Applicability of the source rules to directors’ fees received by overseas non-residents for services performed outside New Zealand

Abstract
This article explores the gaps that exist with regard to the taxation of directors’ fees received by overseas non-residents for services performed outside New Zealand. This research examines both the New Zealand legislation and leading cases in New Zealand and other jurisdictions in the area of source of receipts from personal services, to arrive at some conclusions about the circumstances in which those will fees be found to be taxable income in New Zealand. To determine the legal criteria that identify source of directors fees, the paper analyses Article 16 of OECD Model Tax Convention, Inland Revenue’s historic ruling, ss BD1 (Scope of New Zealand tax), BE 1 (Withholding liabilities) and YD 4 (Source rules) of the Income Tax Act 2007.

In the absence of a clear statutory provision in the Income Tax Act 2007, on the basis of case law the article attempts to explain the underlying principles on which such fees received may be taxed within the broader context of the Income Tax Act 2007.

The article demonstrates that, as evidenced by case law, interpretation of s YD 4 is based on the judicial concept of ‘derived’. In the absence of a clear statutory test this analytical paper attempts to establish a guide for policymakers to take the next step to ensure that unfairness caused by those deficiencies does not ultimately undermine the tax system and at the same time protects revenue, specifically while dealing with the countries New Zealand does not have a Double Tax Agreement with.

1.0 Introduction

In 1991 the New Zealand Government outlined a policy framework for taxing income across international borders.¹ That document emphasised the primacy of domestic tax rules in relieving undesirable double taxation and dealing with international tax problems. It argued that double tax treaties played a secondary role. The global competition, technological developments, mobile capital, in particular intangible assets and the current rules, both national and international, for taxing income are

causing increasing problems for national income tax systems.\textsuperscript{2} Directors’ fees are a part of the domestic tax base and are growing in terms of size because with a decentralized management structure directors are likely to be engaged from different locations. The rapid growth of electronic commerce has made high mobility of directors a widespread phenomenon.

Multinational corporations are outsourcing companies’ labour-intensive departments overseas and have learned the importance of extending their boards’ expertise and experience by having foreign directors.\textsuperscript{3} In addition, there is an increasing numbers of companies incorporated in New Zealand with only foreign directors and shareholders.\textsuperscript{4} A report by Gary Dodd, reporting analyst at New Zealand Companies office shows that out of 50,792 New Zealand companies newly registered between 1 July 2014 and 30 June 2015, 291 companies have only overseas directors and shareholders.\textsuperscript{5} In such situations board meetings are conducted by mail. These New Zealand companies may also held directors’ meetings overseas through tele-conference or video-conference or skype in the non-resident director’s home state, or a third state. However, the Organisation for Economic Co-operation and Development (OECD) provision for directors’ fees was based on the assumption that directors always perform their services in the residence state of the company.\textsuperscript{6} The challenge for New Zealand tax authorities is to provide a legal and administrative environment that allows companies to engage directors from different locations, but one that also allows the revenue authority to collect the tax on directors’ fees sourced from New Zealand resident company.


\textsuperscript{4} Companies Amendment Act 2014 requires that by 28 October 2015 a New Zealand-registered company, must have at least one director living in New Zealand, or in Australia if a director of an Australian incorporated company.

\textsuperscript{5} Companies Register report showing the count of companies incorporated where the companies only had only overseas based directors and shareholders was emailed by Gary Dodd to the author on 17 Sept 2015. A copy of the report is available from the author on request.

\textsuperscript{6} Fiscal Committee/Working Party (1958)1, Second Report on the Taxation of profits or Remuneration in Respect of Dependent and Independent Personal Services.
The objective of this paper to address this potential research gap by analysing the feasibility of using legal and administrative criteria in relation to director’s fee received from a New Zealand tax residence company by the director who is non-resident for tax purposes and has performed services without being present in New Zealand. This study is important because it provides clarity to the taxation system, and at the same time protects and expand their tax base if any loophole is detected under which the taxpayers are getting benefits unintended by Inland Revenue.

The paper proceeds as follows; Section 2 of the paper sets out a brief review of the Article 16 of OECD Model Tax Convention and the commentary of OECD. Section 3 provides a historic technical ruling issued by Inland Revenue in relation to the taxation of directors’ fees. Section 4 of the paper sets out a review of the relevant New Zealand legislative provisions. Section 5 of the paper discusses the relevant cases from New Zealand and Australia in relation to source of income from personal services and expands on Australia’s new statutory provisions. Finally, part 6 discusses relevant tax administration issues and concludes by outlining the salient outcomes of the research.

2.0 OECD Model Tax Convention – Article 16 Directors’ Fees

Directors’ fees are a receipt in return for personal exertion. Article 16 of the OECD Model was based on the principle of taxation at source and on the assumption that directors always perform their services in the residence country of the company. Article 16 of the OECD Model does not take into account the residence state of the director from where the services are performed. The provision is aimed at avoiding difficulties when defining where a director actually performs his work.

Since 1963, the only amendment to the wording of Article 16 occurred in 1977. In the course of the update of the OECD Model, the word “other” was inserted, so that the article has since read:

"Directors’ fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State."

The historic materials on the update of the OECD Model do not elucidate the reasons for this change but this insertion of “other” does not affect the scope of the provision. 

7 OECD Model Tax Convention, Article 16.
8 OECD Model Tax Convention, Commentary on Article16.
Even though to facilitate the interpretation of Article 16 after 1963 the commentary has been upgraded but still Paragraph 2 of the 2014 OECD Commentary to Article 16 to the author’s knowledge does not indicate that even though the job description of a member of a board of directors might contain managerial as well as supervising functions, Article 16 only applies to consideration for supervisory activities. This can be derived from the wording that “the Article does not apply to remuneration paid to such a person on account of […] other functions [author’s emphasis]” and the examples given that only comprise activities that are not part of the job profile of a director and the scope of Article 16 is still vague in many respects. R Prokisch\(^9\) also concluded that neither the OECD Model nor the Commentary provides guidance on the functions that must be carried out by a member of board of directors. The use of the term “directors’ fees and other similar payments” is not limited to encompass solely money but covers payments in kind alike.\(^{10}\) However, Article 16 does not cover employment but only income from independent work\(^{11}\) and the mechanism used in Article 16 to allocate taxing rights is not consistent with other provisions on services in The OECD Model Convention.

In modern era, like many other services, directorship\(^{12}\) can be sourced from overseas. When directorship services are supplied by a non-resident, the service provider may be subject to double taxation arising from taxation of both source and residence. The majority of treaties follow a residence based taxation system, in which residence constitutes the primary and subsidiary jurisdictional principle. To avoid this double taxation, most tax treaties have one article that specifically allocates the right to tax directors’ fees. However, to the best of the author’s knowledge, only most tax treaties signed by the United States of America do not have a separate article for directors’ fees. Most New Zealand’s Double Tax Agreements (DTAs) base their article for directors’ fees on the OECD Model Tax Convention, based on the principle of


\(^{10}\) OECD Model Tax Convention, Commentary on Article16, Paragraph 1.1.


\(^{12}\) Income Tax Act 2007, Section YA states that director means “(i) a person occupying the position of director, whatever title is used….”.
taxation at source i.e. in the residence state of the company, only with few exceptions.\textsuperscript{13} Article 16 of the OECD Model Tax Convention refers to the “the contracting state” for the purpose of residence of the company, the residence state of the board members follow this approach of the source state.

According to Graaf and Potgens,\textsuperscript{14} the tax residence states of the companies have the right to tax directors’ fees. Whether the companies actually pay the directors’ fees\textsuperscript{15} is irrelevant, and whether the directors are present in the company’s residence state is irrelevant. Article 16, in Graaf and Potgens’s opinion, provides an effective source rule and the term ‘resident of a contracting state’ plays a prominent role.

Hunt\textsuperscript{16} had a similar interpretation of Article 16. He suggests that directors’ fees may always be taxed by the companies’ residence states. The allocation of this taxing right is not to be changed even if the services are performed in the other state and/or the directors may also be taxed in their residence states. Hunt describes Article 16 as a special case in comparison to the articles for dependent\textsuperscript{17} and independent personal services.\textsuperscript{18}

New Zealand never enacted legislation to tax directors’ fees in accordance with the

\textsuperscript{13} New Zealand’s DTAs with Belgium and Philippine require that directors’ fees in relation to day-to-day functions of a managerial or technical nature should be taxed under the provision of article 15 – Dependent personal services.

The DTA with Netherlands requires that director’s fee can only be taxed in a company’s residence state if the director has exercised activities of a regular and substantial character in a permanent establishment situated in the company’s residence state. The fact that the director’s fee is still deductible in the company’s residence state is irrelevant.

The DTA with Japan does not have a separate article for directors’ fees. This is because the DTA between New Zealand and Japan is very outdated for political reason. For example, the DTA between Japan and China has an article for directors’ fees and this article has followed the OECD Model Tax Convention.


\textsuperscript{15} The companies may alternatively create a memorandum account or create a debt.


\textsuperscript{17} Article 15 – Income from employment of OECD Model Tax Convention 2010. This article is also known as “Dependent personal services”.

\textsuperscript{18} Article 14 – Independent personal services of OECD Model Tax Convention. OECD deleted this article in the Model Tax Convention 2010 version. Income from independent personal services is taxed under the provision of Article 7 – Business profit.
approach suggested by the OECD. Harris\textsuperscript{19} provides the alternative opinion that the right to tax directors’ fees given by OECD in Article 16 is a non-exclusive right, since the residence state of the director may also tax the fees received. The residence state of the director is obliged to give relief for double taxation under Article 23A or 23B of the OECD Model Convention. The place where the services are performed is irrelevant. According to Harris, New Zealand taxes the fees only to the extent that the services are performed in New Zealand.\textsuperscript{20}

Baker\textsuperscript{21} proposes an explanation for why the OECD has placed directors’ fees in a separate article and allocated the taxing right using a special rule.\textsuperscript{22} According to Baker, domestic laws of tax jurisdictions may have different treatments for directors’ fees such as remuneration for dependent services, income from independent personal services, or neither of the two. As directors’ fees is not a form of employment, therefore to avoid double taxation, Article 16 was specifically designed to override the general rule of Article 15, Income from Employment.

A closer look at the OECD Commentary can assist in providing the intention behind Article 16. Part of paragraph 1 of the OECD Commentary on Article 16 states:\textsuperscript{23}

\begin{quote}
\textit{“Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.”}
\end{quote}

While it is generally agreed that Article 16 deems that the directorship services are performed in the companies’ residence states, which have the right to tax directors’ fees. The reason for this rule, according to the Commentary, is because the places where the services are performed can be difficult to ascertain. The author would like to clarify that the aim of this study is not to investigate why the OECD has given the

\begin{itemize}
\item \textsuperscript{19} G A Harris, \textit{New Zealand’s International Taxation} (Oxford University Press, Auckland, 1990) at 235.
\item \textsuperscript{20} G A Harris, \textit{New Zealand’s International Taxation} (Oxford University Press, Auckland, 1990) at 235. This view of Harris is very relevant to this paper and will soon be revisited in Section 3.
\item \textsuperscript{23} OECD Model Tax Convention 2010, Commentary on Article 16.
\end{itemize}
taxing right to the source state\textsuperscript{24} without any restrictions according to tax treaty law, instead of the residence states of directors. The author can only observe that the OECD has given the taxing right to the states in which the directors’ fees incurred are deductible against the companies’ revenue. However, it is not essential for the application of Article 16 to ascertain who pays or economically bears the remuneration.\textsuperscript{25} Furthermore, residence of the company of which director is a board member might be an indicator of the utilization of the work of director.\textsuperscript{26} The director is “economically present” in the residence state of the company as he directs activities that are presumably to a large extent carried out in this state by subordinates.\textsuperscript{27} Based on the above, it is specified that payments made to partners of the limited partnership that is treated under the tax laws as fiscally transparent in its residence state are not included in Article 16 of the OECD Model.

It should be noted that most of New Zealand tax treaties provide that New Zealand companies could claim deductions for directors’ fees paid to non-resident directors who have performed serviced outside New Zealand and New Zealand may tax the directors’ fees. However, tax treaties cannot allocate to New Zealand companies a right to impose tax obligations on non-resident directors but can be used to relieve double taxation. This tax liability must be incorporated into New Zealand domestic law because tax administrations and courts are bound to defer primarily to domestic law, which gives them their authority.

\textbf{3.0 Inland Revenue Department Ruling}

Inland Revenue’s Technical Rulings Amendment No. 68 covers non-residents’ income from New Zealand.\textsuperscript{28}

\textsuperscript{24} Residence states of the companies.


\textsuperscript{28} The Technical Rulings Amendment No. 68 is a rewrite of Amendment No. 391 issued in January 1987, which has been destroyed. The author has not been able to retrieve this document to determine whether Inland Revenue had previously deemed that directors’ fees had source in New Zealand only when the services were performed in New Zealand.
Paragraph 43.12 of the document states:29
“Directors’ fees, salary and wages, and other remuneration for personal services are deemed to be derived in the country in which the services are performed. The source rules apply to taxing such income in New Zealand irrespective of the employers country of residence or which country the payments are made from.”

The income is deemed to have a New Zealand source as salary/wages, business income, or as contract payments if the services are performed in New Zealand.

Paragraph 43.12.1.1 of the document states:
“If an overseas director, other executive, or employee is paid by a New Zealand company or branch, but is not present in New Zealand at all in the particular income year, no part of the payment is liable to New Zealand taxation. The fact that no New Zealand tax is payable by the recipient does not affect the company or organization making the payment claiming it as a deduction, provided sufficient services are performed overseas on account of the New Zealand operation to justify the payment.”

The terminology used in the above ruling is very clear. Directors’ fees is eligible for taxation in New Zealand if it is sourced from New Zealand. Directors’ fees cannot be taxed in New Zealand if the directors were not present in New Zealand. With the exception of chapter 53 (Charities/Donee Organisations), the updating of the Technical Rulings Manual was discontinued by the Inland Revenue in September 1998. When the Inland Revenue reproduced the Technical Rulings Manual and made it available to the public, the Department announced that this document can best be described as historical guidelines for staff and should not be relied upon as representing Inland Revenue's present views or practice.30 All references have been omitted and Inland Revenue has stated that while dealing with technical issues the principles of statutory interpretation are applied. However, to date there has not been any update on this issue and there is no sign of change from Inland Revenue.


Harris\textsuperscript{31} suggested that directors’ fees are only taxed in New Zealand if the services are performed in New Zealand. The terminology adopted in Inland Revenue’s ruling is very similar to Harris’s book,\textsuperscript{32} which was published 2 years before the ruling. The only reference that Harris provided for this position was Robertson’s case.\textsuperscript{33} This case is discussed in Section 5 of this paper.

The same position has also been held by CCH.\textsuperscript{34} CCH suggests that the country in or from which the remuneration is paid or the country of residence of the employer are not relevant factors and refers to this position as the “general statement of the position”.\textsuperscript{35} Thomson Reuters also noted that a non-resident director of a New Zealand company who does not visit New Zealand incurs no liability to New Zealand tax on director’s fees received.\textsuperscript{36}

It appears that Inland Revenue’s historic ruling, Harris, CCH and Thomson Reuters have reached the same position which provides a quick answer to the question raised in this paper. Since the source of this position seems to be mysterious\textsuperscript{37} therefore they are of little assistance. However, most academics and tax practitioners seem to be influenced by this position when they face the issue of taxation of directors’ fees paid

\textsuperscript{31} G A Harris, \textit{New Zealand’s International Taxation} (Oxford University Press, Auckland, 1990) at 235.

\textsuperscript{32} G A Harris, \textit{New Zealand’s International Taxation} (Oxford University Press, Auckland, 1990) at 234 states: “Under NZ Domestic law, directors’ fees are apparently treated no differently from general employment income. They are sourced in NZ if earned there, that is, if the work is done there; the residence of the company and place of payment are irrelevant.”

\textsuperscript{33} Robertson v FCT [1937] HCA 32; (1937) 57 CLR 147.

\textsuperscript{34} http://inteligonnect.wkasiapacific.com.ezproxy.aut.ac.nz/


\textsuperscript{36} Thomson Reuters, New Zealand, retrieved from Westlaw NZ online. http://www.westlaw.co.nz.ezproxy.aut.ac.nz/ Document patch: Westlaw New Zealand Staples and Tax Rates Guide; Staples Tax Guide>1000 Non-residents and Absentees >1000.40 Personal services of non-resident company director.

\textsuperscript{37} The author cannot find out who originally made this position and how the position was made. Neither Harris nor Inland Revenue’s ruling nor CCH or Thomson Reuters have provided reference for this position.
to non-resident directors who have performed serviced outside New Zealand.\textsuperscript{38} This position will be revisited afterwards. The paper will now consider New Zealand’s statutory law and judicial interpretation.

\textbf{4.0 New Zealand Legislative Provisions}

\textbf{4.1 Section BE 1 of Income Tax Act 2007}

Section BE 1 of the Income Tax Act 2007 (hereinafter referred to as “the Act”), imposes withholding liability to any person who makes a PAYE income payment. Schedule 4, Part B of the Act categories a payment of a company director’s fee as a schedular payment and the tax rate is set at 33%.

The Act requires that any person who pays director’s fee must withhold an amount of 33\% of the payment and pay such an amount to the Commissioner. The sections that govern withholding liabilities, PAYE income payment and PAYE rules do not provide an exception for the situation where the directors’ fees are paid to non-residents who perform the services outside New Zealand. The \textit{facts (is)} of withholding rules under s BE 1 do not shed light on what the law \textit{ought} to. Therefore, in order to determine whether the non-resident directors are liable for income tax in New Zealand, it is necessary to understand legal norms (\textit{ought}).\textsuperscript{39}

\textbf{4.2 Section BD 1 of the Act}

Section BD 1 is the pivotal section which establishes the scope of New Zealand’s taxation. New Zealand tax residents are taxed on their worldwide income. Non-residents, on the other hand, are only taxed on their New Zealand sourced income. Non-residents’ foreign-sourced income is not part of the assessable income in accordance to s BD 1 (5)(c). Section BD 1(1) provides that: “an amount is income of a person if it is their income under a provision in Part C (Income).” Part C of the Act contains a number of specific provisions outlining what is included in the term income for income tax purposes. It also defines amounts that would be income but are exempt\textsuperscript{40} or excluded\textsuperscript{41} under the Act from income tax liability or non-residents’


\textsuperscript{40} ITA 2007, s BD 1(2).

\textsuperscript{41} ITA 2007, s BD 1(3).
foreign-sourced income.\textsuperscript{42} However, director’s fee is neither exempt income nor excluded income. Section CE 1(1)(e) of the Act includes company director’s fee as an amount derived from employment. Therefore, the director’s fee received by a non-resident is taxable in New Zealand if it is sourced in New Zealand and company can be required to withhold tax from the amounts paid to non-resident directors.

\textbf{4.3 Section GC 6 of the Act}

It is a cross border transaction between a New Zealand company and the overseas director. Hence the transfer pricing rules under s GC 6 of the Act may also apply.

Transfer pricing rules focus on the arm’s length principle and ensure that the directors’ fees are not used to shift profit out of New Zealand. It may be a transaction between associated parties and overseas directors may increase the amount of fees to cover the tax deducted in New Zealand. The fees above the market rate will trigger adjustments under transfer pricing rules.\textsuperscript{43} Therefore, there must be a service for the director’s fee paid and the fee must be charged at the market rate. Once Inland Revenue has determined under transfer pricing rules the appropriate prices for the directorship services then they will determine whether the director’s fee has a source in New Zealand.

\textbf{4.4 Section YD 4 of the Act}

Section YD 4, the section most germane to this paper, provides \textit{classes} of incomes treated as having source in New Zealand. The Act and previous revenue acts\textsuperscript{44} have similar lists of incomes that are treated as having source in New Zealand. Cunningham et al,\textsuperscript{45} opined that the policy of New Zealand Act generally follows the English Act, although the law on assessable income in New Zealand has a wider sense than the principle of “property within the jurisdiction” in the United Kingdom.

Section YD 4(4) of the Act identifies personal services in New Zealand and provides:

\begin{quotation}
\textsuperscript{42} ITA 2007, s BD 1(4).
\textsuperscript{43} The discussion on adjustments under transfer pricing rules is outside the scope of this paper.
\textsuperscript{45} HA Cunningham, M I Thompson and J Rodgers, \textit{Cunningham and Thompson’s Taxation Laws of New Zealand} (Butterworths, Wellington, 1973) Volume 1 at 832 – 833.
\end{quotation}
“An amount that is income under section CE 1 (Amounts derived in connection with employment) has a source in New Zealand if the amount is earned in New Zealand, even if the employer is not a New Zealand resident.”

It appears that the source of directors’ fees should be determined under s YD 4(4) of the Act. However, this should not exclude directors’ fees from being found to have source in New Zealand under other subsections of YD 4 such as YD 4(3) and YD 4(18) of the Act.\(^\text{46}\)

Under s YD 4(3)\(^\text{47}\) if there is a contract between a non-resident director and a New Zealand company for the services provided, the director’s fee do not have a source in New Zealand because the director has performed the contract wholly outside New Zealand.\(^\text{48}\) It is arguable that the legislature has intended not to tax income from contracts performed outside New Zealand, therefore the directors’ fees paid to overseas non-resident directors do not have source in New Zealand and should not be taxed in New Zealand. Under s CE1 remuneration deemed to be soured in the residence state of the director.

However, the above argument seems to be incorrect. Under s YD 4 all subsections, except s YD 4(18), are independent of each other. They are not mutually exclusive. Whether one subsection applies to a case does not affect the application of other subsections. In addition, s YD 4 provides a list of incomes that are treated as having New Zealand source and cannot be used to exempt or exclude the tax liability of any income. Director’s fees may be found to be non-residents’ foreign-sourced income in individual cases only if the fees do not have a source in New Zealand under s YD 4.

Although s YD 4(4) of the ITA 2007 clearly accommodates directors’ fees, the phrase

\(^{46}\) ITA 2007, s YD 4(18) states:  
“Income derived directly or indirectly from any other source in New Zealand has a source in New Zealand.”

\(^{47}\) ITA 2007, s YD 4(3) states:  
“Income derived by a person from a contract has a source in New Zealand if the contract is—  
(a) made in New Zealand, except to the extent to which the person wholly or partly performs the contract outside New Zealand, and the income is apportioned to a source outside New Zealand under s YD 5;  
(b) made in New Zealand but the person wholly or partly performs the contract here, to the extent to which the income is apportioned to a New Zealand source under s YD 5.”

\(^{48}\) Whether the contract was made in New Zealand is irrelevant.
“earned in New Zealand” is not defined in the Act. This term was also not defined in any previous acts and it was therefore left to courts and commentators to arrive at a sustainable meaning. The source rules appears to be mere fiction or arbitrary therefore, taxpayers, their advisors together with the Inland Revenue, had no choice but to work within the ambits of an indefinite concept of earned in New Zealand. The New Zealand courts have relied on cases from other jurisdictions in order to derive a general meaning of the word “earn”. Therefore, it is important to analysis the relevant Australian cases and legislation.

4.5 Article 22 of the Double Tax Agreement between New Zealand and Australia

The Article 22 of the Double Tax Agreements (“DTAs”) between Australia and New Zealand is also relevant in relation to the issue of directors’ fees discussed in this paper. In accordance with Article 22, directors’ fees received by New Zealand residents from Australian companies for services performed in New Zealand are deemed to be income from source in Australia for the purpose of the law of Australia relating to its tax and vice versa. The author believes that the function of Article 22 is to provide source rules to Contracting States as a substitute for the domestic source rules. This means that Contracting States may tax the income, profits or gains according to their taxing rights allocated in the DTA even when their domestic laws do not recognise that the sources of the income, profits or gains are in their countries.

49 ITA 2007 defines a similar term “derived in New Zealand” as having a source in New Zealand described in ss YD 4 (Classes of income treated as having New Zealand source) and YZ 1 (Source rule for interest). This definition does not help defining the term “earned in New Zealand”.

50 Source of income. In the earlier NZ Australia DTA it was Article 23.

51 Only three DTAs (DTA with Australia, Malaysia and Singapore) signed by New Zealand have separate article for Source of Income. In DTAs with Malaysia and Singapore, the article for Source of Income do not cover directors’ fees. The Article 22 of the DTA between Australia and New Zealand covers directors’ fees under Article 16. Article 22 was introduced by Australia because same articles for Source of Income can be found in some recent treaties signed by Australia, such as DTA with Turkey in 2010, DTA with Japan in 2008, DTA with France in 2006 and DTA with Norway 2006.

52 Paragraph 1 of Article 22 of the DTA between Australia and New Zealand states: “Income, profits or gains derived by a resident of a Contracting State which, under any one or more of Articles 6 to 8 and 10 to 19 may be taxed in the other Contracting State shall for the purposes of the law of that other Contracting State relating to its tax be deemed to arise from sources in that other Contracting State.”
The benefit provided by Article 22 is clearly available to Australia. Further, whether this article functions as source rules for New Zealand’s tax law depends on whether the New Zealand’s legislative authority to incorporate double tax agreements into domestic law provides that the tax agreements operate notwithstanding anything to the contrary in the Income Tax Act or any other enactment. It is submitted that there is no such a provision in the Act and treaties do not extend the taxing rights. Treaties may intervene to restrict or eliminate the taxing right originating from domestic laws if the person is eligible for the benefits of treaty in relation to that income.

5.0 Source of Income – Is There a Rule of Law?

To determine the source of directors’ fees, cases on source of income from personal services from New Zealand courts are of some help here. The leading Australian cases have influenced New Zealand courts on the issue of source of income. It is very difficult to isolate the New Zealand perspective from the Australian cases and study the issue in a purely New Zealand context. Therefore, first this section will discuss some relevant Australian cases.

5.1 Australia’s Judicial Approach

The two leading Australian cases on source of income from personal services are **FCT v French** and **FCT v Mitchum**. However, the judges in both cases noted **Nathan v FCT** as an important basis for their decisions.

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53 ATO Interpretative Decision (ATO 2008/151).

54 ITA 2007, s BH 1(4).

55 Most of the publications in New Zealand discusses the source of directors’ fees under Article 16 of the OECD Model Tax Convention and New Zealand’s double tax agreements. The author could find discussion on treatment of source of directors’ fees by New Zealand domestic law in Harris’s book *New Zealand’s International Taxation* and Elliffe’s book *International and Cross-Border Taxation in New Zealand*.


57 **FCT v French** [1957] HCA 73; 98 CLR 398; [1958] ALR 49; 11 ATD 288; (1957) 7 AITR 76.


59 **Nathan v FCT** [1918] HCA 45; (1918) 25 CLR 183; 24 ALR 286.
Nathan’s case

The decision in Nathan’s case illustrates the principle that there should be no rule of law applied to determine the source of income in the absence of a statutory provision. In the Nathan’s case Isaacs J stated: 60

“The Legislature in using the word “source” meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belong. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.”

This principle has been consistently followed in subsequent Australian cases. In CIR v NV Philips’ Gloeilampenfabrieken, a New Zealand case, Gresson J approved this principle 61 and said: 62

“What has to be determined is the sense in which the legislature used the word in s 87(n). The test – what a practical man would regard as the real source as a practical, hard matter of fact – which was formulated in Nathan v Federal Commissioner of Taxation ((1918) 25 C.L.R. 183) approved as it has been by the Privy Council in Liquidator, Rhodesia Metals, Ltd (In Liqdn.) v Commissioner of Taxes ([1940] A.C. 774; [1940] 3 ALL E.R. 442), must be adopted.”

It is clear from Philips 63 that Gresson J approved and adopted the test of practical man from Nathan 64 but concluded that the interest income in this case did not have source in New Zealand. 65 Gresson J upheld Latham CJ’s judgment in FCT v United Aircraft Corporation 66 that income can be sourced either from property owned or work done

60 Nathan v FCT [1918] HCA 45; (1918) 25 CLR 183; 24 ALR 286.
61 This principle may also be referred as “the test of practical man” in this paper.
63 CIR v NV Philips’ Gloeilampenfabrieken (1955) 74 NZLR 868 (CA).
64 Nathan v FCT [1918] HCA 45; (1918) 25 CLR 183; 24 ALR 286.
65 The originating cause to the interest income was that the Dutch company lent money in London, which was crucial for the obligation to pay interest. Therefore, the source of this interest income was not in New Zealand.
66 FCT v United Aircraft Corporation [1943] HCA 50; (1943) 68 CLR 525; [1944] ALR 23; 7 ATD 318; 2 AITR 458.
and commented: 67

“A person who neither owns anything in a country nor does nor has done anything in that country cannot, in my opinion, derive income from that country.”

Gresson J’s statement is logically very appealing. When this “two sources only” test is applied as a rule of law literally, the directors’ fees paid to non-resident directors would not have source in New Zealand as the directors did not work in New Zealand nor they own any property in New Zealand. However, the “two source only” test, if applied as a rule of law, seems to be in conflict with the principle of Nathan’s case.

The author suggests that Gresson J’s statement should not be interpreted as a rule of law. It worked as a test of practical man applicable at the time of the case. The “two source only” test could be sufficient back in the time when a person had to be present in a country to provide personal services therein. However, this is no longer necessary with today’s technologies. Many personal services, including directorship services, require knowledge and experience instead of labour or on-site operation. It is possible to imagine situations in which these services can be effectively delivered from any places where there is telephone or internet coverage. The author would not agree that directors’ fees must have source in the companies’ residence states. That would be as incorrect as asserting the opposite by strictly applying the “two source only” test. Although Nathan’s case has established that in the absence of any statutory provision the source of income must be determined by the test of practical man instead of any rule of law, the approach taken by a court to determine the source of income still need to consider relevant previous court precedents. 68

French and Mitchum’s case

67 CIR v NV Philips’ Gloeilampenfabrieken (1955) 74 NZLR 868 (CA).

68 FCT v United Aircraft Corporation [1943] HCA 50; (1943) 68 CLR 525; [1944] ALR 23; 7 ATD 318; 2 AITR 458. Rich J stated: “This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.”
In the absence of any statutory provision, the court in the *French’s case*[^69] identified three most important factors to be considered in determining whether income from personal services have source in a country. These factors are (1) the place where the contract is made; (2) the place where the services are performed; and (3) the place where the payment was made for the services.

In *French*, the court evaluated which factor was more relevant and should be given more weight, and determined the source of income accordingly. The court found that the source of income had the closest nexus to the place where services were performed. It appears that this decision had closely followed *C of T (NSW) v Cam and Sons Ltd*[^70].

However, the decision in *French* only had limited value in specific to the facts of the case and should not be used as a rule of law in other cases. This has been reflected in *FCT v Mitchum*[^71] where Barwick CJ commented on Taylor J’s decision in the *French’s case*:

“In so saying, his Honour was not, in my opinion, laying down a rule of law: he was expressing his reasons for the conclusion of fact to which he had come.”

Further, the principle of *Nathan* or the test of practical man, should apply to the conclusion of *French’s case* and its implication to the source of directors’ fees. In *French* Dixon CJ enunciated in greater detail the difference between the employment

[^69]: *FCT v French* [1957] HCA 73; 98 CLR 398; [1958] ALR 49; 11 ATD 288; (1957) 7 AITR 76. In the *French’s case*, an Australian company’s employee was sent to New Zealand for a couple of weeks each year as an inspecting engineer. The court, after considering the facts in relation to the three factors, concluded that the place where the services are performed was the most important factor in this case and that the income received by taxpayer during his stay in New Zealand had source in New Zealand.

[^70]: Jordan CJ in the *C of T (NSW) v Cam and Sons Ltd* (1936) 4 ATD 32 stated:

“Where income is derived from wages or salary, again the source has several factors. Personal exertion may be involved in negotiating and obtaining the contract of employment, in performing the stipulated services, and in obtaining payment for them. In the present instance, for example, in the case of all the men concerned, in a very real sense it may be said that the source of their wages consisted of the three elements of getting the job, doing it, and getting paid for it. Which of these factors is the most important element of the source in any given case depends upon the facts of that case.”

[^71]: *FCT v Mitchum* [1965] HCA 23; (1965) 113 CLR 401.
income in the case and directors’ fees: 72

“In the first place it is important to notice that Mr. French does not occupy an office as for example a director may be considered to do. … It is thus entirely different from such a case as Robertson v. Federal Commissioner of Taxation where a governing director of a Victorian company earning a substantial salary was abroad for a considerable time.”

It appears that following Robertson’s case 73 mentioned by Dixon CJ in the above statement Harris 74 opined that directors’ fees were only taxed in New Zealand if the services were performed in New Zealand. However, Australian courts have recognised that a director holds an office, which can be physical or virtual, in a company and exercises his/her decisions and management through this office. The director may be located in any places in the world, but his/her office is structured within the company. Director’s fee has stronger nexus to the director’s holding of an office in the company’s residence state.

In Robertson the court did not discuss whether the director’s fee had a source in Australia when the services were performed outside Australia. Somehow the Commissioner conceded on this issue. 75 In the Robertson’s case Dixon J noted: 76

“It does not appear to me to be altogether clear that the source of his remuneration, during his absence, was outside Australia, but for some reason it was admitted on behalf of the commissioner that in respect of the income in question this condition of the Commonwealth exemption was satisfied.”

In French Dixon CJ specifically stated: 77

72 FCT v French [1957] HCA 73; 98 CLR 398; [1958] ALR 49; 11 ATD 288; (1957) 7 AITR 76.
73 Robertson v FCT [1937] HCA 32; (1937) 57 CLR 147; [1937] ALR 410; (1937) 1 AITR 152; 4 ATD 355.
74 G A Harris, New Zealand’s International Taxation (Oxford University Press, Auckland, 1990) at 235.
75 In Robertson the court considered whether the director’s fee should be chargeable for income tax in UK when the director had stayed in UK over 6 months and provided the services in UK.
76 Robertson v FCT [1937] HCA 32; (1937) 57 CLR 147; [1937] ALR 410; (1937) 1 AITR 152; 4 ATD 355.
77 FCT v French [1957] HCA 73; 98 CLR 398; [1958] ALR 49; 11 ATD 288; (1957) 7 AITR 76.
“It is thus entirely different from such a case as *Robertson v Federal Commissioner of Taxation* where a governing director of a Victorian company earning a substantial salary was abroad for a considerable time. Although the commissioner conceded that during his absence the source of his remuneration was outside Australia I felt it desirable to express doubt about the correctness of the admission.”

Having considered Dixon CJ’s comments in the *Robertson* and *French*, it is suggested that following the approach in *Robertson’s case* directors’ fees may have a source in New Zealand even when the director performed the services outside New Zealand.

Taking into account Australia’s judicial interpretation, the paper will now outline the Australian legislative provisions because Australia require courts to interpret the statute rather than common law approach to determine the source of directors’ fees.

**Australia’s New Statutory Approach – Income Tax Assessment Act 1997**

Australian Income Tax Assessment Act 1997 (“ITAA 1997”) the assessable income section has been worded in a way to recognise and utilise the right to tax directors’ fees as agreed in Australia’s DTAs.78 An Australian Tax Office (ATO) Interpretative Decision (ATO ID 2005/180)79 published by the ATO on the ATO website shows this. However, in New Zealand treaties may intervene to restrict or eliminate the taxing right originating from domestic laws if the person is eligible for the benefits of treaty in relation to that income but there is no such provision in the legislation.

The taxpayer was a non-executive director of an Australian company and performed services in Thailand. The director was a resident of Thailand for tax purposes. The question was whether ATO can assess the director’s fee received by a non-resident director from an Australian company. The Tax Office decided that the director’s fee was assessable income in Australia.

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78 The discussion on the Income Tax Assessment Act 1997 in this paper is specifically in relation to directors’ fees. Director’s fees are ordinary income for the purposes of subsection 6-5(3) of the ITAA 1997.

The interpretative decision states that both ITAA 1997 and the International Tax Agreements Act 1953 (“ITAA 1953”) must be considered and read as one act in order to determine non-resident’s assessable income in Australia. The DTA between Australia and Thailand follows the OECD Model Tax Convention. The director’s fee was sourced in Australia under the ITAA 1953, therefore the fee also had a source in the Australia under subsection 6.5(3)(b) of the ITAA 1997 and was assessable income in Australia. The DTA between Australia and Thailand was signed in 1989 and the does not contain the source rules provided by Article 22 in the DTA between Australia and New Zealand.

Article 16 of the DTA between Australia and New Zealand provides a permissive right. It provides that if a New Zealand tax resident provides directorship services to an Australian company without being present in Australia, the director’s fees is assessable income of the New Zealand director in Australia.

5.3 New Zealand’s Judicial Approach

It appears that New Zealand does not have a court case that has specifically determined the source of directors’ fees. However, New Zealand courts approach in defining the terms source of income from personal services may offer some assistance in analysing the source of directors’ fees.

In Case E46 the Taxation Review Authority (TRA) considered whether the salary of an army officer had source in New Zealand when he was posted overseas. The TRA adopted the test of practical man from Nathan’s case. The facts of Case E46 did not

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80 OECD gives the taxing right of directors’ fees to the company’s residence state, which is Australia in this case. The DTA between Australia and Thailand was included in the schedule 30 of the ITAA 1953 which had been repealed from June 2011.

81 The subsection 6.5(3) of the ITAA 1997 establishes the taxing scope for non-resident’s income and provides that the assessable income of a non-resident taxpayer includes ordinary income derived directly or indirectly from all Australian sources during the income year and other ordinary income that a provision includes as assessable income on some basis other than having an Australian source.

82 Directors’ fees and other remuneration. The director’s fee is assessable income in Australia because ITAA 1997 and ITAA 1953 are read as one act and provides that the income has source in Australia. Schedule 4 of the ITAA 1953 had been repealed from June 2011.


84 The taxpayer tax residency in New Zealand was not argued.
resemble the facts of French’s case therefore adopting the conclusion of French’s case was a weak indicium of the source.  

Directors’ fees should have source in New Zealand under section YD 4(4) of the Act if the income is “earned in New Zealand”. In New Zealand’s first Case E46, Barber J considered the word “entitlement” while discussing on the meaning of the word “earn”. In the Case E46 Barber J specifically stated:

‘The word “earn” is defined in the Concise Oxford Dictionary, 6th ed, as “obtain, or be entitled to, as a reward of labour or merit” and other dictionaries have rather similar definitions. Emphasis is on “entitlement” so that para (c) of subs (2) of s 243[87] can, in my view, be said to cover all salaries, wages, allowances and emoluments, the entitlement to which arises in New Zealand.’

In Case E46 Barber J established the principle that income is “earned in New Zealand” if the entitlement to the income arises in New Zealand. The word “entitlement” is defined as “the fact of having a right to something”. The word “entitlement” can be “entitlement in possession” or “entitlement in interest”. In Will of Borger, Hodges J stated: “Entitled usually means “entitlement in possession”, “entitlement to have the thing”, not merely that you will be entitled or may be entitled to get something at some future time.” Therefore, the entitlement to future income from personal exertion, may be crystallised as far back in the past as the contract or commercial reality allows. In Case E46 the army officer’s entitlement to all his future income is “earned in New Zealand”.

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85 Case E46 (1982) 5 NZTC 59,277 per Barber J:
“I see little point in traversing these cases in detail as I am conscious of the holding by the Full Court of the High Court in the later Mitchum case that the source of income is a matter of fact, and the French case seems to me to be quite distinguishable from O’s situation in that French was regarded as covered by a contract of service and the Court did not lay down any firm rule that the source of income is the place where the work is done.”


87 Equivalent to section YD 4(4), ITA 2007.


89 D Hay, Words and Phrases Legally Defined, (Volume 1, Fourth Edition, Edinburgh, LexisNexis Butterworths, 2007), page 813. For the purpose of this paper, income from personal exertion, including directors’ fees, is understood as “entitlement in possession”.

income had come to existence at the time he attested to serve the Queen anywhere in the world. There was no causative link\(^{91}\) between his job overseas and his income provided to him in accordance with the New Zealand law. His posting to another country has no nexus with his entitlement to his income. He would have been paid in terms of the State Services Conditions of Employment Act 1977, wherever he served. It is clear from the judge’s emphasis on the cause of entitlement that the reasoning that income had a source in New Zealand was crucial and not the place of payment.

Further, in the judgment of Philips’ the interpretation and application of the word “derived”\(^{92}\) by Gresson J \(^{93}\) is effectively the same as interpretation and application of the word “earned” by Barber J in the Case E46. Gresson J emphasised the “originating cause” or “causative link”,\(^{94}\) whereas Barber J emphasised the “entitlement”. They both could be seen as the same concept.

In Case H6\(^{95}\) and Case P17\(^{96}\) the approach in Case E46 decision has been followed. In the Case H6, the taxpayer’s (doctor) study grant from the Health Department during his leave from hospital board was income earned in New Zealand. Bathgate J, noted that the entitlement to the income was caused by his previous work with New Zealand hospital board, especially when the recipient was not bonded after the study. In the Case P17, the fellowship, to the taxpayer received for his study overseas was found to be his income earned in New Zealand from the contractual relationship with the employer. The Taxpayer (engineer) remained an employee of Telecom during the period of leave and had an agreement under which he was obliged to work for

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\(^{91}\) In CIR v N v Philips’ Gloeilampenfabrieken Gresson J stated:
“The combination of the words “derived” and “source” import, I think, some causative link."

\(^{92}\) The most important word of s YD 4(18).

\(^{93}\) Gresson J stated in the CIR v N v Philips’ Gloeilampenfabrieken that:
“It appears to me that in interpreting s 87(n), proper regard must be paid to the word “derived”; it should not be read as “received”. The word “derived” means more than received; it connotes the source of origin, rather than the fund or place, from which the income was taken. It means flowing, springing, emanating from, or, as was said in Commissioners of Taxation v Kirk ([1990] A.C. 588, 592), arising from or accruing. To be a “source” of the income within the meaning of the subsection, it is necessary, I think, to look to the originating cause. It is not sufficient to ascertain the fund out of which the income was in fact paid, but why it was paid, that is the determining factor. The emphasis is not upon the receipt, but upon the derivation of the income. ........... The combination of the words “derived” and “sourced” import, I think, some causative link.’

\(^{94}\) See note above.

\(^{95}\) Case H6 (1986) 8 NZTC 147.

\(^{96}\) Case P17 (1992) 14 NZTC 4,115.
Telecom for three years after he returned from the study. The fellowship payments were partly to study overseas and partly to secure his services in New Zealand.

Having considered the judicial interpretation and application, it appears that a director’s fee which is found to have source in New Zealand under s YD 4(4) of the Act will be found to have source in New Zealand under s YD 4(18) of the Act. As noted earlier, if an income has source under any subsections of YD 4, the income should have source under section YD 4(18). This is also reflected in the text of the Act, which defines “derived in New Zealand” as “having a source in New Zealand described in sections YD 4 and YZ 1”. Accordingly, to determine the source of directors’ fees paid to overseas directors how the New Zealand courts will address the cause of entitlement to fees and the place where the cause of entitled arose is illustrated in the example 1 below.

Example 1

<table>
<thead>
<tr>
<th>New Zealand</th>
<th>Bermuda</th>
</tr>
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Co Y

Video Conferencing, fax and Skype

John, tax resident in Bermuda and executive Director of Co Y

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97 Refer to discussion under part 4.4 of the paper. Section YD 4 of the Act
Example 1 is the case where New Zealand resident Company Y owns several retail outlets in New Zealand. The directors of the company live overseas but take all managerial decisions using technology such as phone, fax, internet, video conference and skype. Day-to-day administration and operation is conducted by staff in New Zealand. John, resident in Bermuda, was appointed as a member of board of directors of a New Zealand resident company. He exercised this function accordingly and received remuneration from the company. In this case nexus between the cause of entitlement to the directors’ fees and the place where the directors perform the services is not relevant. More likely New Zealand court will state that the cause of entitlement is that John serves as a member of the board of a New Zealand company. John’s managing company Y from Bermuda is equivalent to holding an office in New Zealand. Therefore, the remuneration is derived from New Zealand and according to s BE 1 of the Act, the New Zealand resident company must deduct withholding tax at the rate 33% of the fees paid.

Tax treatment of director fees received by non-resident director for services performed from overseas where New Zealand resident company is a subsidiary of overseas resident parent company is illustrated in example 2.

Example 2

New Zealand

Co Y
Subsidiary Co

Bermuda

Co X
Parent Co

Video Conferencing and Skype

John, tax resident in
Bermuda and Director

Example 2 is the case where John, resident in Bermuda, was appointed as a member of the board of directors and member of Financial Committee of an overseas
(Bermuda) residence parent company and also a non-executive director of a subsidiary resident in New Zealand. John hold an important role in a subsidiary’s supervisory, budgeting and forecasting. John had never visited New Zealand but he exercised this function by skype and video conferencing and remuneration is paid by New Zealand residence subsidiary company. In this case most likely New Zealand court will state that the cause of entitlement is that John serves as a member of the board of a subsidiary company resident in New Zealand and providing management and supervisory services. Conclusively, the remuneration for exercising the function of director is derived from New Zealand. In summary, the OECD Model is a bilateral convention and is applicable between two contracting states.98

Furthermore, in example 2 if we assume that the parent company is resident in another state e.g. Australia, Article 16 will be applicable between Bermuda (director’s residency state) and New Zealand (source state of income and residence state of subsidiary company) the two contacting states. Consequently, John’s remuneration for exercising the function of director is derived from New Zealand because the cause of entitlement of director’s fees is that John is holding director’s office and providing management services to New Zealand subsidiary.

To the contrary, if we assume that the entity is treated as fiscally transparent99 in New Zealand and income is allocated to partners for tax purposes. In this situation the entity is not resident under the treaty and accordingly Article 16 of the OECD Model Tax Convention is not applicable. However, the directors’ fees will be taxable in New Zealand if they have a source in New Zealand under section YD 4 of the Act.

As we have considered the judicial interpretation and application of source provisions in two countries, the paper will now consider the similarities and differences in their interpretation and application in two countries.

5.4 New Zealand Approach Compared with Australian Approach

The review of cases demonstrates that there is no significant difference between Australian and New Zealand judicial approaches in determining the source of directors’ fees. Both the New Zealand and Australian courts have approved and


99 When in a State the entity is treated as fiscally transparent, means the State ignores that it is limited Partnership and subjects its partners to tax on their share of profits.
adopted the test of practical man from Nathan\textsuperscript{100} to decide the source of income. The fact is, the current statutory law in Australia has been developed to link ITAA 1997 and Australia’s DTAs through IAA 1953.\textsuperscript{101} This exhaustive rules-based statutory mechanism has effectively determined the source of directors’ fees according to Australia’s Double Tax Agreements. New Zealand Income Tax Act\textsuperscript{102} contains statutory provisions with regard to source rules. However, the New Zealand approach is principles-based and it has to date apply the judicial interpretation to determine the source of directors’ fees. Therefore, taxpayers, their advisors together with the Inland Revenue, have had no choice but to work within the ambit of judicial framework.

**Conclusion**

This research illustrates that the Technical Rulings Amendment No. 68 issued by Inland Revenue\textsuperscript{103} was similar to Harris’s\textsuperscript{104} view that directors’ fees are only taxed in New Zealand if the services are performed in New Zealand. The same position had also been held by CCH\textsuperscript{105} and Thomson Reuters\textsuperscript{106}. Nevertheless, this technical Rulings can best be described as historical guidelines for staff and Inland Revenue is no longer bound to follow this ruling.\textsuperscript{107}

\textsuperscript{100} Nathan v FCT [1918] HCA 45; (1918) 25 CLR 183; 24 ALR 286.

\textsuperscript{101} The subsection 6.5(3) of the ITAA 1997 establishes the taxing scope for non-resident’s income. Refer to Australia’s New Statutory Approach.

\textsuperscript{102} Income Tax Act 2007 and earlier acts.


\textsuperscript{104} G A Harris, New Zealand’s International Taxation (Oxford University Press, Auckland, 1990) at 235.


\textsuperscript{106} Thomson Reuters, New Zealand, retrieved from Westlaw NZ online. [http://www.westlaw.co.nz.ezproxy.aut.ac.nz/ Document patch: Westlaw New Zealand Staples and Tax Rates Guide; Staples Tax Guide>1000 Non-residents and Absentees >1000.40 Personal services of non-resident company director.](http://www.westlaw.co.nz.ezproxy.aut.ac.nz/ Document patch: Westlaw New Zealand Staples and Tax Rates Guide; Staples Tax Guide>1000 Non-residents and Absentees >1000.40 Personal services of non-resident company director.)

\textsuperscript{107} IRD Tax Information Bulletin: Volume Ten, No.9 (September 1998) page10.
To prevent the erosion of the tax base and to overcome the deficiency in the legislation in making income from employment or services assessable, the New Zealand Income Tax Act has been amended from time to time.\textsuperscript{108} Certainly the definition of employment income in the Act is broad enough to capture most disputatious receipts.\textsuperscript{109} Nevertheless, there is no legislative provision in the Act that specifically states the source of directors’ fees to be in the country where the services are performed. New Zealand never enacted legislation to tax directors’ fees in accordance with the taxing right given by the OECD.

The principle of \textit{Nathan’s case},\textsuperscript{110} which has been approved by the New Zealand Court of Appeal in \textit{Philips’ case},\textsuperscript{111} requires that no rule of law should apply to determine source of income in the absence of statutory provision. It seems that the courts in New Zealand, being impartial interpreters of the legislature’s intention, will strive to decide the source of directors’ fees on a case by case basis. Further, the Australian (\textit{French})\textsuperscript{112} and New Zealand (\textit{Case E46})\textsuperscript{113} cases covered in this paper, the courts have identified that causes of entitlement to income are different between directors’ fees and ordinary employment income. The review of \textit{Case E46} demonstrates that the New Zealand courts have established that the cause of entitlement to the income and the place where the entitlement arises are strong elements in finding the source of income and the letter of law may diverge from the spirit of law. Certainly the place where the services are performed is not crucial. Even paragraph 1 of the OECD commentary to Article 16 that ‘it might sometimes be difficult to ascertain where the services are performed’ implies that there are

\textsuperscript{108} Income Tax Act 1994 was amended in 2001 to include restrictive covenants and exit inducement paid to employees or contractors as assessable income. Sections CHA 1 and CHA 2 were inserted in the Income Tax Act 1994 with application to amounts derived on or after 27 March 2001. Sections CHA 1 and CHA 2 are equivalent to ss CE 9 and CE 10 of the Income Tax Act 2007. The payments to persuade staff to join (known colloquially as golden hellos) or to encourage bright staff to stay (golden handcuffs) are part of employment income and were assessable income as per Public Information Bulletin, No. 171, March 1988 as well.

\textsuperscript{109} Section CF 1(1) of the Act now provides that if the pension is payable regardless of whether the death or disability is attributable to service in one of the specified forces, and is in the nature of a normal service pension, it remains assessable income. This means that in \textit{FCT v Harris} (1980) ATC 4238, the pension supplements now will be assessable.

\textsuperscript{110} \textit{Nathan v FCT} [1918] HCA 45; (1918) 25 CLR 183; 24 ALR 286.

\textsuperscript{111} \textit{CIR v N v Philips’ Gloeilampenfabriken} (1955) 74 NZLR 868.

\textsuperscript{112} \textit{FCT v French} [1957] HCA 73; 98 CLR 398; [1958] ALR 49; 11 ATD 288; (1957) 7 AITR 76.

\textsuperscript{113} \textit{Case E46} (1982) 5 NZTC 59,277.
uncertainties about the place where directors perform their services. The judgments in other cases such as Case H6 and Case P17 covered similar ground.

According to Arnold, jurisdiction to tax should only be granted to a source state on the condition that the source rule enables that country to collect taxes effectively and efficiently. The source company requirement to withhold tax from fees paid to non-residents directors also ensures reduction in compliance burden for the directors physically performing work from another country. Since directors are not employees they can influence where the activity is performed and where their directors’ fees are taxed which could lead to erosion of tax base in the source country. Moreover, from a substance-over form perspective, the directors’ fees do not relate to the place where they are physically present while working as directors, but to the place where their instructions are received and carried out by the company employees which is decisive for determining the source state. The directors may work from different places all over the world, the quality of their efforts most likely depends on internal information systems of the company, databases and knowledge of senior employees of the company as well as external experts. Therefore, the author supports Craig Elliffe’s opinion and believes that the manner in which legislation has been drafted shows that if the non-resident directors performed the services outside New Zealand, considering services rendered by directors to have been carried out in the company’s residence state (New Zealand) the courts may deem directors’ fees having source in New Zealand.

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115 Case H6 (1986) 8 NZTC 147.


120 Article 16 declares the residence state of the company as the source state.
It is thus unsure, whether withdrawing the historic ruling is sufficient to change the established practise on this issue, specifically with the countries New Zealand do not have a Double Tax Agreement. Therefore, the author advocates that to build more fairness into the tax system New Zealand needs a conceptually sound Income Tax legislation regarding existing source rules that uses economic presence as a basis for taxation and is aimed at avoiding difficulties when defining where a director actually performs his work. The cases analysed in the paper also shows that source rules are a sad fiction or ‘fallacy’ rather than a fundamental guide post. The author hopes that the current paper will increase the government’s awareness of these issues and will encourage further policy analysis of the difficulties in defining source of income. It is submitted, that Inland Revenue should reconsider the historic ruling and provide a sound conceptual and consistent basis on which to ground the directors’ fees taxation rules. Accordingly, it is suggested that to provide legal certainty the government should focus on the need for reform by enacting a legislation that embodies a provision explicitly identifying source of directors’ fees based on coherent income tax policy principles or objectives and would be closer to international (OECD) norms. It will make the Income Tax Legislation conceptually more sound and rational and will achieve greater neutrality, coherence, ability to pay\(^{121}\) and theoretical robustness in the tax system.

Under Article 16 directors’ fees source rule relies on the definition of the residence state of the company of which they are board member. Pamperl\(^{122}\) study suggests that the mismatch between the domestic law treatment of directors’ fees and allocation of taxing rights under Article 16 might encourage the inflation of directors’ fees. The residence state of the company might remunerate its directors with unrealistically high fees where the residence state of the company does not tax income from directors’ fees but claim deduction for fees expenses. Undoubtedly, the harmonization of domestic law and treaty law will protect and expand New Zealand’s tax base and boost their tax revenue by introducing the tax system fair and simple for tax residents and non-residents, specifically when the entity is treated as fiscally transparent or dealing with the countries with which New Zealand do not have a Double Tax Agreement. It will thereby reduce conflicting tax claims between source and resident state of a director, resulting in low compliance costs for taxpayers.


It thus seems that Article 16 covers directors’ fees of those company officials who are engaged in top management, control and supervision of the company but the term management fee is not defined in the Act. Due to this leeway and narrow scope of Article 16, it is possible that the overseas directors and/or the overseas parent companies to avoid the tax liability on directors’ fees in New Zealand may replace the directors’ fees with management fees. The key reason to replace the term as management fees is that it is an expense that may include many charges from another entity and provides a mechanism to shift profit among associated entities. Usage of the term management fees re-characterise the income from personal services and is treated as business income. According to s YD 4(2) of the Act business income does not have source in New Zealand if the business is carried out wholly outside New Zealand and there is no withholding tax liability. Therefore, this study calls for further investigation into whether the replacement of the term management fees may amount to tax avoidance on source deduction of non-resident director’s fees for services performed outside New Zealand. Future research in this area is clearly warranted.


124 The discussion on avoidance, evasion and fraud issues is outside the scope of this paper.

125 Companies may have professional directors and the cause of entitlement to the income may be from independent consultation. In such situations the entitlement has stronger nexus to the personal exertion. When personal exertion takes place outside New Zealand, the income for such a service does not have source in New Zealand.

126 Article 7 (Business Profits) in New Zealand’s DTAs and in the OECD Model Tax Convention provide the same conclusion.