

# Special Determination 27B: Convertible Notes in Respect of a Limited Partnership Interest

Issued: 17 December 2020

S27B

This determination relates to convertible notes in respect of a limited partnership interest in a public private partnership. This determination replaces *Special Determination 27A: Convertible Notes in respect of a limited partnership interest* (Inland Revenue, 2015) to take into account amendments to the convertible notes under the 2020 Amendments.

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## Determination

This determination may be cited as *Special Determination S27B: Convertible Notes in Respect of a Limited Partnership Interest*.

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

1. This determination varies and replaces *Special Determination S27A: Convertible Notes in respect of a limited partnership interest* due to amendments to the terms of the subordinated convertible notes (Convertible Notes) under the 2020 Amendments.
2. This determination relates to Convertible Notes issued by the Holding Partnership to Limited Partner A that will convert to a 45% partnership interest at a single date or several nominated dates in the future to match the partnership contributions by Limited Partner B and some of the partnership contributions by Limited Partner C. The Convertible Notes were issued to provide equity funding to the Holding Partnership as part of an arrangement (the Project) involving the finance, design, construction and ongoing operation of the Facility by the Partnership under a public-private partnership agreement with the Crown.
3. Limited Partners A and C have agreed that Limited Partner A will have the option to sell up to 9.9% of the equity interest in the Holding Partnership (along with up to 9.9% of the shareholding in General Partner 1, in equal proportions) to Limited Partner C. It is envisaged that if the option is exercised it will be exercised after the Convertible Note has converted to committed capital, noting that early exercise rights do exist in limited situations.
4. The Convertible Notes earn a fixed rate of interest that is payable monthly (Coupon Interest Payments) until the Convertible Notes are converted. The Coupon Interest Payments are capitalised on each interest payment date and will be paid to Limited Partner A on the Final Repayment Date (subject to the waiver arrangements described below), so will not convert to a partnership interest.
5. The conversion to a partnership interest will be effected by way of a mandatory set off. Limited Partner A's obligation to make its capital contribution(s) will be satisfied by setting off that obligation against the Holding Partnership's obligation to repay that portion of the Convertible Notes equal to the capital contribution(s) required to be made on the relevant date.

6. At the time the Convertible Notes were issued, the rate of interest was set at an arm's length rate determined under an agreed rate setting process.
7. As part of the 2020 Amendments, Limited Partner A and the Holding Partnership have agreed to amend the Convertible Notes so that from 2 November 2020, interest will be payable at a reduced rate.
8. The 2020 Amendments include various other additional amendments to the Project, as described in the Private Rulings.
9. No commitment fees or upfront fees are payable on the Convertible Notes.
10. In accordance with s EW 6(2), an amount (whether it is income, consideration, gain, loss or expenditure) that is solely attributable to an excepted financial arrangement is not taken into account under the financial arrangement rules.
11. As an interest in a partnership is an excepted financial arrangement under s EW 5(11), only the Coupon Interest Payments are regarded as income or expenditure for the purposes of calculating accrual income or expenditure.
12. This Determination prescribes a method for determining the part of the consideration receivable by the parties to the arrangement that is solely attributable to the excepted financial arrangement as well as the method for spreading the accrual income, gain or loss, or expenditure under the financial arrangement rules. This Determination also requires an adjustment calculation to be undertaken in the income year in which the Convertible Notes are amended.

## 2 Reference

This determination is made under s 90AC(1)(bb) and (h) of the Tax Administration Act 1994.

This determination varies and replaces *Special Determination S27A: Convertible Notes in respect of a limited partnership interest*.

## 3 Scope of determination

1. This determination applies to the Convertible Notes issued by the Holding Partnership to Limited Partner A as part of the Project as set out in detail in the Private Rulings. The Convertible Notes were issued on the following terms:
  - Limited Partner A loaned an amount to the Holding Partnership (subject to the prevailing market rates at Financial Close) with repayment to be set off against the obligation to make capital contribution(s) in respect of a 45% interest in the

Holding Partnership at a single date or several nominated dates in the future. The Convertible Notes have a face value equal to 45% of the total equity requirement (being all of Limited Partner A's 45% interest in the Holding Partnership).

- The Convertible Notes earn a fixed rate of interest that is payable monthly until conversion. At the time the Convertible Notes were entered into, the interest rate was defined as the construction swap rate exclusive of charges, plus a margin, being the rate specified in the base case financial model at Financial Close.
  - The Coupon Interest Payments are capitalised on each interest payment date, and will be paid out to Limited Partner A on the Final Repayment Date; that is, the Coupon Interest Payments will not convert to a partnership interest.
  - The rate of interest was originally set at an arm's length rate determined under an agreed rate setting process.
  - As part of the 2020 Amendments, Limited Partner A and the Holding Partnership have agreed to amend the Convertible Notes so that from 2 November 2020, interest will be payable at a reduced rate.
  - No commitment fees or upfront fees are payable on the Convertible Notes.
  - The Convertible Notes (and any interest payable on the Convertible Notes) are subordinated to senior debt. After conversion of the Convertible Notes, Limited Partner A will rank equally with Holding Partnership contributions made by the other limited partners.
2. This determination is made subject to the continued application of the Private Rulings.

## 4 Principle

1. The Convertible Notes have both debt and partnership interest components. They can be regarded alternatively as:
  - a) a loan to a partnership with repayment by way of an interest in a partnership (debt component); or
  - b) a forward purchase of a partnership interest (in which case the holder of the Convertible Notes is buying an interest in the partnership).

The financial arrangement rules in the Act classify an interest in a partnership as an excepted financial arrangement under s EW 5(11).

2. As the Convertible Notes have this dual character, when calculating income derived or expenditure incurred in relation to the Convertible Notes it is first necessary to separate the debt and partnership interest components of the Convertible Notes.
3. This determination specifies that, apart from the Coupon Interest Payments, all amounts relate to the underlying interest in a partnership, and will not be dealt with under the financial arrangement rules (subpart EW) when calculating income derived or expenditure incurred.
4. Income and expenditure in respect of the Convertible Notes is calculated by daily apportionment of the Coupon Interest Payment to income years in accordance with *Determination G1A: Apportionment of Daily Income and Expenditure* (Inland Revenue 1989). Any potential waiver of interest will not be taken into account when applying the spreading method, but will be taken into account in the base price adjustment calculation under s EW 30.
5. An adjustment calculation must be undertaken in the income year in which the amendments to the Convertible Notes take place, following the methodology in *Determination G25: Variations in the terms of a financial arrangement* (Inland Revenue, 1992).
6. For the purposes of this determination, any change in the market value of the interest in the partnership between the issue date of the Convertible Notes and the conversion into the partnership interest relates to the partnership interest component, and therefore can be ignored when calculating income derived or expenditure incurred under the financial arrangements rules.

## 5 Interpretation

In this determination, unless the context otherwise requires:

- All legislative references are to the Income Tax Act 2007, unless otherwise stated.
- **Convertible Notes** are the subordinated convertible notes issued by the Holding Partnership to Limited Partner A.
- **Coupon Interest Payment** is any amount payable on the Convertible Notes by the Convertible Note issuer (the borrower) to the Convertible Note holder (the lender) other than payments relating to the redemption or conversion of the Convertible Notes.
- **Final Repayment Date** has the meaning provided in the Subscription Agreement.

- **Financial Close** has the same meaning as set out in the Project Agreement referred to in the Private Rulings.
- **Private Rulings** means BR Prv 20/64 and BR Prv 20/65, issued on 17 December 2020, and includes any private rulings issued to replace those Rulings, provided that the change to the relevant Ruling does not affect the application of this Determination.

For convenience, words and phrases defined in this determination are indicated by initial capital letters, but the absence of a capital letter does not alone imply that the word or phrase is used with a meaning different from that given by its definition.

## 6 Method

1. Amounts to be included when calculating income or expenditure under the financial arrangements rules with regard to the Convertible Notes in respect of income, gain or loss, or expenditure, and also of any other consideration receivable by the holder or payable by the issuer, consist of the Coupon Interest Payments.
2. The income derived or expenditure incurred in respect of the Convertible Notes must be calculated by daily apportionment of the Coupon Interest Payments to income years. Any potential waiver of interest is not included in that calculation. The required method is outlined in *Determination G1A*.
3. All other income, gain, loss, expenditure or consideration paid under or with respect to the wider financial arrangement is solely attributable to the excepted financial arrangement component of the wider financial arrangement.
4. An adjustment calculation must be undertaken in the income year in which the amendments to the Convertible Notes take place, following the methodology in *Determination G25*.

## 7 Example

This example illustrates the application of the method set out in this determination.

The example assumes the following:

- On 1 April 2014 a Convertible Note was issued to the holder for \$1,000 with an interest coupon set at the arm's length interest rate of 8.5%. The Convertible Note was intended to convert to a 45% interest in a partnership on 31 March 2019.

- The conversion to a partnership interest will be effected by way of a mandatory set off. The holder's obligation to make its capital contribution will be satisfied by setting off that obligation against the issuer's obligation to repay the Convertible Note.
- Coupon payments accrue monthly, in arrears and are compounding. Interest will be paid to the holder on the first partnership distribution date.
- On the date of issue, the limited partners have agreed that the market value of a 45% partnership interest on 31 March 2019 is \$1,000.
- The parties use a 31 March balance date and apply *Determination G1A* on a 365 day basis when apportioning daily income and expenditure.
- With effect from 1 November 2020, the terms of the Convertible Notes are amended as follows:
  - The interest coupon will be 4% per annum.
  - The Convertible Notes will convert into a 45% interest in a partnership on 22 November 2021.

Prior to amendment, the annual sum of capitalised Coupon Interest Payments, and the deduction permitted under *Determination G1A* is as follows:

<b>Date</b>	<b>Coupon Interest (\$)</b>	<b>Deduction under Determination G1A (\$)</b>
31 March 2015	85.00	108.28
31 March 2016	92.23	108.28
31 March 2017	100.06	108.28
31 March 2018	108.57	108.28
31 March 2019	117.80	108.28
31 March 2020	127.81	108.28
1 November 2020	81.69	63.78

Following the amendment to the terms of the Convertible Notes, the annual amount of capitalised Coupon Interest Payments, and the deductions that would have been permitted under *Determination G1A* had the amendments been known at the outset are:

Date	Coupon Interest (\$)	Deduction under DeterminationG1A (\$)
31 March 2015	85.00	106.13
31 March 2016	92.23	106.13
31 March 2017	100.06	106.13
31 March 2018	108.57	106.13
31 March 2019	117.80	106.13
31 March 2020	127.81	106.13
31 March 2021	89.04	106.13
22 November 2021	68.36	68.33

In the year ended 31 March 2021, an adjustment calculation must be undertaken in accordance with *Determination G25*.

This Determination is signed by me on the 17<sup>th</sup> day of December 2020.

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## About this document

The Commissioner may determine certain matters relating to financial arrangements. A taxpayer may wish to apply for a determination to ascertain the tax treatment of a particular financial arrangement.