Taxing securities lending transactions: substance over form

A government discussion document

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GLOSSARY OF KEY TERMS

Borrower	A financial intermediary or party who wishes to borrow securities because they need to sell or complete a sale of securities, and they do not own the securities they are intending to sell. A borrower may also enter a securities lending transaction because they need to meet margin requirements on an unrealised loss and can do this more cheaply by borrowing securities than by depositing cash. Alternatively, a taxpayer may enter into a securities loan because they are acting as an intermediary between longer term lenders and shorter term borrowers.
Imputation trading	Where a shareholder who is unable to use imputation credits, transfers their shares, on a temporary basis, to another taxpayer who is able to use the credits.
Lender	The owner of the securities who enters into a securities lending transaction in order to obtain an additional return by way of lending fees on top of returns attaching to the security itself. Often a pension scheme or superannuation fund.
Margin requirements	Where a taxpayer with an unrealised loss is required as a condition of their securities transaction to deposit an amount to cover an agreed portion of this loss.
Repurchase agreement	A transaction where securities are sold for cash consideration. The seller is obligated to repurchase the securities at some later point in time at a higher price which reflects a premium (or interest) to the buyer. Typically, such transactions do not extend beyond interest or payment dates. These transactions are also known as “Repos”.
Securities lending transaction	An agreement where securities are lent in consideration for the return of equivalent securities at a later date (plus payment of a fee).
Substitute payment	A payment by a borrower to a lender to reimburse the lender for any dividends and interest paid on the securities over the term of the securities lending transaction. This is also known as a “manufactured dividend”.

Chapter 1

INTRODUCTION

1.1 Internationally, securities lending, which is lending securities for a fee, usually to make up a shortfall, represents a substantial part of the daily settlement value in many transaction systems. It can also play an important role in facilitating market liquidity.

1.2 New Zealand does not have a significant domestic securities lending market, at least in part owing to the potential for securities lending transactions to be taxed on the basis of their legal form rather than their economic substance.

1.3 When New Zealand companies wish to enter into securities lending transactions they are required to go offshore to other markets (Sydney, Hong Kong or London). The size of the offshore securities market consisting of New Zealand investors is estimated to be approximately US$1 billion.

Taxing securities lending transactions

1.4 New Zealand, unlike many other jurisdictions, does not have special tax rules for securities lending transactions. For New Zealand tax purposes, they are taxed on the basis of legal form rather than economic substance.

1.5 The current New Zealand tax treatment of securities lending transactions is inconsistent with international trends, with the economic substance of these transactions (being a securitised loan agreement rather than a sale or disposition) and with the treatment of other commercial transactions, such as hire purchase agreements and finance leases.

1.6 These inconsistencies mean a negative international perception of New Zealand as an investment destination. This has led to calls for a change to the tax treatment of securities lending transactions.

1.7 Although removing barriers to commercial transactions is important, the government is also concerned about tax avoidance opportunities offered by the current tax treatment of securities lending transactions. There is evidence that securities lending transactions are being used to trade in imputation credits, avoid non-resident withholding tax (NRWT) and exploit the lack of specific tax rules in this area in New Zealand. It is estimated that tax lost to date from such transactions is in excess of $100 million.

Objectives

1.8 The purpose of this discussion document is to seek feedback on proposals for reforming the tax treatment of securities lending transactions.

1.9 The discussion document examines the current New Zealand tax treatment of securities lending transactions. It considers the pros and cons of reforming the New Zealand tax legislation in this area, including special tax rules for securities lending transactions. At the same time, it seeks to address concerns about transactions that use securities lending to give rise to undue tax advantages.

Scope of this discussion document

1.10 This discussion document outlines a number of proposals on which the public is invited to comment. The aim is that any changes the government decides upon from this review would be included in amending tax legislation next year.

1.11 If the government proceeds with the proposals outlined here, amendments will be required to the Income Tax Act 2004. It is intended that they would be included in a 2005 taxation bill. The new securities lending rules would apply for income years beginning on or after the date the legislation is enacted, and the new anti-avoidance rules from the date the bill containing amending legislation is introduced into Parliament.

Summary of proposals

Proposals to clarify the current tax treatment and reform the treatment of securities lending transactions cover two broad areas:

- introduction of specific securities lending rules to allow taxation of qualifying transactions on the basis of economic substance rather than legal form; and
- strengthening the imputation and NRWT anti-avoidance rules to ensure that non-qualifying securities lending transactions do not give rise to an unintended fiscal cost.

New securities lending rules for qualifying transactions

The new securities lending rules will operate as follows:

- Qualifying transactions, which must meet a strict list of criteria, will be taxed on their economic substance rather than legal form. There will not be a disposal for tax purposes on entering a qualifying securities lending transaction. Neither the initial transfer of securities nor the subsequent reacquisition of the same or identical securities back to the lender will be treated as a taxable event for income purposes.

- The borrower will be treated as having acquired the borrowed security at its market value and to have returned the replacement security at the same market value.
- Any distribution (dividend or interest) received during the term of a securities lending transaction will be passed on to the lender. This includes any tax credits attached to a dividend. The borrower will also be required to pay a substitution payment to compensate the lender for any distribution made to a third party purchaser of the borrower securities during the term of the securities lending transaction.
- When a taxpayer fails to complete a securities lending transaction in accordance with the qualifying conditions, the Commissioner of Inland Revenue will be given the discretion to continue to apply the securities lending rules to the transaction if the Commissioner is of the opinion that at a later time the transaction will be a qualifying transaction.
- When the Commissioner is of the opinion that the transaction will never constitute a qualifying transaction, the taxpayers affected will be required to amend the tax treatment of the transaction to reflect the general income tax rules.

Qualification criteria

- The new securities lending rules will be applicable to the following securities:
  - shares, units, bonds, debentures, convertible notes or rights or options issued by a company or unit trust listed on a recognised exchange or that are ordinarily available for subscription or purchase by the public; and
  - bonds, debentures or similar securities issued by a government (in New Zealand or elsewhere).
- Agreements will need to be in writing, and any consideration received by the lender from the borrower (such as the lending fee) must be clearly identified in the agreement.
- Taxpayers will be able to use standard international agreements as the basis for their New Zealand lending agreements.
- To qualify for the securities lending rules, identical securities will need to be returned at the end of the lending transaction, along with the return of the collateral, less the agreed lending fee. The replacement securities will need to be the same securities as those originally lent or identical securities.
- Reacquisition of identical securities will need to take place within 12 months of the original disposal.
- The securities lending transaction must be on arm's-length terms and must not be between associated borrowers and lenders.

New anti-avoidance rules for non-qualifying transactions

When a securities transaction falls outside the new securities lending rules, additional anti-avoidance measures will be applied to the transaction:

- Imputation credits will be cancelled if they are paid to a shareholder who lacks economic ownership in the securities and is under an obligation to make a related payment passing on the benefit of receiving tax credits to the economic owner of the shares.
- A similar test will be introduced for NRWT, under which the substitute payment will be deemed to be gross income of the borrower.
- The government is still considering how "lack of economic ownership" and "related payment" will be defined.
- The introduction of a "safe harbour" mechanism for small investors is also being considered.

Benefits of change

1.12 The introduction of specific tax rules for securities lending is expected to be beneficial for the New Zealand economy. If securities lending is encouraged, or at least not discouraged, through the introduction of special tax rules, it will allow institutional investors to "lend" their securities, increasing the number of possible transactions in the market. In theory, this will increase the number of actively traded shares, improve liquidity and lead to a more efficient capital market. It will also resolve many of the problems identified with the current tax treatment of these transactions and will:

- create greater consistency with the treatment adopted in other jurisdictions;
- create greater consistency with economic reality;
- create greater consistency with the treatment of other commercial transactions;
- increase taxpayer certainty; and
- improve the perception of New Zealand as an investment destination.

1.13 At the same time, introducing new anti-avoidance measures for the imputation and NRWT rules will protect the tax base and prevent unintended policy outcomes with respect to securities lending.

1.14 The government recognises that there may be an increase in compliance costs associated with the proposals – for example, in ensuring that securities lending transactions meet the qualification criteria and calculating the level of economic ownership for non-qualifying transactions. On the other hand, the government will attempt to minimise any such increase. By making the qualification criteria consistent with international rules, borrowers and lenders will be able to use standard international agreements. The government is also planning to exempt small investors from the need to comply with the new anti-avoidance rules by introducing a "safe harbour" mechanism as part of the proposals.

Submissions are invited

1.15 Submissions on any aspect of this paper are welcome. They can be mailed to:

Taxing securities lending transactions
C/- The Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

1.16 Alternatively, submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Please put "Taxing securities lending transactions" in the subject line for electronic submissions.

1.17 Submissions should be made by 31 January 2005 and should contain a brief summary of the main points and recommendations. Submissions received by the due date will be acknowledged.

1.18 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that there is any part of your submission that could be properly withheld under the Act, please indicate this clearly in your submission.

Chapter 2

WHAT IS SECURITIES LENDING?

2.1 Securities lending assists financial intermediaries to complete delivery when they have a shortfall of specific securities. It provides a relatively risk-free way for larger holders of shares, such as banks, insurance companies, and funds managers, to increase their overall portfolio returns.

2.2 A significant part of the stock market is held by passive institutional investors. Securities lending provides a way for these institutional investors to "lend" securities to financial intermediaries for a fee. This lending "fee" is an additional return to the institutional investor. Financial intermediaries enter these transactions because it enables them to complete more sale contracts and generate additional income. The percentage of shares actively traded increases, improving market efficiency by providing additional liquidity.

2.3 These transactions also benefit lenders who are able to obtain an additional return by way of fees paid by a borrower on top of returns attaching to the security itself.

2.4 Borrowers enter into the transactions for three main reasons:

- because they need to sell or complete a sale of securities and they do not own the securities they are intending to sell;
- because they need to meet margin requirements and, in some circumstances, it may be cheaper to do this by borrowing securities than by depositing cash; and
- because they are acting as intermediaries between longer term lenders and shorter term borrowers.

2.5 Securities lending transactions are typically entered into when a financial intermediary (the "borrower") does not have sufficient securities to complete a sale. To cover the sale, the borrower obtains the securities needed to complete the sale from a third person (the "lender"). After completion of the sale, the borrower returns replacement securities to the lender, together with an amount equal to any dividends or interest that may have become payable over the loan period. The lender is also paid a fee for the use of the securities. Both before and after the transaction, the lender holds the same number and type of securities. The transactions have the essential characteristics of loan transactions because the lender receives back the equivalent of what was lent.

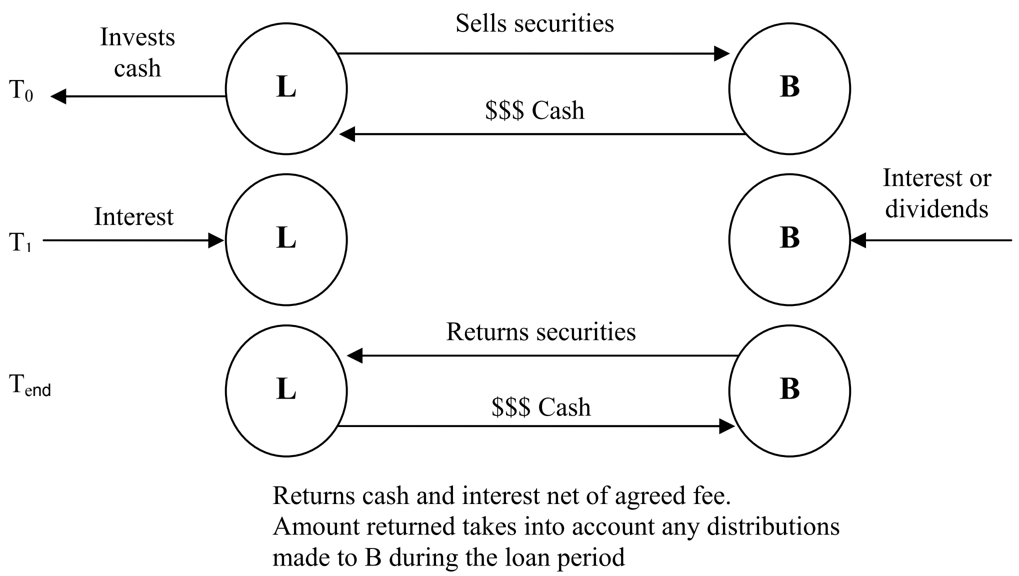
2.6 All lenders give, and all borrowers require, either actual title to securities or such signed transfers and the like as are necessary to be able to give title to third parties. This means that lending transactions will generally be treated as sales and repurchases of securities for tax purposes. Commercially, however, these transactions are described and treated as loans, because in the longer term such transactions do not alter a lender's portfolio. There is a future contractual obligation to reverse or unwind the transaction.

2.7 Example 1 illustrates how a securities lending transaction works.

Example 1: A securities lending transaction

Borrower (B) needs to cover a short sale position with certain government securities. To obtain the needed securities, B enters into an agreement with an owner (L) of the necessary securities.

L lends the securities to B and takes back cash as collateral. During the term of the loan, L receives interest income from the investment of the collateral. B receives any coupon payments made on the securities during the term of the agreement. At the end of the loan term, B returns identical securities to L. L returns the collateral to B. L also pays over to B the interest earned on the collateral net of any agreed fee and any coupon payments received by B.



Securities loan – key characteristics

2.8 The legal form of securities lending agreements varies and the tax implications will depend on the specific facts. However, securities lending transactions generally have the following characteristics.

2.9 *The initial loan and eventual return of the securities*. A securities owner (the lender) agrees to lend securities to a financial intermediary (the borrower) for a set term. To effect the securities "lending" it is necessary for the securities to be "sold" by the lender to the borrower. At a pre-determined time the borrower returns the same amount of securities borrowed to the lender. The replacement securities must be similar in all respects to those transferred to the borrower.

2.10 *Dividends/interest*. Dividends and interest paid during the term of the transaction are paid to the new registered owner of the securities. This could be either the borrower or a third party to whom the securities have been transferred.

2.11 *Substitute payments*. The borrower is required to pay to the lender an amount equal to any such dividends and interest. This is typically known as a "substitute payment" or "manufactured dividend".

2.12 *Loan fees*. In return for the securities, the borrower provides the lender with collateral. This can be in the form of cash, other securities, or a letter of credit, equal or greater in value than the securities loaned. The collateral is generally indexed to the market value of the securities on a daily basis and is increased or decreased as necessary. If the borrower does not return an equivalent amount of securities at the agreed time the collateral is forgone. There may also be fees payable to intermediaries who represent the securities lender, arrange the loan and handle remittances and collections.

2.13 How the securities lender is compensated for lending its securities depends on the character of the collateral provided:

- *Cash collateral*. Collateral is invested for the benefit (and at the risk of) the securities lender. The collateral earns interest over the period of the loan. At the cessation of the loan, the lender returns the collateral and the interest to the borrower (the collateral rebate), minus an amount that has been pre-determined as the fee for the use of the securities.
- *Non-cash collateral*. If the collateral is securities or a letter of credit, the securities borrower will pay a predetermined fee to the securities lender.

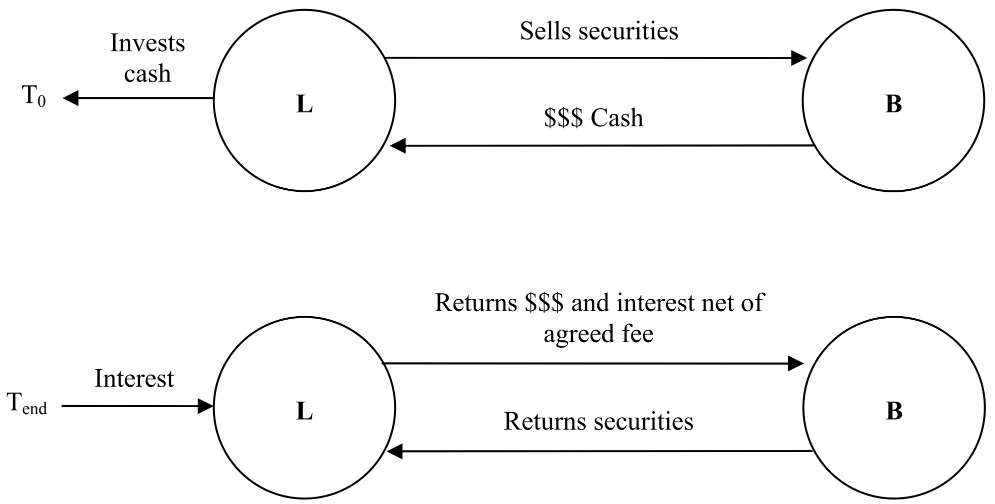
Securities loan versus repurchase agreement

2.14 In summary, securities lending is an agreement whereby securities are lent in consideration for the return of identical securities at a later date. In economic terms the transaction is a loan. However, because the securities are being obtained to complete a sale contract, the borrower must obtain legal title to them. Therefore the lender must legally dispose of the securities to the borrower.

2.15 A securities loan is often confused with a repurchase agreement, or "repo", as the distinction between the two is a fine one. In a repurchase agreement, the owner of the securities sells them to another party for cash consideration under an agreement obligating the owner to repurchase the securities at some later point in time. At the termination of the agreement, the original owner repurchases the securities at a higher price than the securities were originally sold for. The inflated purchase price reflects a premium, or interest, paid to the buyer. Typically, repos do not extend beyond interest or dividend payment dates. Example 2 shows how such an agreement works.

Example 2: A repurchase transaction

L needs to raise cash. L lends securities to B and takes back cash as collateral. During the term of the loan, L receives interest income from the investment of the collateral. At the end of the loan term, B returns identical securities to L. L returns the collateral to B. L also pays over to B the interest earned on the collateral net of any agreed fee.



2.16 Although there are similarities between securities lending transactions and repurchase agreements, there are arguments against adopting a comparable tax treatment because:

- the format of the transactions is different;
- the transactions are used for different purposes;
- other jurisdictions exclude repos from their securities lending rules; and
- the government is not aware of any problems with the tax treatment of repurchase transactions.

2.17 On this basis, the government has decided to limit the changes discussed in this document to true securities lending transactions, although submissions on whether repurchase transactions should be included in the proposed changes are invited.

Chapter 3

PROBLEMS WITH THE CURRENT TAX TREATMENT

3.1 At present, there are no specific rules for the taxation of securities lending transactions in New Zealand. Furthermore, the relevant provisions of the Income Tax Act 2004 were not written in contemplation of these types of transactions.

3.2 For New Zealand tax purposes, securities lending transactions are taxed on the basis of legal form rather than economic substance. The initial lending of the securities gives rise to a disposal. When the securities lent are financial arrangements, such as government stock or debentures, the transfer to the borrower will trigger a base price adjustment under the accrual rules. This crystallises the lender's income or expenditure as at the loan date. During the period of the "loan", the lender and the borrower must account for the accrual income or expenditure under the accrual rules.

3.3 When the securities lent are excepted financial arrangements, such as shares, any gains or losses solely attributable to the shares are not taxed under the accrual rules. Instead, when the securities lent are revenue account property of the lender, the gain or loss on sale will be taxed under the other, non-accrual provisions of the Act.

Reforming the tax treatment

3.4 A number of arguments have been raised in support of reforming the current tax treatment of securities lending transactions in New Zealand. Concerns can be broadly divided into four categories:

- lack of consistency;
- lack of certainty;
- the need to improve the perception of New Zealand as an investment destination; and
- base maintenance.

Lack of consistency

3.5 The current treatment of securities lending is consistent with the concept of taxing on realisation which, for pragmatic reasons, is often preferred in New Zealand's tax system. However, taxing securities lending transactions on a realisation basis does lead to a number of inconsistencies.

Inconsistent with international treatment

3.6 In Australia (1990), Canada (1989), the United Kingdom (1989) and the United States (1983), specific legislation and regulations have been introduced to tax securities lending transactions on the basis of their economic substance. The key details of these international securities lending rules are summarised in the appendix. Typically, the relief provisions are written to limit their application to genuine securities lending transactions rather than those entered into to obtain a tax advantage.

3.7 For New Zealand to compete for international investment dollars it is necessary to provide similar investment opportunities as those available in other jurisdictions. This requires a tax framework that is consistent with international trends.

Inconsistent with economic treatment

3.8 Taxing securities lending transactions on a realisation basis is inconsistent with the economic substance of these transactions.

3.9 The current tax treatment of securities lending does not reflect the fact that, in substance, the transaction is a securitised loan agreement, not a sale or disposition. Even though a transfer of legal title is required for commercial reasons, the lender does not, in substance, intend to dispose of the securities.

Inconsistent with the treatment of other commercial transactions

3.10 Although New Zealand's tax system tends to operate on a form-over-substance basis, the current tax treatment of securities lending transactions is inconsistent with the treatment of other commercial transactions. For example:

- *Hire purchase agreements*. Under a hire purchase agreement, the legal form determines that title does not pass until the final instalment has been paid. As a matter of economic, accounting and taxation practice, the benefits and obligations of ownership pass at the outset. The legal form merely provides the financier with effective security in the event of default.
- *Finance leases*. The tax and accounting treatment of a finance lease also mirrors economic substance. For tax purposes, the leasing of an asset is treated as a sale of that asset to the lessee. The lessee is treated as receiving a loan from the lessor to purchase the asset. No depreciation deduction is available to a lessor during the lease term. Instead, the lessee as economic owner is able to claim depreciation.
- *Livestock bailment*. A bailment of livestock exists when livestock is not in the owner's care, as in livestock grazing arrangements or share-farming transactions. For tax purposes, the bailee is deemed to own the livestock and must take the stock into account at year end.

Lack of certainty

3.11 In analysing the taxation treatment of securities lending, the New Zealand income tax system draws a distinction between two types of corporate fund raising:

- Debt finance – which is subject to the accrual rules; and
- Equity or share finance – which is generally outside the ambit of the accrual rules. This is because shares are "excepted financial arrangements". Even when equity/share finance is part of a wider financial arrangement, equity returns remain outside the accrual rules if they are solely attributable to an excepted financial arrangement.

3.12 Because New Zealand does not have specific tax rules for securities lending transactions, taxpayers and their advisors are required to determine, without much guidance, when an item is solely attributable to an excepted financial arrangement. This interface between the accrual rules and the taxation of equity is, at some points, obscure.

Improving New Zealand as an investment destination

3.13 The lack of special tax rules for securities lending in New Zealand may mean a negative international perception of New Zealand's capital markets. This could have adverse consequences on New Zealand as an investment destination.

Base maintenance concerns

3.14 Although ensuring consistency and certainty are important objectives in the securities lending context, the government is equally concerned that New Zealand's tax base not be undermined. Any tax rules for securities lending transactions must, therefore, minimise the risk of unintended tax advantages and current concerns in this respect should be addressed.

Circumventing the policy intent behind the imputation rules

3.15 The 1987 *Consultative Document on Full Imputation*[1] outlined the policy intent of the imputation rules:

> "*The economic objective of full imputation is to tax a company's income at the marginal rates of shareholders. In principle, imputation credits should therefore be pro-rated across shareholders in proportion to their rights to the company's net cash flows. Rules are therefore needed to ensure that companies are not able to direct credits to those shareholders best placed to use them*."

[1] *Consultative Document on Full Imputation*, Consultative Committee on Full Imputation and International Tax Reform, December 1987, p.13.

3.16 One of the fundamental principles of the imputation rules is that credits are available only to those shareholders who owned the company when the tax was paid, in proportion to shareholding. To support this policy intent, the imputation rules have anti-streaming and shareholder continuity rules.

3.17 Despite these rules, taxpayers not in a position to use imputation credits may, in certain circumstances, be able to use a securities loan to temporarily transfer their shares to taxpayers who can use the credits. "Lenders" retain economic ownership and exposure to the performance of the underlying shares through swap payments and options. However, by using a securities loan they are able pass imputation credits to another entity able to make better use of the tax credits. In return, they receive a non-taxable swap payment. "Borrowers" are able to obtain tax credits from shares they do not economically own. Allowing taxpayers to manipulate ownership in order to pass on the benefit of imputation credits is inconsistent with the underlying intent of the imputation rules.

Circumventing the current anti-streaming rules

3.18 The 1998 *Full Imputation: Report of the Consultative Committee*[2] discussed the requirements for an imputation anti-avoidance rule:

> *"In order to reinforce the effect of the anti-streaming rules and to reduce the scope for trading and recycling of credits, a specific anti-avoidance rule, buttressed by disclosure requirements, should be included in the legislation. The rule should include a provision to counteract temporary transfers of interests aimed at avoiding the allocation rules…*
>
> *[A]nti-avoidance provisions [should] be included to counteract trading in or recycling of credits and temporary transfers of interests in companies in order to obtain a tax benefit."*

3.19 Inland Revenue's *Tax Information Bulletin,* Volume 1, Number 1, July 1989 summarised the purpose of the current imputation anti-avoidance provision in section GC 22:

> *"This section has two purposes:*
>
> *To prevent shareholders buying and selling shares in order to pass imputation (and dividend withholding payment) credits to those best able to use them; and*
>
> *To prevent companies "streaming" credits to those shareholders best able to use them.*

[2] *Full Imputation: Report of the Consultative Committee*, Consultative Committee on Full Imputation and International Tax Reform, April 1988, pages 23-25.

> *The rationale for these anti-streaming provisions is that all shareholders have borne the company tax and the credits should be allocated to them all in proportion to their shareholding. In addition, if streaming is permitted, there is a greater cost to the Revenue in imputation."*

3.20 Section GC 22 (former section 394ZG of the Income Tax Act 1976) was enacted to ensure that imputation credits are allocated consistently between shareholders and on a basis that reflects actual rights to company cash flows.

3.21 In some cases it has been concluded that the section does not apply because securities lending transactions have a commercial purpose, and any tax benefit obtained is merely incidental. However, if the return from the securities in economic terms belongs to the lender, the non-application of section GC 22 would appear to be inconsistent with the policy intent of the imputation rules.

Circumventing the policy intent behind NRWT

3.22 Even if a New Zealand company has no imputation credits, a non-resident can potentially lend securities to a resident and avoid NRWT being withheld by the issuer of the dividend. NRWT applies to non-resident withholding income derived by a non-resident from New Zealand. Non-resident withholding income includes dividends.

3.23 In a securities lending transaction, a non-resident lender is able to exchange a dividend subject to NRWT for a non-taxable swap payment, while retaining economic ownership of the shares. This treatment is inconsistent with the policy intent of the NRWT rules.

3.24 The NRWT rules do contain a specific anti-avoidance rule in section GC 14A. However, this is aimed at transfers of commercial bills to avoid NRWT, not the transfer of shares.

3.25 As such, in the case of schemes to avoid NRWT on dividends, the current rules rely on the general anti-avoidance provisions in sections BG 1 and GB 1. However, the application of the general anti-avoidance provision does not provide sufficient certainty with respect to these transactions. The ability to remove an NRWT liability on dividends by lending securities and obtaining an equivalent swap payment is contrary to policy intent of the NRWT rules and needs to be addressed legislatively.

Chapter 4

NEW RULES FOR QUALIFYING SECURITIES LENDING TRANSACTIONS

Proposed changes

- Qualifying transactions that meet a strict list of criteria will be taxed on their economic substance rather than legal form. There will be no disposal for tax purposes on entering a qualifying securities lending transaction. Neither the initial transfer of securities nor the subsequent reacquisition of the same or identical securities by the lender will be treated as a taxable event for income tax purposes.

- The borrower will be treated as having acquired the borrowed security at its market value and to have returned the replacement security at the same market value.

- Any distribution (dividend or interest) received during the term of the securities lending transaction will be passed on to the lender. This includes any tax credits (imputation credits or dividend withholding payment credits) attached to a dividend.

- The borrower will be required to pay a substitution payment to compensate the lender for any distribution made on the borrowed securities during the term of the securities lending transaction.

- When a taxpayer fails to complete a securities lending transaction in accordance with the qualifying conditions, the Commissioner of Inland Revenue will be given the discretion to continue to apply the securities lending rules if the Commissioner is of the opinion that at a later time the transaction will be a qualifying transaction.

- When the Commissioner is of the opinion that the transaction will never constitute a qualifying securities lending transaction, the taxpayers affected will be required to amend the tax treatment of the transaction to reflect the general income tax rules.

Qualification criteria

- The new securities lending rules will be applicable to the following securities:
  - shares, units, bonds, debentures, convertible notes or rights or options issued by a company or unit trust listed on a recognised exchange or that are ordinarily available for subscription or purchase by the public; and

– bonds, debentures or similar securities issued by a government (in New Zealand or elsewhere).

- Agreements will need to be in writing, and any consideration received by the lender from the borrower (such as the lending fee) must be clearly identified in the agreement.

- Taxpayers will be able to use standard international agreements as the basis for their New Zealand lending agreements.

- To qualify for taxation under the securities lending rules, the transaction must involve identical securities being returned at the end of the lending transaction, along with the return of collateral, less the agreed lending fee. The reacquisition will need to take place within 12 months of the original disposal.

- The securities lending transaction must be on arm's-length terms and not be between associated borrowers and lenders.

4.1 Internationally, there are three areas in which national authorities have made changes to encourage the development of their securities lending markets:

- increased clarity;
- efficiency improvements; and
- removal of barriers (such as the introduction of specific tax rules).

4.2 New Zealand has already introduced greater efficiencies in its securities lending markets through electronic trading. This has reduced settlement times and was expected by the NZX to lead to the development of a market for securities lending as time constraints would make meeting delivery obligations more difficult. However, securities lending does not appear to have increased. This is at least in part attributable to a lack of clarity surrounding the tax treatment of securities lending in New Zealand and a less favourable taxation treatment than that available in international markets.

4.3 In the absence of special tax rules, transfers of securities under a securities loan will generally give rise to a disposal or acquisition for New Zealand income tax purposes. In such cases, the borrower becomes the owner of the securities for the period during which they hold the securities.

4.4 This would change, however, if New Zealand introduced special securities lending rules, similar to those which operate in other international jurisdictions. Under such rules, the transfer of the securities by the lender is not considered to be a taxable disposal of the securities. In addition, the lender is considered to retain beneficial ownership of the securities for tax purposes and is taken to acquire the replacement securities at the cost base of the original securities at the time of the loan. In order to fall within the rules, the securities lending transaction needs to satisfy specific conditions.

4.5 The government considers that the introduction of specific tax rules for securities lending would be beneficial for the New Zealand economy. If securities lending was encouraged (or at least not discouraged) through the introduction of special tax rules, it would allow institutional investors to "lend" their securities, thus increasing the number of possible transactions in the market. In theory, this would increase the number of actively traded securities, improve liquidity and lead to a more efficient capital market. It would also resolve many of the problems identified with the current tax treatment of these transactions and would:

- *Create greater consistency with the treatment adopted in other jurisdictions.* Adopting a consistent tax treatment for securities lending transactions is likely to lead to an enhanced international perception of New Zealand's capital markets. It may also assist with integration of the New Zealand and Australian equities markets.

- *Create greater consistency with economic reality.* Introducing special rules to tax securities lending transactions on the basis of economic reality would reflect the fact that, in substance, the transactions are securitised loan agreements and not a sale or disposition.

- *Create greater consistency with the treatment of other commercial transactions*. Taxing securities lending transactions as loans rather than sales of shares would also ensure a consistent treatment between securities lending and other commercial transactions taxed on the basis of their substance rather than legal form – such as hire purchase agreements, finance leases and livestock bailment.

- *Increase taxpayer certainty*. The introduction of specific rules would resolve much of the uncertainty surrounding the treatment of securities lending transactions.

- *Improve the perception of New Zealand as an investment destination.* As well as ensuring that New Zealand offers the same investment opportunities as other jurisdictions, introducing tax rules which encourage securities lending should improve liquidity in the New Zealand market. Internationally, securities lending represents a substantial part of the daily settlement value in many transaction systems and can play an important role in facilitating market liquidity.

- *Protect the tax base*. By designing specific rules to cater for securities lending, the government will be able to ensure that the transactions which benefit from an economic substance approach are well defined and that others, when appropriate, are subject to specific anti-avoidance rules. This will improve consistency with the policy intent of the imputation and NRWT rules.

Designing specific tax rules for securities lending

4.6 Although the government sees the advantages in moving to specific tax rules for securities lending, there are many associated technical problems that will need to be resolved before these can be implemented.

4.7 Specific tax rules for securities lending are likely to be based on those operating in other countries and, in particular, Australia. This will ensure international consistency and provide a tested framework for implementing these changes in New Zealand.

4.8 The aim of any New Zealand securities lending rules will be to allow qualifying transactions that meet a strict list of criteria to be taxed on their economic substance rather than legal form. There will be no disposal for tax purposes on entering a qualifying securities lending transaction.

4.9 Progressing the proposal will require working through a significant number of detailed technical considerations. These questions primarily concern the inter-relationship of other parts of the Income Tax Act 2004 and ensuring that no unforeseen consequences arise.

4.10 The following section discusses some of the key decisions that will need to be made in designing securities lending rules for New Zealand.

Qualification criteria

4.11 All the countries which have introduced securities lending rules have made a considerable legislative effort to carefully define the range of securities lending activities that are eligible for relief. The major difficulty will be to ensure that the list of qualifying criteria are general enough to allow for commercial variation while specific enough to exclude tax driven transactions.

4.12 Using international securities lending rules as a guideline (see the appendix for a summary of the individual rules) a number of qualification criteria have been proposed.

What securities should be covered?

4.13 To provide a boundary around which transactions are eligible for taxation based on economic substance, a number of the key overseas jurisdictions specifically list which types of securities qualify for securities lending rules. The government proposes to adopt a similar approach, making the following securities eligible for the securities lending rules:

- shares, units, bonds, debentures, convertible notes, rights or options issued by a company or unit trust listed on a recognised exchange or ordinarily available for subscription or purchase by the public; and
- bonds, debentures or similar securities which are issued by a government (in New Zealand or elsewhere).

Will there be a prescribed form for the securities lending agreements?

4.14 It is a standard requirement for most international securities lending rules that agreements need to be in writing. As this would be normal commercial practice, the government plans to adopt a similar requirement.

4.15 Should the government also require taxpayers to use industry standard agreements? This appears to be a requirement of the Australian rules, which require qualifying transactions to be "of the kind known as a securities lending arrangement". Given the objective of ensuring consistency between New Zealand's securities lending rules and comparable international rules, it would be appropriate to require taxpayers to use standard international agreements. This would also reduce the need for taxpayers to have lending agreements approved by the Inland Revenue.

Will identical securities need to be returned?

4.16 One of the key features of a securities lending transaction is that identical securities must be returned at the end of the lending transaction. Therefore the government plans to include this as one of the qualification criteria for the New Zealand securities lending rules. The replacement securities must be the same securities as those originally lent or identical securities.

4.17 The reacquisition of the identical securities must also take place within 12 months of the original disposal. This is consistent with international rules.

4.18 "Identical securities" for the purposes of the new rules will require the same number of shares in the same company, conferring identical rights and imposing identical conditions, to be returned. Relief is not available if non-identical securities are returned.

Example 3

A lender transfers 100 ordinary shares in ABC Limited to a borrower under a securities lending agreement. The borrower must return 100 ordinary shares in ABC Limited to the lender. The shares must also have the same rights and obligations as those which were originally lent. Relief will not be available if the lender returns 100 preference shares or 100 debentures in ABC Limited.

How will the rules deal with distributions and substitute payments?

4.19 A number of practical complications arise when a dividend or coupon is paid during the term of a securities lending transaction – for example, how to deal with imputation credits attached to a dividend and the tax treatment of any substitute payment made to the owner of the securities.

4.20 Although distributions create added challenges to introducing special tax rules for securities lending transactions, the government considers that excluding transactions which cross distribution dates would be too restrictive. Therefore distributions and the payment of substitute payments will be addressed under the proposed rules.

4.21 Special provision will also be made for the case when, during the period of the securities lending agreement, a right or option is issued or, if the borrowed securities are rights or options, the rights or options are exercised.

4.22 One of the key arguments for introducing special tax rules for securities lending transactions is that the current treatment does not reflect economic reality – in other words, that the transaction is a loan and that the lender is still effectively the owner of the shares throughout the transaction. Therefore it is important that transactions qualifying for the special tax rules have this characteristic. The qualification criteria should also include the requirement for any corporate actions in relation to the securities, such as the payment of a dividend, to benefit the lender. The lender must retain the risks and rewards of ownership.

What consideration will be required?

4.23 It is also a common feature of international securities lending rules to require adequate consideration or arm's-length terms. The government plans to include a similar requirement in the qualification criteria for the New Zealand rules. However, this is likely to be a general requirement for arm's-length terms rather than a requirement for a pre-determined level of consideration.[3]

4.24 Any consideration received by the lender from the borrower in addition to the replacement securities must be clearly identified in the written agreement. The loan fee (whether interest or a flat payment), indemnity payments for variations in the market value of the securities and any other payments must be clearly identified in the securities lending agreement.

4.25 To ensure that transactions occur on arm's-length terms, the government also plans to exclude any transactions between associated lenders and borrowers from the securities lending rules.

[3] The Canadian rules require collateral to equate to 95% of market value.

Tax treatment under the securities lending rules

4.26 Once a securities lending transaction meets all the qualification criteria, the next question is what impact this has on the tax treatment of the transaction. The following section summarises the proposed tax treatment of a qualifying securities lending transaction. Transactions which do not qualify for the new rules will generally continue to be taxed on a realised basis under the current rules, subject to the proposals for improving the anti-avoidance provisions in this area.

Income from securities lending

4.27 Under a qualifying securities lending transaction, the lender will not be subject to any tax consequences other than those arising from receiving the lending fee and any distribution over the term of the transaction. Neither the initial transfer of securities nor the subsequent reacquisition of the same or identical securities will be treated as a taxable event.

4.28 This will require an exemption under the tax rules. The initial loan and the return of the securities should not constitute an event requiring a base price adjustment or be taken into account in any future base price adjustment calculation. Similarly, when a securities lending transaction would have been taxable under the general tax rules, rather than the accrual rules, the transaction will now be ignored, apart from the transaction fee and any distributions which occur over the term of the transaction.

Cost base to the borrower

4.29 Under the proposed rules, the borrower will be deemed to have acquired the borrowed security and to have returned the replacement security at the same market value (the market value at the date of acquisition).

Example 4

Company A lends a parcel of eligible securities to Company B. The transaction meets all of the securities lending qualification criteria. Company B disposes of the securities to Company C. Under the proposed securities lending rules, Company B is deemed to have acquired the securities from Company A at their market value. When Company B returns either the original or identical securities to company A, Company B is deemed to have disposed of the securities to Company A at the same market value. Company B has not, therefore, made either a profit or loss on the loan transaction. Any profit by Company B derives only from the difference between the price at which the securities were sold to Company C and the market value of the securities.

Distributions made over the term of the transaction

4.30 It is intended that any distribution (dividend or interest) received during the term of the securities lending transaction should be passed on to and be taxable to the lender. This includes any tax credits (imputation credits and dividend withholding payment credits) attached to a dividend. A number of practical issues arise in trying to achieve this end.

4.31 Submissions on how distributions should be dealt with as part of introducing specific tax rules for securities lending transactions are welcomed.

4.32 One possible option is to deem both the dividend and tax credits to be received by the lender, who would be subject to tax on these in the normal way. There would be no tax consequences to the borrower as a result of a distribution being paid on the securities.

4.33 Alternatively, the borrower could be taxable on the dividend received and be required to make a non-deductible "substitution payment" to pass on the cash received to the lender. The borrower would also be required to impute the "substitution payment" to the same level as the underlying dividend.

4.34 When the "borrowed" securities have been transferred to a third party and a distribution is made during the term of the securities lending transaction, the third party will continue to keep both the cash distribution and any associated tax credits. However, the borrower will be required to make a "substitution payment" to the lender equivalent to the cash distribution. The borrower will also be required to impute the substitution payment to the same extent as the underlying dividend. To the extent the underlying dividend was not fully imputed, the substitution payment will be subject to NRWT as if it were a dividend.

How is the fee paid by the lender to the borrower treated?

4.35 The loan fee (whether interest or a flat payment) will generally be taxable to the lender and deductible to the borrower.

What happens if a transaction is not completed?

4.36 Taxpayers will not be certain that a transaction qualifies for the proposed securities lending rules until the time the transaction is completed. However, they will need to make assumptions about qualification at the start of the transaction.

4.37 What happens when, for some reason, a taxpayer fails to complete a securities lending transaction in accordance with the qualifying conditions? For example, what happens when the borrower is unable to obtain identical securities? It is expected that this situation will be fairly rare. However, it is proposed that the Commissioner of Inland Revenue be given the power to apply the securities lending rules to such a transaction, if of the opinion that at a later time the transaction will be a qualifying transaction. Taxpayers will need to apply to Inland Revenue to request that the Commissioner exercises his discretion with respect to a given transaction.

4.38 When the Commissioner is of the opinion that the transaction will never constitute a qualifying securities lending transaction, the taxpayers affected will be required to amend the tax treatment of the transaction to reflect the standard income tax rules. This restatement should occur at the time the transaction fails the qualification criteria. Depending on the circumstances, shortfall penalties may apply.

Chapter 5

NEW ANTI-AVOIDANCE MEASURES FOR NON-QUALIFYING TRANSACTIONS

Proposed changes

- Imputation credits will be cancelled if they are paid to a shareholder who lacks economic ownership in the securities and is under an obligation to make a related payment passing on the benefit of receiving tax credits to the economic owner of the shares.
- A similar test will be introduced for non-resident withholding tax (NRWT), under which the substitute payment will be deemed to be gross income of the borrower.
- The government is still considering how "lack of economic ownership" and "related payment" will be defined.
- The introduction of a "safe harbour" mechanism for small investors is also being considered.

5.1 A necessary part of reviewing the tax treatment of securities lending transactions is ensuring that the tax rules protect and maintain the revenue base. All the countries reviewed that have introduced securities lending have strengthened their tax rules as part of the package.

5.2 Although the majority of securities lending transactions are not tax-driven, any changes to produce increased certainty and consistency would affect a number of different tax rules. Great care needs to be taken to ensure that the new rules do not create new base maintenance concerns and that existing ones are adequately addressed.

5.3 The rules which exist in other jurisdictions provide some guidance as to the level of risk for New Zealand. The ability to use the rules for transactions which result in an unintended policy outcome has generally been mitigated by setting strict conditions for what constitutes a qualifying securities lending transaction. Jurisdictions have also enacted anti-avoidance provisions targeting imputation trading and similar transactions.

5.4 Therefore, as part of the move to clarify and improve the taxation treatment of securities lending, the government has reviewed the application of the imputation and NRWT rules in this context.

Are new rules required?

5.5 The first step in determining whether new rules are required is to conduct a review of the existing provisions. The current measures in place can be divided between specific and general anti-avoidance provisions.

Specific anti-avoidance measures

5.6 The current imputation anti-avoidance rule (section GC 22) was designed to ensure that the imputation credits are allocated consistently between shareholders and on a basis that reflects actual rights to company cash flows. It is aimed at arrangements whose predominant underlying purpose is to transfer imputation credits from one party who is unable to use those credits to another party who is able to use them.

5.7 The first three paragraphs of section GC 22(1)(a) are so broadly worded that they would catch the majority of share sales. In practice, therefore, sub-paragraph (iv) provides the only test for distinguishing between transactions that are subject to attack under section GC 22(1)(a) and those that are not.

GC 22 IMPUTATION: ARRANGEMENT TO OBTAIN TAX ADVANTAGE

(1) For the purposes of this section, there is an arrangement to obtain a tax advantage where –

(a) there is an arrangement for the sale or other disposition of shares or issue of shares where –

(iv) the purpose, not being an incidental purpose, of the arrangement is that a party to the arrangement would obtain any such tax advantage.

5.8 There is no question that a "tax advantage" arises from an imputation trading arrangement. The term "tax advantage" is very broadly defined to include both the allowance of a credit of tax, and a credit arising to an imputation credit account. The "borrower" can receive both forms of credit in a securities lending transaction. The issue is determining whether this tax advantage is more than a merely incidental purpose of the arrangement.

5.9 Determining whether an arrangement involves more than a merely incidental purpose of obtaining a tax advantage involves considering the effect of the transaction. Is it to achieve a manufactured tax advantage or does any tax advantage merely arise from prudent attention to the tax implications of a course of action?

5.10 The effect or end the taxpayer seeks to achieve is determined objectively by looking at the terms of the transaction. This involves considering the economic reality of a given transaction against whether it involves exploitation of the tax statute. Factors that could be considered are:

- the term of the transaction;
- the commerciality of the payment flows under the respective legs of the transaction;
- the commerciality of the interest rate charged (influenced by the credit rating of the "borrower", the fact that shares are provided as security and the existence of any guarantees); and
- whether the transaction was driven by the need to realise funds, rather than a situation where shares were acquired for the purpose of entering into the transaction.

5.11 Because securities lending transactions are recognised commercial transactions, it can be difficult to establish that a tax advantage gained from any particular transaction is more than merely incidental.

5.12 There is no specific anti-avoidance provision in relation to NRWT. Reliance is placed on the general anti-avoidance provision.

General anti-avoidance provision

5.13 Under section BG 1, a tax avoidance arrangement is void against the Commissioner of Inland Revenue. Under Part G of the Income Tax Act 2004, the Commissioner may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement. A transaction constitutes such an arrangement if tax avoidance was the purpose of the arrangement and "not merely incidental".

5.14 A merely incidental purpose is something which is necessarily linked to some other purpose. An incidental purpose is one which is a subsidiary or minor purpose when compared to the other purposes associated with an arrangement.

5.15 As with section GC 22, because securities lending transactions are recognised commercial transactions, it can be difficult to establish that a tax advantage gained from the arrangement is more than merely incidental. The government needs more certainty in this area.

Strengthening the New Zealand rules

5.16 One of the underlying principles of the imputation system is that the benefits of imputation should be available only to the true economic owners of shares, and only to the extent that those taxpayers are able to use the imputation credits themselves. To support this policy intent, the imputation rules have anti-streaming and shareholder continuity rules.

5.17 Despite these rules, taxpayers not in a position to use imputation credits may, in certain circumstances, be able to use a securities loan to temporarily transfer their shares to taxpayers who can use the credits. "Lenders" retain economic ownership and exposure to the performance of the underlying shares through swap payments and options. However, by entering into the scheme they are able to convert a taxable dividend into a non-taxable swap payment. "Borrowers" are able to obtain tax credits from shares they do not economically own. Allowing taxpayers to manipulate ownership in order to pass on the benefit of imputation credits is inconsistent with the underlying intent of the imputation rules.

5.18 The proposed securities lending rules will ensure the correct tax policy result for qualifying transactions by transferring imputation and dividend withholding credits to the economic owner of the securities. However, ensuring the correct policy outcome for securities lending transactions which fall outside the strict qualification criteria will be dependent on the anti-avoidance provisions. If the current tax rules cannot ensure the right policy result with respect to securities lending transactions, new rules are required. On this basis, the government is considering introducing new anti-avoidance measures for the imputation and NRWT rules.

What form will the new rules take?

5.19 In introducing a new anti-avoidance measure to prevent unintended policy outcomes with respect to securities lending transactions, there are a number of possible options.

"Lack of economic risk"

5.20 The new anti-avoidance rule should ensure that shareholders have economic ownership in the underlying shares before they are able to access imputation credits. Therefore one option is to deny imputation credits when there is lack of economic risk.

5.21 If such a measure is introduced, one of the key questions will be how to define lack of economic risk.

5.22 One option is a general requirement for shareholders to have economic ownership in the underlying shares before imputation credits can be accessed. However, what constitutes "economic ownership"? A general requirement without some specific measure would lead to taxpayer uncertainty as to when the anti-avoidance provision applied.

5.23 Including a precise method for determining when there is a lack of economic ownership increases taxpayer certainty. However, it also increases complexity, as evidenced by the rules operating in other jurisdictions.

5.24 Australia introduced extensive legislation in 1998 to address avoidance concerns with respect to the trading of franking credits. The Australian rules measure whether economic exposure exists for a share by determining the delta of the taxpayer's position in a share. If the delta of a taxpayer's position in a share is less than 0.3, the taxpayer is deemed not to have economic exposure to the shares, and no tax credit is allowed.

5.25 Delta is a well-recognised financial concept that measures the change in value of the taxpayer's position for a $1 change in share price. Taxpayers highly exposed to share price volatility have a high delta and are deemed to have economic risk. Taxpayers who have a low delta do not have much exposure to movements in the share price and are deemed not to have economic risk.

Example 5

Jack holds 1000 shares in a company and writes a call option with a delta of 0.6 in respect of those shares. He will not have a materially diminished risk because his net position in relation to the shares will be in excess of 0.3. To determine the net position, the delta of the sold call option is subtracted from the delta of the shares (the delta of a share against which the delta of an option or other derivative is calculated is, by definition, +1.0). Accordingly, the net position of the taxpayer is:

$((1000*1) – (1000*0.6))/1000 = 0.4$

In contrast, Jill who holds 1000 shares and writes a call option with a delta of 0.9, will have a materially diminished risk because her net position is 0.1.

Focusing on the related payment

5.26 There is a risk that focusing solely on lack of economic risk could unintentionally catch ordinary business transactions which do not result in a tax treatment contrary to policy intent, such as transactions aimed at hedging risk.

5.27 It appears that for an imputation trading transaction to be tax effective, the unintended tax advantage must be passed on through some form of deductible payment from the borrower to the lender. Such a payment is made in return for the receipt of tax credits, such as imputation credits or dividend withholding payment credits, or to share the benefit of NRWT being avoided. Therefore another possible option for the new anti-avoidance rule would be to focus on there being a related payment passing on the tax benefit of the transaction. This will necessitate a wide definition of "related payment".

5.28 The Australian legislation includes a detailed definition of what is meant by "related payment":

> *(i) Causing a payment(s) to be made to, or in accordance with the directions of, the other person(s); or*
> *(ii) Causing an amount(s) to be credited to, or applied for the benefit of, the other person(s); or*
> *(iii) Causing services to be provided to, or in accordance with the directions of, the other person(s); or*
> *(iv) Causing property to be transferred to, or in accordance with the directions of, the other person(s); or*
> *(v) Allowing any property or money to be used by the other person(s) or by someone nominated by the other person(s); or*
> *(vi) Causing an amount(s) to be set off against, or to be otherwise applied in reduction of, a debt(s) owed by the person(s) to the taxpayer or associate; or*
> *(vii) Agreeing to treat an amount(s) owed to the other person(s) by the taxpayer or associate as having been increased.*

5.29 Although this definition does cover a number of scenarios, there may be other situations which need to be included – for example, alteration of the sale price of the shares and the interest rate paid by the "lender". The effectiveness of the new provision will rely heavily on the definition of related payment. For the provision to operate effectively, the term "related payment" must be interpreted widely.

Requiring a set holding period

5.30 A further option could be to require shareholders to have held shares for a set period before imputation credits are available.

5.31 To prevent trading of franking credits, Australia denies franking credits if the taxpayer effectively has no interest in the dividend because of an obligation to pass it (or an equivalent payment) to another taxpayer.

5.32 The measure applies when the taxpayer has not effectively held the shares for 45 days (measured from 45[4] days before to 45 days after the shares became "ex-dividend").

5.33 Although a holding period test has the advantage of simplicity, there are also significant disadvantages with this measure. It potentially penalises a taxpayer on the basis of an arbitrary time period. It also introduces additional record-keeping requirements because taxpayers will need to calculate the number of days they hold shares in relation to the payment of a dividend.

[4] The rule is 90 days in the case of preference shares.

Preferred option

5.34 The government's preferred approach is to combine options one and two. This will ensure that (non-qualifying) securities lending transactions are taxed in a way which is consistent with the imputation and NRWT rules, while targeting those transactions aimed at obtaining an unintended tax benefit.

5.35 On this basis, the government is proposing to introduce a further requirement to the imputation rules which will require shareholders to have economic ownership in the underlying shares before they are able to access imputation credits, if the benefit of obtaining the tax credits is passed on through a related payment. A similar test will be introduced for NRWT, although the mechanism for removing the tax benefit obtained will be different. It is not intended that a holding period test be introduced.

5.36 In order to reduce compliance costs, the government is considering introducing a safe harbour mechanism (likely to be based on the value of securities held) to exempt small investors from the need to comply with the new anti-avoidance rules. This exemption would operate in a similar way as the cash basis person mechanism in the accrual rules. Submissions on how a safe harbour should operate are welcomed.

What happens if the test applies?

5.37 The tax benefit of entering into a securities lending transaction will be eliminated by focusing on the benefit derived by the "borrower", namely denying the tax credits the borrower receives on any dividends.

5.38 This approach is:

- consistent with the underlying principle of the imputation rules that imputation credits are available only to the true economic owners of shares;
- consistent with the intended effect of the existing anti-avoidance rule in section GC 22;
- consistent with the approach adopted in other jurisdictions; and
- easy to administer as the target of the rule, the recipient of the dividend, is within the New Zealand tax base.

5.39 Although this approach will prevent imputation trading, it could not be replicated if the problem involves a non-resident lending shares to a resident to circumvent NRWT. In this case, there will not be any tax credits to cancel.[5]

[5] The New Zealand borrower is likely to hold a certificate of exemption and will not be subject to the resident withholding tax rules.

5.40 Instead, when the issue is NRWT avoidance, the substitute payment would be taxable, as occurs already under section GC 14A. Section GC 14A is a specific anti-avoidance provision aimed at preventing non-residents from avoiding NRWT on a redemption payment by disposing of a commercial bill to a resident immediately before its maturity. Section GC 14A does this by including the redemption payment in the resident person's gross income if the sale or transfer from the non-resident to the resident "has the purpose of avoiding non-resident withholding tax or the approved issuer levy".

Submission points

5.41 The government is interested in obtaining feedback on the proposed new anti-avoidance test, and whether it is appropriate to determine economic ownership through a delta test.

5.42 The government is also interested in comments on the definition of "related payment" and whether this will be a suitable way of limiting the application of the anti-avoidance provision to those transactions whose purpose is obtaining a tax advantage.

5.43 Finally, comments are welcomed on the proposed method for eliminating the unintended tax benefit, both for imputation and NRWT purposes, and the proposed safe harbour mechanism.

Appendix

SUMMARY OF INTERNATIONAL SECURITIES LENDING RULES

	Australia	United Kingdom	Canada	United States
Date introduced	1990	1989	1989	1983
Conditions for qualifying transactions				
Agreement in writing	Y	Y		Y
Return of securities	Y	Y	Y	Y
Substitute payments required	Y. Initially, lending transactions would not qualify if they straddled a distribution date. This has now been amended.	Y. In addition, the transaction must treat any amount received by the lender in excess of the underlying payment, including any interest on collateral, as the lender's fee for entering into the transaction.	Y	Y
Lender retains risk/rewards of ownership	Y		Y	Y
Termination period	Initially 3 months. Later amended to 12 months.			Lender must be able to terminate within 5 business days.
Consideration easily ascertainable	Y			
Limitation on parties involved		Limited to approved borrowers and lenders. Maximum of three parties.		
Is for the purpose of allowing the borrower to fulfil a contract to sell securities.	Y. The transaction must be of the type known as a "securities lending arrangement". Therefore the rules will generally not apply to repo transactions.	Y		
Transaction on arm's-length terms/adequate collateral		Y (unless condition waived by Inland Revenue).	Y[6]	
Securities covered	Shares, bonds, debentures, convertible notes, rights or options issued by a "public" company. Units, bonds, debentures, convertible notes, rights or options issued by a unit trust, the units of which are quoted on an official stock exchange or are ordinarily available for subscription/ purchase by the public. Bonds, debentures or similar securities which are issued by a government authority.	UK treasury stock, stock exchange listed securities of UK companies and non-UK companies where within UK withholding tax rules, overseas securities.[7] The UK stock lending rules specifically exclude repos. These are covered by separate tax rules.	Shares, bonds, debentures, notes, warrants, rights, options and similar instruments of Canadian public companies. Shares listed on prescribed foreign exchanges, government securities also qualify.	

[6] If borrower provides collateral (qualifying security) with a market value equal to 95% of the market value of the securities borrowed, the substitute payments will retain the character of the underlying payments.

[7] The original UK stock lending rules avoided problems relating to UK tax on overseas dividends by making approved lending impossible where such tax would arise. The stock lending rules were subsequently extended to cover overseas securities, subject to adequate accounting for tax on manufactured overseas dividends. The widening of the provisions resulted from industry pressure. For overseas securities not within the UK withholding rules, the UK Inland Revenue treats substitute payments in the same manner as if true dividends or interest were received. The regulations are not as stringent as there are fewer approvals over the parties involved. Instead there are detailed accounting rules involving memoranda accounts to ensure that tax on dividends is properly accounted for to the Inland Revenue. The principles underlying the accounting procedures are that the lender should receive any manufactured dividend with the same amounts deducted as the overseas and UK tax that would have been deducted from the real dividend had the stock not been lent, and that this tax should be accounted for to the UK Inland Revenue.