[JOINT COMMITTEE PRINT]

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

SCHEDULED FOR A HEARING
BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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INTRODUCTION

This pamphlet provides an explanation of the proposed income tax treaty as clarified by the proposed protocol between the United States and New Zealand. The proposed treaty and protocol were signed on July 23, 1982. A similar treaty between the two countries, signed in 1948, is currently in force. The proposed treaty has been scheduled for a public hearing on May 24, 1983, by the Senate Committee on Foreign Relations.

The proposed treaty is similar to other recent U.S. income tax treaties, the U.S. model income tax treaty, and the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). However, there are certain deviations from those documents.

The first part of the pamphlet is a summary of the applicable provisions of the proposed treaty. The second part provides an overview of U.S. tax rules relating to international trade and investment and U.S. tax treaties in general. This is followed by a detailed, article-by-article explanation of the proposed treaty and protocol.

I. SUMMARY

In General

The principal purposes of the proposed income tax treaty between the United States and New Zealand are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard tax treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 or 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, certain capital gains and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, 13, and 21). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit or, in certain cases, a partial exemption.

This treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, it contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

The proposed treaty differs in certain respects from other U.S. income tax treaties and the U.S. model. It also differs in significant respects from the present treaty with New Zealand. Some of these differences are as follows:

(1) U.S. citizens who are not also U.S. residents are not generally covered. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(2) The proposed treaty does not provide for determination of a single residence for all corporations that are residents of both the United States and New Zealand under local law. The U.S. and Organization for Economic Cooperation and Development (OECD) model treaties do each provide for such a determination. The effect of the lack of such a provision in the proposed treaty is to deny treaty benefits to dual resident corporations.

(3) The definition of permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model and in many existing U.S. treaties. The principal differences are that the proposed treaty provides that an enterprise has a permanent establishment in a country if it carries on activities in connection with the exploration for or exploitation of natural resources situated in that country or its continental shelf for at least 6 months in any 12 month period (rather than the model's 12 months) or if it carries on supervisory activities in connection with a building site for more than 12 months. The model does not treat such activities as a permanent establishment independently of other tests. The present treaty does not contain special rules for these activities.

(4) The proposed treaty does not contain a definition of the term "business profits", although certain categories of business profits are defined in various articles. This leaves to local law the definition of that term in some cases, and accordingly the profits that must be attributed to a permanent establishment before those profits can be taxed by the country where the permanent establishment is located. Many U.S. treaties, and the U.S. model, define the term business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. Absence of this definition means that persons who earn such rental or licensing income could be subject to tax on a gross basis, not a net basis, in the source country unless they maintain a permanent establishment there.

(5) The proposed treaty does not allow investors in real property in the country not of their residence to elect to be taxed on such investments on a net basis. The U.S. model allows such an election. Although current New Zealand law (and current U.S. law) provides for net basis taxation, there is no guarantee that New Zealand will continue such treatment.

(6) The proposed treaty does not restrict source country taxation of profits from shipping and air transport so tightly as does the U.S. model treaty. Under the proposed treaty, the source country must exempt income that a lessor earns from bareboat leases of ships, aircraft, or containers only if both (1) those items are used in international traffic and (2) the income is incidental to other income that the lessor earns from the operation of ships or aircraft

in international traffic. The model treaty mandates source country exemption if the lease meets either one of these two criteria.

(7) The limit on the gross dividend withholding tax that the country of source may impose is 15 percent (Article 10) in contrast to the 5 percent limit on direct dividends and 15 percent limit on portfolio dividends in the U.S. model. The present treaty does not limit New Zealand's dividend withholding tax, presently 30 percent. The analogous U.S. rate is also 30 percent.

(8) The tax at source on interest is limited to 10 percent of the gross interest (Article 11) rather than the zero rate in the U.S. model, except that interest derived by or insured or guaranteed by the other government is exempt at source. A zero rate is not generally achieved in many treaties, but is at times achieved for interest earned by banks on loans made into the source country. The present treaty does not limit the rate of the withholding tax on interest. The current New Zealand statutory withholding rate is 15 percent, while the analogous U.S. rate is 30 percent.

(9) The tax at source on royalties is limited to 10 percent (Article 12) rather than the zero rate in the U.S. model. New Zealand's statutory rate on royalty payments (which would be reduced to 10 percent by the proposed treaty) is generally 15 percent. The present treaty does not generally limit source country taxation of royalties, but does specifically allow taxpayers earning certain royalty income to elect to be taxed on a net basis. The proposed treaty contains no net basis election, although certain rentals are taxed on a net basis by New Zealand. The present treaty provides separate rules for film royalties. They are exempt from the income tax in New Zealand, but are subject to a film-hire tax and film-hire duty. Under the proposed treaty film rentals may not be taxed in excess of 10 percent of the gross amount; however, so long as New Zealand law taxes such income at the corporate rate of 45 percent on a deemed profit of 10 percent of the gross amount, that lower statutory provision will prevail. As in the present treaty the customs duty (film-hire duty) is not a covered tax.

(10) The proposed treaty allows source country taxation of income from independent personal services on the basis of presence in that country for more than 183 days in any consecutive 12 month period. Under the model, independent personal services of a nonresident are taxable only if the nonresident has a fixed base available in the source country.

(11) The proposed treaty allows source country taxation of wages of an employee on the basis of presence in that country for more than 183 days in any consecutive 12 month period. The U.S. model treaty allows source country taxation in that case only if there is 183 days' presence in a taxable year.

(12) The proposed treaty prevents application of sanctions against treaty-shopping until the competent authorities of the two countries have consulted each other. The U.S. model requires no consultation. In addition, the proposed treaty does not require either country to endeavor to collect for the other amounts necessary to insure that the treaty is not benefitting unintended parties. The U.S. model requires collection endeavors in that case.

(13) The proposed treaty allows source country taxation of an entertainer or athlete who earns more than $10,000 there during a

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taxable year; the comparable amount in the U.S. model treaty is $20,000.

(14) The proposed treaty does not limit taxation of alimony or child support payments. The model treaty allows taxation of alimony payments only in the country of residence of the recipient, and taxation of child support payments only in the country of residence of the payer. Although New Zealand does not now allow a deduction to the payer or tax either kind of payment to the recipient, there is no guarantee that New Zealand will continue that treatment.

(15) The present treaty exempts from source country taxation the salaries of teachers from the other country who visit for two years or less. The proposed treaty, like the U.S. model, subjects those amounts to its standard rules, which would ordinarily result in full source country taxation.

(16) The proposed treaty's nondiscrimination provision is more limited than the U.S. model and provisions found in many U.S. tax treaties because it does not apply to tax rules that were in effect in either country on the date of signature, July 23, 1982, and because it does not prevent discrimination by States and localities in their tax laws. The existing treaty, however, does not limit discrimination at all.

(17) The U.S. model treaty provides for the exchange of information about all taxes imposed by the parties to the treaty, and not just those that the treaty covers. The exchange of information provision in the proposed treaty covers only those taxes that the treaty otherwise covers.

Issues

The proposed treaty presents the following specific issues:

(1) The nondiscrimination provision of the proposed treaty would permit discrimination under existing tax laws but not future laws. The United States model and most U.S. tax treaties contain a broad nondiscrimination provision that would prohibit the treaty partner from discriminating against U.S. investors. At the insistence of New Zealand, the nondiscrimination provision in the proposed treaty is not so comprehensive as that sought by the United States or as that contained in the U.S. or the OECD model treaties.

It could be argued that it is inappropriate to enter into a treaty with a developed country that permits even limited forms of discrimination. However, this article follows the U.S. position for the future, and is the broadest agreed to by New Zealand. (New Zealand has reserved its position on the OECD model Article.) Also, it is an improvement over the existing treaty which contains no nondiscrimination provision.

A secondary issue is whether, if discrimination is permitted, the United States should allow a foreign tax credit for the discriminatory taxes.

(2) The proposed treaty contains a permanent establishment article that is broader than that contained in the U.S. or OECD models. This would permit the country in which the activities are carried on to tax activities sooner than it would be able to under the model. Under the proposed treaty, U.S. enterprises carrying on activities in connection with exploration for and exploitation of

natural resources may be subject to New Zealand tax if they are present in New Zealand territory for as little as 6 months in any 12 month period. Under the U.S. model, they must be present there for at least one year. The practical effect of the provision could be to increase New Zealand taxation of mineral exploration activities. These expansions were made at the insistence of New Zealand.

On the one hand, it might be argued that the United States should not make developing country concessions to a developed country. On the other hand, they recognize New Zealand's status as a capital importing country, and also must be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States.

(3) The proposed treaty would permit New Zealand to tax the income earned by lessors of ships, aircraft or containers in international traffic unless (1) the lease is merely incidental to the operation in international traffic of ships or aircraft by the lessor and (2) the leased item is used in international traffic. Under the U.S. model, this income is exempt from tax at source so long as one of these two criteria is met. The gross withholding tax permitted by the proposed treaty could exceed net income from leasing in certain cases. Shipping companies who lease containers in international traffic as an incidental part of their business would not be subject to the tax, while competing container leasing companies that do not engage in shipping would be subject to the tax. Accordingly, such companies would have a competitive advantage over pure leasing companies.

While this provision is less favorable to container leasing companies than the model provision, it must be viewed in the context of the overall treaty. Also, container leasing companies may receive more protection under the proposed treaty than under the existing treaty.

(4) The proposed treaty does not deal with the New Zealand "customs duty" imposed on films brought into New Zealand. New Zealand imposes a "customs duty" on foreign films based on the rent that New Zealand residents pay for them. New Zealand now imposes this "duty" at the rate of 15 percent of the amount charged for the rental. Since the "customs duty" is based on the rental paid for the film instead of its value, it resembles an income tax imposed on the gross amount of royalty income. This raises the issue whether it is appropriate, in the context of an income tax treaty, to allow a foreign country to impose a tax of the kind generally covered by income tax treaties without treaty protection. Unlike income taxes, customs duties are not generally covered by income tax treaties and are not covered by any U.S. income tax treaty. This is because customs duties do not present issues of double taxation. Similarly, our internal mechanism for avoiding international double taxation, the foreign tax credit provisions of the Internal Revenue Code, does not apply to customs duties.

(5) The proposed treaty resembles in a few respects a treaty between a developed country and a developing country. In these respects, it does not conform to the U.S. model treaty. It provides for relatively high rates of source country withholding taxes and it provides permanent establishment rules that permit taxation of enterprises in cases where the U.S. model treaty would not. In addi-

tion, its nondiscrimination provision does not apply to existing rules. Although New Zealand is not so industrialized as the United States, it is a developed country. New Zealand is, however, a capital importer. Also, on balance, it can be argued that the proposed treaty is the product of a hard bargaining over a period of years and is better for U.S. interests than the existing treaty.

II. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

A. United States Tax Rules

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income which is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income which is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation which is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent they are connected with income which is effectively connected.

United States source fixed or determinable annual or periodical income (e.g., interest, dividends, rents, salaries, wages, premiums, annuities) which is not effectively connected income and which is received by a nonresident alien or foreign corporation is subject to tax at a rate of 30 percent of the gross amount paid. This gross tax on fixed or determinable income is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty.

The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

Certain exemptions from the gross tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are also provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. U.S. treaties also provide for exemption from tax in certain cases.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of U.S. real estate, discussed below.

Prior to June 18, 1980, noneffectively connected capital gains from the sale of U.S. real estate were subject to U.S. taxation only if received by a nonresident alien who was present in the United States for at least 183 days. However, in the Omnibus Reconciliation Act of 1980 a provision was added to the Internal Revenue Code that the sale, exchange, or disposition of U.S. real estate by a foreign corporation or a nonresident alien would be taxed as effectively connected income. Also taxable under the legislation are dispositions by foreign investors of their interests in certain U.S. corporations and other entities whose assets include U.S. real property and associated personal property.

The source of income received by nonresident aliens and foreign corporations is determined under special rules contained in the Internal Revenue Code. Under these rules interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are considered U.S. source income. However, if a U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by that corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, at least 50 percent of the income of which is effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be 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 by generally allowing U.S. persons to credit their foreign income taxes 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 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. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate limitations on the foreign tax credit are provided for certain interest and for DISC dividends; also, special rules are provided for taxes imposed on oil extraction income.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems in the world, it would be virtually impossible to develop in the Code rules which uniterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and our treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates which exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross income basis. (Most countries, like the United States, generally tax domestic source income on a gross income basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax which would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and 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.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The 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 some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by each of the two countries. Treaties also 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 branch or other permanent establishment or fixed base. The treaties 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 of over a certain amount.

Treaties deal with passive income such as dividends, interest, or royalties, or capital gains, from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the U.S. generally imposes a 30 percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by our treaty partner.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can therefore still arise. Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some of our treaty partners, by providing that income will be exempt from tax in the country of residence. The United States 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 limitations of U.S. law. An important function of a treaty is to define the taxes to which it applies and to provide that they will be considered creditable income taxes for purposes of the treaty.

The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases, or more generally, by consultation between tax officials of the two governments.

Administrative cooperation also includes provision for an exchange of tax-related information to help the United States and its treaty partners administer their tax laws. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the 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 not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The IRS (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

The 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 that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

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III. EXPLANATION OF PROPOSED TAX TREATY

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the treaty and contains other rules including the "saving clause."

The proposed treaty applies generally to residents of the United States and to residents of New Zealand, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. Residence is defined in Article 4.

The proposed treaty provides that it does not restrict any benefits accorded by internal law or by any other agreement between the United States and New Zealand. Thus, the treaty will apply only where it benefits taxpayers.

The proposed treaty also contains the "saving clause" contained in all U.S. income tax treaties that provides, with specific exceptions described below, that the treaty is not to affect the taxation by either country of its residents. In addition, subject to those specific exceptions, the treaty is not to affect taxation by the United States of U.S. citizens and U.S. companies. Consequently, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens and companies that are residents of New Zealand, as if the treaty were not in force. Residents for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4 (Residence)).

Under Section 877 of the Internal Revenue Code of 1954 ("Code"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79–152, 1979–1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the articles dealing with Associated Enterprises (Article 9); Pensions and Annuities (Article 18); Relief from Double Taxation (Article 22); Non-Discrimination (Article 23); and Mutual Agreement Procedure (Article 24).

In addition, the saving clause does not apply to the benefits conferred by one of the countries under the articles dealing with Government Service (Article 19), Students (Article 20), or Diplomatic Agents and Consular Officers (Article 26), upon individuals who are not citizens of that conferring country and who do not have immigrant status in that conferring country.

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and New Zealand.

In the case of the United States, the proposed treaty applies to (1) the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes, and (2) the excise tax on private foundations. In the case of New Zealand, the proposed treaty applies to the New Zealand income tax, but excluding the excess retention tax and the bonus issue tax. The excess retention tax is similar in concept to the U.S. personal holding company tax. The bonus issue tax applies to certain capitalizations of reserves. Although the U.S. model treaty applies to the excise tax on private foundations and (in certain cases) to the excise tax on insurance premiums paid to foreign insurers, the proposed treaty does not apply to those taxes. Thus, the United States could continue to impose them on payments to residents of New Zealand.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose. The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any substantial changes in the tax laws of his country.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "person" is defined to include an individual, an estate or trust, a company and any other body of persons. A "company" is any body corporate or any entity which is treated as a company or body corporate for tax purposes. The term "United States company" is defined to mean a company that is created or organized under the laws of the United States or any State thereof or the District of Columbia.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise" it would have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, partnership, company, or other entity.

The proposed treaty defines international traffic as any transport by a ship or aircraft by an enterprise of one of the two countries, except where the transport is solely between places in the other country. Accordingly, with respect to a New Zealand enterprise, purely domestic transport in the United States is excluded.

The U.S. competent authority is the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of the Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection. The New Zealand competent authority is the Commissioner of Inland Revenue or his delegate.

The "United States" means the United States of America, a term that does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory. The definition of the United States also includes, when the term is used in a geographical sense, the territorial waters of the United States and any area beyond the territorial waters that, in accordance with international law and the laws of the United States, is (or may at a later time be) an area within which the United States may exercise rights with respect to natural resources. The intent of this rule is to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The term "New Zealand" means the territory of New Zealand but does not include Tokelau or the Associated Self Governing States of the Cook Islands and Niue; it also includes any area beyond the territorial sea which by New Zealand legislation and in accordance with international law has been, or may at a later time be, designated as an area in which the rights of New Zealand with respect to natural resources may be exercised. Therefore, income earned on the New Zealand continental shelf is covered.

The term "Contracting State" means the United States or New Zealand, as the context requires. The proposed treaty would define the term "tax" as meaning United States tax or New Zealand tax as the context requires. The terms "New Zealand tax" and "United States tax" do not include any amount that represents a penalty or interest imposed under the law of either country that relates to taxes covered by the treaty. Thus, the right of a country to impose penalties or interest is not limited by the proposed treaty.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where under the laws of the countries the person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. The Code, however, does not define the term "residence." Instead, IRS regulations state that an alien is a resident of the United States if he is actually present in the United States and is not a mere transient or sojourner. Whether he is a transient is determined by his intentions as to the length and nature of his stay. (See Treas. Reg. sec. 1.871-2(b).) A company is resident in the United States if it is organized in the United States.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that State, is subject to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. However, the term "resident of a Contracting State" does not include any person who is subject to tax in that country in respect only of income from sources in that country, nor does it include a person who is subject to tax in that country by reason of citizenship but who is not resident in that country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas (in countries other than New Zealand) are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model. The U.S. position is achieved in very few treaties.

Moreover, in the case of income derived or paid by a partnership, an estate, or trust, the term "resident of a Contracting State" applies only to the extent that the income derived by the partnership, estate, or trust is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. residents in the profits of a U.S. partnership is only one-half, New Zealand would have to reduce its withholding tax on only half of the New Zealand source income paid to the partnership.

The term "resident of a Contracting State" also includes a company or trust that would be subject to tax as a resident of a contracting country but for a determination by the competent authority of that country that the company or trust is exempt from tax in that country because it is organized and operated exclusively for charitable or other purposes that make it exempt from tax under the law of that country.

A set of "tie-breaking" rules is provided to determine residence in the case of an individual who, under the basic treaty definition, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests". If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a citizen. If he is a citizen of both States or of neither of them, the competent authorities of the Contracting States are to endeavor to settle the question of residence by mutual agreement.

In the case of a person other than an individual or a company who is resident of both countries under the basic treaty definition, the proposed treaty requires the competent authorities of the two countries to endeavor to settle the question by mutual agreement and to determine how the treaty applies to that person.

The interaction of United States and New Zealand law can result in a company being a resident of both countries under local law. For example, a company incorporated in the United States but carrying on business and being managed in New Zealand would be considered a domestic company by both countries under their local laws. The proposed treaty provides that, for treaty purposes, the competent authorities of the United States and New Zealand are to settle the question of residence by mutual agreement and to determine whether the company is a resident solely of one country. If the competent authorities are unable to make such a determination, the company is neither a U.S. nor a New Zealand company for treaty purposes generally and thus would not be entitled to the treaty benefits. In this definition of residence, the proposed treaty differs from the U.S. model treaty, which seeks to find a single residence for companies.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the reduced rates of, or certain exemptions from, tax provided for dividends, interest, and royalties will apply unless the asset generating the income is effectively connected with the permanent establishment. in which case such items of income are taxed as business profits. U.S. taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site or construction or installation project, if the site or project lasts for more than 12 months. This 12-month period corresponds to the rule of the U.S. model treaty.

An enterprise of one country will also be deemed to have a permanent establishment in the other country if it engages in supervisory activities in that other country for more than 12 months in connection with a building site or construction or installation project in that other country. This 12-month rule for such supervisory activities activities corresponds to the rule, described above, for the maintenance of such a site or project. There is no special rule for such supervisory activities in the U.S. model treaty. Therefore, income from such activities would be taxable under the model, if the taxpayer maintained an office in the source country.

Carrying on activities in connection with exploration for or exploitation of natural resources situated in a country gives rise to a permanent establishment if an enterprise carries on those activities in that country for at least 6 months in any 12 month period. This 6-of-12 months rule differs from the 12-month rule of the U.S. model treaty. For the purposes of this rule, activities carried on in a country by an enterprise associated with another enterprise are to be regarded as carried on by the enterprise with which it is associated if those activities are connected with activities carried on in that country by the last-mentioned enterprise. An enterprise is to be deemed to be associated with another enterprise if one is controlled directly or indirectly by the other, or if both are controlled directly or indirectly by a third person or persons.

The current treaty does not contain special rules for building sites, exploration and exploitation of natural resources, etc.

The general rule is modified to provide that a fixed place of business that is used solely for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise or for the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, any other preparatory or auxiliary activity.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise will be deemed to have a permanent establishment in the first country. This rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Real Property

This article covers income from owning real property. The rules governing income from the sale of real property are in Article 13.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property. Ships, boats and aircraft are not real property.

The source country may tax income derived from the direct use, letting, subletting or use in any other form of real property. These rules allowing source country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Certain U.S. treaties and the current U.S. model treaty permit residents of one country to elect to be taxed on income from real property in the other country on a net basis. The proposed treaty does not contain that election, but such an election is provided for United States real property income under the Code (secs. 871(d) and 882(d)), and New Zealand taxes income from real property on a net basis. Also, certain treaties limit the tax a country may impose on rental or royalty income from real property. There is no limit in the proposed treaty.

Under Article 13 (Alienation of Property), gains on the sale, exchange or other disposition of real property (and shares of certain corporations owning real property) may also be taxed by the country where the property is located.

Article 7. Business Profits

United States Code rules.—United States law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent (or lower treaty rate) rate of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules.—Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the enterprise of which it is a permanent establishment, or with any other associated enterprise. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions include executive and general administrative expenses, research and development expenses, interest, and other expenses. Thus, for example, a

U.S. company which has a branch office in New Zealand but which has its head office in the United States will, in computing the New Zealand tax liability of the branch, be entitled to deduct the executive, general administrative and other expenses incurred in the United States by the head office that are reasonably connected with the profits of the New Zealand branch.

Unlike some U.S. treaties and the U.S. model, the proposed treaty does not define the term "business profits." Thus, to the extent not dealt with in other Articles, the term will be defined under the laws of the two countries. If the definitions cause double taxation, the competent authorities could agree on a common meaning of the term.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not this Business Profits Article, will govern the treatment of those items of income. Thus, for example, film rentals are taxed under the provisions of Article 12 (Royalties), and not as business profits.

The proposed treaty allows either country to continue to tax the income and profits of persons carrying on an insurance business under its internal law rather than under the treaty rules. New Zealand taxes foreign insurance companies on the basis of a formula. The United States taxes foreign insurance companies not subject to the U.S. income tax with an excise tax computed on the basis of a percentage of premiums they receive in respect of U.S. risks. Both countries could continue current tax treatment of foreign insurers, or could impose new regimens of taxation for foreign insurance companies.

The proposed protocol provides that so long as New Zealand continues to tax the income of film renters under section 224 of the Income Tax Act of 1976 and to exempt from tax the royalty remittance to persons not New Zealand residents, this article would not affect New Zealand's tax or its exemptions from that tax. That is, the proposed protocol confirms that defining film rentals as royalties under Article 12 (Royalties) will not deprive U.S. film renters of the treatment now authorized under New Zealand law or cause them to be subject to both the New Zealand tax on deemed profit under section 224 and a tax on the royalty remittance under the treaty. Under section 224, film renters are subject to a tax of 45 percent on a deemed profit of 10 percent of gross rental receipts.

Article 8. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations operating ships or aircraft documented under U.S. law. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

The proposed treaty provides that profits which are derived by a resident of one country from the operation of ships or aircraft in international traffic ("shipping profits") shall be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in one of the countries (Article 3(1)(e) (General Definitions)).

This exemption applies even if the ship or aircraft is not registered in either country. Thus, for example, income of a U.S. resident from the operation of a ship flying, for example, the Liberian flag would not be subject to New Zealand tax. The exemption also applies to income derived from the operation of ships and aircraft in international traffic through participation in a pool, a joint business, or an international operating agency.

Under the proposed treaty, certain profits from the rental of ships or aircraft would be exempt from tax in the source country as profits from the operation of ships and aircraft in international traffic. Profits of an enterprise of one of the countries referred to in the general rule from the rental of ships or aircraft or from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) shall be taxable only in that country to the extent that those ships, aircraft or containers are used in international traffic and such profits are incidental to profits that that enterprise makes from operating ships or aircraft in international traffic.

This rule governing leases of ships or aircraft and leases of containers and related equipment provides a narrower exemption for lessors than that provided in the U.S. model treaty, which provides the exemption if the rented property is used in international traffic or the profits are incidental to profits from the operation of ships or aircraft in international traffic. That is, the model provides exemption if the lessor operates ships in international traffic and enters into a casual lease of a ship for use within the source country. In addition, the model provides exemption in the source country for a lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic but that leases ships, aircraft, or containers for use in international traffic. The proposed treaty would allow the source country to tax the income under the provisions of Article 12 (Royalties).

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

These provisions of the proposed treaty are not intended to affect the application of any law in either country that relates to the determination of the tax liability of a person. This provision makes clear that the U.S. retains the right to apply its intercompany pricing rules (section 482) and its rules relating to the allocation of deductions (sections 861, 862, and 863, and Treas. Reg. Section 1.861-8). Moreover, these provisions are not to supersede U.S. or New Zealand law relating to determinations in cases where the information available to the competent authority is inadequate to determine the income to be attributed to an enterprise, so long as the competent authority proceeds on the basis of available information consistently with these rules. Thus, the treaty does not affect the U.S. rule that the burden of proof is on the taxpayer.

Article 10. Dividends

The United States 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 like a U.S. person at the standard graduated rates on a net basis. U.S. source dividends are dividends paid by a U.S. corporation, and certain dividends paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country may be taxed by both countries. However, the rate of tax that the country of which the payor is a resident may impose on dividends paid to a beneficial owner in the other country cannot exceed 15 percent of the gross amount of the dividends. This limitation would not apply to taxation of the company in respect of the profits out of which the dividends are paid.

The existing treaty with New Zealand limits the U.S. tax on U.S. source dividends paid to New Zealand residents to 15 percent in the case of portfolio dividends and 5 percent in the case of direct dividends, but does not limit New Zealand's tax at the source on dividends. The existing treaty provides, however, that either country may terminate the dividend article without the standard six months' notice if New Zealand taxes New Zealand source dividends paid to U.S. residents at a rate exceeding the analogous (15 percent and 5 percent) limits on the United States in that existing treaty. Since April 1, 1982, the statutory rate in New Zealand has been 30 percent. Prior to that date, the rate was 15 percent. Accordingly, this abbreviated termination procedure is available to the United States.

The proposed treaty contains a provision that would apply its rate limitation retroactively. If the proposed treaty enters into force before April 1, 1984, the 15 percent limit will apply to dividends paid by New Zealand companies, beneficially owned by U.S. residents, and derived on or after April 1, 1982, the date of New Zealand's statutory rate increase (Article 27 (Entry into Force)).

The proposed treaty's 15 percent rate is greater than the five-percent rate that applies to direct dividends in many U.S. treaties and the U.S. model, but New Zealand has not to date agreed to any treaty providing a lower rate. The proposed protocol provides that if in any future tax treaty with a member of the Organization for Economic Co-operation and Development, New Zealand limits its tax at the source to a lower rate than that provided in the proposed treaty, New Zealand will without undue delay enter into negotiations with the United States to review this article with a view to providing that lower rate on a reciprocal basis.

The proposed treaty does not define dividends. The proposed treaty's general rule for undefined terms applies: unless there is mutual agreement between the competent authorities, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest (see Article 3(3) (General Definitions)). Thus, for example, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring forms for the identification of foreign recipients of income).

The reduced rates of tax on dividends will apply unless the recipient carries on business through a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Dividends effectively connected with a permanent establishment are to be taxed on a net basis as business profits (Article 7). Dividends effectively connected with a fixed base are to be taxed on a net basis as income from the performance of independent personal services (Article 14).

One country may not tax dividends paid by a company resident in the other country except in four cases: first, where a resident of the first country receives the dividends; second, where the dividends are attributable to a permanent establishment or a fixed base of the beneficial owner in the taxing country; third, where at least 50 percent of the paying company's gross income was attributable to one or more permanent establishments in the taxing country; and fourth, where the dividends are paid by a United States company which is resident in New Zealand for the purposes of New Zealand tax. In the third and fourth cases (in a situation where the payment is not taxable under the first or second case), and where the beneficial owner of the dividends is a resident of the other contracting State, tax may be imposed by the first-mentioned State according to its law but the rate of tax may not exceed 15 percent. In the third case, however, the tax can be imposed only to the extent the dividends are paid out of the profits attributable to those permanent establishments. Under this provision, the rate of tax on the taxable portion is limited to the 15-percent withholding rate applicable to dividends. This third provision enables the United States to continue to tax dividends paid by foreign corporations doing substantial business in the United States. The provision is, however, different from the U.S. rules because the proposed treaty's permanent establishment concept is somewhat more limited than the U.S. trade or business concept. (See discussion in Article 7 (Business Profits).)

Article 11. Interest

The United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that are applicable to dividends. Under the Code, U.S. source interest generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that corporation.

Under the proposed treaty, interest may be taxed by a country if the beneficial owner of the interest is a resident of that country, the interest arose in that country, or the indebtedness to which the interest relates is effectively connected with a permanent establishment or fixed base in that country. The proposed treaty limits the withholding tax imposed at source to 10 percent generally. The present treaty does not limit the withholding tax on interest, although the current New Zealand statutory rate of withholding tax is 15 percent. The U.S. model treaty provides for elimination of the withholding tax on portfolio interest (a zero rate), although this result is rarely achieved. The proposed protocol provides that if in any future tax treaty with a member of the Organization for Economic Co-operation and Development, New Zealand limits its tax at the source to a lower rate than that provided in the proposed treaty, New Zealand will without undue delay enter into negotiations with the United States to review this article with a view to providing that lower rate on a reciprocal basis.

The lower rate in the proposed treaty applies only if the interest is beneficially owned by a resident of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident.

The reduced tax rate will not apply if the recipient carries on business through a permanent establishment or fixed base in the source country and the debt claim is effectively connected with that permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty does not define interest. Therefore, the proposed treaty's general rule for undefined terms applies: unless there is mutual agreement between the competent authorities, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest. Thus, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring forms for the identification of foreign recipients of income).

Interest would be exempt from tax by the source country under the proposed treaty if the interest is derived and beneficially owned by the other country or any instrumentality of that other country which is not subject to tax on its income by that other country or is derived and beneficially owned by a resident of the other country with respect to debt obligations guaranteed or insured by that country or an instrumentality of that country (such as the Export-Import Bank) which is not subject to tax on its income by that country.

The proposed treaty provides a source rule for interest (which is also used in Article 22 (Relief from Double Taxation) for foreign tax credit purposes). Interest will be sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country, or is a United States company which is resident in New Zealand for the purposes of New Zealand tax but is treated as a resident of neither country under the treaty (Article 4 (Residence)). However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in a country other than his country of residence and the indebtedness was incurred with respect to that permanent establishment (or fixed base), interest will be sourced in that country, regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (sections 861-862) which provide that interest income is sourced in the country in which the payor is resident. Thus, for example, if a New Zealand resident has a permanent establishment in France and that New Zealand resident incurs indebtedness to a U.S. person for that French permanent establishment, and the permanent establishment bears the interest, then the interest will have its source in France and New Zealand will not tax the interest.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by providing that the amount of interest for purposes of the treaty will be the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of this treaty (e.g., excess interest paid to a parent corporation may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of this treaty).

Article 12. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

The present treaty with New Zealand does not generally limit source country taxation of royalties. The present treaty generally allows residents of one country deriving certain royalties from sources within the other country to elect to be taxed on a net basis on the royalty income, however. The present treaty exempts from source country taxation rentals for motion picture films derived in one country by a resident of the other who has no permanent establishment in the source country, but this rule of the present treaty does not limit the New Zealand film-hire duty or the New Zealand film-hire tax on income from the business of renting motion picture films.

The proposed treaty provides for a limitation of the rate of source basis taxation of royalties. Royalties from sources (under the royalty source rule discussed below) in one country that are beneficially owned by a resident of the other country may be taxed by both countries. However, the withholding tax imposed in the source country may not exceed 10 percent of the gross royalty. The competent authorities of the two countries are to endeavor to settle the mode of application of this limitation. The 10-percent rate limitation in the proposed treaty applies only if the royalty is beneficially owned by a resident of the other country; it does not apply if the recipient is a nominee for a nonresident.

The U.S. model treaty exempts royalties from tax at source. The proposed protocol provides that if in any future tax treaty with a member of the Organization for Economic Co-operation and Development, New Zealand limits its tax at the source to a lower rate than that provided in the proposed treaty, New Zealand will without undue delay enter into negotiations with the United States to review this article with a view to providing that lower rate on a reciprocal basis.

The reduced withholding tax rate does not apply where the beneficial owner carries on business through a permanent establishment in the source country or performs personal services in an independent capacity from a fixed base in the source country, and the royalties are attributable to the permanent establishment or fixed base. In that event the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

Royalties are defined to mean payments of any kind received as a 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, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

The term royalties also includes payments of any kind received as consideration for the use of, or the right to use, industrial, commercial, or scientific equipment other than payments under a hire-purchase agreement; and income or gains from the alienation of any property or rights that would yield royalty income to the extent that such income or gains are contingent on productivity, use or disposition of such property or rights.

In certain cases, income from leasing of ships, aircraft, and containers would be royalties subject to withholding tax at the source of up to 10 percent of gross receipts if the lessor had no permanent establishment in the source country (see Article 8 (Shipping and Air Transport)).

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring forms for the identification of foreign recipients of income).

The proposed treaty provides special source rules for royalties. Generally, under U.S. tax rules (section 861-862) royalty income is sourced where the property or right is being used. The treaty alters this rule in certain cases. If a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, by a resident of one of the countries, or by a U.S. company that is resident in New Zealand under New Zealand law but that does not have a single residence for treaty purposes, then the income will generally be sourced in the country of residence of the payor. However, if the payor has a permanent establishment or fixed base in a contracting state in connection with which the obligation to pay the royalty was incurred, and if the royalties are borne by the permanent establishment or fixed base, the royalties arise (for purposes of the proposed treaty) in the country in which the permanent establishment or fixed base is situated. Finally, if the above rules do not result in a U.S. or New Zealand source for the royalties, and if the royalties relate to the use of or the right to use rights or property in either the United States or New Zealand, then the source of the royalties will be that country.

The proposed treaty provides that in the case of royalty payments or credits between persons having a special relationship, only that portion of the payment or credit that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount will be taxable according to the law of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article 10.

The proposed protocol provides that so long as New Zealand continues to tax the income of film renters under section 224 of the Income Tax Act of 1976 and to exempt from that tax certain payments received from those film renters by persons not New Zealand residents, this article would not affect New Zealand's tax or its exemptions from that tax. U.S. film renters will be taxed by New Zealand under the present statutory regime (45 percent of a deemed profit of 10 percent of the gross receipts) as long as that lower statutory tax continues in force, rather than under the terms of this Article. The proposed protocol results in a tax of 4.5 percent of gross receipts rather than the 10 percent rate authorized by this Article.

Article 13. Alienation of Property

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. A U.S. real property interest includes certain corporations holding U.S. real property.

Under the proposed treaty gains from the disposition of real property may be taxed in the country where the real property is situated. The treaty defines real property situated in the United States and real property situated in New Zealand separately. Real property situated in the United States includes real property located here for the purposes of Article 6. It also includes United States real property interests. This definition allows the United States to tax any transaction of a New Zealand resident taxable under the Foreign Investment in Real Property Tax Act of 1980.

Real property situated in New Zealand includes three categories of property: real property located there for the purposes of Article 6; shares (or comparable interests) in a company whose assets are wholly or principally New Zealand real property; and an interest in a partnership, trust, or estate whose assets are wholly or principally New Zealand real property. Such shares and interests are deemed to be situated in New Zealand, wherever the entity was created or is operated, and wherever any shares or other evidences of ownership may be found. The treaty does not define the term "principally."

Gains from the sale or exchange of ships, aircraft or containers operated or used by an enterprise of one country in international traffic are taxable only by the country of residence. However, the other country (not the country of residence) may tax the gain to the extent that it allowed depreciation to that enterprise in respect of such items. Thus, that country may recapture that depreciation. Gains from dispositions of property or rights that are subject to tax under the royalty article (Article 12) as contingent on productivity, use, or further disposition are taxable only under that article; that is, the source country tax is generally limited to 10 percent of the gross amount.

Income or gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a country has or had in the other country, or which are attributable to a fixed base available or previously available to a resident of a country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other country.

Income or gains from the alienation of any property other than property discussed above would be taxable under the proposed treaty only in the country where the alienator is a resident.

Article 14. Independent Personal Services

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from income from the performance of personal services as an employee.

Income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless (1) the person performing the personal services is present in the country where the services are performed for more than 183 days during any consecutive 12 month period, or (2) the individual has a fixed base regularly available to him in that country for the purpose of performing the services. In the second situation, the source country can tax only that portion of the individual's income which is attributable to the fixed base.

Independent personal services include all independent activities, not merely those of persons in professions such as physicians, lawyers, engineers, architects, dentists, and accountants.

The proposed treaty provides a broader exemption from tax than the present treaty. While the present treaty contains a 183-day rule, it does not exempt income under that rule unless the person performing the services does so for or on behalf of a resident of the country of which he is resident. However, the present treaty does not contain the fixed base rule of the proposed treaty; under the present treaty, a fixed base maintained in a country for the purpose of performing services does not necessarily cause taxation of those services in that country. The U.S. model treaty, by contrast, does not contain a 183-day rule, but rather allows taxation in the source country only on the basis of a fixed base regularly available to the individual performing the independent services.

Article 15. Dependent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during any consecutive 12-month period; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. In the U.S. model, the fewer than 184 day test is computed on the basis of a tax year, not on the basis of 12 consecutive months.

Compensation derived by an employee as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only by the country where the employee resides.

This article is modified in some respects for pensions (Article 18) and for compensation as a government employee (Article 19).

The present treaty does not distinguish between dependent and independent personal services. Those present treaty rules are discussed in the discussion of Article 14, above. In addition, the present treaty contains a special rule for teachers that allows visits of up to two years duration without subjecting the visiting teacher to taxation in the country he visits. Under the proposed treaty, as in the U.S. model, teachers who perform dependent personal services will be subject to the general rules for employees.

Article 16. Limitation On Benefits

The proposed treaty contains a provision which is intended to limit the benefits of the treaty to persons who are entitled to those benefits by reason of their residence in the United States or New Zealand.

The proposed treaty is intended 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 use a treaty. Such use is known as "treaty shopping", and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed treaty contains provisions intended to limit the use of the treaty to bona fide residents of the two countries. This is accomplished by providing that a person other than an individual (such as a corporation, partnership, trust, or other business organization) is not entitled to the benefits of the convention unless it satisfies any one of an ownership test, a public company test, or a good business purpose test. Under the ownership test, more than 75 percent of the beneficial interest (in the case of a company, more than 75 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of New Zealand or the United States, citizens of the United States, publicly traded companies (discussed below), or the countries (the United States and New Zealand) themselves. This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest or royalties to a New Zealand company that is owned by individual residents of a third country.

Under the public company test, a company that is a resident of one of the countries and that has substantial and regular trading in its principal class of stock on a recognized stock exchange in the United States or New Zealand is entitled to the benefits of the treaty regardless of where its actual owners reside. In addition, any interest that such a company holds is a qualifying interest under the 75-percent test, above. The term "recognized stock exchange" includes the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; the New Zealand Stock Exchange; and any other stock exchange agreed upon by the competent authorities of the two countries.

Under the good business purpose test, denial of treaty benefits does not occur if it is determined that the acquisition, ownership and maintenance of an entity that is a resident of the United States or New Zealand and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the proposed treaty. Accordingly, the provision will not apply if there was no treaty shopping motive for forming the company and if its operation does not have as one of its principal purposes the purpose of obtaining the treaty benefits. Thus the burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming treaty benefits.

The proposed treaty disallows any treaty benefits to any income derived by a trustee that is treated as income of a resident of the United States or New Zealand for purposes of the treaty if the trustee derived that income in connection with a scheme one of whose principal purposes was to obtain a benefit under the treaty.

The proposed treaty contains a rule not found in the U.S. model or in recent U.S. income tax treaties that requires consultation between the competent authorities upon invocation of this anti-treaty shopping article.

Article 17. Artistes and Athletes

The proposed treaty contains an additional set of rules which apply to the taxation of income earned by entertainers (such as theater, motion picture, radio or television "artistes" or entertainers, musicians, and athletes). The proposed article supplements the other provisions dealing with the taxation of income from personal services (Articles 14 and 15), and is intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the Article, one country may tax an entertainer who is a resident of the other country on the income from his personal services as an entertainer in that country during any year in which the gross receipts derived by him from such activities, including his reimbursed expenses, exceed $10,000 or its equivalent in New Zealand dollars. (The comparable amount in the U.S. model treaty is $20,000.) Thus, if an New Zealand entertainer maintained no fixed base in the United States and performed (as an independent contractor) for two days in one taxable year in the United States for total compensation of $9,000, the United States could not tax that income. If, however, that entertainer's total compensation were $11,000, the full $11,000 (less appropriate deductions) would be subject to U.S. tax. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence or, in the case of the United States, the country of citizenship, from also taxing that income (subject to a foreign tax credit).

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete accrues not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles 7 and 14.) For this purpose, participation in the profits of the recipient of the income includes (without limitation) the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Article 18. Pensions and Annuities

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. (This rule does not apply in the case of pensions which are paid to citizens of one country attributable to services performed by the individual for government entities of the other (Article 19 (Governmental Service)).

Pension payments and other payments made under the Social Security legislation of one country to a resident of the other country or to a U.S. citizen will be taxable only by the paying country. This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on New Zealand social security payments.

The proposed treaty also provides that annuities may be taxed by only the country of residence of the person who derives and beneficially owns them. Annuities are defined as stated sums paid periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration (other than services).

The U.S. model treaty contains rules for alimony payments and child support payments that the proposed treaty does not contain. Under the model treaty, alimony payments (and other maintenance payments other than child support payments) are taxable only by the country of residence of the recipient, while child support payments are taxable only by the country of the payor. The child support rule in the U.S. model is not subject to the saving clause. Under the proposed treaty, alimony payments and child support payments are covered under Article 21 (Other Income) and could be taxable in the country of residence of the recipient and in the country of the source of the income. At present New Zealand rules provide that such payments are neither deductible to the payor nor taxable to the recipient.

Article 19. Government Service

The proposed treaty contains the standard provision that as a general rule exempts the wages of employees of one of the countries from tax by the other country.

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services in the discharge of functions of a governmental nature rendered to that country (or subdivision or authority) would generally be taxable only in that country. However, such remuneration would be taxable only in the other country (the country not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a citizen of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, New Zealand would not tax the compensation of a U.S. citizen and resident who is in New Zealand to perform services for the U.S. government in the discharge of governmental functions, and the United States would not tax the compensation of a New Zealand citizen and resident who performs those services for the U.S. Government in New Zealand.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) would generally be taxable only in that country. However, such pensions would be taxable only in the other country if the individual is both a resident and a citizen of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature) the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes) and 18 (Pensions and Annuities) would apply to remuneration and pensions for services rendered in connection with the business.

This provision is generally excluded from the saving clause.

Article 20. Students

Under the proposed treaty, an individual who is a resident of one country and who is present for the purposes of his full-time education in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance or education. This rule also applies to a student who was a resident of one country immediately before visiting the other country. There is no precise limitation on the amount of income to which the exemption applies. The saving clause does not apply to this article.

Article 21. Other Income

This article is a catch-all article intended to cover items of income not specifically covered in other articles, and to assign the right to tax third country income to only one of the countries. It applies to income from third countries as well as income from the United States and New Zealand.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence. However, if the income is sourced in the other country, it may also be taxed by that country. The source of an item of income is determined under the domestic laws of the two countries unless the treaty contains a special rule. This provision, for example, gives the United States the sole right to tax income sourced in a third country and paid to a resident of the United States. This provision is subject to the saving clause, so U.S. citizens who are New Zealand residents would continue to be subject to U.S. taxation on their worldwide income.

The proposed protocol provides that so long as New Zealand continues to tax the income of film renters under section 224 of the Income Tax Act of 1976 and to exempt from that tax certain payments received from those film renters by persons not New Zealand residents, this article would not affect New Zealand's tax or its exemptions from that tax.

Article 22. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay 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 on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on only foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest and for DISC dividends.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income. This article provides further relief where both New Zealand and the United States will still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty generally provides for relief from double taxation by each country permitting a credit against its tax for the appropriate amount of taxes paid to the other country on income from sources within that other country. The credit is provided, however, only to the extent permitted under certain domestic laws.

The proposed treaty provides separate rules for relief from double taxation for the United States and New Zealand. In addition, it provides special rules covering U.S. citizens and companies resident in New Zealand.

United States

The proposed treaty contains the provision found in many U.S. income tax treaties that the United States will allow a citizen or resident a foreign tax credit for income taxes paid or accrued to New Zealand. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the general principles of the credit).

The proposed treaty also allows the U.S. deemed paid credit (section 902) to U.S. corporate shareholders of New Zealand corporations receiving dividends from those corporations if the U.S. company owns 10 percent or more of the voting stock of the New Zealand corporation. The credit is allowed for New Zealand income taxes paid by or on behalf of the New Zealand corporation on the profits out of which the dividends are paid. This deemed paid credit is not available in the case of a U.S. company that is a resident of New Zealand.

This article provides that New Zealand income taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such New Zealand taxes will be eligible for the U.S. foreign tax credit. These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty.

New Zealand

The proposed treaty generally provides that New Zealand is to credit U.S. taxes paid by New Zealand residents on U.S. source income. This credit is not to exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen or a United States company. That is, in the case of a New Zealand resident who is subject to U.S. tax on worldwide income as a U.S. citizen or company, New Zealand will credit only the U.S. tax to which the New Zealand resident would have been subject absent U.S. citizenship or incorporation. In addition the credit is to be computed in accordance with, and subject to any provisions of, the law of New Zealand which may from time to time be in force and which relate to the allowance of a credit against New Zealand tax for tax paid in a country outside New Zealand (which do not affect the general principle of allowing a credit). Thus, New Zealand could limit its foreign tax credit on a country by country and class-of-income by class-of-income basis.

To be creditable, the United States tax must be paid under the law of the United States and consistently with the proposed treaty. U.S. taxes are generally creditable whether imposed directly or by deduction.

The credit does not apply, in the case of a dividend, to tax paid in respect of the profits out of which the dividend is paid. The proposed treaty provides an exemption-like system for dividends received by certain New Zealand corporations from U.S. corporations in which they own at least ten percent of the paid-up share capital. Where a company which is a resident of New Zealand beneficially owns at least 10 percent of the paid-up share capital of a United States company, any dividend derived by the New Zealand company from the United States company (that would, in accordance with the taxation law of New Zealand in existence at the date of signature of the proposed treaty (July 23, 1982), be exempt from New Zealand tax) would be exempt from New Zealand tax under the proposed treaty.

The proposed treaty provides a special rule for U.S. citizens and companies that are New Zealand residents. Such persons are entitled to a credit against U.S. tax liability in the amount of the New Zealand tax paid. Thus, New Zealand generally would have primary taxing jurisdiction over the income of such persons. This U.S. tax credit is not to reduce U.S. taxation on a source basis of such a person's U.S. source income.

In this article, the proposed treaty also provides source rules for determining when an item of income arises in one of the countries. These source rules are used for the purpose of allowing relief from double taxation under this Article. These source rules do not supersede the U.S. source of income rules for the purpose of internal U.S. law.

The general source rule is that an item of income of a resident of one country that may be taxed in the other country under the treaty is considered to arise in that other country. Accordingly, income taxes paid to that other country on that income will be creditable (subject to any relevant limitations) in the country of residence.

The general source rule (described above) does not apply to income derived by an New Zealand resident that is taxable in the United States solely by reason of U.S. citizenship or solely by reason of U.S. incorporation. Such income will not be treated as U.S. source income. Income of a U.S. citizen or company resident in New Zealand is to be treated as New Zealand source income to the extent necessary to implement the special treaty rule, described above, that allows primary taxing jurisdiction to the United States on the U.S. source income of such a person while allowing primary taxing jurisdiction to New Zealand on the non-U.S. source income of such a person.

The treaty does not affect the U.S. treatment of taxes not covered by Article 2 (Taxes Covered), whatever the source of the affected income under the treaty. The treaty's source rules do not apply for purposes of computing the limitation for other foreign taxes.

Article 23. Nondiscrimination

The proposed treaty contains a non-discrimination provision relating to the taxes covered by the treaty similar to provisions which have been embodied in other recent U.S. income tax treaties. This non-discrimination provision differs from other recent treaties and from the U.S. model in that it allows existing practices to continue, and in that it does not cover either U.S. or New Zealand taxes not generally covered by the proposed treaty or the taxes of States, localities, or other political subdivisions.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes (or requirements connected with taxes) on citizens of the other country than on its citizens in the same circumstances. This provision applies whether or not those citizens are residents of the United States or New Zealand. However, for the purposes of United States tax, a United States citizen who is not a resident of the United States and a New Zealand citizen who is not a resident of the United States are not in the same circumstances.

Similarly, in general, one country cannot impose less favorable taxes on permanent establishments of residents of the other country than it imposes on its comparable residents. However, a country need not grant to residents of the other country the personal allowances, exceptions, rebates, reliefs, or deductions for taxation purposes on account of personal status that it grants to its own residents.

The non-discrimination provision is subject to two exceptions regarding permanent establishments not found in the U.S. model treaty. First, it does not prevent a country from imposing on the profits attributable to a permanent establishment in that country of a company which is a resident of the other country a tax not exceeding 5 percent of those profits in addition to the tax that would be chargeable on those profits if they were the profits of a company which was a resident of the country where the permanent establishment had its location. The United States does not impose such a tax, known as a branch profits tax. New Zealand now imposes a branch profits tax at the rate of 5 percent. Such a tax is analogous to the U.S. tax on certain dividends of foreign corporations that are attributable to U.S. operations (see discussion of Article 10 above). The U.S. model clearly contemplates coexistence of that U.S. tax with a broad non-discrimination article.

The proposed treaty differs from the U.S. model non-discrimination provision for permanent establishments in a second way. The proposed treaty would not require a country to grant to a company which is a resident of the other country the same tax relief that it provides to a company which is its resident with respect to dividends received. The United States allows U.S. branches of foreign corporations a dividends received deduction of no more than 85 percent, whereas U.S. corporations sometimes may deduct dividends received in full. New Zealand allows resident—but not nonresident—companies a dividends received deduction. The specific coverage in this treaty is at the request of New Zealand.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(6) (Interest), and 12(6) (Royalties)) to allow a resident to deduct interest, royalties, and other disbursements paid by the resident to a resident of the other country under the same conditions that they allow deductions for such amounts paid to residents of the same country as the payor.

The rule of non-discrimination also applies to corporations of one country which are owned in whole or in part by residents of the other country. An enterprise resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, would not be subjected in the country of its residence to any taxation or any directly connected requirement which is more burdensome than the taxation and directly connected requirements that the country of its residence imposes or may impose on its enterprises carrying on the same activities but the capital of which is owned or controlled by its residents.

The proposed treaty would permit a country to continue any discriminatory tax laws in force on July 23, 1982 (the date of the signing of the treaty), and to adopt any later discriminatory laws that are substantially similar in general purpose or intent to tax laws in effect on July 23, 1982, but that are enacted after that date. In addition, either country could adopt discriminatory laws reasonably designed to prevent or defeat tax avoidance or evasion. Any such substantially similar law or anti-avoidance law cannot favor citizens or residents of any third country over citizens or residents of the treaty partner (the United States or New Zealand) of the country adopting the modification. The proposed treaty does not prevent such discrimination in favor of a third country by treaty, however.

Although this provision does not comport with the U.S. model treaty, New Zealand has never agreed to a more comprehensive non-discrimination rule than that of the proposed treaty.

The non-discrimination provisions do not generally require either country to treat nonresidents as it treats residents.

If the United States or New Zealand considers that future tax measures of the other country violate this non-discrimination clause, the competent authorities of the countries are to consult together in an endeavor to resolve the matter.

The non-discrimination provision is not intended to override the right of the United States to tax foreign corporations on their dispositions of a U.S. real property interest because the effect of the provisions imposing the tax is not discriminatory.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to this non-discrimination article.

Article 24. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of both the United States and New Zealand to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under the proposed article a resident of one country who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The taxpayer must notify this competent authority of his case within three years from the time the taxpayer receives notice of the action he considers improper. The competent authority then makes a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority would endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the Convention. The provision requires the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the Contracting States are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

Unlike the U.S. model, the proposed treaty does not list particular matters to which the competent authorities might agree. However, it is intended that, as under the U.S. model, the competent authorities would be authorized to agree to the allocation of income, deductions, credits, or allowances, to the determination of the source of income, and to the common meaning of terms.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. These provisions make clear that it is not necessary to go through standard diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or New Zealand.

Article 25. Exchange of Information

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes covered by the treaty insofar as the taxation under those domestic laws thereunder is not contrary to the treaty. The exchange of information is not restricted by Article 1 (General Scope). Therefore, third country residents would be covered. The U.S. model treaty provides for the exchange of information about all taxes imposed by either country (whether or not otherwise covered by the treaty). The proposed treaty is more limited, applying only for enforcement of the taxes listed in Article 2 as generally covered by the treaty (generally income taxes).

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. Exchanged information is to be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the treaty. Such persons or authorities could use the information for such purposes only. Persons involved in the administration of taxes include legislative bodies involved in the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider to be necessary to carry out their oversight responsibilities.

Upon an appropriate request for information, the requested country is to endeavor to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, once the U.S. Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the United States investigators can no longer use an administrative summons to obtain information. If, however, New Zealand could still use administrative process to obtain requested information, it would be expected to do so even though the United States cannot. The United States could not, however, tell New Zealand which of its procedures to use.

Where specifically requested, the requested competent authority would attempt to provide the information in the form requested.

Specifically, the competent authority would attempt to provide depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, and writings) to the extent that they can be obtained under the laws and practices of the requested country in the enforcement of its own tax laws.

A country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information which is not obtainable under the laws or in the normal course of the administration of either country, to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

The U.S. model treaty provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain such a collection provision.

Article 26. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the convention will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply to this article, so that, for example, U.S. diplomats who are considered New Zealand residents would not be subject to New Zealand tax.

Article 27. Entry Into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon as possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged.

With respect to U.S. taxes withheld at source, the treaty will be effective for amounts or credited on or after the first day of the second month next following the date on which the treaty enters into force. With respect to other U.S. taxes, the treaty is to be effective for taxable years beginning on or after the date on which the treaty enters into force.

With respect to New Zealand withholding taxes on income derived by nonresidents of New Zealand, and with respect to other New Zealand taxes, the treaty will be effective for any income year beginning on or after the first day of April next following the date on which the treaty enters into force.

If the Convention enters into force before April 1, 1984, New Zealand is to apply the provisions of Article 10 (Dividends) for the purposes of New Zealand tax to dividends derived on or after April 1, 1982 and beneficially owned by a resident of the United States. That is, the reduced rate of New Zealand withholding taxes on dividends would apply retroactively.

The existing treaty is to be phased out as the proposed treaty becomes effective. When the proposed treaty becomes fully effective, the existing treaty will terminate.

Article 28. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months prior notice through diplomatic channels.

If termination occurs, with respect to U.S. taxes withheld at source, the termination will be effective for amounts paid or credited on or after the first day of January next following the expiration of the six month period. With respect to other U.S. taxes, the termination will be effective for taxable periods beginning on or after the first day of January next following the expiration of the six month period.

With respect to New Zealand withholding taxes on income derived by nonresidents of New Zealand, the termination will be effective for income derived on or after the first day of April next following the expiration of the six month period. With respect to other New Zealand taxes, the termination will be effective for any income year beginning on or after the first day of April next following the expiration of the six month period.

Proposed Protocol

A proposed protocol to the treaty was signed at the time the proposed treaty was signed. The proposed protocol clarifies certain points raised in the treaty. The clarifications relate to the Articles dealing with dividends (Article 10), interest (Article 11), royalties (Article 12), and the Articles dealing with business profits (Article 7), royalties (Article 12), and other income (Article 21). The clarifications are described in the Articles affected.

IV. REVENUE EFFECT

The treaty is expected to have a negligible effect on budget receipts.

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