essentially the same criteria as those used for control interests. The differences are that the interests held by associated persons are disregarded, and interests which the taxpayer is entitled to acquire, such as options, are excluded.

Direct income interests in a CFC are determined according to the criteria set out in s 245D(2) of the Act. Indirect income interests in a foreign company are interests in that company held by another foreign company in which a New Zealand tax resident holds an income interest. Such indirect income interests are calculated through the application of s 245D(3). Where there are tiers of CFCs, income is attributed separately from each of the CFCs.⁹

As with control interests, the direct and indirect income interests of the taxpayer are then aggregated. The final income interest is determined to be equal to the highest percentage in any category.

3. The Attribution of Income

Section 245G provides a mechanism for calculating the attributed income and losses to the New Zealand resident taxpayer based upon the branch equivalent method. Thus, New Zealand tax rules are generally applied in calculating the CFC's assessable income as if that foreign company were in fact a foreign branch of a New Zealand company.

Section 245F qualifies the application of s 245G by providing that in the case of persons who are either non-resident throughout the entire accounting period,¹⁰ or who have income interests in the controlled foreign company of less than ten percent,¹¹ it is not necessary to calculate any attributed foreign income or loss derived on account of their interests in a CFC. As a result, that such persons own shares in a controlled foreign company will be irrelevant for the purpose of calculating their assessable income.

For a resident taxpayer who has income interests greater than ten percent in a controlled foreign company, s 245G(2) specifies the basis of calculating the relevant attributed foreign income or loss as $a \times b$ where:¹²

a = the income interest (expressed as a percentage) of the person in the controlled foreign company for that accounting period; and

⁹ Section 245J(9) provides an exemption for dividend income received by one CFC from another CFC to avoid double counting of income.

¹⁰ Section 245F(1)(a).

¹¹ Section 245F(1)(b).

¹² Section 245G(2). Note that the attribution mechanism in this subsection will only be activated where a shareholder has an income interest of *ten percent or greater*.

b = the branch equivalent income or loss of the controlled foreign company calculated in relation to that person pursuant to section 245J of this Act for that accounting period.

III: A PROPOSED STRUCTURE FOR THE MINIMISATION OF TAX LIABILITY UNDER THE CONTROLLED FOREIGN COMPANIES REGIME

This section formulates a specific asset divestment procedure and resultant investment structure which could be applied to a prospective immigrant to New Zealand at any time before becoming tax resident in this country. The general concept is to interpose a discretionary trust between the immigrant and the foreign income-generating entity (usually a company) prior to residence. This off-shore trust then assumes the immigrant's shareholding interests in the foreign company in an attempt to sever the control interest link between the immigrant and the company. This prevents the activation of the CFC regime once the immigrant becomes resident in New Zealand.

Some immediate problems present themselves. For example, the effect of the settlor regime for the taxation of trusts,¹³ and the immigrant and the trustee might still be associated persons for the purposes of the CFC regime,¹⁴ which would render any such arrangements completely nugatory.

Rather than respond directly to these concerns, an analysis of a hypothetical investment model, with a step by step divestment process, will be used. Should this model survive the following examination, it is hoped that it might provide a useful blueprint for similar structures which could utilise the same principles in order to minimise tax in this area.

1. A Hypothetical Scenario of Immigration to New Zealand

Consider the case of Mr Akihiro Fujimoto, a Japanese businessman. Mr Fujimoto and his two brothers have taken advantage of the strong yen to develop a prosperous family business which imports large quantities of New Zealand venison into both Japan and Thailand for distribution and on-sale to restaurants and retailers.

This company, operated by the brothers and incorporated in Thailand as New Zealand Venison Imports Limited ("NZVIL"), is a private company unlisted on the stock exchange. The company is incorporated in Thailand for strategic reasons, perhaps the most important of which, having regard to potential exposure to New Zealand taxation, was to avoid the application of Japan's Double Tax Agreement with New Zealand.

¹³ Sections 226 - 231.

¹⁴ See s 245B(g)(i) and (ii). See text *infra* at Part VI for further discussion of association.

Ownership of shares in the company is spread between the three brothers (each with a 20 percent holding), and four family friends (each with ten percent). The three brothers, and two of the family friends are all directors of the company, with Hiroshi, the eldest brother, appointed as Managing Director.

Following the recent launch of “Cervena” venison by the New Zealand Venison Marketing Board and buoyed by a rapidly expanding Asian cuisine market, the company has decided to pursue an aggressive product development plan over the next few years. Hiroshi is given the task of marketing the company’s product at a series of international food conventions in the Asian region, which they hope may lead to expansion opportunities in Taiwan, Singapore, and Korea. Koji, the middle brother, is charged with examining the feasibility of expanding into the lucrative traditional Asian medicinal market.

The brothers agree that for any of these initiatives to succeed, the New Zealand venison must be upgraded and closely monitored. In particular, their concern centres around the individual cuts of meat being produced by the domestic industry, and the way the venison is packaged for export to Japan, neither of which meet the product image the brothers have decided to pursue.

The brothers decide to send Akihiro to New Zealand to act as a consultant to the existing New Zealand producers, although technically still employed by the brothers’ company. Akihiro will remain in New Zealand for some years to oversee the new developments and may eventually become a permanent resident.

On learning of New Zealand’s CFC regime, the brothers are concerned that Akihiro may be liable for New Zealand tax once he becomes resident in New Zealand. This liability may arise on account of his income interest in NZVIL (of 20 percent)¹⁵ through both his own shareholding, and also potentially through those of his brothers.¹⁶

The directors decide that it is in the best interests of the company for Akihiro’s liability to the CFC regime to be minimised. The expense of setting up a structure to achieve this goal is viewed as an unfortunate but necessary cost to be borne by the company. Without such a structure, the company may have to make distributions to meet Akihiro’s additional tax liability on top of his salary. However, to do so may make the proposal to send Akihiro to New Zealand economically unviable, or at least more detrimental to the company in the long term than the alternative cost of setting up such a scheme. Moreover, the NZVIL directors would rather not make distributions in forthcoming years, so that the profits can be used to expand the company.

15 Note that Akihiro’s holding exceeds the ten percent minimum income interest level established by s 245F.

16 For the purposes of calculating Akihiro’s control interests in NZVIL under s 245C(3), the direct and indirect control interests of any *associated persons* must also be taken into account. Pursuant to s 245B(d), “relatives” are also associated persons for the purpose of the section. Given that Akihiro’s brothers fit the definition of this term in s 245A(1) as being within the second degree of blood relationship, their control interests (40 percent combined), will also be attributed to him on becoming resident in New Zealand, to be considered along with his own interests. As a result, Akihiro will be deemed to have aggregate control interests in NZVIL which are greater than 50 percent, and the CFC regime will thus be activated once he arrives in New Zealand.

After much deliberation, the brothers and their advisers come up with a detailed plan. Before it can be implemented, the Board of Directors of NZVIL is convened to examine the proposals, and proceedings are held in strict accordance with the company law requirements of Thailand.¹⁷ Akihiro, as an interested director, abstains from the vote, and is not present at the meeting.

(a) The proposed scheme

It is decided that the following structure will be implemented :

STEP ONE: By directors' resolution, the Thai company, NZVIL, will settle a discretionary trust in a foreign jurisdiction by making a monetary payment to the trustees sufficient for that purpose.

The geographical location of the trust will inevitably be in the jurisdiction which is most beneficial in terms of the maintenance, operation, and most importantly, taxation of the trust. It is therefore proposed that the trust be settled in the same jurisdiction as the planned tax haven company (see Step two), namely the Cayman Islands.

Professional trustees resident in the tax haven jurisdiction will then be approached to operate and manage the discretionary trust. A widely drafted trust deed will be used to take advantage of the laws applicable to that jurisdiction, particularly in terms of specifying potential beneficiaries.

STEP TWO: A company will also be formed in a tax haven jurisdiction, (the Cayman Islands), where professional directorial and management services will be retained. The newly-formed discretionary trust will then subscribe for all available shares in the company.

The trust will effectively own the newly-formed company, apart from any shares that must by local law be held elsewhere.

STEP THREE: Akihiro Fujimoto will stand down as a director of NZVIL and will divest himself of his shares in the company by offering them up for sale. The newly-formed tax haven company will then, by directors' resolution, purchase Akihiro's shares at full market value.

Step three effectively enables Akihiro to transfer his shares in NZVIL to the tax haven company, which is in turn owned by the discretionary trust. Akihiro may be specified as a potential beneficiary, depending on the drafting of the trust instru-

¹⁷ The exact requirements for internal compliance by the Thai company is beyond the scope of this article. Nevertheless, it is assumed that any such requirements are met.

ment and the flexibility of local laws. Nevertheless, he will not be directly entitled to receive any distributions, which will only be made at trustees' discretion. Thus, NZVIL will be effectively insulated from any scrutiny under the CFC regime because Akihiro has divested himself of all his interests in that company.

STEP FOUR: Akihiro Fujimoto will then be able to move to New Zealand, and after the appropriate amount of time, become a tax resident in that country.

By virtue of the interposition of the discretionary trust between Akihiro and the tax haven company, it is hoped that liability under the CFC regime will be avoided on the basis that the control link between Akihiro and that company has been effectively severed. As a result, the tax haven company will be able to enjoy minimal corporate tax rates as it slowly accumulates income, without such income being subject to scrutiny by New Zealand revenue authorities. Likewise, the trust will also be able to take advantage of the similarly favourable tax rates for trusts in such jurisdictions.

(b) Diagrammatical representation

This four step process is illustrated by the diagram on the opposite page.

2. But Does it Work?

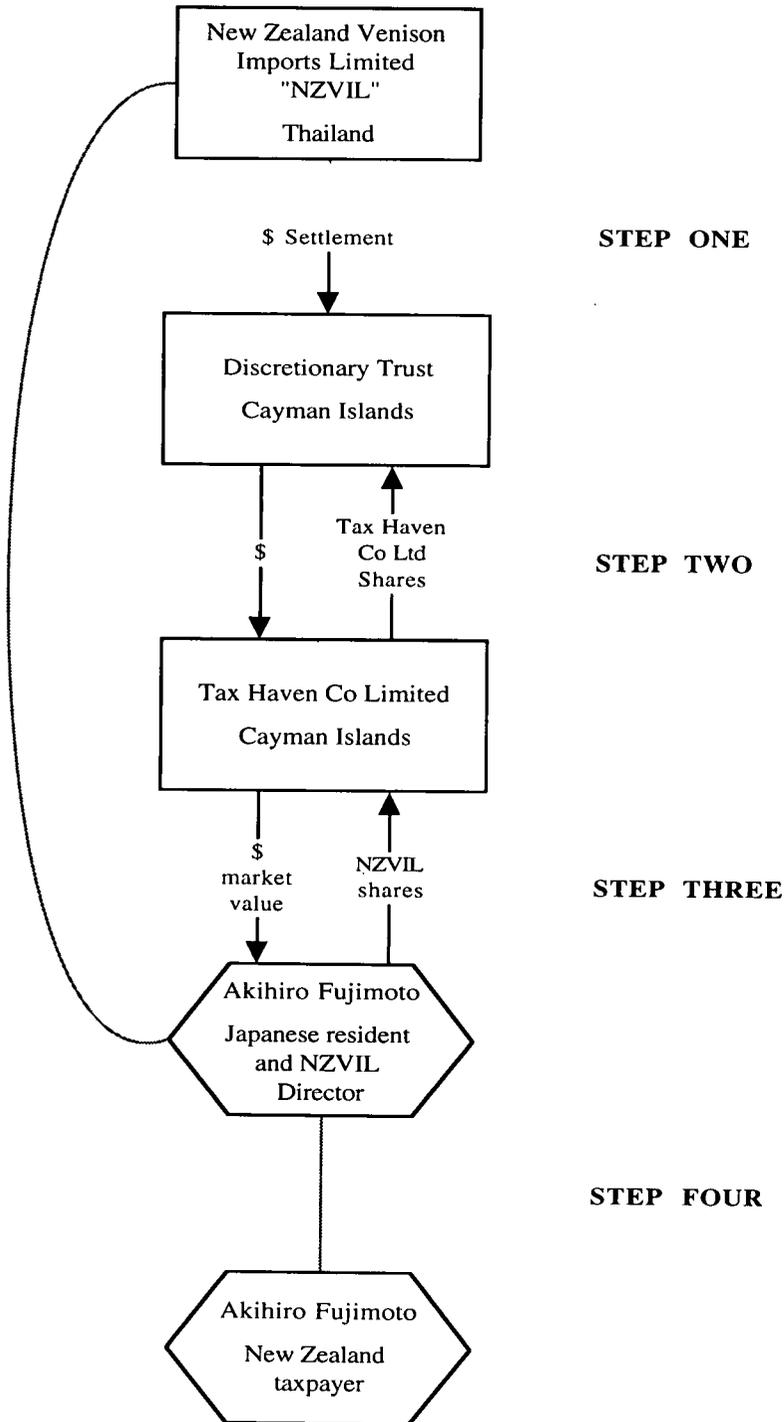
The remainder of this article analyses whether this proposed structure will be successful in minimising Akihiro's New Zealand tax liability under the CFC regime.

(a) Will NZVIL be deemed to be a CFC?

In terms of s 245C(1)(a) of the Act, a foreign company will be a controlled foreign company where there are five or fewer persons resident in New Zealand whose aggregate control interests in the foreign company are greater than 50 percent. Further, pursuant to s 245C(3), such aggregate control interests include both *direct* and *indirect* control interests.

In the hypothetical example, Akihiro will effectively divest himself of all of his holdings in the Thai company before becoming resident in New Zealand. Thus, he will personally have no *direct* control interests in NZVIL.

However, in terms of s 245C(3) he could be attributed with both the direct and indirect control interests of any persons associated with him. Section 245B



includes within the definition of associated persons the concept of relatives¹⁸ connected by the second degree of relationship.

This definition includes Akihiro's brothers, Hiroshi and Koji, who each have a 20 percent holding in NZVIL, as associated persons. The other four shareholders in NZVIL will not be caught in the same way, as they will not be associated with Akihiro under any of the provisions of s 245B.

The attribution of his brothers' control interests in NZVIL could raise Akihiro's direct control interests to the level of 40 percent. Given that there are no other controlled foreign companies interposed between the brothers and the Thai company,¹⁹ any question of indirect control interests will be irrelevant for the purposes of this analysis.

Thus, as the sole brother residing in New Zealand, Akihiro's final control interest in NZVIL would be deemed to be no more than 40 percent. In terms of s 245C(1)(a) this would be insufficient to make NZVIL a controlled foreign company for the purposes of the New Zealand taxation regime. However, a control interest of 40 percent would activate s 245C(1)(b)(i) in that Akihiro would be a single person resident in New Zealand with a control interest equal to or greater than 40 percent.

This analysis, however, is altered in Akihiro's case by the application of s 245C(3A). This section precludes Akihiro from being associated with his brothers, as long as they are not resident in New Zealand. Thus, he will not be attributed with their interests in NZVIL, although they would otherwise be associated persons for the purposes of the CFC regime. Once Akihiro becomes resident in this country, implementation of the tax haven arrangements will be successful at least in terms of insulating NZVIL's earnings from scrutiny and potential taxation under the New Zealand CFC regime.

(b) The tax haven company and trust

Although NZVIL might be effectively insulated from the CFC regime, whether the tax haven company will also be protected must be addressed. Two immediate problems arise regarding the proposed arrangement. Both relate to how the tax haven company may deal with any income it accrues over time. The professional directors of the company have two options available, both of which have various potential taxation consequences for Akihiro. These options are to retain the earnings in the tax haven company, or to distribute the earnings of the company to the shareholders.

¹⁸ The term "relatives", as included in s 245B, is further defined in s 245A(1) by reference to "blood relationship, marriage or adoption". The section further specifies that persons will be connected by "blood relationship" if within the "second degree of relationship".

¹⁹ See s 245C(5).

(i) Retention of earnings

If the tax haven company makes no distributions to the trust as its main shareholder, then any taxation analysis will be concerned solely with the ambit and effect of the CFC regime on the company, by virtue of Akihiro's interest in the company through the trust.

This raises two further issues. First, can Akihiro have a control interest in the tax haven company by virtue of his interest in the discretionary trust which owns the majority of shares in that company, although, at best, he may be merely a potential beneficiary with no direct entitlement?

If the answer to this question is in the affirmative, then it is likely that Akihiro will have an *indirect* control interest sufficient for the purpose of activating the provisions of the CFC regime. As a result, he will be assessed for New Zealand domestic tax on the additional basis of any attributed income or loss on account of his indirect income interest in the tax haven company.

Second, if that answer is in the negative, it is still possible that Akihiro will have an *indirect* control interest in the tax haven company by being associated with the trustee of the discretionary trust pursuant to section s 245B(g). Thus, Akihiro would again be liable for domestic tax on the basis of the earnings of the tax haven company.

(ii) Distribution of earnings

If the company chose to distribute its earnings to the shareholders, the trust, as major shareholder, would receive the bulk of any distribution. At that time, the trustees would have the discretionary power to distribute earnings to whomever they choose, with regard also to those beneficiaries further appointed by deed by Akihiro. As the trust would be classified as a foreign trust in New Zealand, any distribution which the trustees decided to make to Akihiro would be taxed either at 33 percent once it had been received in this country, or, if beneficiary income, at Akihiro's marginal tax rate.²⁰

Whether the New Zealand revenue authorities could throw their net wider to encompass the entire earnings of the trust itself is perhaps a moot point. In this context, the ambit of the so-called settlor regime, adopted in New Zealand for the taxation of trusts, is crucial to determining whether Akihiro is liable for additional tax as either a resident settlor of the trust or a beneficiary under a non-qualifying trust.

The answers to any of these questions are premised upon a deeper analysis of the nature and definition of the discretionary trust to be used. Attention must also be given to the way in which such trusts are taxed in New Zealand, with a view to defining Akihiro's potential liability.

²⁰ Section 227(1) provides that beneficiary income is part of assessable income.

IV: THE NATURE AND DEFINITION OF THE PROPOSED DISCRETIONARY TRUST

The proposed trust will be non-exhaustive and discretionary, such that the trustees will be under no duty to distribute either all or part of the trust property in a particular year. The potential flexibility of the trust is enhanced by the inclusion of a *hybrid mere power of appointment* within the trust instrument. This enables the trustees to appoint anyone in the world, with the exception of a specified class or group, as a beneficiary under the trust.

The validity of these types of trusts, in terms of their certainty of objects, has been reinforced by cases such as *In re Manisty's Settlement*²¹ and *In re Hay's Settlement Trusts*.²² In particular, *In re Manisty's Settlement* established that hybrid mere powers can be valid powers in terms of the requisite certainty of objects, as long as the class of excepted persons is sufficiently clear. The "is or is not" test expressed in *In re Gulbenkian's Settlement*²³ can be used to determine certainty of objects in this respect. Thus, it will be sufficient if the trustees are able to say whether any given person is or is not within the category of excepted persons. Consequently, and subject to the construction of the trust instrument in question, certainty of objects will not be dependent upon whether it is possible to compile a list of the excepted persons.²⁴

This structure sits well with the potential influences and requirements of the domestic jurisdiction - namely the Cayman Islands - in which the trust is to be settled. Such jurisdictions are often attractive to the tax planner because of their comparatively relaxed laws relating to the drafting of trusts and their minimal taxation regimes. In particular, jurisdictions such as the Cayman Islands have traditionally been relatively unconcerned with specified beneficiaries being added or subtracted from the trust deed. One of the principal advantages of granting such freedom to settlors and trustees relates to the area of income and asset protection. An immigrant could be omitted from the trust instrument while resident in a particular country, so as to avoid domestic tax on that income, only to be reinserted as a potential beneficiary upon emigration.

In the context of the Fujimoto hypothetical example, Akihiro can be omitted as a beneficiary in the trust instrument prior to his migration to New Zealand. This would ensure a greater degree of protection from a potentially increased income tax liability under the CFC regime. Once Akihiro is no longer resident in New Zealand, he could be inserted into the trust instrument as a potential beneficiary. At the trustees' discretion, he would then be eligible to receive a distribution from

21 [1974] 1 Ch 17.

22 [1982] 1 WLR 202 (Ch D).

23 [1970] AC 508 (HL).

24 Traditionally at common law, the requisite certainty of objects for fixed trusts was only met where it was possible to compile a list of all potential beneficiaries. See, for example, *Inland Revenue Commissioners v Broadway Cottages Trust* [1955] Ch 20 (CA).

the trust property without any consequences in terms of a liability to New Zealand tax.

Nevertheless, for the purposes of this article, the Fujimoto brothers choose to follow a cautious route so as to ensure Akihiro's eventual ability to receive distributions from the trust once he leaves New Zealand. Accordingly, the decision is made that Akihiro will be specified as a potential beneficiary in the original trust instrument.

V: THE TAXATION OF THE TRUST

It is now necessary to examine the taxation consequences of using widely drafted discretionary trusts in New Zealand. This analysis focuses on determining whether the earnings of the tax haven company, once distributed to the trust, will be taxable by New Zealand revenue authorities. The critical features of the regime for the taxation of trusts are :

- (i) The assessability of trust income turns on the residence of the settlor.
- (ii) For taxation purposes, a trust derives a duality of income,²⁵ some or all of which may be beneficiary income.²⁶
- (iii) Trustee income and capital gains which are distributed to beneficiaries may be taxable in the beneficiary's hands, depending on the nature of the trust. It is in the context of distributions that the classification of a particular trust as either qualifying, foreign, or non-qualifying is relevant.

Distributions of beneficiary income are taxed at the beneficiary's own marginal tax rate, regardless of the type of trust they are paid from. The taxation of distributions, other than beneficiary income, turns on the classification of the trust. There are three classes provided for in s 226(1) of the Act:

- (i) Qualifying trusts - where the trustee income has been subject to New Zealand tax in each income year from the inception of the trust to the date of the distribution in question, and all trustee liabilities in regard to that tax have been satisfied. Distributions from qualifying trusts of amounts other than beneficiary income do not bear further tax.

²⁵ Crawford & Holmes, "New Zealand Immigrants And Their Trusts: Some Thoughts", Coopers & Lybrand Auckland/Wellington Tax Seminar, Rotorua, 15-17 March 1990, p1.

²⁶ Beneficiary income is defined in s 226(1) as income derived during that income year by a trustee of a trust which either "during that income year vests absolutely in interest in the beneficiary", or "[i]s paid or applied by the trustee to or for the benefit of the beneficiary during, or within 6 months after the end of, that income year".

- (ii) Foreign trusts - trusts without a New Zealand resident settlor in the period from 17 December 1987 or the date the trust was first settled, whichever is the later, until the date of the distribution in question. Distributions from these trusts, which comprise neither beneficiary income nor the corpus of the trust, are taxable distributions and are assessable to a New Zealand resident recipient beneficiary at the rate of 33 percent.
- (iii) Non-qualifying trusts - distributions to New Zealand residents from these trusts, other than of beneficiary income or the corpus of the trust, are subject to tax in New Zealand at the punitive rate of 45 percent.

1. The Residence of the Settlor

Pursuant to s 228(2), a trustee is liable to income tax on all trustee income which the trust derives from New Zealand. However, the taxation of trustee income derived from outside New Zealand is determined on the basis of where the settlor resides.

Trustee income derived from outside New Zealand in an income year is liable to tax if at any time during that income year the settlor of the trust is resident in New Zealand,²⁷ or the trustee is resident in New Zealand and the settlor died resident in New Zealand, whether in that income year or otherwise.²⁸

If a settlement has been made on the trust after 17 December 1987, any settlor who is resident in New Zealand at any time during an income year is liable to tax on the trustee income, derived in that income year, as agent of the trustee.²⁹ However, there are certain situations in which the settlor will not be liable. First, where a trustee is resident in New Zealand during the entire income year.³⁰ Second, where the settlor, being a natural person, was not resident in New Zealand at the time of any settlement by that settlor and who has not at the time of any settlement since 17 December 1987 previously been resident in New Zealand.³¹ Third, where the settlor can establish to the satisfaction of the Commissioner of Inland Revenue that his or her liability to income tax on trustee income exceeds the liability which that settlor should bear, in comparison to other persons who have made a settlement on the trust.³²

27 Section 228(3)(a).

28 Section 228(3)(b).

29 Section 228(4).

30 Section 228(5)(a).

31 Section 228(5)(b).

32 Section 228(5)(c).

2. The Immigration of a Settlor

Section 226A of the Act provides for a trust settled before the settlor became resident to be classified as a qualifying trust through a process of election.³³ Pursuant to s 226A, a trust which is settled by an individual who then becomes a resident of New Zealand after 17 December 1987 gives any settlor, trustee, or beneficiary of that trust (or any combination thereof), the right to elect to pay, and therefore become liable for, income tax on the trustee income of the trust.

The trust will thus be treated as a foreign trust for the taxation of distributions made from income or capital gains derived by the trustee before the date on which the election was made. After the election, the trust will be treated as a qualifying trust and any distributions taxed accordingly.³⁴

If no election is made, and no further settlements are made on the trust after the date on which the settlor becomes resident, then the settlor will not be liable for tax on the trustee income of the trust. As the non-resident trustee is also not liable to New Zealand tax,³⁵ the resident beneficiaries will be taxed at a higher rate on taxable distributions (retained income and capital gains), namely 45 percent. This is to allow for the deferral from New Zealand income tax which the trustee income has enjoyed as it has been accumulated. In this case, the trust will be classified as a non-qualifying trust.

3. Taxation of the Trust in the Fujimoto Hypothetical Example

Initially, the Cayman Islands trust will be a foreign trust for the purpose of liability to New Zealand taxation, as the settlor of the trust (NZVIL) is not resident in this country. However, the situation becomes complicated following Akihiro's migration to New Zealand, depending on whether he can be classed as a settlor for the purposes of the Act.

If he does not qualify as a settlor, then the trust remains classified as a foreign trust, and any taxable distributions received by Akihiro will be taxed in his hands at a rate of 33 percent. Given that it is unlikely that the trust will make any

33 The election may be invoked under s 228(7), and must be made within 12 months of 31 May 1989 or the day on which the settlor first became resident in New Zealand, whichever is the later.

34 No method is actually prescribed by the legislation for determining the amount of trustee income derived on or after the day on which the election is made. However, it would appear that one of the following methods will be used :

(i) calculation of income actually derived after the date of election; or
(ii) a time-based apportionment similar to the method prescribed in s 226A(4).

35 Section 228(3), however, specifies that a trustee will be liable to tax on trustee income derived from outside New Zealand "and, if the trustee is not a resident of New Zealand, as if the trustee were resident in New Zealand" during any year where a settlor of the trust is resident in this country. This provision will of course prove somewhat difficult to enforce.

distributions, the trust will effectively be insulated from New Zealand taxation until its earnings are actually distributed.

However, if Akihiro does qualify as a settlor, then once he becomes resident s 228(7) will present him with the choice whether or not to elect to be liable as agent for the New Zealand taxation for all trustee income of the trust. His alternative is to have the trust classified as a non-qualifying trust, with a 45 percent penal tax rate on all taxable distributions.

The crucial question is whether Akihiro is a settlor in terms of the Cayman Islands trust, although the settlement was actually made upon the trust by NZVIL.

4. The Definition of a Settlor

A broad definition of the term “settlor” is contained in s 226(2) of the Act:

[T]he term “settlor”, in relation to any trust, means any person who, directly or indirectly and whether by one transaction or by a series of transactions, -

(a) Makes, or has made at any time, any disposition of property³⁶ to or for the benefit of the trust or on the terms of the trust for less than market value; or

(b) Makes, continues to make, or has made at any time, any property available (including the provision of any financial assistance whether by way of a loan, guarantee, the provision of security, or otherwise) to or for the benefit of the trust for less than market value ... or

(c) Provides, continues to provide, or has provided at any time, any service to or for the benefit of the trust for less than market value; or

(d) Acquires, or has at any time acquired, or obtains the use of, or continues to obtain the use of, or has at any time obtained the use of, any property of the trust or any service provided by the trustee of the trust for greater than market value,-

and includes any person who acts or abstains from acting or directly or indirectly enters into a transaction or a series of transactions with or in relation to the trust with the effect of defeating the intent and application of this definition:

Provided that for the purposes of this subsection the fact that a person is or will become a beneficiary of the trust shall not constitute the giving or receiving of any value.

The inclusion of indirect transactions reduces the opportunity for a person to avoid settlor status by indirectly transferring value to a trust. An example of this would be the sale of property at less than market value to a third party pursuant to the understanding that the third party will on-sell that property at an equivalent price to a trust. The concept of market value ensures that the test is an objective one, and disregards the intention or purpose of the parties involved in the transaction.

³⁶ “Disposition of property” is widely defined in s 226(1) as any conveyance, transfer, assignment, settlement, delivery, payment, or other alienation of property, either at law or in equity.

The definition of a settlor is also extended by s 226(3), which provides that where any person has made a settlement on a trust as nominee for any other person, or has settled a nominal amount at the request of any other person, then that other person will be deemed to be the settlor.

5. Is Akihiro Fujimoto a Settlor?

Under the definition of a settlor provided by s 226(2), Akihiro has made neither a disposition of property to the trust,³⁷ nor made any property available to the trust,³⁸ nor provided any services to the trust.³⁹ Nor will he do so in the future. Similarly, he has not, and will not, acquire or obtain the use of trust property for greater than market value.⁴⁰

However, a potential problem arises in terms of the anti-avoidance provision contained in s 226. It deems a person who “acts or abstains from acting or directly or indirectly enters into a transaction or series of transactions ... with the effect of defeating the intent and application of [s 226(2)(d)]” to be a settlor.

With regard to the intent and application of that subsection, it is important to remember that the international tax reforms in this country, which led to the implementation of the present trust regime in 1988, were primarily targeted at pre-existing residents with overseas interests. They were not directed at immigrants with foreign-sourced wealth made without reliance on the economic resources of New Zealand. Neither the 1987 *Consultative Document*,⁴¹ nor the Valabh Committee Reports,⁴² which preceded the enactment of this legislation, considered immigrants in any detail at all. Rather, they concentrated on the practices of New Zealand taxpayers who were already resident in this country, deferring their tax liability through the use of off-shore entities, effectively insulating their investments from scrutiny by New Zealand revenue authorities.

Thus, a distinction should be made between a New Zealand resident who turns to a foreign entity (whether a trust or otherwise) in order to defer his or her New Zealand tax liability, and a foreign national who has perhaps made substantial earnings overseas and wants to insulate that income from New Zealand taxation before migrating to New Zealand.

The former is a threat to the maintenance of the New Zealand tax base, contemplating the investment of money overseas through foreign entities for the purpose of taking advantage of potential domestic taxation deferral. The latter, however, is not depriving New Zealand of any revenue which it would otherwise

37 Section 226(2)(a).

38 Section 226(2)(b).

39 Section 226(2)(c).

40 Section 226(2)(d).

41 *Consultative Document on International Tax Reform*, (Wellington, Government Printer, 1987).

42 The Consultative Committee on Full Imputation and International Tax Reform (1988) is commonly referred to by the name of its Chairman, Mr Arthur Valabh.

have received. The immigrant is in fact supplementing it by the amount of domestic taxation which he or she will incur while resident in this country. Additionally, the immigrant may be able to justify any actions taken to insulate foreign-sourced income on the grounds of prudent business activity beyond the scope of mere tax minimisation.

With this in mind, it could be argued that the detailed arrangements entered into by NZVIL and Akihiro Fujimoto were not implemented primarily to defeat the intent and application of the settlor regime, but rather were founded on pragmatic business principles and a desire to act in the best interests of the Thai company. As noted earlier, the Board of Directors of NZVIL chose to send Akihiro to New Zealand as a company officer. Thus, they felt an obligation to reimburse him for any expenses incurred in the performance of his duties. From this perspective, the primary motivation behind the implementation of these arrangements was a desire to save the Thai company money. This saving would be achieved by minimising Akihiro's liability to tax in New Zealand under the CFC regime, on the basis of his control and income interests in NZVIL.

The reaction of the New Zealand revenue authorities to this argument must partially be based on policy considerations. If it is worthwhile encouraging skilled and wealthy immigrants to this country, then it can only be expected that the cost of such a decision will be the implementation of various arrangements for the minimisation of their liability to New Zealand tax once they arrive. Should the revenue authorities ignore the merits of arguments such as that advanced in the case of Akihiro Fujimoto, they will effectively be sending a message to prospective immigrants which may conflict with the Government's immigration policies.

It is unlikely that Akihiro would be adjudged a settlor solely on the basis of this part of the definition in s 226(2), because the reasons for his conduct should outweigh the charge of acting deliberately to avoid the regime. As a result, this leaves NZVIL to solely assume the mantle of a non-resident settlor of the Cayman Islands trust.

For predominantly commercial reasons relating to Akihiro's proposed migration to New Zealand, the trust has been settled by the Thai company, NZVIL. As a result, this settlement could not have been performed by the company as a nominee for Akihiro,⁴³ given that the actions of the company were dictated by a Board meeting where NZVIL's interests took precedence above those of the individual directors, past or present.

Furthermore, since all of Akihiro's holdings in NZVIL were eventually transferred to the tax haven company, it is unlikely that the settlement could have been a "nominal amount made at the request of any other person".⁴⁴

For these reasons, Akihiro should not be deemed a settlor of the Cayman Islands trust under the tests contained in s 226. The anti-avoidance argument is obviously the most tenuous. It also involves the most serious considerations in this area of taxation law, including questions of Government policy. These are issues

⁴³ Section 226(3)(a).

⁴⁴ Section 226(3)(b).

which the Inland Revenue Department would not be able to brush lightly aside.

Assuming that Akihiro will not be considered a settlor, his residence in New Zealand will not affect the Cayman Islands trust remaining classified as a foreign trust. Therefore, any beneficiary income from the trust remains taxable at Akihiro's marginal tax rate. In the unlikely event of other distributions from the trust being made to Akihiro, not including the corpus of the trust or certain capital profits, they will be taxable and assessable at the rate of 33 percent.

VI: THE FUJIMOTO ARRANGEMENT AND THE CONTROLLED FOREIGN COMPANIES REGIME

Since the tax haven company will retain its earnings without making any distributions, the only potential avenue open to the New Zealand revenue authorities is to tax Akihiro on his previous foreign holdings through the CFC regime. Thus, there are two issues which must be considered:

- (i) Does Akihiro, by virtue of being a discretionary beneficiary under the trust, have an *indirect* interest in the tax haven company sufficient to activate the attribution mechanisms of the CFC regime?
- (ii) If not, is Akihiro still liable to tax under the CFC regime on the grounds that he was associated with the trustees of the Cayman Islands trust, for the purpose of calculating the relevant control interests in the tax haven company?

1. The Question of Indirect Interest

An indirect control interest in a CFC is defined as any control interests held by a CFC in *another* foreign company, where such interests will be attributable back to that "group of 5 or fewer persons resident in New Zealand whose control interest ... in that first tier controlled foreign company is greater than 50 percent".⁴⁵

In this case, however, since it is a *trust* that is interposed between the (controlled) foreign company and the New Zealand resident, the tests for an indirect control interest cannot be met by s 245C alone. There is no provision in the New Zealand legislation for the attribution of control interests through any medium other than a controlled foreign company. Consequently, the Cayman Islands trust arrangement does not fall within the Act.

⁴⁵ Section 245C(5)(a)(i).

2. The Question of Association

A far greater threat to the Fujimotos' arrangement is posed by the fact that the legislation which provides for situations where the beneficiaries and trustees of a trust might be deemed to be associated for the purposes of calculating control interests in terms of the CFC regime.⁴⁶ If Akihiro was attributed with the Cayman Islands trustees' control interests, this would activate the provisions of the CFC regime on the basis of his residence in New Zealand. The term "associated persons" is defined in detail in s 245B of the Act.⁴⁷

(a) *The test in section 245B(g)(i)*

Section 245B(g)(i) provides that two persons are associated if one person is the trustee of a trust under which the other person either "has benefited, or will benefit, either directly or indirectly".

This is a very broad test, but nevertheless scope remains for arguing that this section will not be able to cover all types of trustee-beneficiary relationships - especially in the context of wide non-exhaustive discretionary trusts drafted with a hybrid mere power of appointment in the trust instrument. The test in s 245B(g)(i) is based on whether a person "has benefited, or will benefit" under the trust. In the case of such a discretionary trust, the question of who *will* benefit from the trust can never be determined with certainty until such a distribution has been made. Until that time, the wide class of persons specified in the trust instrument have a remote chance of receiving any such benefit. As Gravells notes:⁴⁸

[T]he interests of the potential beneficiaries under a discretionary trust are essentially similar. Since the trustees of a discretionary trust have a discretion to select some and not others to benefit from the distribution of trust property, it must follow that, as in the case of a power of appointment, no individual member of the class has an interest in any part of the trust property unless and until the trustees exercise their discretion in his favour.

Furthermore, under a widely drafted hybrid mere power, the potential class of beneficiaries might feasibly amount to the entire world, less a small excepted class of beneficiaries. While a number of cases show that this type of trust is valid,⁴⁹ in this context the test in s 245B(g)(i) would surely have to be considered unwork-

46 See "Controlled Foreign Companies: Tax Information Bulletin Appendix" [1990] 2 (3) TIB para 20.6: "Where trustees of a trust hold control interests in a foreign company those interests will be taken into account by persons associated with the trustees in determining whether the foreign company is a CFC: s 245C(3)."

47 Section 245B(g) provides when a trustee, settlor, or beneficiary may be deemed to be an associated person for the purposes of the CFC regime.

48 Gravells, "Discretionary Trusts and Powers of Appointment: Progressive Assimilation" (1992) 5 *Canta LR* 67, 71.

49 *Supra* at notes 21 and 22, and accompanying text.

able. The trustee could be associated with an enormous number of potential beneficiaries, whom, under a hybrid mere power, might never benefit at all.

If potential beneficiaries under a non-exhaustive discretionary trust are unable to determine whether they will benefit under the trust, the Inland Revenue Department must surely be faced with the same problem. Once a distribution has been made, the recipient beneficiary will fall squarely within the ambit of s 245B(g)(i). However, until that time it would be unacceptable for the Inland Revenue Department to be able to apply the provisions of s 245B(g)(i) to potential beneficiaries who may never receive a distribution.

With regard to the Fujimoto hypothetical example, s 245B(g)(i) could not feasibly be applied to deem Akihiro and the Cayman Islands trustees to be associated persons. The extremely wide drafting of the discretionary trust, in terms of the inclusion of a hybrid mere power of appointment, would effectively preclude the identification of those beneficiaries who will benefit under the trust.

(b) The test in s 245B(g)(ii)

Section 245B(g)(ii) provides that two persons will be associated if one person is the trustee of a trust under which the other person *may* benefit either directly or indirectly. While this rule catches potential beneficiaries under a discretionary trust, it will only apply if the person who may benefit under the trust is associated with any settlor of the trust by virtue of the tests contained in either ss 245B or 8 of the Act.

The term “settlor” is defined in s 245A(1) as having the meaning assigned to it by s 226. For the purposes of the Fujimoto hypothetical example, earlier discussion has shown that the settlor of the Cayman Islands trust was the Thai company, NZVIL. Thus, any analysis of this area must proceed on the basis of whether any potential beneficiaries, especially Akihiro, can be deemed to be associated with that company in terms of the tests specified either in ss 245B or 8.

Section 8(1) provides that the following persons and entities will be associated:

- (a) Any 2 companies which consist substantially of the same shareholders or are under the control of the same persons; or
- (b) Any company and any person (other than a company) who holds 25 percent or more of the paid-up capital or 25 percent or more in nominal value of the allotted shares of that company; or
- (c) Any 2 persons who are relatives; or
- (d) A partnership and any person, where that person and any partner in that partnership are, in accordance with the foregoing provisions of this subsection, associated persons.

Whether NZVIL will be deemed to be associated with Akihiro is of primary importance. The test contained in s 8(1)(b) must be further considered.

(i) Company-Person association

Section 8(1)(b) provides that a company and a person (other than a company) will be associated if the person holds 25 percent or more of the paid-up capital or allotted nominal capital of the company. Section 8(2) contains two further rules that apply for the purpose of implementing s 8(1)(b). First, s 8(2)(a) provides that the paid-up capital of one company held by another company will be deemed to be held by the shareholders in the latter company. Second, s 8(2)(b) provides that where a nominee of any person holds any paid-up capital of a company, that paid-up capital will be deemed to be held by the person instead of the nominee.⁵⁰

Section 8(1)(b) appears to be broader in scope than the parallel provision in the CFC regime, s 245B(b), since the threshold limit applies at 25 percent instead of the 50 percent limit applicable in the latter section. However, a narrower range of interests are taken into account for the purposes of s 8(1)(b) than for the purposes of s 245B(b). In the case of the former section, only paid-up capital and the nominal value of allotted shares are considered, while in the latter section, the following income interests are examined: nominal capital, paid-up capital, voting rights, entitlement to income, and entitlement to the distribution of assets.⁵¹

Section 8(1)(c) provides that any two persons who are relatives will be associated. This is potentially broader in scope than the test in s 245B(d) because, although the definition of “relative” contained in s 2 of the Act applies to s 8(1)(b), it does not apply to s 245B(d), which instead is based upon a narrower definition contained in s 245A.

(c) The effect of the s 245B(g)(ii) test on the Fujimoto hypothetical example

As s 245B(g)(ii) concerns potential beneficiaries, Akihiro will be caught as a person who may benefit, irrespective of the wide drafting of the trust instrument, and the presence of a hybrid mere power. The question then becomes whether he could be associated with the Thai corporate settlor, NZVIL, in terms of the tests expressed either in ss 8 or 245B of the Act. This naturally leads to a separate analysis of the provisions of both ss 245B and 8.

50 The definition of “nominee” for the purposes of this section includes both “any other person who may be required to exercise his voting power in relation to the company in accordance with the direction of that person, or who holds shares directly or indirectly on behalf of that person”, as well as any relative of that person.

51 See s 245D for calculation of that interest, and s 245E for variations of that interest.

(i) *The tests of s 245B*

Section 245B(c) states that the following will be associated:⁵²

(c) Any company and any person where the person is *by virtue of any of the provisions of this section* associated with another person who is by virtue of any of the provisions of this section other than this paragraph associated with the company....

In effect, this provision ties Akihiro to the interests of any relatives in the company with whom he will be associated under s 245B(d). Furthermore, where such relatives are also associated with NZVIL, then Akihiro will be deemed to be associated with the company, thereby satisfying the requirements of s 245B(g)(ii). This will attribute the trustees' control interests in the Cayman Islands company to Akihiro, thereby activating the CFC regime.

As already discussed, s 245B(d) is based upon a narrow test, as defined in s 245A, which deems persons to be connected by blood relationship where they are within the second degree of relationship. This definition will encompass the interests of Akihiro's two brothers.

It must be determined whether Akihiro's relatives are associated with the company, in order to satisfy s 245B(c). Given that the brothers will all be associated with each other, their effective group interest when combined will total 40 percent, being the combination of the two brothers' individual interests of 20 percent each. This will not be enough in terms of s 245B(b) to deem them to be associated with NZVIL, as their combined income interests will not total "50 percent or more in that company".⁵³ As a result, Akihiro will not be deemed to be associated with the Cayman Islands trustees on the basis of being associated with the settlor of the trust, NZVIL, on the grounds specified in s 245B.

(ii) *The tests of s 8*

In comparison, the application of s 8 poses more difficulties. Under s 8(1)(b), a company and a person will be associated where that person "holds 25 percent or more of the paid-up capital or 25 percent or more in nominal value of the allotted shares"⁵⁴ in that company.

The definition of "nominee" in s 8(2)(b) will once again catch the shareholding interests of the two other Fujimoto brothers. Given that the brothers are all relatives within the definition in s 2, their combined interests of 40 percent will be able to be grouped and attributed to Akihiro under s 8(2)(b), on the grounds that the other two brothers will be nominees for the purposes of that section. Although this may not be particularly realistic, this classification will be sufficient to satisfy

⁵² Emphasis added.

⁵³ Section 245B(b).

⁵⁴ Section 8(1)(b).

s 8(1)(b). This will deem Akihiro and NZVIL to be associated persons for the purposes of the Act.

(d) Summary

Given that Akihiro will be deemed to be associated with the settlor of the Cayman Islands trust (NZVIL) by virtue of s 8(1)(b), the requirements of s 245B(g)(ii) will be satisfied so as to deem Akihiro and the trustees of the trust also to be associated for the purposes of the Act. As a result, in terms of s 245C(3), the control interests of the trustees will be attributable to Akihiro for the purposes of determining whether the tax haven company is a CFC.

Since the direct control interests of the Cayman Islands trustees will total nearly 100 percent in the tax haven company, it is inevitable this company will be adjudged to be a CFC upon Akihiro achieving tax residence in New Zealand. From that time, the income attribution mechanisms of the regime will be activated so that Akihiro will be taxed on his income interest in the earnings of that company.

Determination of the tax haven company as a CFC is almost totally dependent upon whether Akihiro is named as a potential beneficiary in the initial trust instrument. If a tax planner wanted to take full advantage of the flexibility of the domestic laws of the Cayman Islands relating to trusts, and given the presence of a hybrid mere power of appointment of beneficiaries in the trust deed, one solution to this problem would be to leave Akihiro out of the original trust instrument altogether. When he ends residency in New Zealand, he could be added to the trust instrument as a potential beneficiary, and be able to receive distributions from the trust without any concerns about the CFC regime.

That the tax haven company might in this case be a CFC clearly demonstrates the potential susceptibility of closely held family-oriented companies to the CFC regime as it currently exists. The application of the association provisions of the regime can have a great influence on whether or not a foreign company will be deemed to be a CFC. For example, in the Fujimoto hypothetical example, where only one brother becomes resident in New Zealand without any interests in the foreign company, he may still be attributed with the interests of his non-resident relatives, thereby making that company a CFC, and himself liable for additional tax.

This problem could be solved, and the tax haven company saved from being a CFC, if the relatives in question also divested themselves of their interests in NZVIL, so that s 245B(g)(ii) could not apply to attribute the control interests of the Cayman Islands trustees to Akihiro. One approach could be for Hiroshi and Koji to also set up tax haven trusts into which they transfer their holdings in NZVIL. Although perhaps slightly impractical from the perspective of the continuing management of the Thai company, each brother could settle a trust for the other, so

that both brothers would effectively have no interests in the company itself. As long as neither brother ever becomes tax resident in New Zealand (since each would be a settlor of a foreign trust), this arrangement would suffice to protect the original tax haven company from being a CFC.

Although, under the terms of the original hypothetical example, the tax haven company will be deemed to be a CFC on the basis of the application of s 245B(g)(ii), NZVIL will not be classified as a CFC for the purposes of the New Zealand income tax regime. This is because the tax haven company only holds an interest of 20 percent in the Thai company, which under s 245C(1) would not be enough to deem the latter company a CFC. Despite the tax haven company being adjudged a CFC, the derivation of income interests in this context might still prove difficult.

3. The Question of Income Attribution

Except for the limited purpose of determining whether a person holds an income interest of ten percent or greater in a CFC, interests held by associated persons are not aggregated in order to calculate income interests.⁵⁵ The Inland Revenue Department has specified that the effect where income interests are held by trustees or by persons associated with trustees is as follows:⁵⁶

Income interests held by non-resident trustees of a trust in a foreign company are not aggregated with income interests held by resident beneficiaries in calculating the income interests of the beneficiaries in that company. However, income interests are taken into account in determining whether resident beneficiaries hold an income interest of 10 percent or greater in a CFC. For example, if a resident beneficiary of a trust holds an income interest of 5 percent in a CFC, and non-resident trustees of the trust hold an income interest of 6 percent in the CFC, the resident beneficiary is deemed to hold an income interest of 10 percent or greater in the CFC by virtue of s 245F(2). However, the beneficiary is required to calculate attributed foreign income or loss in relation to the income interest of 5 percent only.

Thus, in terms of the Fujimoto hypothetical example, Akihiro's income interests will not be affected by the direct income interests of the Cayman Islands trustees, other than for the initial purpose of satisfying the ten percent minimum income interest requirement.

Beyond that stage lies the difficult question of determining what Akihiro's indirect income interests will be, given that he does not hold a direct income interest in the tax haven company at any time. Two problems in particular present themselves.

First, the definition of "indirect income interests" in s 245D(3) refers only to the situation:⁵⁷

⁵⁵ See *supra* at note 46, at para 20.8(a).

⁵⁶ *Ibid.*

⁵⁷ Emphasis added.

Where a person has at any time a direct income interest in a *controlled foreign company* and that controlled foreign company ... has at that time a direct income interest in another foreign company which is at that time a *controlled foreign company* [in that it satisfies the tests in 245C(1) itself]

It would therefore seem that the enacted legislation has no provision for considerations of attributed income interests through any medium other than a CFC in which the attributee already has a direct income interest. This would not be so in this case. It would be impossible to calculate an indirect income interest for Akihiro which could be used as a basis of attributing any foreign income or loss to him while resident in New Zealand.

Second, even if the Cayman Islands trust was deemed an appropriate medium for such attribution, Akihiro's interest in the earnings of that trust will also be unable to be determined with any certainty. This is because the proposed trust is a non-exhaustive discretionary trust with a hybrid mere power of appointment, under which Akihiro has only a remote chance of ever receiving a benefit.

Although the tax haven company might be classified as a CFC, the actual imposition of any additional taxation on Akihiro in the form of attributed foreign income (or loss) may well prove virtually impossible, on the grounds that his income interests in the tax haven company are too vague to be determined.

While the tax haven company will be caught as a CFC (if Akihiro is a potential beneficiary under the tax haven trust), the actual operation of the CFC machinery in New Zealand will be hampered by the interpositioning of a non-exhaustive discretionary trust between Akihiro and the company itself. This will not be satisfactory in terms of insulating the tax haven company from scrutiny by New Zealand revenue authorities. Nevertheless, it seems the proposed scheme will be successful in at least partially avoiding the provisions of the CFC regime in terms of Akihiro actually incurring an additional tax liability once he becomes resident in New Zealand.

Finally, it must be reiterated that in light of this analysis, the best structure for the insulation of the tax company's earnings will involve the complete absence of Akihiro as a potential beneficiary from the trust instrument. This would be based on the presence of the hybrid mere power of appointment, and the flexibility of the domestic laws of the Cayman Islands with regards to the validity of trusts.

VII: CONCLUSION

For an immigrant arriving in New Zealand, the CFC regime poses a substantial obstacle to the successful insulation of any foreign assets or earnings from scrutiny by revenue authorities in this country. The provisions of the regime have been widely drafted, in order to take account of the diverse potential arrangements that may be implemented by immigrants wishing to avoid the additional burden of being taxed on their attributed foreign income while resident in New Zealand.

One of the deficiencies of the current CFC regime is the way in which it applies

to business people who come to New Zealand for perhaps only a short period, and for purely business reasons. These people will be taxed under the CFC regime in the same manner as New Zealand resident taxpayers who might previously have been guilty of utilising foreign tax havens for deferral purposes, thereby eroding the domestic tax base. A natural desire to avoid the application of the CFC regime has often led these business-related immigrants into complex and seemingly unnecessary arrangements.

It is arguable that a distinction does need to be made between prior residents and business immigrants coming to New Zealand, on the grounds that in the latter case the CFC regime is potentially too far-reaching. With regard to these immigrants, the application of the CFC regime may in fact go beyond its original mandate of eliminating the practice of deferral for *resident taxpayers*, thereby protecting New Zealand's tax base. These concerns cannot apply in the same terms to immigrants arriving in this country for the first time.

Given the present trend towards increased geographical mobility within the Asian region, situations such as that proposed by the Fujimoto hypothetical will become more common. The challenge facing tax advisers in this country, and the Inland Revenue Department, will be to react appropriately.

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The Society is a charitable organisation which receives no direct Government support but receives funds from donations, legacies, bequests, and memberships. The goal is to reduce the number of people who develop, or die from, cancer and to ensure the best possible quality of life for cancer patients, through research, health promotion and patient support.

Means of supporting the Society are:

Donations — from individual people, families, community groups and businesses, who from time to time wish to contribute to the Society's work.

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In Memoriams — are a tangible and constructive way of remembering someone who has died of cancer. All members of families are advised of this gesture of condolence and receipts are issued to the donor.

Bequests and legacies — have traditionally been one of the Society's major sources of income. The Society appreciates the foresight of its many benefactors who have considered it in this way.

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I GIVE AND BEQUEATH (free of all duties) to the AUCKLAND DIVISION CANCER SOCIETY OF NEW ZEALAND INCORPORATED the sum of for research and/or general purposes thereof AND I DECLARE that the receipt of the Secretary or other proper officer thereof shall be full and sufficient discharge to my Trustee for the said legacy nor shall my Trustee be bound to see to the application thereof.

The legal title of the Society is:

Auckland Division Cancer Society of New Zealand Incorporated
PO Box 1724
AUCKLAND

Telephone: (09)524-0023