Determination G22A: Optional Convertible Notes Denominated in New Zealand Dollars

This determination may be cited as "Determination G22A: Optional convertible notes denominated in New Zealand dollars".

1. Explanation (which does not form part of the determination)

This determination gives the methods under the financial arrangements rules for calculating income, expenditure and the base price adjustment in relation to optional convertible notes that are denominated in New Zealand dollars.

An optional convertible note is a type of convertible note. A convertible note is a financial arrangement in the form of an instrument issued by a company (the issuer) to a person (the subscriber or a holder) who provides money to the company. A third party (a holder) may acquire a previous holder's interest in the optional convertible note. Under a convertible note, the company is required to repay in cash or new shares in the issuer at a future date. A convertible note usually, although not necessarily, requires the company to pay interest during the period of the loan.

Optional convertible notes may grant either the company or the holder the right to elect to have the underlying debt settled for either cash or shares. This determination applies only to optional convertible notes under which the holder has a right to choose whether the repayment is to be in cash or new issuer shares.

This determination applies to an optional convertible note which contains either an option that can be exercised only at maturity (a European-style warrant) or allows the holder to exercise the warrant component during the optional convertible note's term (an American-style warrant).

This determination applies to persons who become a party to the relevant optional convertible note on or after the date of this determination. It also applies to relevant optional convertible notes entered into before the date of this determination if the four-year "grandparenting" period provided for in sections 90 (6B) and 90AE of the Tax Administration Act 1994 has expired.

Those applying this determination must also have the following information by their first balance date following the date on which they become a party to the convertible note:

(a) The value of the consideration that the person holding the note may choose to accept (the cash redemption amount) in repayment instead of shares;

(b) the maturity date;

(c) the amounts and dates of payments to be made under the note by the holder;

(d) the dates of payments to be made under the note by the company; and

(e) the amounts of the payments, other than in repayment, to be made under the note by the company or the fixed relationship between the amount of each such payment and a market or indicator interest rate.

As this information is necessary to calculate the net present value of the debt component of the optional convertible note, this determination does not apply if the preceding information is not available by the appropriate time.

This determination recognises that an optional convertible note has both a debt component and an equity component; the equity component is the option (or warrant) to receive repayment of the debt in the form of new shares. This determination prescribes methods of separating the consideration under the convertible note into debt and equity components. The value of the debt component is used to calculate, for the purposes of the financial arrangements rules, financial arrangement income or expenditure during the term of the optional convertible note and the base price adjustment at the end of the term.

Generally, if the issuer and the subscriber are members of the same wholly owned group of companies or if the exercise of the option would result in there being no change in the ownership of the company, no value will be attributed to the optional convertible note's equity component. Accordingly, all consideration paid by or to or on behalf of any person under the optional convertible note is attributed to the debt component. However, this rule does not apply in circumstances where the subscriber subsequently sells the notes to third parties within 93 days of acquisition.

If the value of the optional convertible note's equity component is not zero, the equity component's value (for both company and holder) is the amount by which the consideration paid by the holder exceeds the debt component's present value. The present value is calculated as required by another determination by reference to the debt component's cashflows. Cashflows consist of the following payments payable over the term of the optional convertible notes:

(a) The cash redemption amount;

(b) the coupon interest payments, if any; and

(c) any contingent fees.

The income or expenditure for each of the years before the final year of the term must be calculated by reference to the debt component's value. The calculation must be made using the yield to maturity method or using an alternative method producing results that are not materially different from those that would be produced by the yield to maturity method. The appropriate methods, and their application, are prescribed under the Income Tax Act 2004 ("the Act").

This determination provides for the following consideration flows for calculating the base price adjustment under the financial arrangements rules:

(a) where the optional convertible note contains a European-style warrant, this determination assumes that the debt component of the consideration paid or received by the issuer or holder on maturity is the face value of the optional convertible note. If the holder elects to be repaid with new shares, any difference between the value of the shares and the optional convertible note's face value is treated as being attributable to the equity component; and

(b) where the optional convertible note contains an American-style warrant that allows the holder to exercise the warrant component during the optional convertible note's term, this determination assumes that the debt component of the consideration paid or received by the issuer or holder on the exercise date is the present value of the optional convertible note debt component.

The overall effect of this determination is that the financial arrangements rules treat an optional convertible note as if it were a bond that:

(a) is issued at a price that excludes any amount paid or received for the optional convertible note's equity component (if any); and

(b) is settled for its face value (or its present value if converted before the end of its term).

This determination replaces Determination G22*. It applies:

(a) from the date of this determination to financial arrangements that a person becomes party to on or after the date of this determination; and

(b) four years after the date of this determination for financial arrangements that were entered into before the date of this determination, and that currently apply Determination G22, satisfy the criteria of this determination and have not matured within that four-year period.

2. Reference

This determination is made under sections 90 (1) (c) and (g), and 90AC (1) (d) and (h) of the Tax Administration Act 1994.

3. Scope

1. This determination replaces Determination G22. It applies in relation to a financial arrangement that is a convertible note which contains either a share warrant that the holder can exercise only on the maturity date or a share warrant that allows the holder to exercise the warrant component during the convertible note's term:
   (a) that a person becomes party to on or after the date of this determination; and
   (b) four years after the date of this determination for financial arrangements that were entered into before the date of this determination, and that currently apply Determination G22, satisfy the criteria of this determination and have not matured within that four-year period.
2. This determination applies in relation to a financial arrangement that is a convertible note for which:
   (a) all amounts payable under the convertible note are denominated in New Zealand dollars; and
   (b) the person has the following information by the person's first balance date that follows the day on which the person issues or acquires the convertible note:
      (i) The cash redemption amount; and
      (ii) the maturity date; and
      (iii) the amounts and dates of payments to be made under the convertible note by the holder; and
      (iv) the dates of payments, other than in repayment, to be made under the convertible note by the issuer; and
      (v) the amounts of the payments, other than in repayment, to be made under the convertible note by the company that issues the convertible note or the fixed relationship between the amount of each such payment and a market or indicator interest rate; and
   (c) the person holding the convertible note may choose whether consideration in the form of shares or other consideration is to be provided by the company issuing the convertible note in discharge of the liability to make repayment; and
   (d) the company that issues the convertible note cannot require the person holding the convertible note to accept consideration in a particular form in discharge of the liability to make repayment; and
   (e) the option to accept shares in repayment cannot be separated from the convertible note.

4. Principle

1. An optional convertible note is a financial arrangement with a debt component and an equity component. The equity component, being the share warrant, is an excepted financial arrangement.
2. To apply the financial arrangements rules to a person and an optional convertible note, it is necessary to identify the part of the consideration provided and received by the person under the optional convertible note that is solely attributable to the optional convertible note's equity component. That part is not included in the calculation under the financial arrangements rules of the income or expenditure arising under the optional convertible note.
3. None of the consideration provided or received by a party under the optional convertible note is attributed to the optional convertible note's equity component and all consideration paid or received under the optional convertible note is attributed to the debt component if:
   (a) the parties to the optional convertible note at the date of issue are members of the same wholly owned group of companies; or
   (b) the parties to the optional convertible note at the date of issue are beneficially owned or ultimately controlled by the same person; or
   (c) under the arrangement, however structured at the date of issue, there would be no change to either of the voting interests or the market value interests in the issuer if the share warrant were exercised at that time.
4. Subclause (3) does not apply if the subscriber intends to sell the optional convertible notes to an independent third party within 93 days of acquiring the notes and does so sell them.
5. If subclause (3) does not apply, the effect of this determination is that a party to an optional convertible note is taxed as if the optional convertible note were a bond that:
   (a) is issued at a price excluding an amount paid or received for the share warrant; and
   (b) is redeemable for the cash redemption amount or its present value if converted early; and
   (c) otherwise has the same terms as the optional convertible note.
6. If subclause (3) does not apply, this determination attributes to the value of the share warrant any difference between the consideration actually provided under the optional convertible note and the consideration that is deemed to be provided for the bond described in subclause (5).

5. Interpretation

1. In this determination, a reference to the Act is a reference to the Income Tax Act 2004.
2. In this determination:

cash redemption amount, for an optional convertible note, means the amount that the holder receives in repayment under the optional convertible note if the person elects not to exercise the share warrant which is part of the optional convertible note, being its agreed future value or face value

contingent fees is the amount of the fees payable by the person that are contingent on the optional convertible note being issued

convertible note—

(a) means an instrument issued by a company that:

  (i) is evidence of, acknowledges, creates, or relates to, a loan or other advance to the company, or any other secured or unsecured liability of the company; and

  (ii) provides that there is an option to require all or part of the liability referred to in subparagraph (i) to be redeemed or paid by the issue or delivery of new shares in the company:

(b) includes any subsidiary or collateral agreement that fixes the amount of a coupon interest payment to be made under the instrument described in paragraph (a)

coupon interest, for an optional convertible note, means an amount that:

(a) is payable or receivable under the optional convertible note by the company; and

(b) is not a contingent fee or part of the cash redemption amount for the optional convertible note

debt component, for an optional convertible note, means that portion of the optional convertible note that is subject to the financial arrangements rules and treated under this determination as if it were a bond but does not include the equity component

Determination G22 means Determination G22: Optional Conversion Convertible Notes Denominated in New Zealand Dollars Convertible at the Option of the Holder issued by the Commissioner on 24 October 1990

equity component, for an optional convertible note, means the share warrant

holder, for an optional convertible note, means the subscriber or a person other than the subscriber that has acquired the optional convertible note

issuer, for an optional convertible note, means the company issuing the optional convertible note and, in respect of any obligation to issue new shares on redemption, includes any company that is required to issue those shares

market value interests means market value interests as defined in paragraph (a) of the definition in section OB 1 of the Act

maturity date, for an optional convertible note, means the last date on which the company is required to settle the optional convertible note (whether for the cash redemption amount or for new shares in the company)

optional convertible note means a convertible note that satisfies the following requirements:

(a) all amounts payable under the convertible note are denominated in New Zealand dollars; and

(b) the person either issues, subscribes for or acquires the convertible note on or after the date of this determination or the person issued, subscribed for or acquired the convertible note before the date of this determination, has applied Determination G22 to the convertible note and the convertible note has not matured within four years of the date of this determination; and

(c) the person has the following information by the person's first balance date that follows the day on which the person issues or acquires the convertible note:

  (i) the cash redemption amount; and

  (ii) the maturity date; and

  (iii) the amounts and dates of payments to be made under the note by the holder; and

  (iv) the amounts, or the fixed relationship between the amount of each such payment and a market or indicator interest rate, and dates of payments (other than in repayment) to be made under the note by the issuer; and

(d) the holder can elect to settle the convertible note's face value for new shares in the issuer, rather than the cash redemption amount; and

(e) the issuer cannot elect whether the convertible note can be cash settled or redeemed for shares; and

(f) the share warrant cannot be separated from the convertible note.

specified rate, for an optional convertible note and a date, means the specified rate given for the optional convertible note and the date by Determination G23: Specified Rate

share warrant, for an optional convertible note, means the right of the subscriber or holder to elect to settle the optional convertible note by receiving new shares in the issuer

subscriber, for an optional convertible note, means the person that subscribes for the optional convertible note issued by the issuer

term, for an optional convertible note and a person, means the period between the date on which the optional convertible note is issued and the maturity date

voting interests means voting interests as defined in paragraph (a) of the definition in section OB 1 of the Act

3. In this determination, a term not referred to in subclauses (1) and (2) has the meaning given to the term for the purpose of—

(a) the financial arrangements rules, if the term is defined in the Act for that purpose;

(b) the Act, if paragraph (a) does not apply.

4. In this determination, a reference to another determination made by the Commissioner includes a reference to a determination that, with or without modification, replaces or corresponds to that determination.

6. Method

1. This determination treats an optional convertible note as having both a debt component and an equity component. The equity component, being the share warrant, is an excepted financial arrangement.
2. This determination gives the method for determining the amount of consideration paid or received under the optional convertible note that is solely attributable to the equity component for the purposes of determining:
   (a) the income or expenditure for an income year that is attributable to the debt component;
   (b) the base price adjustment for the debt component.

Consideration provided by person that is attributable to equity component

3. The amount of the consideration provided by a subscriber or received by an issuer that is solely attributable to the equity component of the optional convertible note is nil if:
   (a) the parties to the optional convertible note at the date of issue are members of the same wholly owned group of companies; or
   (b) the parties to the optional convertible note at the date of issue are beneficially owned or ultimately controlled by the same person; or
   (c) under the arrangement, however structured at the date of issue, there would be no change to either of the voting interests or the market value interests in the issuer if the share warrant were exercised at that time.
4. Subclause (3) does not apply if the subscriber:
   (a) acquired the optional convertible note with the intention of selling it within 93 days to any person whose exercise of the share warrant would result in a change to either of the voting interests or the market value interests of the issuer; and
   (b) does so sell the optional convertible note.
5. If subclause (3) does not apply, the amount of the consideration provided or received by a person that is attributable to the equity component of the optional convertible note is the greater of—
   (a) nil; or
   (b) the amount given by the following formula:

$$y - s$$

6. In subclause (5) (b), **y**, being the consideration for the optional convertible note, is:
   (a) for the issuer, the amount of consideration that has been paid, and consideration that is or will be payable, to the issuer for or under the optional convertible note, ignoring non-contingent fees;
   (b) for the subscriber, the amount of consideration that has been paid, and consideration that is or will be payable, by the subscriber for or under the optional convertible note, ignoring non-contingent fees.
7. In subclause (5) (b), **s**, being the present value of cashflows, is the present value of the amount given by the following formula:

total coupon interest + contingent fees + cash redemption amount

8. In subclause (7), **total coupon interest** is the total amount of all coupon interest payable or receivable during the term of the optional convertible note.
9. In subclause (7), **contingent fees** and **cash redemption amount** are as defined in subclause 5 (2) of the interpretation section of this determination.
10. In subclause (7), the present value of an amount is determined by applying:
    (a) Method A of *Determination G10B: Present Value Calculation Methods*; or
    (b) an alternative method that produces a result that is not materially different from the method referred to in paragraph (a).
11. If the amount of a coupon interest payment under an optional convertible note has a fixed relationship to a market or indicator interest rate, a person who is required by this determination to estimate the amounts of future coupon interest payments under the optional convertible note may assume that the coupon interest rate applicable to the first coupon interest payment in the term applies to the remaining coupon interest payments in the term.

Spreading the debt component

12. For the purposes of the financial arrangements rules, the amount of income or expenditure under an optional convertible note that a person must attribute to an income year in the term of the optional convertible note is found by using a spreading method prescribed under sub-part EW of the Act to spread the consideration referable to the debt component of the optional convertible note. In this context, the consideration referable to the debt component is the amount given by the following formula:

    For the issuer:

    (consideration received – value of warrant) – consideration paid

    with a negative amount being a deduction under the financial arrangements rules.

    For the holder:

    consideration received – (consideration paid – value of warrant)

    with a positive amount being income under the financial arrangements rules.
13. In subclause (12):
    (a) **consideration received** is the amount of consideration that is or will be received, and the amount of consideration that has been received, by the person for and under the optional convertible note, including coupon interest receipts and contingent fees, but ignoring non-contingent fees and treating any consideration received in repayment of the optional convertible note as being equal to the cash redemption amount.

(b) **consideration paid** is the amount of consideration that is or will be payable, and the amount of consideration that has been paid, by the person for and under the optional convertible note, including coupon interest payments and contingent fees, but ignoring non-contingent fees and treating any consideration paid in repayment of the optional convertible note as being equal to the cash redemption amount.

(c) **value of warrant** is the amount of consideration referable to the equity component as determined under subclause (3) or (5) above

Secondary market

14. Where a holder sells or transfers an optional convertible note to another holder, the amount of the consideration provided or received that is solely attributable to the equity component of the optional convertible note is nil if:
    (a) at the time of the sale or transfer the parties are members of the same wholly owned group of companies; or
    (b) at the time of the sale or transfer the parties are beneficially owned or ultimately controlled by the same person; or
    (c) under the arrangement, however structured, there would be no change to either of the voting interests or the market value interests in the issuer if the share warrant were exercised both prior to and after the sale or transfer.
15. If subclause (14) does not apply, subclauses (5) to (12) will apply to determine the amount of consideration received by a holder and paid by the new holder that is referable to the debt component of the optional convertible note when the optional convertible note is sold or transferred.

Base price adjustment on maturity or exercise

16. For the purposes of the base price adjustment formula specified in section EW 31 of the Act, in determining the **consideration** that is paid by the issuer or paid to the holder:
    (a) where the holder can exercise the share warrant only on the maturity date, any consideration paid in repayment of the optional convertible note is treated as being equal to the cash redemption amount; or
    (b) where the holder can exercise the share warrant at any time or at agreed times prior to the maturity date, and the share warrant is exercised prior to the maturity date, any consideration paid in repayment of the optional convertible note is treated as being equal to the present value of the optional convertible note's debt component on the date the share warrant is exercised.
17. In subclause (16) (b), the present value of the optional convertible note's debt component is determined by applying the formula specified in subclause (7).

7. Examples

Example A: From the perspective of the issuer

On 1 April 2007, a publicly listed New Zealand company, ABC Ltd, raised $120 million from the market through the issue of 100 million $1 optional convertible notes with a five-year term. The optional convertible notes had an aggregate face value (FV) of $100 million and paid a coupon rate of 5% per annum semi-annual.

At the time the optional convertible notes were issued, ABC Ltd had one billion shares on issue, which were trading at $1.00 each. The terms of the optional convertible notes provided that the holders could at any time over the term of the optional convertible notes elect to redeem each optional convertible note for cash or for one share per note held. The exercise price on the American-style warrant component of each optional convertible note was $1.00 per share. The total consideration paid by the holders of the optional convertible notes was $120 million. ABC Ltd paid $1 million to a broker for the successful issue of the optional convertible notes.

The five-year New Zealand government bond rate at the time of issue was 5.81%.

ABC Ltd has a 31 March balance date.

This determination requires that a bifurcation process be applied in order to calculate an amount that is solely attributable to the warrant component of the optional convertible notes. The warrant is an excepted financial arrangement and is excluded from calculation of financial arrangement income or expenditure under the financial arrangement rules.

To calculate the total amount of consideration attributed to the equity component of the optional convertible notes, subclause 6 (5) of this determination must be applied.

The consideration paid for the optional convertible notes is $120 million. Therefore y = $120 million.

The present value (PV) of the bond component applying subclause 6 (7) is $96,528,457.95. This amount may be calculated in accordance with Determination G10B or through the use of the standard market bond pricing formula. The discount rate applicable to this calculation is the specified rate in accordance with Determination G23. Therefore s = $96,528,457.95.

The aggregate amount attributable to the equity component of the optional convertible notes is therefore:

$120,000,000.00 – $96,528,457.95 = $23,471,542.05.

This amount may be ignored for the purposes of calculating income or expenditure under the financial arrangement rules.

In order to calculate financial arrangement income or expenditure, the yield to maturity (YTM) method has been applied. This may be done in accordance with Determination G3: Yield to Maturity Method, G11A: Present Value Based Yield to Maturity Method or any other determination that may apply, or an alternative method producing not materially different results.

The yield to maturity for the financial arrangement is 6.04973318% or 3.024867% per semi-annual period.

Notwithstanding the methods available which have been described above, the YTM rate is most easily calculated by calculating the net present value (NPV) of the cash flows arising under the bond component of the optional convertible notes by iterating the discount rate used until a result of zero is achieved.

Using Determination G3, the following table can be constructed (taking into account the deduction of $1 million of fees paid by ABC Ltd):

Critical dates	*Amount of principal outstanding at start of period*	*YTM calc F.A. expenditure at end of period*	*Actual coupon interest at end of period*	*Amount of principal outstanding at end of period*
1 Apr 07	95,528,457.95	2,889,608.41	2,500,000.00	95,918,066.36
1 Oct 07	95,918,066.36	2,901,393.54	2,500,000.00	96,319,459.90
1 Apr 08	96,319,459.90	2,913,535.16	2,500.000.00	96,732,995.06
1 Oct 08	96,732,995.08	2,926,044.05	2,500,000.00	97,159,039.11
1 Apr 09	97,159,039.11	2,938,931.31	2,500,000.00	97,597,970.42
1 Oct 09	97,597,970.42	2,952,208.40	2,500,000.00	98,050,178.82
1Apr 10	98,050,178.82	2,965,887.10	2,500,000.00	98,516,065.92
1 Oct 10	98,516,065.92	2,979,979.56	2,500,000.00	98,996,045.48
1 Apr 11	98,996,045.48	2,994,498.30	2,500,000.00	99,490,543.78
1 Oct 11	99,490,543.78	3,009,456.22	2,500,000.00	100,000,000.00
1 Apr 12	0			
Totals		29,471,542.05	25,000,000.00	

The difference between financial arrangement expenditure and coupon interest paid by ABC Ltd is $4,471,542.05 and is equal to the difference between the FV of the bond component and its price calculated using the specified rate of 5.81% per annum semi-annual plus the $1 million in fees paid by ABC Ltd.

Financial arrangement expenditure is spread between income years, in accordance with Determination G1A, on a daily basis.

So, for example, in the 2008 income year, ABC Ltd would return financial arrangement expenditure of $5,791,001.95 in relation to this financial arrangement. The sum of $5,839,579.21 would be returned in the 2009 income year.

A base price adjustment (BPA) is required in the final year of the optional convertible notes' term.

The formula for a BPA is:

Consideration – income + expenditure + amount remitted.

Consideration in relation to the financial arrangement is:

96,528,457.95 + (25,000,000) + (1,000,000) + (100,000,000) = (29,471,542.05)

Income is zero.

Expenditure is $23,467,587.53 and is the amount of financial arrangement expenditure calculated and deducted up to and including 31 March 2011.

There is no remission.

The BPA amount is therefore:

(29,471,542.05) – 0.00 + 23,467,587.53 + 0.00 = (6,003,954.52).

As this is a negative amount, it is financial arrangement expenditure for ABC Ltd.

As no amount is remitted, the amount of the BPA is exactly equal to the amount of financial arrangement expenditure calculated in the final year of the financial arrangement under the YTM method.

A similar calculation must be undertaken to calculate the holder's position if the holder is subject to the financial arrangements rules.

Example B: From the perspective of the issuer

On 1 April 2007, XYZ Ltd, a non-listed company and a wholly owned subsidiary of another company ("Parent") raised $100 million through the issue of 100 million $1 optional convertible notes with a five-year term to Parent. The optional convertible notes had an aggregate face value (FV) of $100 million and paid no coupons.

At the time of the optional convertible notes issue, XYZ Ltd had 100 shares which were issued for $1.00 each. The terms of the optional convertible notes provided that the holder could at any time over the term of the optional convertible notes elect to redeem the optional convertible notes for cash or for one share per note held. The exercise price on the American-style warrant component of the optional convertible notes is $1.00 per share. The total consideration paid by Parent for the optional convertible notes was $100 million. XYZ Ltd paid no fees to issue of the optional convertible notes.

The five-year New Zealand government bond rate at the time of issue was 5.81%.

XYZ Ltd has a 31 March balance date.

This determination requires that a bifurcation process be applied in order to calculate an amount that is solely attributable to the warrant component of the optional convertible notes. The warrant is an excepted financial arrangement and is excluded from calculation of financial arrangement income or expenditure under the financial arrangement rules.

To calculate the amount of consideration attributed to the equity component of the optional convertible notes, subclause 6 (5) of this determination must be applied, unless subclause 6 (3) applies. As the companies are members of the same wholly owned group of companies, the amount of consideration attributable to the warrant component of the optional convertible notes is nil.

Accordingly, all of the consideration received from the issuance by XYZ Ltd of the optional convertible notes must be attributed to the bond component.

Therefore, no financial arrangement income or expenditure arises in relation to this financial arrangement.

A similar calculation must be undertaken to calculate the holder's position if the holder is subject to the financial arrangements rules.

Example C

On 1 April 2007, a publicly listed New Zealand company, XYZ Ltd, raised $100 million through the issue of 100 million $1.00 optional convertible notes with a five-year term. The optional convertible notes had an aggregate face value of $100 million, paid a coupon of 3% per annum, semi-annual, and were issued at par to the optional convertible notes' face value. For commercial reasons, the subscriber for the optional convertible notes was a member of the same wholly owned group of companies that acquired the notes with the intention of selling the optional convertible notes to institutional third party investors for $100 million. Settlement with the institutional third party investors was to occur on 1 July 2007.

At the time the optional convertible notes were issued, XYZ Ltd had one billion shares on issue, which were trading at $1.00 each. The terms of the optional convertible notes provided that the holders could at any time over the term of the optional convertible notes elect to redeem the optional convertible notes for cash or for one share per note held. The exercise price on the American-style warrant component of the optional convertible notes is $1.00 per share. The total consideration paid by the subscriber (a member of the same wholly owned group of companies as XYZ Ltd) of the optional convertible notes was $100 million. No fees were payable by XYZ Ltd in relation to issue of the optional convertible notes.

The five-year New Zealand government bond rate at the time of issue (1 April 2007), and when the optional convertible notes were on-sold (1 July 2007), was 5.81%.

XYZ Ltd has a 31 March balance date.

Given the subscriber's intention to sell the optional convertible notes within 93 days of their issuance date, the provisions contained in subclause 6 (3) of this determination do not apply if the notes are sold to relevant third parties within the requisite period. In such circumstances, the bifurcation process described in subclause 6 (5) of this determination must be applied by XYZ Ltd when the optional convertible notes are initially issued to the member of the same wholly owned group of companies on 1 April 2007. The bifurcation process must also be applied by the relevant parties (to the extent that the financial arrangements rules apply) on 1 July 2007 when the subscriber sells the optional convertible notes to the third party investors.

XYZ Ltd's financial arrangements rules treatment of the optional convertible notes is the same as if it had issued the notes directly to third party investors. However, should the subscriber fail to sell the notes to those investors within the requisite time frame, subclause 6 (3) will apply to XYZ Ltd.

In regard to the first part of this arrangement, the aggregate consideration for the optional convertible notes when they were initially issued was $100 million. Therefore y = $100 million.

The PV of the bond component on the original date of issue applying subclause 6 (7) is $87,956,749.20. Therefore s = $87,956,749.20.

The aggregate amount attributable to the equity component of the optional convertible notes is therefore:

$100,000,000.00 – $87,956,749.20 = $12,043,250.80.

This amount may be ignored for the purposes of calculating income or expenditure under the financial arrangement rules.

The YTM method or alternative method, as prescribed under the Act, must be applied in order to calculate financial arrangement income or expenditure on the bond component of the optional convertible notes by XYZ Ltd.

For the tax period ending 31 March 2008, XYZ Ltd's calculation of financial arrangement expenditure will be $5,140,939.04. If the optional convertible notes are not exercised and run for their full maturity under the contracted terms of the arrangement, XYZ Ltd will be entitled to claim total financial arrangement expenditure of $27,043,250.81, apportioned each year under the YTM method and BPA requirements.

If the financial arrangements rules apply to the subscriber, that person will derive income from the bond component of the optional convertible notes calculated in accordance with subclause 6 (5) of this determination and the requirement to perform a BPA.

Assuming the subscriber is subject to the financial arrangements rules, it paid $100 million to XYZ Ltd on 1 April 2007 and received $100 million from third party investors when the optional convertible notes were sold on 1 July 2007. The PV of the bond on 1 July 2007 was $89,218,194.23, applying the bifurcation process, a difference of $1,261,445.03 from the PV of $87,956,749.20 calculated applying the bifurcation process on 1 April 2007. The subscriber is required to perform a BPA and account for this amount of financial arrangement income.

The formula for a BPA is:

Consideration – income + expenditure + amount remitted.

Consideration in relation to the financial arrangement is:

(87,956,749.20) + 89,218,194.23 = 1,261,445.03

Income is zero as the BPA occurs in the first year of the financial arrangement and, consequently, no other income has been recognised for the purposes of the financial arrangements rules.

Expenditure is zero.

There is no remission.

The BPA amount, is therefore:

1,261,445.03 – 0.00 + 0.00 +0.00 = 1,261,445.03.

As this is a positive amount, it is financial arrangement income for the subscriber.

For the avoidance of doubt, if the subscriber does not sell the optional convertible notes to the institutional investors (or any other relevant third party) within 93 days from the date of issue, subclause 6 (3) will apply.

Example D: From the perspective of the issuer

In Example A of this determination, on 1 April 2007 ABC Ltd raised $120 million from the market through the issue of 100 million $1 optional convertible notes with a term of five years. The optional convertible notes had an aggregate face value (FV) of $100 million and paid a coupon rate of 5% per annum semi-annual and could be exercised for 100 million shares at any time on or before 1 April 2012.

For the purposes of this example, the optional convertible notes described in Example A were widely held. On 1 April 2009, for commercial reasons, all of the investors holding the optional convertible notes elected to exercise the warrant component of the optional convertible notes and redeem the optional convertible notes for 100 million shares priced at $1.00 each.

It should be noted that the investors made their election to convert immediately following receipt of the coupon payment (totalling $2.5 million) from ABC Ltd on 1 April 2009.

In accordance with section EW 29 of the Act, ABC Ltd is required to perform a base price adjustment.

The specified rate on 1 April 2009 for the three-year government bond was 5.81% per annum semi-annual (there had been no change to the specified rate which applied when the optional convertible notes were originally issued on 1 April 2007.) The PV of the aggregate bond component of the optional convertible notes on 1 April 2009 calculated in accordance with Determination G10B or through the use of the standard market bond pricing formula is $97,799,112.60 and would be the amount that ABC Ltd would be required to repay all of the holders of the optional convertible notes if the debt were extinguished at that point.

The formula for a BPA is:

Consideration – income + expenditure + amount remitted

In accordance with subclause 6 (16), the amount of consideration referable to the financial arrangement (debt component of the optional convertible notes) is:

(120,000,000 – 23,471,542.05) – (10,000,000 + 1,000,000 + 97,799,112.60) = (12,270,654.65)

Income is zero.

Expenditure is $11,630,581.16 and is the amount of financial arrangement expenditure calculated and deducted up to and including 31 March 2009.

An extract from the table constructed in Example A has been replicated below to assist with the explanation of how the financial arrangements expenditure amount has been calculated for the purpose of this BPA example.

Critical dates	*Amount of principal outstanding at start of period*	*YTM Calc F.A. expenditure at end of period*	*Actual coupon interest at end of period*	*Amount of principal outstanding at end of period*
1 Apr 07	95,528,457.95	2,889,608.41	2,500,000.00	95,918,066.36
1 Oct 07	95,918,066.36	2,901,393.54	2,500,000.00	96,319,459.90
1 Apr 08	96,319,459.90	2,913,535.16	2,500.000.00	96,732,995.06
1 Oct 08	96,732,995.08	2,926,044.05	2,500,000.00	97,159,039.11
1 Apr 09	97,159,039.11			
Totals		11,630,581.16	10,000,000.00	

There is no remission.

The BPA amount is therefore:

(12,270,654.65) – 0.00 + 11,630,581.16 + 0.00 = (640,073.49)

As this amount is a negative amount, it is financial arrangement expenditure for ABC Ltd.

A similar calculation must be undertaken to calculate each holder's position if that person is subject to the financial arrangements rules.

Signed on the 26th day of September 2006.

JIM GORDON, Policy Manager, Inland Revenue Department.

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