



31 January 2005

Taxing Securities Lending Transactions
C/- The Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Dear Officials

Taxing Securities Lending Transactions

We applaud the manner in which the Inland Revenue and the Government have responded to the identification of this longstanding bugbear of the New Zealand capital markets. We similarly applaud the priority with which this has been addressed to date. We strongly support the expeditious progression of this issue and would be truly delighted to see the incorporation of appropriate securities lending legislation in the May 2005 tax bill.

NZX also very strongly supports that the rules facilitate stock lending transactions from a commercial perspective as compared to creating a market driven by the tax consequences that result from these rules.

Our key points in relation to the implementation of an efficient and appropriate securities lending regime are:

1. Qualifying Transactions:

- NZX supports the qualification criteria as currently proposed, as these should ensure only legitimate securities lending transactions are covered by the regime, and will also provide both the taxpayers and the Inland Revenue with a clear and certain outcome.
- Having qualifying transactions potentially subject to any avoidance provisions undermines this regime and thus we recommend that the avoidance provisions do not apply to such transactions. Rather we support the Inland Revenue monitoring this regime and if imputation trading transactions or other unwanted activities arise via the circumvention of the regime then there should be legislative modification.
- In pure lender-borrower transactions, NZX supports the deeming of the dividend, including the imputation credits, to be received by the lender.



- Where third parties are involved, we support the proposal that the borrower should make a “substitution payment” to the lender. In this scenario we recommend that:
 - the net dividend (i.e. excluding imputation credits) be paid to the lender which should be both deductible to the borrower and taxable to the lender.
 - The borrower should pay to the Inland Revenue an equivalent amount to any imputation credits attached to the dividend paid on the underlying securities.
- We also note that we do not anticipate more than a minor portion of the transactions undertaken in the securities lending market being those that will include a third party buyer of the securities loaned to the borrower.

2. Anti-Avoidance:

- The creation of stringent qualification criteria should be the forefront of any anti-avoidance measures. Given these are proposed as above, we would recommend that no specific avoidance rules are introduced at this time other than a rule where taxpayers structure securities lending transactions so that they do not meet the definition of a qualifying transaction (with the effect that imputation credits have been traded).
- We recommend that the Delta test not be included in any test of economic ownership. The Delta can be manipulated by the parties undertaking the securities lending transactions, and is a largely confusing concept to taxpayers that will only increase uncertainty.
- We also recommend the discarding of the holding period due to its arbitrary and unsubstantiated basis.

We provide detailed comments on the reasoning behind our proposals in the attached annex.

We would appreciate the opportunity to meet with officials to discuss these proposals further. In addition, if following the submissions you still have specific technical areas on which you still require information, we will be happy to put you in contact with the appropriate people either in New Zealand or offshore.

Yours faithfully

A handwritten signature in black ink, appearing to be 'Mark Weldon', written in a cursive style.

Mark Weldon
Chief

Executive

SECURITIES COVERED

NZX supports the list of securities in paragraph 4.13.

QUALIFYING TRANSACTIONS

1. We agree that before a securities lending transaction is provided relief under new legislation, that transaction must meet a legitimate set of criteria in order to justify the underlying policy rationale. This will enable taxpayers to clearly understand when these rules apply and allow the Inland Revenue to administer and review this regime. As one of the fundamental principles of the imputation regime is that imputation credits should only be available to those shareholders who had a shareholding in the company at the time the tax was paid, strict qualification criteria are required to reinforce this policy.
2. The criteria proposed includes:
 - Agreements must be in writing
 - Standard forms, including international precedents
 - Identical securities must be returned
 - A 12 month return period for the securities subject to these rules

NZX supports the above criteria. In this regard we support that the rules should be flexible with regards to who the lender and borrower may be, for example allowing it to include non residents, tax exempt entities, and non corporate entities. We discuss the complexities that this raises below.

3. We note that we do not think that transactions which meet the criteria for being a qualifying transaction should be subject to any anti-avoidance provisions. Having qualifying transactions potentially subject to any avoidance provisions undermines this regime and thus we recommend that the avoidance provisions do not apply to such transactions. Rather we support the Inland Revenue monitoring this regime and if imputation trading transactions or other unwanted activities arise via the circumvention of the regime then there should be legislative modification. As discussed later in the document in relation to the avoidance issues, we believe that ensuring no tax benefit arises at the front end should be a key in first meeting the qualification criteria.
4. Where the criteria has been met, and thus the transaction is deemed to be a qualifying transaction, that transaction should be taxed on the basis of its true economic substance. In such scenarios there is no justification for taxing on the basis of legal form as the qualifying criteria will have already ensured that any chance of avoidance is minimal.

Criteria

5. We note that, excluding the two minor points below, we do not comment in detail on the specific qualification criteria as we believe that the criteria as outlined in the discussion document are adequate to ensure that only legitimate securities lending transactions, and



not transactions undertaken with a purpose of which tax avoidance is more than a merely incidental purpose, are covered by the regime.

6. We believe it would be of substantial aid to taxpayers if the Inland Revenue discussed and published a list of approved securities lending agreements in order to create certainty for all parties, including the Inland Revenue. There should also be the ability for the Commissioner to exercise discretion over the approval of any non-standard agreement.
7. In relation to the requirement for the securities lending agreements to be in writing, we question whether the need exists for every agreement to be in writing. Given the current environment of on-line share trading and increasing electronic usage, we recommend that provision be made for the allowance of electronic transactions to occur, subject to the following requirements:
 - a. A master agreement between the lender and the borrower exists prior to any electronic transactions occurring; and
 - b. All details required to be included in a standard securities lending agreement be captured in the electronic transaction.
8. For entities undertaking large numbers of securities lending transactions, completing written agreements for each such transaction will be an overly onerous process, and one which can potentially be remedied by the above recommendation.

Distributions over the term of a transaction

9. We see the issue of the treatment of distributions made during the period under which securities are being loaned as one of the key areas needing certainty. We thus provide our detailed comments and recommendations on the most appropriate treatment of those distributions. For completeness we agree that there should be no implications for
 - the entity issuing the securities or
 - any non associated acquirer of the securities from the borrower.

These taxpayers/entities are likely to be unaware of any prior securities lending transaction and therefore should have no consequences from such transactions.

Lender – Borrower transactions

10. As a starting point, we note that in the standard dividend scenario involving a company and a shareholder, the payment of an imputed dividend would result in the distributing company's ICA being debited with imputation credits and the shareholders' ICA (assuming the shareholder is a corporate and maintains an ICA) being credited for the same amount.
11. The ultimate result from the operation of a securities lending transaction, at least where it is a pure lender-borrower transaction, should mirror the above scenario - a debit to the distributing company's ICA and a **net** corresponding credit to **only** one other parties' ICA which ultimately will be the lender (given they are the true economic owner).



12. The same outcome, net of any offsetting ICA debits/credits resulting from the passing on, deeming or cancellation of any credits, should be achieved. Ultimately, only one of the other parties should end the transaction with a net credit to their ICA, and no party other than the distributing company should end up with a net debit to their ICA.
13. We would not support a situation where there is no mechanism for the lender to obtain a credit for any imputation credit that is attached to a dividend paid while the securities have been subject to a securities lending transaction. That is, under a securities lending transaction, the lender will physically receive from the borrower an amount equivalent to the cash dividends paid by the underlying securities (should the underlying security pay a dividend). This is and should be taxable to the lender, thus the lender should be entitled to such credits.
14. The discussion document outlines two options under this scenario, being:
 - a. Paragraph 4.32 raises the possibility of deeming both the cash dividend and any imputation credits attached to be received by the lender. The lender would then be taxable on the gross value of the dividend.
 - b. Paragraph 4.33 states that the Borrower receives the dividend and imputation credits (these being taxable) and passes the dividend and imputation credits onto the lender via a non deductible substitution payment (which carries imputation credits).
15. We note that under the first option there is the practical question of whether a credit entry is ever made into the borrower's ICA (and a debit upon transfer/deeming) or no credit ever arises to the borrower. We do not see any significant issue under either scenario, and may rather come down to a question of balance between record maintenance and traceability versus compliance cost in adjusting a companies ICA for numerous securities lending transactions.
16. Thus applying the option in paragraph 4.32, the lender would be taxable on both the cash dividend passed on by the borrower and the amount of imputation credits deemed to have been paid to by the distributing company. The borrower is deemed not to have received any gross income in relation to the distribution as the cash has been passed directly on to the lender and the imputation credits never arose to the borrower.
17. The proposal in paragraph 4.33 however requires further consideration. Here it is proposed that the borrower would be taxable on the gross dividend, but still be required to make a non-deductible "substitution payment" to the lender, which would be imputed to the level of the initial dividend.
18. Where the borrower is taxable on the gross dividend, but is required to pass the imputation credits onto the lender, the borrower will be left in the position of having further tax to pay to the extent that the dividend is not imputed. Given that the policy rationale underlying these securities lending proposals is the mirroring of the economic substance of the transaction, to tax the borrower when, in substance, they haven't received the imputation credits is unpalatable. The proposal as strictly outlined in



paragraph 4.33 should not be implemented. We propose that corresponding substitution payment should be deductible to the extent that the dividend from the underlying securities is not imputed. We are happy to consider further the position of withholding taxes.

19. In summary, when dealing with a strict lender-borrower transaction, NZX supports the first proposal of deeming the dividend, including the imputation credits, to be received by the lender. The borrower must pay the cash amount to the lender and any imputation credits are deemed to be a credit to the lenders ICA. The lender will be taxable on that gross amount of the dividend and the borrower will have no taxable/deductible income/expenditure directly relating to that dividend
20. Flowing from the above, we believe that whether it is part of the qualification criteria or whether it is just a subsequent requirement, there should be provision for all dividend statements and documentation required under the Tax Administration Act to be passed on to the lender for supporting evidence to their tax return files.

Third Party transactions

21. When the borrowed securities are then transferred to a third party the dynamics and underlying economic substance are considerably more complex. In this scenario it may not be possible to give rise to the overall net effect achievable under a strictly lender-borrower transaction.
22. We support the proposal that the borrower should make a “substitution payment” to the lender where the underlying securities lent have been transferred to a third party. In this scenario we recommend that:
 - a. the net dividend (i.e. excluding imputation credits) be paid to the lender which should be both deductible to the borrower and taxable to the lender.
 - b. The borrower should pay to the Inland Revenue an equivalent amount to any imputation credits attached to the dividend paid on the underlying securities. In this regard we note:
 - (i) This would not give rise to an imputation credit to the borrower.
 - (ii) The credit would be treated as an imputation credit by the lender (i.e. it would be taxable, creditable against its tax liabilities and treated as a credit to its ICA if it maintain such an account).
 - (iii) This payment would be deductible to the borrower.
 - (iv) This would also facilitate non residents being borrowers (and New Zealand person who do not maintain ICAs) in that the non resident would be able to provide conclusive evidence of the payment that gives rise to the imputation credit; if the borrower does not make the payment there would be no corresponding credit available to the lender.



(v) In relation to NRWT liabilities, we note that is only an issue to the extent that the underlying dividend was not imputed. To the extent that the dividend is not imputed, New Zealand resident borrowers would be required to pay the equivalent amount of NRWT to the Inland Revenue; this payment would not give rise to imputation credits for the borrower but would be tax deductible to it.

23. We also note that in addition to the recommendation in paragraph 22.b, we also raise the possibility of existing imputation credits of the borrower being able to be passed on to the lender rather than the borrower having to pay further tax. While we recognise that there may be opportunities for entities that, for example, are unable to utilise their imputation credits to circumvent the policy intent, we believe that in some scenarios the passing on of existing imputation credits would not be contrary to that policy and thus should be allowed.

24. In relation to the lender, the effect of receiving the substitution payment should be identical to that of receiving the actual distribution itself. Thus the lender will be taxable on the gross value of the dividend.

25. In relation to resident withholding tax, we submit that all payments by borrowers to lender should be exempt from such a withhold. We recommend this for the following reasons:

- To require it to be subject to RWT will require various deeming provisions; this will overly complicate this regime
- We expect lenders of such transactions to be sophisticated entities and as such will be able to make appropriate adjustments to their provisional tax calculations or will hold certificates of exemptions in any event.

Non-completion of transactions

26. We believe that the new regime should also leave open the flexibility for the Commissioner's discretion to be exercised in some cases where the transactions are not completed, as is proposed in the discussion document.



ANTI-AVOIDANCE

27. In implementing a new securities lending regime we recognise the need for the maintenance of the New Zealand tax base, and thus the need for specific anti-avoidance measures to ensure that the new regime is only used for legitimate securities lending transactions that do not have tax avoidance as more than merely an incidental purpose.
28. By way of introduction and as stated in paragraph 5.18, the proposed security lending rules discussed above will address many avoidance concerns officials may have. Namely where a shareholder (for example a non resident shareholder) enters into a security lending transaction with another taxpayer (a New Zealand resident taxpayer), the proposed security lending rules will ensure non residents can not transfer imputation credits by entering into such transactions with New Zealand residents. We can appreciate the concern that shareholders could enter into security lending transactions however structure such arrangement so that they do not meet the definition of the qualifying transaction hence are not subject to the proposed rules.
29. Given the above we would recommend that no specific avoidance rules are introduced at this time other than a rule where taxpayers structure securities lending transactions so that they do not meet the definition of a qualifying transaction (with the effect that imputation credits have been traded). We are happy to discuss this further. For completeness we note that applying the proposal in paragraph 4.33 will result in the borrower also being subject to the proposed avoidance rule.
30. We comment further below should you not implement our submission above.

Lack of Economic Ownership

31. We believe that the economic ownership test, in its theoretical application, provides a sound and workable solution to deciding between which transactions are such legitimate securities lending transactions. That said, we can see issues with this, for example where a person has contracted to sell shares but between the date of the agreement and the settlement date the company pays a dividend; we strongly believe that any proposed rule should NOT apply in this type of situation.
32. We comment on each of the three measurement options proposed below.

The Delta Test

33. We believe that this test may provide another arbitrary number as is the case with the holding period. Basing economic ownership on such a complex and easily manipulated criteria would only create uncertainty and the potential for illegitimate transactions to qualify under the new regime.
34. We note from our meeting with Carolyn Palmer and Maree Pallot on 9 December 2004, it was outlined by one of the interested parties present that the Delta figure is easily manipulated, and in most cases sits very close to either 0 or 1. While we do not have any in depth or first hand knowledge of the mechanics of the Delta number, we would



suggest that some of the key features of the measurement option(s) chosen to determine economic ownership should be:

- a. the inability of the measurement to be illegitimately influenced; and
- b. the certainty of allowing the transacting parties to determine whether that transaction qualifies or not.

35. Thus we recommend that the proposal to include a Delta test as a measurement of economic ownership be discarded.

Related Payments

36. We believe that the key to ensuring the benefit of any tax paid and associated tax credits is received by the intended party under the new regime is to focus on the dividend and substitution payments at the front end, as discussed above in the Qualifying Transaction section of this submission.

37. Paragraph 5.27 of the discussion document outlines 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. The ideal theoretical solution is to simply require all credits etc to be removed from the borrower and placed with the lender in the same manner as if they had received the dividend them self; this will be achieved under the securities lending proposals.

38. We believe that identifying each of the potential scenarios in which a securities lending transaction can take place and ensuring that the legislative provisions result in the credits ultimately lying where the policy intends them too, as being the ideal solution. This also provides the added advantage of being able to provide an interpretation statement with actual examples that occur, and will thus enhance the level of certainty for both the taxpayers and the Inland Revenue and reduce compliance and audit costs.

Holding Periods

39. We do not comment further on the holding period option, other than to agree with the Inland Revenue's current position of not proceeding with this option. Setting a minimum number of days for which the securities must be held provides an unjustified and arbitrary test which is of no real relevance to the underlying economic substance of a securities lending transaction.