

Discussion document proposes changes to taxation of securities

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Niels Campbell - Partner

On 30 November 2004, the government released a discussion document proposing reform of the taxation of securities lending transactions in New Zealand.

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Securities lending

Securities lending involves the “lending” of securities by way of sale coupled with the subsequent sale of those securities back to the lender at a later date in return for a fee.

Financial intermediaries borrow securities to remedy shortfalls of specific securities needed for delivery to a third party. Those lending the securities, usually passive institutional investors, benefit from these lending returns in addition to the usual dividends and other benefits generated by the securities themselves.

There are currently no specific rules governing the taxation of securities lending transactions in New Zealand and ordinary principles apply to the taxation of such transactions based on their legal form.

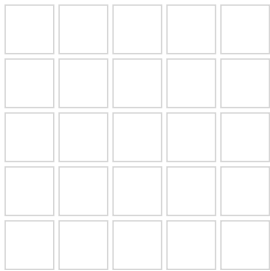
The discussion document proposes the introduction of tax rules that will apply to certain qualifying securities lending transactions. It also proposes a strengthening of the existing imputation credit and non-resident withholding tax (“NRWT”) anti-avoidance rules to reduce tax avoidance opportunities that arise as a result of the current tax treatment of securities lending transactions.

Current tax treatment

In substance, securities lending transactions are similar to loans but, as the borrower of the securities must actually obtain legal title to them, the lender must legally dispose of the securities. This triggers a taxable event for the lender.

If the securities concerned are financial arrangements (for example, debentures or government stock), a base price adjustment under the accrual rules will be triggered when the securities are transferred by the lender. The borrower and lender must also account for accrual income and expenditure under the accrual rules during the period of the transaction.

If the securities concerned are excepted financial arrangements, such as shares, the accrual rules will not apply. Any gain or loss on the transfer of the shares will be taxed under ordinary principles. If the lender holds the shares on revenue account (i.e. acquired the shares with intention of resale or is a dealer in shares) any gain will be taxable.



Taxation

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Monique Mackie – Solicitor

As a result, potential lenders are often reluctant to enter into securities lending transactions where a taxable gain would be realised.

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Proposed rules for “qualifying transactions”

The government has proposed taxing “qualifying” securities lending transactions on their economic substance rather than their legal form.

Qualification criteria

The proposed new rules will apply to a wide range of securities:

- Shares;
- Units;
- Bonds;
- Debentures;

- Convertible notes;
- 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;
- Bonds, debentures or similar securities issues by any government.

In addition, all the following criteria must be met:

- Agreements must be in writing and any consideration received by the lender from the borrower must be identified in the written agreement. Standard international agreements may be used as the basis for New Zealand lending agreements.
- Identical securities must be returned at the end of the loan period, along with the collateral minus any lending fee;
- The securities must be returned to the lender within 12 months of disposal;
- The transaction must be on arm’s-length terms and not between associated borrowers and lenders.

If these criteria are met, no taxable event will be triggered for the lender upon the transfer and reacquisition of the securities. The lender will not be taxed, apart from the tax implications of receipt of a lending fee and any corporate action distribution received for the securities during the term of the lending transaction.

Under the proposed rules, the borrower will be assumed to acquire the securities and dispose of them at the same market value, avoiding tax consequences for the borrower.

Proposed anti-avoidance rules

Where a transaction does not meet the “qualifying” criteria, ordinary principles will continue to apply but new anti-avoidance measures will be introduced to prevent taxpayers trading imputation credits or avoiding non-resident withholding tax (“NRWT”) through securities lending.

These proposed rules are designed to prevent a taxpayer who is not in a position to fully benefit from imputation credits from, for example, temporarily “lending” their shares to another taxpayer who is able to use those credits.

The government is concerned that the borrower could be able to obtain imputation credits for shares they do not economically own and believes this to be against the intent of the imputation rules.

The discussion document also proposes cancelling imputation credits if they are paid to a shareholder who does not have “economic ownership” of the shares and who is under an obligation to make a related payment passing on the benefit of receiving tax credits to the economic owner of the shares (i.e. the lender).

One proposal put forward to measure economic risk is to adopt the Australian approach of determining the “delta” of a taxpayer’s position in a share.

Delta is a financial concept that measures the change in the value of a taxpayer’s position for a \$1 change in share price. In Australia, if a taxpayer’s delta position in a share is less than 30%, then the taxpayer is deemed not to have economic exposure to the shares. The higher a taxpayer’s delta, the higher the economic risk the taxpayer bears, as the taxpayer is highly exposed to volatility in share prices.

A similar test will be introduced for NRWT.

The government is also considering the introduction of a “safe harbour” mechanism to exempt small investors from the need to comply with the new anti-avoidance rules. Any safe harbour is likely to be based on the value of securities held.

Recent House of Lords decision

The discussion document approach - to look at the substance of such transactions and evaluate the degree of risk involved - will derive some support from the 25 November 2004 decision of the House of Lords in *CIR v Scottish Provident Institution*.

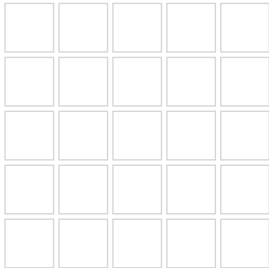
The case involved a mutual life office implementing a proposal put forward by Citibank to take advantage of a change in the law relating to the taxation of qualifying government stock transactions.

Prior to the law change, Scottish Provident Institution (“SPI”) granted Citibank an option to buy government stock at a large discount, in return for a large premium. Prior to the law change, the premium received was tax free.

After the law change, Citibank exercised its option and SPI incurred a large loss, which was now deductible if the transaction was a qualifying option. To avoid the commercial risk of a rise or fall in interest rates, a matching option was granted by Citibank to SPI.

Although the terms of the matching option differed, the aggregate of the option premium and the exercise price equalled Citibank’s option less an amount agreed as Citibank’s fee. Further, the strike price of the option was found to have been carefully chosen by the parties at a level which gave only an outside chance that the option would not be exercised.

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The case turned whether there was a practical likelihood that the risk would arise. If not, the two options could be viewed as a composite transaction, and thus no qualifying transaction would arise after the date of the change in law.

At first instance, the transaction was upheld:

“If the chance of the price movement occurring was similar to an outsider winning a horse race we consider that this, while it is small, is not so small that there is no reasonable likelihood of its occurring; outsiders do sometimes win horse races.”

The House of Lords disagreed and held that although there was a real commercial risk, the odds were favourable enough to make it a risk that the parties were willing to accept in the interests of the scheme.

As a result, the composite effect of the scheme was evaluated as it was intended to operate without regard to the possibility that, contrary to the expectations of the parties, it might not work as planned.

Conclusion

The proposed rules are designed to bring the New Zealand tax treatment of securities lending transactions into line with international standards, to position the country as an attractive investment option and to stimulate the development of an onshore securities lending market.

However, there is a sting in the tail, as the Government is using the opportunity proposed by the NZX to bring in additional anti-avoidance rules.

The Government has requested feedback on the proposals contained in the discussion document. Submissions are due by 31 January 2005.

Advice and information

Please contact our tax team if you would like further information on the discussion document, or would like advice on making a submission.

For further information, please contact your usual Bell Gully adviser or:

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