EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND NEW ZEALAND

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On November 10, 2009

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the present income tax treaty between the United States and New Zealand (the "proposed protocol"). The proposed protocol was signed on December 1, 2008. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for November 10, 2009.[2]

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of New Zealand's tax laws. Part IV provides a discussion of investment and trade flows between the United States and New Zealand. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and New Zealand* (JCX-51-09), November 6, 2009. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at http://www.jct.gov.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 111-3.

I. SUMMARY

The principal purposes of the present treaty between the United States and New Zealand are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The present treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the Convention and Protocol between the United States and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income signed at Wellington on July 23, 1982 (the “present treaty”). The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the United States Model Income Tax Convention of November 15, 2006 (“U.S. Model treaty”), and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (“OECD Model treaty”). However, the present treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed protocol in Part V of this pamphlet.

Articles I (General Scope), II (Taxes Covered), III (General Definitions) and X (Independent Personal Services) generally update the provision of the present treaty to conform to the U.S. Model treaty.

The proposed protocol replaces the definition of “resident of a Contracting State” in Article 4 (Residence) of the present treaty with one that is identical to the definition in the U.S. Model treaty. The proposed protocol’s definition of a resident of a Contracting State reverses an exclusion from the definition in the present treaty for a person who is subject to tax in a treaty country by reason of that person’s citizenship but who is not a resident of that country. Consequently, under the proposed protocol, a nonresident citizen of the United States may (subject to the article’s other rules) be treated as a resident of the United States. The proposed protocol also conforms to the U.S. Model treaty’s two tie-breaker rules for determining the residence of an individual who otherwise would be a resident of both treaty countries. Accordingly, residence under these tie-breaker rules is determined based on the country of which the individual is a national, rather than, as under the present treaty, on the individual’s country of citizenship.

The proposed protocol adds new paragraphs 8 and 9 to Article 7 (Business Profits) of the present treaty. New paragraph 8, like the U.S. Model treaty, provides that business profits may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. New paragraph 9 differs from the U.S. Model and OECD Model treaties, and specifically addresses New Zealand law relating to trusts. It provides that (1) if a fiscally transparent entity, or trustee, has a permanent establishment in one treaty country, and (2) a resident of the other treaty country is beneficially entitled to a share of profits from a business carried on by the entity or trustee through a permanent establishment in the first country, then the beneficial owner is treated as carrying on the business through the permanent establishment.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains the generally applicable maximum rate of withholding at source of 15 percent, but also adds a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the voting power of dividend-paying company. Like several other recent treaties and protocols, the proposed protocol also provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. The proposed protocol adds special rules that apply to dividends received from regulated investment companies ("RICs") and real estate investment trusts ("REITs") which are similar to provisions included in other recent treaties and protocols.

The proposed protocol replaces Article 11 (Interest) of the present treaty with a new article that retains source-country taxation of interest at a maximum withholding rate of 10 percent, but allows a special zero rate of withholding for certain financial institutions and governmental entities.

The proposed protocol revises Article 12 (Royalties) of the present treaty. It provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to five percent. This is a reduction from the 10-percent rate provided in the present treaty.

The proposed protocol makes two modifications to Article 13 (Alienation of Property). The proposed protocol makes a conforming change to reflect the elimination of Article 14 (Independent Personal Services) of the present treaty in a manner consistent with the OECD Model treaty. Additionally, to avoid double taxation, the proposed protocol updates the present treaty to allow U.S. individuals who expatriate to New Zealand (who are required to recognize taxable gain on a deemed sale of all of their property under section 877A of the Code) to get a step up in tax basis for New Zealand tax purposes by treating the property deemed sold as immediately repurchased at its fair market value.

The proposed protocol replaces Article 16 (Limitation on Benefits) of the present treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits solely by reason of residence in New Zealand or the United States.

The proposed protocol makes certain conforming changes to Article 22 (Relief from Double Taxation) of the present treaty to reflect changes by the proposed protocol to Article 2 (Taxes Covered). It also reflects a change to the New Zealand tax law that had previously exempted dividends from a foreign subsidiary from tax in certain circumstances. Following the change in law, such dividends are no longer exempt from tax, but may be eligible for relief from double taxation through New Zealand's foreign tax credit system.

The proposed protocol replaces the nondiscrimination rules of Article 23 of the present treaty with new rules that are similar to the nondiscrimination provisions of the U.S. Model treaty and other recent U.S. income tax treaties. These rules generally forbid each treaty country from discriminating against nationals of the other country by imposing on those nationals more burdensome taxes than it would impose on its own comparably situated nationals in the same circumstances. Similarly, neither treaty country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. The nondiscrimination provision does not include the U.S. Model treaty rule which provides that the nondiscrimination rules apply to taxes of every kind and description imposed by a treaty country or by a political subdivision or local authority of that treaty country. Accordingly, the nondiscrimination rules apply only to taxes covered by the present treaty (as modified by the proposed protocol) and not, for example, to U.S. state and local taxes.

The proposed protocol does not change the provisions of Article 24 (Mutual Agreement Procedure) of the treaty. Thus, the treaty, as modified by the proposed protocol, does not require the mandatory arbitration procedure that is sometimes referred to as "last best offer" arbitration. Pursuant to this procedure, which has been included in recent treaties between the United States and Canada, Germany and Belgium (and which is included in the proposed protocol that was signed with France on January 13, 2009), each competent authority proposes one (and only one) amount for settlement, and the arbitrator must select one of those figures as the award. However, the treaty, as modified by the proposed protocol, is consistent with the U.S. Model treaty, which does not incorporate "last best offer" arbitration.

The proposed protocol replaces Article 26 (Exchange of Information) of the present treaty with rules that conform closely to the U.S. Model treaty. The proposed rules generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and New Zealand concerning taxes imposed at a national level, to the extent the taxation under those laws is not contrary to the treaty, as modified by the proposed protocol. It provides – for the first time – for mutual assistance in the collection of tax debts between the United States and New Zealand. Such assistance is limited to tax debts that arise from improperly granted treaty benefits.

The proposed protocol replaces paragraph 1 of the protocol to the present treaty. Under the proposed protocol, New Zealand is required to consult with the United States for purposes of providing the same treatment on a reciprocal basis if (1) it enters into a double taxation treaty with any country (and not just with an OECD member) and (2) that treaty limits the withholding tax rates on interest or royalties (but not dividends) to a rate lower than the one provided for in the treaty with the United States.

Under the provisions of Article XVI, the proposed protocol enters into force on the date of the later of the notifications. The relevant date is the date on the second of the notification documents, and not the date on which the second notification is delivered to the other treaty country. Generally, the proposed protocol is effective on a prospective basis. However, the competent authority provisions under Article 26 (Exchange of Information) are effective retroactively to taxable periods preceding the entry into force of the proposed protocol.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, special limitations apply to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. Thus, this provision explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. These requests can include information to be used in criminal investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain "anti-treaty shopping" provisions designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF TAXATION IN NEW ZEALAND[3]

A. National Income Taxes

Overview

New Zealand imposes tax on net income at the national level. The definition of income subject to tax is expansive; capital gains, however, are normally not included for income tax purposes.[4] Taxable income is computed on an annual basis and is either taxed by assessment[5] or by withholding tax.[6] Withholding tax paid may be credited against income tax liability, and any excess may be refunded.[7] Aside from a few special exceptions, New Zealand residents and non-residents are generally subject to the same rules and tax rates on New Zealand-source income.[8] New Zealand has recently enacted legislation that significantly changes how foreign dividends and offshore income earned through controlled foreign companies are taxed.[9]

Individuals

Individuals resident in New Zealand are taxed on their worldwide income.[10] An individual's taxable income is the sum of all gain and profits from the following sources:

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[3] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including, in large part, Casey M.V. Plunket, Business Operations in New Zealand, Tax Management Portfolio No. 975-3rd, available at http://taxandaccounting.bna.com/btac/ [hereinafter TMP New Zealand]; IBFD Regional Analysis, New Zealand, available at http://checkpoint.riag.com [hereinafter IBFD New Zealand Country Survey or IBFD New Zealand Country Analysis, as the case may be]; and Ernst & Young's 2009 Worldwide Corporate Tax Guide [hereinafter E&Y]. The information in this section was reviewed by foreign law specialists on the staff of the Law Library of Congress. The description is intended to serve as a general overview; many details have been omitted and simplifying generalizations made.

[4] Income Tax Act 2007 (New Zealand), Part C, *available at* the New Zealand Legislation website at: http://www.legislation.co.nz/act/public/2007/0097/latest/DLM1512301.html (last visited Oct. 29, 2009). See also IBFD New Zealand Country Analysis A.7.2.1.5.

[5] Tax Administration Act 1994, (New Zealand) Part 6, *available at* the New Zealand Legislation website at: http://www.legislation.co.nz/act/public/1994/0166/latest/DLM348343.html (last visited Oct. 29, 2009). See also IBFD New Zealand Country Analysis B.1.11.

[6] Tax Administration Act 1994 § 33A. See also IBFD New Zealand Country Analysis B.1.11.

[7] Tax Administration Act 1994, Part 11. See also Income Tax Act 2007, subpart RM. See also IBFD New Zealand Country Analysis B.1.11.4.

[8] Non-residents are only taxed on income that has a source in New Zealand Income Tax Act 2007 § BD 1(5)(c)). See the Income Tax Act 2007 § YD 4 for classes of income treated as having a New Zealand source. See also IBFD New Zealand Country Analysis B.1.2.1.

[9] Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, *available at* the New Zealand Legislation website at: http://www.legislation.co.nz/act/public/2009/0034/latest/DLM1400107.html.

[10] Income Tax Act 2007 § BD 1 and Part C. Part C contains no general territorial exclusion to the source of income of the recipient.

employment income;[11] business income;[12] pension income;[13] and investment income (dividends,[14] interest,[15] and royalties[16]).[17] New Zealand has no capital gains tax as such and capital gains are normally not included in income for income tax purposes.[18] Profits from the sale of personal property or real property and some unrealized capital accretions may, however, be included in income in certain circumstances.[19] Losses can be carried forward indefinitely to offset future net income from any source.[20] There is no time limit within which the losses must be used, but losses may not be carried back. It is not possible to make a capital loss for tax purposes since there is no tax on capital gains.[21] New Zealand-source dividends and interest income are subject to resident withholding tax of 33 percent[22] and 39 percent (reduced to 33 percent or 19.5 percent in certain cases),[23] respectively. Royalties are not subject to resident withholding tax.[24]

Generally, no deductions are allowed to employees for expenses incurred in producing employment income. Employees, as well as other individuals, are entitled to allowable tax credits, which are deducted from income tax payable. Allowable tax credits include, among others, charitable donations tax credit,[25] redundancy tax credit[26] and family assistance tax credit.[27] The income tax rate structure is progressive and extends from 12.5 percent for taxable

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[11] *Ibid*. § CE 1.

[12] *Ibid*. § CB 1.

[13] *Ibid*. § CF 1.

[14] *Ibid*. § CD 1.

[15] *Ibid*. §§ CC 4 and CC 5.

[16] *Ibid*. § CC 9(1).

[17] IBFD New Zealand Country Survey B.1.3.

[18] See generally Income Act 2007, Part C. See also IBFD New Zealand Country Survey B.1.6 and IBFD New Zealand Country Analysis A.1.7.1.

[19] Income Tax Act 2007 §§ CB 4-CB 15. See also IBFD New Zealand Country Analysis A.7.2.1.5.

[20] Income Tax Act 2007 § BC 4(4). See also Income Tax Act 2007 § Part I (“Treatment of Tax Losses”).

[21] IBFD New Zealand Country Survey B.1.8.

[22] Income Tax Act 2007, Schedule 1, Part D, cl. 5.

[23] *Ibid*. cl. 3 and 4.

[24] Income Tax Act 2007 § RE 2(1) for the definition of resident passive income that is subject to withholding tax. See also IBFD New Zealand Country Analysis B.1.10.3.

[25] Income Tax Act 2007 §§ LD 1-LD3.

[26] *Ibid*. §§ ML 1-ML 3.

[27] *Ibid*. § LB 4; IBFD New Zealand Country Analysis B.1.8.

income up to NZ $14,000 (US $8,112)[28] to 38 percent for taxable income exceeding NZ $70,000 (US $40,558).[29]

Corporations

Companies that are resident in New Zealand are taxed on their worldwide income.[30] The definition of company is broad and confers company status for tax purposes on unit trusts, incorporated societies, and credit unions.[31] For income tax purposes, a company is resident in New Zealand if it passes any one of the following four tests: (1) it is incorporated in New Zealand; (2) it has its head office in New Zealand; (3) it has its "center of management" in New Zealand; or, (4) it is controlled by its directors in New Zealand.[32] In general, all income derived by a corporation is taxable business income; this includes income from sales of goods and services, commissions, rents, royalties, rents and dividends.[33] Capital gains are generally not subject to tax. Profits from the sale of personal property or real property and some unrealized capital gains may, however, be included in the taxable income in certain circumstances.[34] The standard corporate tax rate is 30 percent.[35]

For dividends paid by a resident company to another resident company that is not in a consolidated group with the recipient are subject to withholding tax at a rate of 33 percent.[36] Dividends received by a resident company from a wholly-owned subsidiary resident in New Zealand are exempt from tax.[37] Under new legislation enacted in 2009, most foreign dividends received by resident companies are exempt from tax.[38] New Zealand uses an imputation system.

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[28] The quoted tax rates and local currency apply in 2009. U.S. dollar equivalents were calculated using the exchange rate for January 1, 2009 according to OANDA's FX Converter, available at www.oanda.com.

[29] For basic income tax rates, see Income Tax Act 2007, Schedule 1, Part A. From April 1, 2010 the rate structure will extend from 12.5 percent for taxable income up to NZ $14,000 (US $8,112) to 37 percent for taxable income exceeding NZ $70,000 (US $40,558). Personal tax cuts were included in the Taxation (Personal Tax Cuts, Annual Rates, and Remedial Matters) Act 2008, *available at* http://www.legislation.co.nz/act/public/2008/0036/27.0/DLM1328009.html, and the Taxation (Urgent Measures and Annual Rates) Act 2008, *available at* http://www.legislation.co.nz/act/public/2008/0105/latest/DLM1764914.html.

[30] Income Tax Act 2007 Part C. See also IBFD New Zealand Country Analysis A.7.2.1.

[31] See the definition of "company" in § YA 1 of the Income Tax Act 2007.

[32] Income Tax Act 2007 § YD 2. See also TMP New Zealand V.A.

[33] Income Tax Act 2007 § BD 1 and Part C. See also E&Y, p. 717.

[34] Income Tax Act 2007 §§ CB 3 - CB 15. See also IBFD New Zealand Country Analysis A.1.7.1.

[35] Income Tax Act 2007 Schedule 1, Part A, cl. 2.

[36] *Ibid*. §§ RE 1 - RE 3. The withholding tax rate for dividends is set out in the Income Tax Act 2007, Schedule 1, Part D, cl. 5.

[37] *Ibid*. § RE 2(5) (g). See also E&Y, pp. 715-716.

[38] *Ibid*. § CW 9. See also Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, § 41.

Thus, the payment of tax by a resident company gives rise to "imputation credits," which the company can attach to its dividends when paying them out to its shareholders.[39] The dividends are grossed up in shareholders' hands by the value of imputation credits attached to the dividends.[40] The value of those imputation credits is limited by the amount of income tax paid by the distributing company.[41] Shareholders can use the attached imputation credits as tax credits against their tax liability.[42] Corporate recipients may convert excess imputation credits into tax losses.[43] New Zealand-source dividends and royalties paid to a non-resident are subject to a non-resident withholding tax of 30 percent[44] and 15 percent,[45] respectively. New Zealand-source interest paid to a non-resident (other than a person engaged in business in New Zealand through a fixed establishment) is subject to a non-resident withholding tax of 15 percent.[46]

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[39] Income Tax Act 2007 § CD 15.

[40] *Ibid*. § LE 1.

[41] *Ibid*. §§ LE 8 and OA 18.

[42] *Ibid*. § LE 1.

[43] *Ibid*. § LE 2. See also IBFD New Zealand Country Survey A.1.1.

[44] Income Tax Act 2007 § RF 8.

[45] *Ibid*. § RF 7

[46] *Ibid*. §§ RF 2 and RF 7. See also TMP New Zealand X.B.

B. International Aspects of Taxation in New Zealand

Individuals

Individuals resident in New Zealand are taxed on their worldwide income.[47] New Zealand resident individuals are individuals having a permanent place of abode in New Zealand, and individuals physically present in New Zealand for more than 183 days in any 12-month period.[48] Non-resident individuals are subject to the same tax rules and tax rates on their New Zealand-source income.[49] New Zealand-source income includes: income from business carried on in New Zealand, rent from land located in New Zealand, and employment income earned in New Zealand.[50] New Zealand-source capital gains of non-residents are not subject to tax in New Zealand.[51]

New Zealand imposes a 30-percent (reduced to 15 percent or zero percent in certain cases) non-resident withholding tax on dividends paid by resident companies to non-residents.[52] Interest and royalty income arising from New Zealand sources are subject to a 15-percent non-resident withholding tax.[53] No withholding tax is payable on interest if the payer pays an approved issuer levy at the rate of two percent.[54]

Corporations

Companies resident in New Zealand are generally taxed on their worldwide income.[55] A non-resident company is subject to the same tax rules and tax rates as resident companies if it has an establishment in New Zealand or receives New Zealand-source income. A New Zealand establishment is any fixed installation through which a foreign enterprise conducts, wholly or partly, its business activities in New Zealand.[56] New Zealand-source income includes: income

[47] See Income Tax Act 2007 § BD 1 and Part C.

[48] Income Tax Act 2007 § YD 1. See also IBFD New Zealand Country Survey B.7.1.

[49] Income Tax Act 2007 § BD 1(5) (c) excludes income that is from a foreign source and is derived by a person not resident in New Zealand.

[50] *Ibid*. § YD 4.

[51] IBFD New Zealand Country Survey B.6.3.1.

[52] Income Tax Act 2007 §§ RF 8 - RF 12.

[53] *Ibid*. §§ RF 2 and RF 7. "Non-resident company" is defined in § YA 1 as a company that is not a New Zealand resident.

[54] *Ibid*. § RF 12(3) and Tax Administration Act 1994 § 32M. See also IBFD New Zealand Country Analysis B.7.3.2.

[55] *Ibid.* § YD 2 contains the definition of a resident company.

[56] See the definition of "fixed establishment" in Income Tax Act 2007 § YA 1. See also IBFD New Zealand Country Survey A.6.2.1.

from business carried on in New Zealand, rent from land located in New Zealand, and employment income earned in New Zealand. New Zealand-source capital gains of non-residents are not subject to tax in New Zealand.[57]

New Zealand imposes a 30 percent (reduced to 15 percent or zero percent in certain cases) non-resident withholding tax on dividends paid by resident companies to non-residents.[58] Interest and royalty income arising from New Zealand sources are subject to a 15 percent non-resident withholding tax.[59] No withholding tax is payable on interest if the payer pays an approved issuer levy at the rate of two percent.[60]

New Zealand has recently enacted legislation that repealed the previous system of attributing most income from controlled foreign companies ("CFCs") to New Zealand owners as it accrued.[61] Under the new rules, only passive income is attributed, and if the passive income of a CFC is less then five percent of its total income then no income is attributed to the resident company (this is known as the "active business test").[62] There is also no attribution of income for CFCs in Australia.[63] Attributable passive income includes interest, rent, royalties and dividends.[64] The new rules will apply to all companies whose financial year begins after July 1, 2009.

Relief from double taxation

A key feature of the 2009 legislation is that most foreign dividends paid to companies resident in New Zealand are now exempt from tax.[65] Such dividends were previously subject to tax, with relief from double taxation provided in the form of tax credits. There are some exceptions to the new exemption for foreign dividends received by resident companies. In

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[57] Income Tax Act 2007 § YD 4 contains the classes of income treated as having a New Zealand source. See also IBFD New Zealand Country Survey B.6.3.1.

[58] Income Tax Act 2007 §§ RF 8 - RF 11.

[59] *Ibid*. §§ RF 2(1) and RF 7.

[60] *Ibid*. § RF 12(3), Tax Administration Act 1994 § 32M, and Stamp and Cheque Duties Act 1971 Part 6B, available at http://www.legislation.co.nz/act/public/1971/0051/latest/DLM399729.html. See also IBFD New Zealand Country Survey A.6.3.2.

[61] See Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, available at http://www.legislation.co.nz/act/public/2009/0034/latest/DLM1400107.html. Previously, exemptions were only available for CFCs based in certain "grey listed" countries.

[62] Income Tax Act 2007 § 21 B. See also Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 § 162.

[63] Income Tax Act 2007 § EX 22.

[64] *Ibid*. § 20 B.

[65] *Ibid*. § CW 9. See also Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 § 41.

particular, dividends from a less than 10 percent interest in a foreign investment fund that is comprised of shares in certain types of companies, dividends from fixed rate shares, and dividends that are deductible in a foreign jurisdiction remain subject to taxation.[66] Foreign dividends and other foreign income received by resident individuals remain subject to taxation. In the absence of a treaty, relief from double taxation of foreign source income may be provided in the form of a tax credit. The credit is subject to both country-by-country and source-by-source limitations, in that the credit for foreign tax paid on income from one class is limited to the amount of New Zealand tax that would be payable on that class of income from the same country.[67] Excess foreign tax credits cannot be carried forward or refunded.[68]

[66] Income Tax Act 2007 § CW 9(2). See also Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 § 41.

[67] Income Tax Act 2007, Subparts LF and LJ. See also § CD 19(1) (Foreign tax credits and refunds linked to dividends) and § BH 1 (Double tax agreements). Note that subparts LF and LJ were amended by the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 §§ 328 and 335-339.

[68] Income Tax Act 2007 § LA 5.

C. Other Taxes

Inheritance, gift and wealth taxes

Gift duty is imposed on the donor of gifts made within a 12-month period at a rate ranging from fivr percent to 25 percent, depending on the value of the gifts. Gifts below NZD $27,000 (USD $15,644) are not subject to the duty.[69] Estate duty was abolished effective 1993.[70] New Zealand does not levy a wealth tax.[71]

Social security

New Zealand does not levy social security contributions.[72] However, employers are required to pay an accident compensation levy.[73] The levy is based on the earnings of employees, the type of business conducted and the risk of injury in that activity. The maximum earnings of an employee to be used in calculating the levy are NZD $106,473 (USD $61,690).[74] A health and safety levy of 0.05 percent is also imposed.[75]

Other indirect taxes

New Zealand imposes a goods and services tax ("GST") which is a value-added tax on the consumption of goods and services. Although the GST is levied at each stage of the economic chain, it is ultimately borne by the final customer. The GST due on any sale is a percentage of the sale price less all the tax paid at the preceding stages. The standard VAT rate is 12.5 percent. The rate is reduced to zero for certain products and services.[76]

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[69] Estate and Gift Duties Act 1968, Schedule 3.

[70] Estate Duty Abolition Act 1993 § 5. See also IBFD New Zealand Country Analysis B.6.

[71] IBFD New Zealand Country Analysis B.5.1.

[72] IBFD New Zealand Country Analysis B.3.

[73] Injury Prevention, Rehabilitation and Compensation Act 2001 § 168, available at http://www.legislation.govt.nz/act/public/2001/0049/latest/DLM99494.html.

[74] Injury Prevention, Rehabilitation, and Compensation (Earners' Levy and Earners' Account Residual Levy) Regulations 2009 (SR 2009/19), cl. 5(2), available at http://www.legislation.govt.nz/regulation/public/2009/0019/latest/DLM1837601.html?search=ts_regulation_injury+prevention%2c+rehabilitation%2c+and+compensation_resel&sr=1.

[75] Health and Safety in Employment (Rates of Funding Levy) Regulations 1994 (SR 1994/49), cl. 2, available at http://www.legislation.co.nz/regulation/public/1994/0049/latest/DLM188252.html. See also IBFD New Zealand Country Survey A.4.4.

[76] Goods and Services Act 1985 § 8, available at http://www.legislation.co.nz/act/public/1985/0141/latest/DLM81035.html. See also IBFD New Zealand Country Survey A.8.

New Zealand imposes also excise duty on alcohol, tobacco and petroleum products.[77] Cheque duty is imposed on bills of exchange at NZ $0.05 (US $0.03) per bill of exchange. There are a number of exemptions from the duty.[78]

[77] Customs and Excise Act 1996, Schedule 3., available at http://www.legislation.co.nz/act/public/1996/0027/latest/DLM377337.html.

[78] Stamp and Cheque Duties Act 1971, Part 6, available at http://www.legislation.co.nz/act/public/1971/0051/latest/DLM399729.html. See also IBFD New Zealand Country Survey A.9.

IV. THE UNITED STATES AND NEW ZEALAND: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for businesses in one country that aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that arises from different transactions, but may also increase or decrease that burden. If there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment have the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed protocol, it may be beneficial to examine the cross-border trade and investment between the United States and New Zealand. Whether measured by trade in goods or services or by direct and non-direct cross-border investment, the United States and New Zealand engage in significant cross-border activity. The income from cross-border trade and investment generally is subject to income tax in either the United States or New Zealand and in many cases the income is subject both to gross basis withholding taxes in the source country and net basis income tax in the residence country (before possible elimination of one country's tax under the proposed treaty).

B. Overview of International Transactions Between the United States and New Zealand

Cross-border trade

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and New Zealand is not publicly available, one can document the value of trade between the United States and New Zealand. In 2008, the United States exported $2.5 billion of merchandise to New Zealand and imported $3.2 billion in merchandise from New Zealand. This made New Zealand the United States' 58th largest merchandise export destination and the 60th largest source of imported merchandise.[79]

Trade in services includes: transportation of goods; travel by persons and passenger fares; professional services such as management consulting, architecture, engineering, and legal services; financial services; insurance services; computer and information services; and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2005, U.S. parent businesses received approximately $75 million in royalty and license fees from their affiliates in New Zealand. In 2005, U.S. affiliates paid a negligible amount in royalties and license fees to their parents in New Zealand.[80]

Cross-border investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

In 2008, U.S. persons held direct investments in New Zealand valued at $5.3 billion on a historic cost basis[81] and persons from New Zealand held direct investments in the United States

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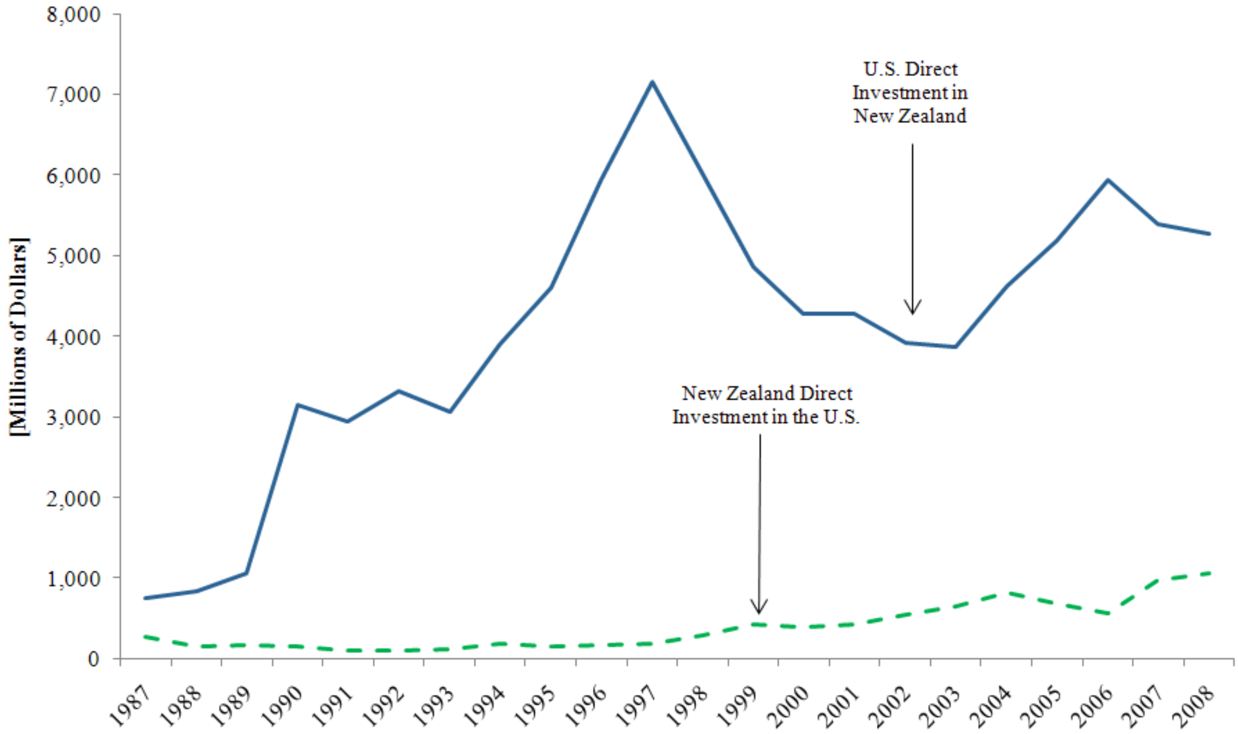
[79] Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2008," June 10, 2009.

[80] Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," www.bea.gov/international, May 2007.

[81] The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For

valued at $1.1 billion. Figure 1, below, documents the value in U.S. direct investment in New Zealand and direct investment by New Zealanders in the United States on a historical cost basis at year-end for 1987 through 2008.

Figure 1. Value of U.S. Direct Investment in New Zealand and New Zealand Direct Investment in the U.S. on an Historical Cost Basis, 1987-2008
[Millions of Dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, October 2009.

U.S. direct investments in New Zealand produced approximately $445 million in income to U.S. persons in 2008. New Zealander direct investments in the United States produced approximately $32 million in income to New Zealander persons in 2008. Figure 2, below, details income from U.S. direct investments in New Zealand and direct investments by New Zealanders in the United States for the period 1982-2008. Measured in real dollars, income earned by U.S. persons from direct investments in New Zealand has fluctuated since 1987. Over the same period, direct investments in the U.S. have generally produced either small or negligible amounts of income for persons from New Zealand.

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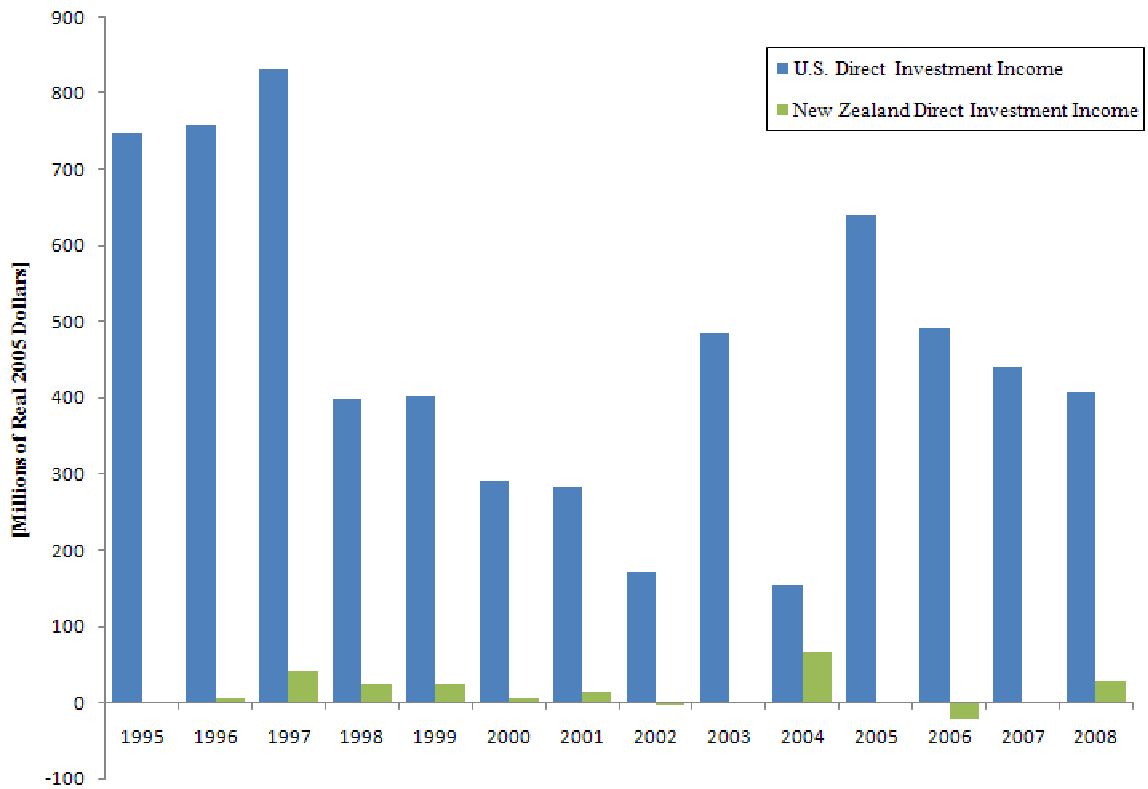
estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

Figure 2.-Income From U.S. Direct Investments in New Zealand and New Zealand Direct Investments in the U.S.
[millions of real 2005 dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, October 2009.

The data presented above do not report the amount of U.S. or New Zealand portfolio investments or holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally reports portfolio holdings by country only for the several largest portfolio investment countries.

C. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above report the amount of direct investment in New Zealand by U.S. persons and the amount of direct investment in the United States by persons from New Zealand. Data from tax returns reflect the magnitudes of cross-border investment and trade and income flows reported above.[82] U.S. corporations, including U.S. parent companies of New Zealander controlled foreign corporations, reported the receipt of $766 million of dividends from New Zealand corporations in 2005.[83] Of the $766 million in dividends reported, approximately $159 million reflected the grossed up value of net dividends to account for deemed taxes paid to New Zealand. U.S. corporations recognized about $912.9 million in taxable income originating in New Zealand, including the dividend amounts just cited. This income was subject to an average New Zealand corporate income tax rate of approximately 30.6 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2005 show that the United States collected approximately $21.3 million through withholding of taxes on payments to New Zealand.[84] Data on withholding taxes may not be an accurate indicator of cross-border investment and income flows, however, because a taxpayer can often control the amount and timing of tax paid. However, withholding tax is only paid when dividends are repatriated to the home country.

[82] The data reported below are classified according to the geographical location of the direct payor and may not capture the full extent of tiered activity.

[83] Melissa Costa, "Corporate Foreign Tax Credit, 2005," *Statistics of Income Bulletin*, Summer 2009, pp. 146-196.

[84] Scott Lutrell, "Foreign Recipients of U.S. Income, 2005," *Statistics of Income Bulletin*, Winter 2009, pp. 99-109.

D. Analyzing the Economic Effects of Income Tax Treaties

Tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources results and economic growth in both countries is enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and New Zealand income tax liabilities.

Generally, a treaty-based reduction in withholding rates directly reduces U.S. tax collections in the near term on payments from the United States to foreign persons, but increases U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to foreign persons and related decrease in foreign tax credits begins to reverse. The proposed protocol's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to New Zealand. Over the longer term, the withholding tax rate changes coupled with other changes in the proposed protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and nontax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is also an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED PROTOCOL

Article I. General Scope

In general

Article I of the proposed protocol makes three material changes to Article 1 (General Scope) of the present treaty generally to conform to the U.S. Model treaty. Paragraph 1 of Article 1 replaces the "saving clause" provision of the present treaty to reflect changes in U.S. law regarding taxation of former citizens or long-term residents. Paragraph 2 of Article 1 adds new paragraphs 5 and 6 to Article 1. New paragraph 5 specifically relates to non-discrimination obligations of the treaty countries under the General Agreement on Trade in Services (the "GATS"). New paragraph 6 addresses whether income is considered to be derived by a resident of a treaty country in cases in which such income is derived through, or received from, a fiscally transparent entity.

Saving clause

The present treaty includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties. By reason of the saving clause, unless otherwise specifically provided in the treaty, either treaty country may continue to tax its residents and citizens who are residents of the other treaty country as if the treaty were not in force. For purposes of the proposed protocol (and, thus, for purposes of the saving clause), the term "residents," which is defined in Article 4 (Residence), includes corporations and other entities as well as individuals. According to the Technical Explanation,[85] if (1) a resident of New Zealand performs professional services in the United States, and (2) the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. However, if the resident of New Zealand is also a citizen of the United States, the saving clause permits the United States to include such remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)).

The proposed protocol modifies the saving clause to reflect changes in U.S. tax law relating to the present treaty provision under which a former U.S. citizen may be taxed under U.S. law for the period of ten years following the loss of citizenship provided that the loss of citizenship had as one of its principal purposes the avoidance of tax. Under the proposed protocol, a former citizen or former long-term resident of either treaty country may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that treaty country. Also, under the proposed protocol, the provision no longer includes the requirement of a purpose to avoid tax.

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[85] Department of the Treasury Technical Explanation of the Protocol Signed at Paris on January 13, 2009 Amending the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Paris on August 31, 1994, as Amended by the Protocol Signed on December 8, 2004 (hereinafter referred to as the "Technical Explanation").

Under U.S. domestic law, an individual is considered a "long-term resident" of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Section 877 of the Code provides special rules for the imposition of tax on certain individuals who expatriate (that is, U.S. citizens and long-term residents who relinquish their citizenship or cease to be long-term residents) before June 17, 2008. Under Code section 877, those taxpayers are subject to U.S. tax for a period of ten years on both their U.S.-source income (including deemed U.S.-source income), and their foreign-source income that is effectively connected with the conduct of a trade or business within the United States.

For any individual who expatriates on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,[86] replaces Code section 877 with the mark-to-market regime provided in Code section 877A. In general, taxpayers who expatriate are treated as having sold all of their property on the day before the expatriation date for its fair market value.[87] However, at a taxpayer's election, the time for payment of additional tax attributable to any gain so recognized (but not realized) may be deferred until the taxpayer actually disposes of property deemed sold.[88] This election may be made only if the taxpayer irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.[89]

The proposed protocol's ten-year grant of taxing jurisdiction to the treaty country from which an individual has expatriated corresponds with the ten-year rule in Code section 877. However, for any individual who expatriates on or after June 17, 2008, Code section 877A requires the payment of tax after the ten-year period if that individual elects to defer payment of the Code section 877A tax and sells property after the ten-year period. In this circumstance, the individual will have been required, as a condition of making the election under Code section 877A, to waive the benefits of the proposed protocol's ten-year rule.

Non-discrimination under the GATS

The proposed protocol also relates to the non-discrimination obligations of the treaty countries under the GATS. Like the U.S. Model treaty, the proposed protocol includes an exception in the case of two provisions of the GATS to the rule that the treaty does not restrict

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[86] Pub. L. No. 110-245, sec. 301 (June 17, 2008).

[87] Code sec. 877A(a)(1).

[88] Code sec. 877A(b)(1).

[89] Code sec. 877A(b)(5).

benefits under other agreements. This exception may not be strictly necessary, if the proposed protocol could be interpreted to apply by its terms only to agreements between the United States and New Zealand and not to multilateral agreements to which the United States and New Zealand are parties, such as GATS.

The proposed protocol provides that the dispute resolution procedures under the mutual agreement article of the treaty (Article 24) take precedence over the corresponding provisions of paragraph 3 of Article XXII (Consultation) of GATS in interpreting or applying the treaty and in determining whether a taxation measure is within the scope of the treaty.

The proposed protocol also provides that the provisions of Article XVII (National Treatment) of GATS do not apply to any taxation measure, unless the competent authorities agree that the measure is not within the scope of the non-discrimination provisions (Article 24) of the treaty. The Technical Explanation points out that consequently, the consultation provision of GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of the United States and New Zealand have determined that the relevant taxation measure is not within the non-discrimination provision (Article 23) of the treaty. For purposes of this provision, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

Fiscally transparent entities

The proposed protocol contains special rules for fiscally transparent entities that are identical to those in the U.S. Model treaty. Under these rules, as explained in the Technical Explanation, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, as explained in the Technical Explanation, if a New Zealand company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (i.e., in the United States, New Zealand, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is (1) treated for New Zealand tax purposes as a corporation and (2) owned by a shareholder who is a New Zealand resident for New Zealand tax purposes, is not considered derived by its shareholder. This is true even if the entity is treated as fiscally transparent under the tax laws of the United States. Rather, for purposes of the proposed protocol, the income is treated as derived by the U.S. entity.

The Technical Explanation generally defines fiscally transparent entities as entities in which income derived by such entities is taxed at the beneficiary, member, or participant level, under the law of either the United States or New Zealand. Entities are not considered fiscally transparent if the entity tax may be relieved under an integrated system. For example, in the United States, a partnership, common investment trust under Code section 584, or grantor trust, or a limited liability company ("LLC") that is treated for tax purposes as a partnership or disregarded entity, is considered a fiscally transparent entity.

The Technical Explanation also states that the treatment of fiscally transparent entities is not an exception to the saving clause. Therefore, such treatment does not preclude a treaty country from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with New Zealand members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether New Zealand views the LLC as fiscally transparent.

Article II. Taxes Covered

Article II of the proposed protocol replaces Article 2 (Taxes Covered) of the present treaty and specifies the U.S. taxes and the taxes of New Zealand to which the treaty applies. This article follows the U.S. Model treaty and the OECD Model treaty.

The proposed protocol applies to all taxes on income irrespective of the manner in which they are levied, including taxes on gains from the alienation of property. In the case of New Zealand, the proposed protocol applies to the income tax. In the case of the United States, the proposed protocol applies to the Federal income taxes imposed by the Code, excluding social security and unemployment taxes, and to excise taxes imposed on the investment income of foreign private foundations.

The proposed protocol will also apply to any taxes that are identical or substantially similar to the taxes described in the preceding paragraph and that are imposed after the signing of the proposed protocol in addition to or in place of existing taxes. The proposed protocol obligates the competent authority of each country to notify the competent authority of the other country of any changes in its internal taxation or other laws that significantly affect a country's obligation under the proposed treaty. This provision is, in all material respects, the same as paragraph 2 of Article 2 of the present treaty and follows the U.S. Model treaty.

Article III. General Definitions

Article 3 (General Definitions) of the treaty provides definitions of a number of terms for purposes of the treaty. Paragraph 1 of Article III of the proposed protocol replaces the definition for the term "company." Under the proposed protocol, it is defined as a body corporate or an entity treated as a body corporate for tax purposes in the state where it is organized. According to the Technical Explanation, the definition refers to the law of the country in which an entity is organized. This is intended to ensure that an entity that is treated as fiscally transparent in its country of residence does not obtain inappropriate benefits, such as the reduced withholding rate provided by Article 10 (Dividends).

Paragraph 2 of Article III of the proposed protocol replaces the definition of the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" to also include an enterprise carried on by a resident of a treaty country through an entity (such as a partnership) that is treated as fiscally transparent in that treaty country. The Technical Explanation states that an enterprise conducted by such an entity is be treated as carried on by a resident of a treaty country to the extent its partners or other owners are residents.

Paragraph 3 of Article III of the proposed protocol amends the geographical scope of the treaty with respect to the United States. Similar to the U.S. Model treaty, it encompasses the United States, including the states, the District of Columbia and the territorial sea of the United States and excludes Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. The term departs from the U.S. Model treaty by (1) including any area beyond the territorial sea over which the United States exercises sovereign rights in accordance with international law, and (2) excluding the Commonwealth of the Northern Mariana Islands.

Paragraph 4 of Article III of the proposed protocol amends the geographical scope of the treaty with respect to New Zealand. The term "New Zealand" encompasses the territory of New Zealand but does not include Tokelau; it also includes any area beyond the territorial sea designated under New Zealand legislation and in accordance with international law as an area in which New Zealand may exercise sovereign rights with respect to natural resources.

Paragraph 6 of Article III of the proposed protocol amends paragraph 1 of Article 3 of the present treaty by adding a definition for the terms "national", "pension fund", and references for the terms "enterprise" and "business." The proposed protocol defines "national" as (1) any individual possessing the nationality or citizenship of the treaty country, and (2) any legal person, partnership, or association deriving its status as such from the laws in force in that treaty country. The definition is the same as that in the U.S. Model treaty. The term national is relevant for Articles 19 (Government Services) and 23 (Non-Discrimination) of the treaty. The term "pension fund" is defined similarly to the U.S. Model treaty. It includes any person established in a treaty country that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements, and in the case of the United States, is generally exempt from income taxation. In the case of New Zealand, the term "pension fund" slightly deviates from the U.S. Model treaty and does not include persons established in New Zealand that are generally exempt from income taxation in New Zealand. The term "pension fund" is relevant for Articles 4 (Residence) and 10 (Dividends) as amended by the protocol

In the case of New Zealand, the term "pension fund" refers to a superannuation scheme registered under the Superannuation Schemes Act 1989, a KiwiSaver Scheme registered under the KiwiSaver Act 2006, the New Zealand Superannuation Fund, or the Government Superannuation Fund.

The Technical Explanation provides that, in the case of the United States, the term "pension fund" includes the following: a trust providing pension or retirement benefits under a Code section 401(a) qualified pension plan, profit sharing or stock bonus plan;[90] a trust providing pension or retirement benefits under a Code section 403(b) plan; a trust that is an individual

[90] The Technical Explanation further provides that Code section 401(k) plans and group trusts described in Rev. Rul. 81-100, 1981-1 C.B. 326, and meeting the conditions of Rev. Rul. 2004-67, 2004-2 C.B. 28, qualify as pension funds because they are covered by Code section 401(a).

retirement account under Code section 408, a Roth individual retirement account under Code section 408A, or a simple retirement account under Code section 408(p); a trust providing pension or retirement benefits under a simplified employee pension plan under Code section 408(k); a trust described in Code section 457(g) providing pension or retirement benefits under a Code section 457(b) plan; and the Thrift Savings Fund under Code section 7701(j).

Similarly to the OECD Model treaty, the term "enterprise" applies to the carrying on of any business. The term "business" is not defined, but the proposed protocol provides that the term includes the performance of professional services and other activities of an independent character. According to the Technical Explanation, the references to the these terms are intended to clarify that income from the performance of professional services or other activities of an independent character is addressed under Article 7 (Business Profits), and not Article 21 (Other Income).

Paragraph 7 of Article III of the proposed protocol replaces paragraph 3 of Article 3 of the treaty and addresses those terms that are not defined in the treaty. Paragraph 7 provides that in the application of the treaty (as modified), any term not defined in the treaty (as modified) has the meaning that it has under the law of the country whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning pursuant to Article 25 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a treaty country, the definition in the tax law prevails.

Article IV. Residence

The proposed protocol makes certain changes to Article 4 (Residence) of the present treaty. Those changes generally are in accord with the residence rules of the U.S. Model treaty.

The proposed protocol replaces the definition of "resident of a Contracting State" in paragraph 1 with a revised definition that is identical to the definition in the U.S. Model treaty. Under the revised definition, a "resident of a Contracting State" is any person, who under the laws of that treaty country, is liable to tax there by reason of domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, and also includes that government of that treaty country and any political subdivision or local authority of that government. The Technical Explanation notes that this definition incorporates the definitions of residence in the tax laws of the United States and New Zealand. The Technical Explanation also notes that residents of the United States under this definition include aliens who are considered U.S. residents under the substantial presence and green card tests of the Code.

The proposed protocol's definition of a resident of a Contracting State reverses an exclusion from the definition in the present treaty for a person who is subject to tax in a treaty country by reason of that person's citizenship but who is not a resident of that country. Consequently, under the proposed protocol, a nonresident citizen of the United States may (subject to the article's other rules) be treated as a resident of the United States.

According to the Technical Explanation, entities such as U.S. regulated investment companies and real estate investment trusts are residents of the United States for purposes of the treaty even though those entities are rarely required to pay tax. The Technical Explanation notes that these entities are taxable to the extent they do not satisfy certain requirements for distributing their profits currently and, consequently, that they may be considered "liable to tax" in the United States.

Under revised paragraph 1, the term "resident of a Contracting State" does not include any person who is liable to tax in that treaty country only in respect of income from sources in that country or in respect of profits attributable to a permanent establishment in that country. Consequently, according to the Technical Explanation, a New Zealand consular official posted in the United States is not a resident of the United States because, under the Code, he may be taxed by the United States on his U.S.-source investment income but not on his non-U.S. source income.

A "resident of a Contracting State" under revised paragraph 1 also includes a pension fund established in that treaty country and an organization that is established and maintained in that country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes even though all or part of the income or gains of the pension fund or the latter organization may be exempt from tax under the internal law of that country.

The present treaty includes certain tie-breaker rules for determining the residence of an individual who otherwise would be considered a resident of both treaty countries. Those rules provide that, if neither of two other tie-breaker rules applies, then (1) if an individual has a habitual abode in both treaty countries or in neither treaty country, the individual is deemed to be a resident of the country of which he is a citizen, and (2) if he is a citizen of both treaty countries or of neither treaty country, the competent authorities of the treaty countries must endeavor to settle the individual's residence by mutual agreement.

The present treaty provides that if, under the definition of a resident of a Contracting State a company is a resident of both treaty countries, the competent authorities of the United States and New Zealand must endeavor to settle the company's residence by mutual agreement. If the competent authorities are unable to agree, the company "shall be treated as a resident of neither Contracting State for purposes of the Convention." The proposed protocol replaces the quoted phrase with the phrase "will not be treated as a resident of either Contracting State for purposes of its claiming any benefits provided by the Convention."

According to the Technical Explanation, this revised wording has two implications for a dual resident company, the residence of which is not agreed upon by the competent authorities. First, the dual resident company may claim treaty benefits that are not limited to residents, such as those provided by the nondiscrimination rules of Article 23. Second, under the revised wording, the dual resident company may be treated as a resident of a treaty country for purposes other than obtaining benefits under the treaty. For example, according to the Technical Explanation, if a dual resident company pays a U.S.-source dividend to a resident of New Zealand, the tax on the dividend is limited to the treaty rate, because the treaty reduction is a benefit of the resident of New Zealand, not a benefit of the dual resident company. Moreover, information related to the dual resident company may be exchanged because Article 25 (Exchange of Information and Administrative Assistance) is not limited to residents of the treaty countries.

Article V. Business Profits

The proposed protocol adds new paragraphs 8 and 9 to Article 7 (Business Profits) of the present treaty.

New paragraph 8, like the U.S. Model treaty but unlike the OECD Model treaty, provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed protocol the rule of section 864(c)(6) of the Code (which provides that any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year). This rule applies for purposes of the rules for business profits under this article, dividends (Article 10, paragraph 6), interest (Article 11, paragraph 4), royalties (Article 12, paragraph 4), gains (Article 13, paragraph 6).

New paragraph 9 provides a clarification of the treatment of fiscally transparent entities, including trusts. New paragraph 9 differs from the U.S. Model treaty and the OECD Model treaty, and the Technical Explanation states that New Zealand requested this clarification because under New Zealand law, the trustee of a trust (but not necessarily the beneficiaries of the trust who have a beneficial entitlement to trust income but no legal ownership) might be regarded as the only person connected to the trust with a permanent establishment. Without clarification, any permanent establishment resulting from a trade or business in which the trust has an interest might be considered the permanent establishment of the trustee rather of than the beneficiaries.

Thus, new paragraph 9 provides that if a fiscally transparent entity, or trustee, has a permanent establishment in one treaty country, and a resident of the other treaty country is beneficially entitled to a share of profits from a business carried on by the entity or trustee through a permanent establishment in the first country, then the beneficial owner is treated as carrying on the business through the permanent establishment. Profits attributable to the business are treated as attributable to the permanent establishment and may be taxed in the State of the permanent establishment, but only those profits attributable to the permanent establishment. The Technical Explanation points out that new paragraph 9 is added solely to address New Zealand law relating to trusts, so the absence of similar language in other U.S. treaties does not give rise to the negative inference that a resident may avoid permanent establishment treatment with respect to business profits by investing through a fiscally transparent entity.

Article VI. Dividends

Overview

Article VI of the proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains the generally applicable maximum rate of withholding at source of 15 percent, but also adds a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the voting power of dividend-paying company. Like several other recent treaties and protocols, the proposed protocol also provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. The proposed protocol adds special rules that apply to dividends received from RICs and REITs which are similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States.–The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate foreign direct investment.

A REIT is a corporation, trust, or association that is subject to the corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is generally treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, a distribution from a REIT is generally treated as gain from the disposition of a U.S. real property interest that must be recognized by a nonresident alien or a foreign corporation to the extent that the distribution is attributable to gain from the sale or exchange of a U.S. real property interest by the REIT.[91]

[91] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Code sec. 897(h)(1). Such distributions are treated as dividends under U.S. internal law.

A REIT is generally organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law.

U.S. internal law also generally treats a regulated investment company ("RIC") as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Dividends paid by a RIC are generally treated as dividends received by the payee, and if the RIC distributes substantially all of its income, it generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2010, net short-term, capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has such net capital gains.[92] Nonresident aliens and foreign corporations are generally not subject to tax on capital gains. However, a distribution by a RIC to a nonresident alien or a foreign corporation before January 1, 2010 is treated as gain recognized by such person from the sale or exchange of a U.S. real property interest to the extent such gain is attributable to gain from sales or exchanges of U.S. real property interests.[93]

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[94] may generally designate a dividend it pays prior to January 1, 2010 as derived from such interest income, to the extent of such income.[95] Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to such interest income.

[92] Code sec. 871(k)(2)(C).

[93] Code sec. 897(h)(1), (4)(A)(i)(II), (4)(A)(ii).

[94] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under Code section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under Code section 871(h)(4); and (4) any interest-related dividend from another RIC.

[95] Code sec. 871(k)(1)(C).

New Zealand.–New Zealand generally imposes withholding tax at a rate of 30 percent on the gross amount of dividends paid by resident companies to nonresident individuals and companies. However, this tax is reduced to 15 percent for certain other dividends, including fully imputed dividends, and it is reduced to zero in the case of noncash dividends that are fully imputed.[96]

Proposed protocol limitations on internal law

In general.–Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in the other country. Such dividends also may be taxed by the country in which the payor company is resident, but the rate of such tax is limited. Under the proposed protocol, source-country taxation of dividends (i.e., taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. In addition, the proposed protocol lowers the rate to five percent if the beneficial owner of the dividend is a company that owns shares representing at least 10 percent of the voting power in the dividend-paying company. This reduction is consistent with both the U.S and OECD Model treaties. The proposed protocol also provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends").

The term "beneficial owner" is not defined in the present treaty or proposed protocol, and thus is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, the Technical Explanation states that paragraph 6 of Article 1 (General Scope) applies to determine whether dividends received by a company holding shares through a fiscally transparent entity should be treated as having been received by a resident of the other treaty country.

Zero rate for direct dividends.–Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the present treaty, a withholding tax of up to 15-percent may be imposed on such dividends. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either contracting state).

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[96] Payments of tax by a resident company give rise to "imputation credits," which the company can attach to its dividends when paid out to its shareholders. Dividends are grossed up to shareholders by the value of the attached imputation credit. A dividend is fully imputed when the amount of credits attached to the dividend equal the corporate tax imposed on the underlying earnings that are being distributed as a dividend. Thus, based on New Zealand's 33% corporate tax rate, a $100 dividend is fully imputed if the company attaches imputation credits equal to $49.25 [($100 multiplied by the tax rate, 33%) / (1 minus the tax rate, 33%)] to the dividend because $49.25 reflects a 33% tax on an underlying distribution of earnings in the amount of $149.25 [the $100 dividend equals $149.25 in earnings less the 33% tax on such earnings, $49.25].

Eligibility for the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than those that otherwise apply under the present treaty, as modified by the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must either: (1) meet the "publicly traded" test of the limitation-on-benefits article; (2) meet the "ownership-base erosion" test *and* satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend; or (3) receive a favorable determination from the competent authority of the source country with respect to the benefits of the zero-rate provision for such dividends.

The Technical Explanation states that these additional restrictions are intended to prevent companies from reorganizing in order to become eligible for the zero rate. As an example, the Technical Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned New Zealand subsidiary in order to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. The Technical Explanation expresses concern that treaty shopping would be encouraged in such a case because the New Zealand company satisfies the active trade or business test with respect to the dividend. For this reason, the proposed protocol does not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

<u>Dividends paid by U.S. RICs and REITs</u>.–The proposed protocol generally denies the five percent and zero rates of withholding tax to dividends paid by RICs and REITs organized in the United States.

The 15-percent rate of withholding generally applies to dividends paid by a RIC. The 15-percent rate of withholding applies to dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or pension fund holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of shares that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's shares; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is "diversified." A REIT is diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property. For purposes of determining if a REIT is diversified, (1) foreclosure property is not considered an interest in real property and (2) a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The Technical Explanation states that the restrictions on the availability of the lower rates are intended to prevent the use of RICs and REITs to gain unjustifiable U.S. tax benefits. For example, a company resident in New Zealand could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends distributed with respect to those shares. Absent these restrictions, such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally subject to a 15 percent withholding tax into direct investment dividends subject to a five percent withholding tax or eligible for elimination of withholding tax).

Similarly, the Technical Explanation provides an example of a resident of New Zealand directly holding real property and required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Definitions, special rules and limitations.–The proposed protocol generally defines "dividends" as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (for example, constructive dividends). With respect to New Zealand, the Technical Explanation states that returns from statutory instruments referred to as "FC1" and "FC2" debentures are treated as dividends for purposes of Article 10 (Dividends). In addition, the Technical Explanation states that a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity by the source country.

As with the present treaty, the proposed protocol's reduced rates of tax on dividends do not apply if (1) the dividend recipient carries on business through a permanent establishment in the source country, and (2) the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such cases, the dividends effectively connected to the permanent establishment are taxed as business profits under Article 7. The only changes to this provision are those which conform the article to the deletion of Article 14 (Independent Personal Services), as provided for in Article X of the proposed protocol.

The proposed protocol prevents each treaty country from imposing tax on dividends paid by a resident of the other treaty country, unless such dividends are paid to a resident of the first country or are attributable to a permanent establishment or fixed base in such country. For example, the United States may not impose a secondary withholding tax on dividends paid by a New Zealand resident company unless such dividends (1) are paid to a U.S. resident or (2) are attributable to profits the New Zealand company derives from a U.S. permanent establishment.

The proposed protocol also allows the United States to impose a branch profits tax on a New Zealand resident company that (1) has business profits attributable to a permanent establishment in the United States, (2) derives income from real property in the United States that is taxed on a net basis under Article 6 (Income from Real Property), or (3) realizes gains taxable in the United States under Article 13 (Alienation of Property). Consistent with the branch profits tax rules under U.S. internal law (specifically, Code section 884), the tax may only be imposed on the portion of such business profits or income that represents the "dividend equivalent amount." The rate of branch profits tax is generally limited to five percent, but a zero rate applies where limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied.

Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 3 of Article 1 (General Scope) permits the United States to tax dividends received by its residents and citizens (subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation)) as if the treaty had not come into effect.

The benefits of Article 10 (Dividends) are also subject to the provisions of Article 16 (Limitation on Benefits) set forth in the proposed protocol.

Article VII. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain "excess interest" of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC's income (generally, interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor – referred to as the investor's "excess inclusion" – may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

New Zealand

New Zealand-source interest payments made to nonresident individuals and foreign corporations generally are subject to a withholding tax of 15 percent of the gross amount of the interest. However, no tax is withheld if an approved issuer levy is paid by the payer at the rate of two percent.

Proposed protocol limitations on internal law

The proposed protocol replaces the Article 11 (Interest) of the present treaty with new rules. Under the proposed new rules, interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty country generally may be taxed by both countries. However, the proposed treaty generally limits the rate of source-country tax that may be imposed so that it may not exceed 10 percent of the gross amount of the interest. These provisions are similar to those in the present treaty, but differ from the U.S. Model treaty, which provides an exemption from source-country tax for interest earned by a resident of the other country.

The proposed protocol exempts interest from taxation in the source country in certain cases. No source-country tax may be imposed on interest beneficially owned by the other treaty country or an instrumentality of that other treaty country that is not subject to tax on its income by that other country. Similarly, no source-country tax may be imposed on interest beneficially owned by a resident of the other treaty country with respect to debt obligations guaranteed or insured by that other country or an instrumentality of that other treaty country that is not subject to tax on its income by that other country. Finally, no source-country tax may be imposed on interest beneficially owned by a resident of the other treaty country that is either (1) a bank unrelated to the payer of the interest or (2) an enterprise substantially deriving its gross income from the active and regular conduct of a lending or finance business involving transactions with unrelated parties that is unrelated to the payer (the "unrelated bank or lending or finance business exemption").

For purposes of applying the rule described in (2) above, the term "lending or finance business" includes: (1) the business of making loans; (2) purchasing or discounting accounts receivable, notes, or installment obligations; (3) engaging in finance leasing (including entering into finance leases and purchasing, servicing, and disposing of finance leases and related lease assets); (4) issuing letters of credit or providing guarantees; or (5) providing charge and credit card services.

Two exceptions to the unrelated bank or lending or finance business exemption permit certain interest that would otherwise qualify for the exemption to be taxed at a rate not exceeding 10 percent of the gross amount of the interest. The first exception provides that the exemption is unavailable in the case of interest arising in New Zealand if the interest is paid by a person that has not paid approved issuer levy in respect of the interest. This exception does not apply if New Zealand does not have an approved issuer levy, the payer is not eligible to elect to pay the approved issuer levy, or the rate of the approved issuer levy payable in respect of such interest exceeds two percent of the gross amount of the interest. For this purpose, "approved issuer levy" includes any identical or substantially similar charge payable by the payer of interest arising in New Zealand enacted after the date of the proposed protocol in place of the approved issuer levy. The second exception provides that the exemption is unavailable if interest is paid as part of an arrangement involving back-to-back loans or another arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.

The limitations in the proposed protocol on a source-country's taxation of interest income do not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the debt claim in respect of which the interest is paid is effectively connected with that permanent establishment.[97] In that circumstance, the interest is taxed as business profits (Article 7). According to the Technical Explanation, interest attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country in which the permanent establishment existed.

The proposed protocol includes a rule for determining the source of interest. Interest generally is deemed to arise in a treaty country when the payer of the interest is the treaty country, a political subdivision or a local authority of that country, or a resident of that country. If, however, the person paying the interest has a permanent establishment in a treaty country, the indebtedness on which the interest is paid was incurred in connection with that permanent establishment, and the interest is borne (that is, is deductible) by that permanent establishment, the interest is deemed to arise in the treaty country in which the permanent establishment is situated. This source rule is not in the U.S. Model treaty, but is equivalent to the rule in the OECD Model treaty and is similar to the rule in the present treaty.

The proposed protocol addresses non-arm's-length interest charges between a payer and a beneficial owner that have a special relationship. In such cases, the provisions of Article 11 (Interest) apply only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under a country's internal laws and, accordingly, is entitled to the benefits of Article 10 (Dividends). The Technical Explanation notes that the term "special relationship" is not defined in the present treaty or in the proposed protocol and states that the United States considers the term to include the relationships described in Article 9 (Associated Enterprises). Those relationships, according to the Technical Explanation, involve control as defined under the transfer pricing rules of Code section 482.

Interest is defined in the proposed protocol as income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term "interest" also includes all other income that is subjected to the same tax treatment as income from money lent under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The term "beneficial owner" is not defined in the present treaty or in the proposed protocol and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of the interest for purposes of this article is the person to which the interest income is attributable for tax purposes under the laws of the source country.

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[97] The Technical Explanation describes interest as being "attributable to" the permanent establishment, a common usage in U.S. income tax treaties, rather than adopting the U.S. Model treaty's phrase that a debt claim is "effectively connected with" a permanent establishment.

The proposed protocol provides two anti-abuse exceptions to the general interest provisions. The first exception relates to contingent interest payments arising in the United States. If the contingent interest is of a type that does not qualify as portfolio interest under U.S. law, it may be taxed by the United States. If the beneficial owner is a resident of New Zealand, however, the interest may not be taxed at a rate exceeding 15 percent. According to the Technical Explanation, the reference to the U.S. definition of contingent interest (found in Code section 871(h)(4)) is intended to ensure that the exceptions of Code section 871(h)(4)(C) apply.

The second anti-abuse exception provides that the general interest provisions do not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. That interest may be taxed by the United States in accordance with its domestic law. The Technical Explanation states that this exception is consistent with the policy of Code sections 860E(e) and 860G(b) that excess inclusions with respect to a REMIC should bear full U.S. tax in all cases.

The proposed protocol includes a rule that permits the United States to impose its branch-level interest tax on excess interest payments deemed to be received by a corporation resident in New Zealand. Under this rule, the United States may tax an amount that is deemed to be interest equal to the excess of (1) the amount of interest allocable to the profits of a company resident in New Zealand that are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income from Real Property) or Article 13 (Alienation of Property) over (2) the interest actually paid by the permanent establishment or trade or business in the United States. The United States may tax that excess amount as if the deemed interest arose in the United States and were beneficially owned by a resident of New Zealand. Thus, the deemed interest may generally be taxed at a rate not exceeding the 10-percent rate generally permitted to a source country. However, if the recipient is a corporation described above as one of the persons exempt from taxation of interest in the source country, then no tax may be imposed by the source country.

The proposed protocol provides that nothing in Article 11 is intended to limit or restrict, in any manner, the right and ability of a treaty country to apply and enforce any anti-avoidance provisions of its taxation law.

The Technical Explanation notes that the benefits of Article 11, like benefits provided by other articles, are subject to the saving clause of paragraph 3 of Article 1 (General Scope) and are available only if a resident satisfies the limitation-on-benefits requirements of Article 16.

Article VIII. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on the gross amount of U.S.-source royalties paid to nonresident alien individuals and foreign corporations. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

New Zealand

Royalties paid to nonresidents are generally subject to a withholding tax at a rate of 15 percent on the gross amount of royalties paid by resident companies to nonresident individuals and companies.

Proposed protocol limitations on internal law

Article VIII of the proposed protocol revises Article 12 (Royalties) of the present treaty. It provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to five percent. This is a reduction from the 10-percent rate provided in the present treaty. However, this continued application of source taxation is inconsistent with both the U.S. and OECD Model treaties, both of which exempt royalties from source taxation.

As with the present treaty, the term "royalties" means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematographic films, films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. The proposed protocol amends the definition of "royalty" by omitting consideration for the "use of, or the right to use, industrial, commercial, or scientific equipment other than payments under a hire-purchase agreement." This change is consistent with both the U.S. and OECD Model treaties, and reflects that consideration for tangible property is more in the nature of a lease payment, which should therefore be taxed as business profits, rather than as royalties.

The term "royalties" does not expressly include consideration for the use of computer software. The Technical Explanation states that consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment. The primary factor in determining whether such consideration is treated as royalties or as business profits is the nature of the rights transferred.

Consistent with the U.S. Model treaty and the present treaty, the term "royalties" includes contingent gain from the alienation of any property that gives rise to royalties. "Contingent gain" is gain contingent on the productivity, use, or disposition of the right or property. To the extent that any gain from the alienation of such property is not contingent gain, the Technical Explanation states that such gain is addressed in Article 13 (Alienation of Property).

Consistent with the U.S. and OECD Model treaties, and the present treaty, in the event that (1) the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and (2) the right or property with respect of which the royalties are paid is effectively connected with such permanent establishment, the royalties are taxed as business profits (Article 7). The only changes to this provision are those which conform this article to the deletion of Article 14 (Independent Personal Services), as provided for in Article X of the proposed protocol.

Consistent with the present treaty, royalties are generally treated as arising in the treaty country if they are paid by (1) a resident of that country, (2) that country itself, (3) a political subdivision that country, or (4) a local authority of that country. An exception applies to royalties that arise from the use of, or right to use, royalty-generating property by a permanent establishment located in a treaty country. If the expenses of such royalties are borne by the permanent establishment (i.e., they are taken into account in determining taxable income of the permanent establishment), then they are considered to have arisen in that treaty country. If the royalties are paid with respect to the use of, or right to use, property in one of the treaty countries, but (1) the payor is a resident of neither treaty country and (2) the royalties are not borne by a permanent establishment in either treaty country, then the royalty is considered as arising in the country of use. In contrast, the U.S. and OECD Model treaties (which, unlike the proposed protocol, exempt royalties from source country taxation) do not contain provisions that define the source of a royalty payment, relying instead on the application of the source country's domestic law of for purposes of determining which royalties qualify for the zero rate on royalties.

Consistent with the U.S. and OECD Model treaties, and the present treaty, the proposed protocol addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any excess amount of royalties paid is taxable according to other provisions of the proposed protocol. For example, the Technical Explanation states that if excess royalties paid by a subsidiary corporation to its parent corporation are treated as a profit distribution under the domestic laws of the source country, such excess amount is taxed as a dividend and not as a royalty. However, the tax imposed on the dividend payment is subject to the rate limitations of Article 10 (Dividends).

Article IX. Alienation of Property

The proposed protocol amends Article 13 (Alienation of Property) of the present treaty. The proposed protocol replaces paragraph 6 of Article 13 of the present treaty but makes no material modifications. Paragraph 6 permits a treaty country to tax gains from the alienation of personal property that forms a part of the business property of a permanent establishment that a resident of the other treaty country has or had in the first treaty country. This rule permits source country (i.e., the country in which the property is located) taxation of gains from the alienation of the permanent establishment. By extending taxation to property that a resident previously owned in the treaty country, this rule incorporates the rule of section 864(c)(6) of the Code, such that income attributable to a permanent establishment that is deferred and received after the permanent establishment no longer exists may nevertheless be taxed by the country in which the permanent establishment was located. Consistent with Article X of the proposed protocol, which eliminates Article XIV (Independent Personal Services) of the present treaty, new paragraph 6 does not include any reference to personal property pertaining to a "fixed base" or to the "performance of independent personal services."

In addressing what constitutes gain attributable to a permanent establishment, the Technical Explanation discusses the taxation of a resident of New Zealand that is a partner in a partnership that has activities in the United States that rise to the level of a U.S. permanent establishment. It clarifies that, as a result of its partnership interest, the partner generally has a

U.S. permanent establishment. The U.S. may, therefore, tax the partner on the partner's distributive share of income realized by a partnership on the disposition of movable property forming part of the business property of the partnership in the United States.

New paragraph 7 provides a rule to address the mark-to-market exit-tax regime for "covered expatriates" under section 877A of the Code. According to the Technical Explanation, this rule is intended to coordinate United States and New Zealand taxation of gains in the case of a timing mismatch. For example, such a mismatch may occur where a U.S. resident recognizes, for U.S. tax purposes, gain on a deemed sale of all property on the day before the individual expatriates to New Zealand.

The proposed protocol permits the avoidance of double taxation by allowing a resident to make an election to be treated for tax purposes in one treaty country as having sold and repurchased the property for its fair market value immediately before the taxable event in the other country. The effect of the election is to give the individual an adjusted basis for New Zealand tax purposes equal to the fair market value of the property as of the date of the deemed alienation in the United States, with the result that only post-emigration gain is subject to New Zealand tax when there is an actual alienation of the property in the future.

The Technical Explanation discusses additional requirements that must be met by an individual that makes the election under new paragraph 7. First, if an individual recognizes losses and gains in one treaty country from the deemed alienation of multiple properties, then the individual must apply this election consistently with respect to all properties. Such election, however, may only be made to the extent the deemed alienation of all such properties results in a net gain. Second, the deemed sale election may only be made for property that is eligible for such election under the treaty country's deemed disposition rule. Property currently ineligible for the deemed disposition rule in the United States is as follows: (1) a deferred compensation item as defined under section 877A(d)(4) of the Code; (2) a specified tax deferred account as defined under section 877A(e)(2) of the Code; and (3) an interest in a non-grantor trust as defined under section 877A(f)(3) of the Code.

Article X. Independent Personal Services

The proposed protocol deletes Article 14 (Independent Personal Services) from the present treaty, consistent with the U.S. and OECD Model treaties. The Technical Explanation notes that under Article 14 (prior to its deletion), income from independent personal services could be taxed by the treaty country in which the services were performed if the individual was present in that country for more than 183 days in any consecutive 12-month period. Under the proposed protocol, the deletion of Article 14 has the effect that income from independent personal services is governed by the provisions of Article 5 (Permanent Establishment) and Article 7 (Business Profits). Thus, an individual providing services is taxed in the source country only if the individual meets the threshold of a permanent establishment in that country.

The proposed protocol makes numerous technical conforming changes to reflect the deletion of Article 14.

Article XI. Limitation on Benefits

In general

The proposed protocol replaces the rules of Article 16 (Limitation on Benefits) of the present treaty with rules that are similar to the limitation-on-benefits provisions included in recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in New Zealand or the United States.

The present treaty, as modified by the proposed protocol, serves to limit double taxation caused by the interaction of the tax systems of the United States and New Zealand as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, under the proposed protocol, a resident of either treaty country is entitled to all the benefits accorded by the treaty if the resident is a qualified person. A "qualified person" is a resident that is: (1) an individual; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) an organization established to provide pension or retirement benefits that satisfies a beneficiaries test or an organization established to earn income for the benefit of one or more organizations established to provide pension or retirement benefits; (5) an organization that is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, even if all or part of its income or gains are exempt from tax under the residence country's domestic law; or (6) an entity that satisfies an ownership test and a base erosion test. A resident that is not a qualified person may be entitled to treaty benefits with respect to certain items of income under the active business test.

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Special anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases."

Qualified persons eligible for all treaty benefits

Individuals

Under the proposed protocol, an individual resident of the United States or New Zealand is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed protocol provides that the United States and New Zealand, and any political subdivision or local authority of either of the two countries, are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of the United States or New Zealand is entitled to all treaty benefits if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on one or more recognized stock exchanges in its country of residence (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, a company resident in New Zealand meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The term "regularly traded" is not defined in the present treaty or in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(4)(i)(B). Based on that provision, the Technical Explanation states that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" requirement.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc., any stock exchange registered with the U.S.

Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934, the New Zealand Stock Market, and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term "primarily traded" is not defined in the present treaty or in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded in the company's country of residence if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares (and any disproportionate class of shares) of which is regularly traded on a recognized stock exchange, but which does not satisfy the primary trading test (that is, the requirement that a company's principal class of shares be primarily traded on one or more recognized stock exchanges in the company's country of residence), may claim treaty benefits if it satisfies the management and control test – that is, if the company's primary place of management and control is in the treaty country of which it is a resident. A company's primary place of management and control is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed protocol, by contrast, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or New Zealand. This rule allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the treaty.

Pension funds

A pension fund established in one of the treaty countries is entitled to all treaty benefits. In the case of a pension fund operated principally to administer or provide pension or retirement benefits, however, more than 50 percent of the fund's beneficiaries, members, or participants must be individuals resident in either the United States or New Zealand. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Tax-exempt organizations

An organization established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes is entitled to treaty benefits notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that country. The Technical Explanation notes that a tax-exempt organization other than a pension fund qualifies for benefits without regard to the residence of its beneficiaries or members.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year shares or other beneficial interests representing at least 50 percent of the entity's aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension funds, or tax-exempt organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension funds, or tax-exempt organizations. Arm's-length payments made in the ordinary course of business for services or tangible property, and certain payments in respect of financial obligations to a bank that is not related to the obligor, do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the ownership and base erosion tests.

Active business test

Under the proposed protocol, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed protocol provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer.

The term "trade or business" is not defined in the present treaty or in the proposed protocol. According to the Technical Explanation, under paragraph 3 of Article 3 (General Definitions) of the treaty, as amended by the proposed protocol, when determining whether a resident of New Zealand is entitled to the benefits of the treaty under the active business test with respect to an item of income derived from sources within the United States, the United States ascribes to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority is to refer to the regulations issued under Code section 367(a) for the definition of the term "trade or business." In general, a trade or business is considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally is considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally is considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity tends to result in success or failure for the other. In cases in which more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation is considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed protocol provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country.

The proposed protocol provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by partnerships in which that person is a partner and activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

<u>Grant of treaty benefits by the competent authority</u>

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted.

The triangular case

The proposed protocol provides a special anti-abuse rule that, according to the Technical Explanation, addresses a New Zealand resident's use of the following structure to earn interest income from the United States. The New Zealand resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The New Zealand resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the New Zealand resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between New Zealand and the third country, New Zealand does not tax the income earned by the permanent establishment. Alternatively, New Zealand may choose to exempt the income of the permanent establishment from New Zealand income tax. Consequently, the income is not taxed in New Zealand or the United States, and is only lightly taxed in the third country.

Under the proposed protocol, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in New Zealand and the third country is less than 60 percent of the tax that would have been payable to New Zealand if the income were earned in New Zealand and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source state, notwithstanding any other provision of the treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer).

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Article XII. Relief from Double Taxation

Paragraph 1 of Article XII of the proposed protocol makes a conforming change to reflect modifications to Article 2 (Taxes Covered). As a result, the taxes covered under subparagraph 3(a) and paragraph 4 of Article 2 (Taxes Covered) are considered income taxes for purposes of this Article.

Paragraph 2 of Article XII of the proposed protocol deletes the final sentence in paragraph 2 of Article 22 (Relief from Double Taxation) to reflect a change to the New Zealand tax law that had previously exempted dividends from a foreign subsidiary from tax in certain circumstances. Following the change in law, such dividends are no longer exempt from tax, but may be eligible for relief from double taxation through New Zealand's foreign tax credit system.

Article XIII. Non-Discrimination

The proposed protocol replaces the nondiscrimination rules of Article 23 of the present treaty with new rules that are similar to the nondiscrimination provisions of the U.S. Model treaty and other recent U.S. income tax treaties.

In general, under the proposed protocol, neither treaty country is permitted to discriminate against nationals of the other country by imposing on those nationals more burdensome taxes than it would impose on its own comparably situated nationals in the same circumstances.[98] Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (for example, the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

Under the proposed protocol, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. The Technical Explanation notes that there may be circumstances in which two enterprises are not similarly situated and differences in treatment may be appropriate. For example, according to the Technical Explanation, imposing in a reasonable manner different information reporting requirements on a foreign enterprise than the reporting requirements applicable to a domestic enterprise does not violate the nondiscrimination requirement because information from a foreign enterprise may not be as readily available to the treaty country's tax administration as information from a domestic enterprise.

[98] A national of one treaty country may claim protection under this article even if the national is not a resident of either treaty country. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in New Zealand as a comparably situated New Zealand national.

As under the U.S. and OECD Model treaties, however, a treaty country is not obligated to grant residents of the other treaty country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities that it grants to its own residents.

Except in circumstances in which the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 6 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a treaty country to a resident of the other treaty country must be deductible under the same conditions as if those amounts had been paid to a resident of the first treaty country. The Technical Explanation states that the exception relating to paragraph 6 of Article 11 (Interest) applies to the denial or deferral of certain interest deductions under section 163(j) of the Code, thus allowing United States to apply its earnings stripping rules.

The nondiscrimination rules also apply to enterprises of one treaty country that are owned in whole or in part by one or more residents of the other treaty country. An enterprise of one treaty country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other treaty country, may not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two countries not to violate the nondiscrimination provision of the proposed protocol, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, the rules that prevent foreign persons from owning stock in subchapter S corporations, and the rules that prevent foreign corporations from joining in filing consolidated returns with domestic corporations.

The proposed protocol provides that nothing in the nondiscrimination article may be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 8 of Article 10 (Dividends).

The nondiscrimination rules of the proposed protocol do not apply to any provisions of the tax laws of either treaty country that are reasonably designed to prevent or defeat tax avoidance or evasion.

The saving clause of Article 1 (General Scope) does not apply to the nondiscrimination rules. Thus, a U.S. citizen who is a resident of New Zealand may claim benefits in the United States under Article 23.

The proposed protocol's nondiscrimination provision does not include the U.S. Model treaty rule which provides that the nondiscrimination rules apply to taxes of every kind and description imposed by a treaty country or by a political subdivision or local authority of that treaty country. Accordingly, the nondiscrimination rules described above apply only to taxes covered by the present treaty (as modified by the proposed protocol) and not, for example, to U.S. state and local taxes.

Article XIV. Exchange of Information

The proposed protocol replaces the Article 25 (Exchange of Information and Administrative Assistance) in the present treaty with a revised and expanded Article 25. The new Article 25 provides that the two competent authorities will exchange such information as is relevant to the assessment, collection and enforcement of the domestic laws of the two countries and that this exchange of information is not restricted by Article 1 (General Scope) or Article 2 (Taxes Covered). The treaty countries may exchange information with respect to third-country residents under these procedures.

The lack of a restriction based on taxes covered by the treaty (as modified by the proposed protocol) broadens the scope of information available in several ways. First, it means that information may be exchanged with respect to any tax imposed by one of the treaty countries, provided that the tax would not be contrary to the treaty. Thus, information may be exchanged with respect to U.S. estate and gift taxes, excise taxes, and New Zealand value-added taxes. In addition, the requests need not relate to the initial determination of the correct tax. A request for information relevant to collection or enforcement of tax is explicitly authorized; the information need not be intended to be used to ascertain the correct tax at an early stage in an examination. Use in prosecutions or to support a tax determination on appeal is also contemplated.

In using the word "relevant," rather than "necessary," to establish the standard for determining whether or not information may be exchanged under the treaty (as modified by the proposed protocol), the new article now conforms to the standard used in Code section 7602, which is the principal source of authority for U.S. information gathering and examination of records. Under Code section 7602, the IRS may request to examine any books, records or other material that "may be relevant," as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell.*[99]

In the United States, the administrative authority of the IRS to obtain information by service of an administrative summons extends to the territories and possessions under Code section 7651 in the same manner as if the possession or territory were a state. Thus, even though Article III of the proposed protocol provides a new definition of "United States" (in paragraph 1(g) of Article 3 (General Definitions)) that limits its meaning to its geographic sense for most purposes under the treaty (as modified by the proposed protocol), and specifically carves out its possessions and territories, information in the possessions is subject to exchange of information pursuant to a proper request under the treaty (as modified by the proposed protocol).

Confidentiality of the information subject to exchanges is protected in provisions that are updated to be consistent with Article 26 (Exchange of Information and Administrative Assistance) of the U.S. Model treaty. The article provides that any information exchanged under the proposed protocol is treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved

[99] 379 U.S. 48 (1964).

in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed protocol applies, or persons or authorities engaged in the oversight of such taxes (for example, the tax-writing committees of Congress and the Government Accountability Office). Such persons or authorities must use the information for such purposes only. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

As is true under the present treaty, the proposed protocol provides that nothing in the treaty requires either country to take action that would be contrary to its domestic law or administrative practice, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to provide information that would disclose any trade, business, industrial, commercial, or professional secret or trade process or information, if the disclosure of such information would be contrary to public policy ("*ordre public*"). The Technical Explanation notes that this has the effect of permitting a State to deny a request for information if that information would be obtained only by use of measures or procedures broader than those available in the requesting state. However, the fact that the requested treaty country's statute of limitations period has passed is not a basis for denying a request. The limitations period in the treaty country requesting the information governs whether to exchange information.

If information is requested by a treaty country in accordance with this article, the proposed protocol requires that the other treaty country use its domestic powers to obtain the requested information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the other treaty country and were being imposed by that treaty country. This requirement applies even if the treaty country that receives the request to exchange information does not need, and could not use, such information in a tax inquiry, and notwithstanding the limitations otherwise placed on the obligations of the treaty countries. A similar, but non-mandatory, provision is in paragraph 2 of the present treaty.

More importantly, a new paragraph similar to paragraph 5 of Article 26 of the U.S. Model treaty limits the ability of either treaty country to posit that domestic secrecy laws preclude response to a request for information. It does so by providing that, notwithstanding the above described limitations on the obligations to obtain information if to do so would be at variance with local law, a state cannot refuse to exchange information merely because the information is maintained by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. The proposed protocol also provides that the competent authorities may not refuse to exchange information because it relates to information concerning ownership interests in a "person." Because the language in the proposed protocol refers to "interests in a person" rather than interests in "persons or instruments," it may not be sufficiently broad to require exchanges with respect to bearer bonds. The Technical Explanation confirms, however, that this provision requires disclosure of the beneficial owner of bearer shares.

If specifically requested by the competent authority of a treaty country, the competent authority of the other treaty country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested treaty country with respect to its own taxes. In the present treaty, a similar provision existed, under paragraph 2, but was phrased in permissive rather than mandatory language. The new provision conforms to paragraph 6 of the U. S. Model treaty.

Paragraph 7 provides, for the first time, for mutual assistance in the collection of tax debts between the United States and New Zealand. The assistance required is limited to tax debts that arise from improperly granted treaty benefits. Under the proposed protocol, the treaty countries must assist one another in collection to the extent necessary to ensure that relief granted under the treaty (as modified by the protocol) does not inure to the benefit of persons not entitled thereto, but need not carry out any administrative measures that would be contrary to its sovereignty, security, or public policy. Thus, to the extent that a person in one treaty country has obtained benefits under the treaty (for example, a reduced withholding rate, or exclusion of income for certain artists and athletes) and the competent authorities agree that the person was not entitled to such benefits, the treaty country that granted the benefits may ask the other treaty country for collection assistance. The treaty countries are not, however, required to provide collection assistance with respect to tax debts that arise from any other reason.

The Technical Explanation provides an example under which a New Zealand payer of a U.S.-source portfolio dividend receives a Form W-8BEN or other documentation. In reliance on that documentation, the U.S. withholding agent withholds at the portfolio dividend rate of 15 percent. If the payee of the dividend was, in fact, a nominee on behalf of a third-country resident, this paragraph would obligate New Zealand to withhold and remit to the United States the additional tax that should have been collected by the U.S. withholding agent.

The proposed protocol requires a treaty country to permit entry into the country by representatives of the other country for the purpose of conducting interviews and examining books and records, provided the persons to be interviewed or whose records are to be examined have agreed. The consent of the person whose tax liability is under examination is not required if that person is not to be interviewed or the owner of the books and records to be reviewed. This paragraph is consistent with paragraph 8 of the U.S. Model treaty.

Finally, consistent with the U.S. Model treaty, the treaty partners may exchange information with respect to years prior to the entry into force of the proposed protocol. According to the Technical Explanation, the exchange of information program will be administered under the treaty in force at the time of the request, without regard to any restrictions that may have been applicable during the year to which the request relates. The Technical Explanation refers to paragraph 3 of Article 28 (Entry into Force) for confirmation of this interpretation.

Article XV. Agreement to Consult on Lowering Withholding Tax Rates on Interest and Royalties

Article XV of the proposed protocol replaces paragraph 1 of the protocol to the present treaty. Under the present treaty, if New Zealand (1) enters into a double taxation treaty with any country that is a member of the OECD and (2) that treaty limits the withholding tax rates on dividends, interest or royalties to a rate lower than the one provided for in the treaty with the United States, paragraph 1 requires New Zealand to negotiate with the United States for purposes of providing the same treatment on a reciprocal basis. Under the proposed protocol, New Zealand is required to consult with the United States if (1) it enters into a double taxation treaty with any country (and not just with an OECD member) and (2) that treaty limits the withholding tax rates on interest or royalties (but not dividends) to a rate lower than the one provided for in the treaty with the United States. Article XV does not include a reference to withholding taxes on dividends, presumably because (1) it was included at the request of the United States and (2) the proposed protocol already includes the zero rate provision for dividends, which is more generous than Article 10 (Dividends) of the U.S. Model treaty.

Article XVI. Entry into Force

The proposed protocol is subject to ratification in accordance with the applicable procedures of each treaty country. Each treaty country is to notify the other in writing, through diplomatic channels, when it completes the required procedures. The proposed protocol enters into force on the date of the later of the notifications. The relevant date is the date on the second of the notification documents, and not the date on which the second notification is delivered to the other treaty country.

With respect to withholding taxes (dividends, interest and royalties), subparagraph 2(a) of Article XVI states that the proposed protocol has effect for amounts paid or credited on or after the first day of the second month following the date on which the Convention enters into force. For example, if the instruments of ratification are exchanged on April 25 of 2010, the withholding rate under paragraph 2 of Article 10 (Dividends) (as modified) applies to dividends paid after June 1, 2010.

With respect to the United States, subparagraph 2(b) of Article XVI provides that, for other taxes, the proposed protocol has effect for taxes chargeable to tax periods beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

Similarly, subparagraph 2(c) of Article XVI provides that, with respect to New Zealand, the proposed protocol has effect for other taxes chargeable to tax periods beginning on or after the first day of April next following the date on which the proposed protocol enters into force. For example, if the instruments of ratification are exchanged on April 25, 2010, any modifications made by the proposed protocol to the taxation of business profits in New Zealand under Article 7 (Business Profits) have effect on April 1, 2010.

With respect to the powers given to Competent Authority under Article 26 (Exchange of Information and Administrative Assistance), paragraph 3 of Article XVI provides that these have retroactive effect to taxable periods preceding the date on which proposed protocol enters into force. For example, if the instruments of ratification are exchanged on April 25, 2010, modifications made by the proposed protocol to Article 26 (Exchange of Information and Administrative Assistance) have effect for any information exchange related matters already under consideration by the competent authorities of the United States or New Zealand as of that date.

VI. ISSUE: EXCHANGE OF INFORMATION

Background

In the proposed protocol, Article 26 (Exchange of Information) is revised and updated to closely track the language of the exchange of information provisions in the U.S. Model treaty in most respects. The proposed protocol facilitates the exchange of information, and tends to limit the circumstances in which the treaty countries can refuse to provide requested information. In particular, the proposed protocol permits the competent authorities to exchange such information as is relevant to the assessment, collection and enforcement of the domestic laws of the two countries, rather than limiting the information to that which is necessary. This conforms to the standard of section 7602 of the Code. The proposed protocol also requires that the other country use its domestic powers to obtain the requested information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other country and were being imposed by that country, whether or not the country receiving the request needs the information currently. Further, the proposed protocol provides that a treaty country may not refuse to provide requested information on the basis of domestic bank secrecy laws. Finally, it permits mutual assistance in collecting tax debts arising from improperly granted treaty benefits.

Effectiveness of U.S. Model treaty Article 26

Since the proposed protocol was signed last year, there has been extensive bilateral and multilateral cooperation in addressing issues of cross-border tax compliance and financial regulatory reform. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in the past year. Greater attention to all means of restoring integrity and stability to financial institutions has led to greater efforts to reconcile the conflicts between jurisdictions, particularly between jurisdictions with strict bank secrecy and those seeking information to enforce their own tax laws.[100] As a result, the Committee may wish to inquire as to whether the U.S. Model treaty published in 2006 remains the appropriate standard by which to measure an effective exchange of information program.

The U.S. Model treaty conforms with the norms for transparency and effective exchange of information articulated by the OECD, which are in turn the standards by which the OECD determines whether a country is committed to transparency. Those standards require that the existence of mechanisms for exchange of information upon request; that exchange of information is available for purposes of domestic tax law in both criminal and civil matters; that there are no restrictions of information exchange caused by application of the dual criminality principle[101] or

[100] See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009. Section VI of that pamphlet provides an overview of the international efforts to address these issues.

[101] The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

a domestic tax interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged; and availability of reliable information (in particular bank, ownership, identity and accounting information) and powers to obtain and provide such information in response to a specific request.[102]

1. Methods of exchange of information

The OECD standards do not require exchange other than upon specific requests for information, although the language would permit the treaty country to agree to provide for other exchange mechanisms. The OECD, in its commentary to the exchange of information provisions in the OECD Model treaty, specifies that the treaty "allows" the competent authorities to exchange information in any of three ways that treaty countries have traditionally operated [103] – routine, spontaneous,[104] or specific exchanges.[105] With regard to the latter type of exchange, the Committee may wish to inquire as to the extent to which a request that a treaty country provide information in response to a John Doe summons[106] is a specific request within the meaning of the article, and whether protracted litigation similar to that which occurred in the UBS litigation[107] can be avoided or shortened.

[102] OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 8.

[103] OECD, "Commentary on the Model Treaty Article 26," par. 9.

[104] A "spontaneous exchange of information" occurs when one treaty country is in possession of an item of information that it believes may interest the other treaty country for purposes of its tax administration and spontaneously transmits the information to that other country through their respective competent authorities.

[105] A "specific exchange" is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and the need for the information and submit it to the Competent Authority in their country. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart.

[106] When the existence of a possibly noncompliant taxpayer is known but not his identity, as in the case of holders of offshore bank accounts or investors in particular abusive transactions, the IRS is able to issue a summons to learn the identity of the taxpayer, but must first meet greater statutory requirements, to guard against fishing expeditions. Prior to issuance of the summons intended to learn the identity of unnamed "John Does," the United States must seek judicial review in an *ex parte* proceeding. In its application and supporting documents,[106] the United States must establish that the information sought pertains to an ascertainable group of persons, that there is a reasonable basis to believe that taxes have been avoided, and that the information is not otherwise available.

[107] On July 1, 2008, a Federal district court in Florida granted the IRS permission to issue a John Doe summons to UBS seeking the names of as many as 20,000 U.S. citizens who were UBS customers for which reporting or withholding obligations may not have been met, Case No. 08-21864-MC-LENARD/GARBER. The summons was served on July 21, 2008. A petition to enforce that summons was filed on February 21, 2009. See *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.). On August 19, 2009, after extensive negotiations between the Swiss and U.S. governments, the United States and UBS announced that UBS had agreed to provide information on over 4,000 U.S. persons with accounts at UBS.

The Committee may wish to explore issues related to "routine exchange of information." In this type of exchange, also referred to as "automatic exchange of information," the treaty countries identify categories of information that are consistently relevant to the tax administration of the receiving jurisdiction and agree to share such information on an ongoing basis, without the need for a specific request. Information that is automatically shared under this authority may include information that is not taxpayer-specific, such as news about changes in domestic tax legislation, or it may comprise voluminous taxpayer filings, such as magnetic disks containing the information from IRS Form 1042-S, relating to U.S.-source fixed or determinable income paid to persons claiming to be residents of the treaty country receiving the forms. The type of information, when it will be provided, and how frequently it will be provided are determined by the respective Competent Authorities after consultation. Once an agreement is reached, the information is automatically provided.

Practical challenges with automatic exchanges are not exclusive to the United States. The OECD has developed standards for the electronic format of such exchanges, to enhance their utility to tax administration.[108] Despite these efforts to standardize the information exchanged and improve its usefulness, there remain numerous shortcomings, both practical and legal, in the routine exchange of information. Chief among them is the lack of taxpayer identification numbers ("TINs") in the information provided under the exchange, despite the recommendation of the OECD that member states provide such information.[109] Ideally, the information received by the IRS should either include a TIN or be subject to a process referred to as "TIN perfection" to enable the IRS to correlate account data in the information received with a valid TIN in its taxpayer databases, although such an undertaking may be time-consuming and costly.

The Committee may wish to inquire about the existence of any practical impediments to effective automatic exchange of information under the proposed protocol and what steps are needed to remove these impediments. In the past, there have been concerns that information received pursuant to automatic exchanges under bilateral and multilateral agreements was not in a usable form. Examples of practical hurdles that reportedly limited the value of information exchanged were the lack of timeliness of its production, lack of conformity in reporting periods, the need to translate the language of the documents and the currencies, and its voluminous nature.[110] To the extent that useful information can be gathered through exchange of information, the United States may be able to reduce its reliance upon self-reporting, that is, information provided by the taxpayer and therefore only available with respect to those in compliance with the tax laws.

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[108] See OECD, Committee on Fiscal Affairs, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*, Module 3 (January 23, 2006) ("OECD Exchange Manual").

[109] The OECD Exchange Manual refers to a recommendation dating to 1997, "Recommendation on the use of Tax Identification Numbers in an International Context" C(97)29/FINAL (1997).

[110] Letter from Commissioner, IRS to Chairman, Senate Committee on Finance (June 12, 2006), 2006 *Tax Notes Today* 115-17.

2. U.S. reciprocity in providing information on beneficial ownership

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income. The criticism has focused on disparities between the U.S. standards and foreign standards governing "know-your-customer" rules for financial institutions and the maintenance of information on beneficial ownership. With respect to the latter, U.S. norms have been criticized in recent years.[111] The Committee may wish to explore the extent to which either the existing U.S. know-your-customer rules or the corporate formation and ownership standards prevent the United States from providing information about beneficial ownership on a reciprocal basis with its treaty countries. It may also consider whether there are steps to take that would help refute any perception that the United States permits states to operate as tax havens, by helping the United States better respond to information requests received from treaty countries in the course of their tax evasion and anti-money laundering investigations of their citizens and residents suspected of engaging in illegal activities through U.S. corporations and limited liability companies.[112]

3. Override of domestic law privileges or confidentiality

The scope and operation of the provision that overrides potential arguments based on bank secrecy law of the requested treaty country presents questions about its possible impact on other privileges. Under the proposed protocol as well as both the OECD Model and U.S. Model treaties, a treaty country is generally not obligated to take any action at variance with its domestic law, including disclosure of professional or trade secrets. That principle is limited by a special rule, which provides that a treaty country may not decline to provide information on the ground that the information is held by a financial institution, nominee, or person acting in an agency or intermediary capacity. The Technical Explanations to the proposed protocol and to the U.S. Model state that this rule overrides claims of bank secrecy, but do not address its potential intersection with the law of professional privileges. In contrast, the OECD explains the general principle and provides, as an example of information that a requested treaty country could decline to obtain, any information that would violate safeguards against self-incrimination.[113] The OECD further explains the abrogation of the general principle and clarifies that the provision may limit the use of certain claims of professional privilege, but only to the extent that the domestic law in question was so broad as to base its protection solely on the status

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[111] Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America at* pp. 10-11 (June 23, 2006); Government Accountability Office, *Company Formations: Minimal Ownership Information Is Collected and Available,* a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); Government Accountability Office, *Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities,* GAO-01-120 (October 31, 2006).

[112] E.g., the "Incorporation Transparency and Law Enforcement Assistance Act,"111th Congress, 1st Sess., S. 569 (March 11, 2009), would require States to obtain and periodically update beneficial ownership information from persons who seek to form a corporation or limited liability company.

[113] OECD, "Commentary to the OECD Model Treaty Article 26," par. 15.2.

of the person holding the information.[114] Under the OECD approach, a treaty country may refuse to supply information held by a bank, financial institution, agent, fiduciary or nominee as long as the ground for refusal is not the mere fact of the custodian's status as a bank, financial institution, agent, fiduciary or nominee. The OECD provides an example of a legal representative acting for a client in an agency capacity. To the extent that confidential communications between the legal representative and his client are protected under local law, the general rule against requiring a treaty country to violate its own law continues to apply and the treaty country may decline the request to exchange information.

At least one recently concluded treaty, the Income Tax Treaty between the United States and Finland,[115] departs from the U.S. Model treaty and expressly provides that the override of domestic law is not intended to include the ability to obtain information that would reveal confidential communications between a client and an attorney, in cases in which the client seeks legal advice. The Committee may wish to inquire as to the intended scope of the provision of the proposed protocol as well as of the U.S. Model Treaty, and the extent to which the provision may override any privilege or confidentiality law that may be available under a treaty country's domestic law, and the circumstances in which this provision is likely to be involved. The Committee may wish to specifically inquire about its effect on the attorney-client privilege in the United States.

[114] OECD, "Commentary to the OECD Model Treaty Article 26," pars. 19.12, 19.14.

[115] Senate Treaty Doc. 109-18.