

Special Determination 28B: Application of the Financial Arrangements Rules to the Design and Construction Phase in a Public-Private Partnership

Issued: 17 December 2020

S28B

This determination relates to an arrangement involving the finance, design, construction and on-going provision of operation and maintenance services under a public-private partnership agreement. In particular, this determination relates to the design and construction phase of the public-private partnership agreement. This determination replaces *Special Determination 28A: Application of the financial arrangements rules to the D&C Phase in a public-private partnership* (Inland Revenue, 2015) to take the 2020 Amendments into account.

Determination

This determination may be cited as *Special Determination S28B: Application of the Financial Arrangements Rules to the Design and Construction Phase in a Public-Private Partnership*.

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

1. This determination varies and replaces *Special Determination S28A: Application of the financial arrangements rules to the D&C Phase in a public-private partnership* to take the 2020 Amendments into account.
2. This determination relates to an arrangement (the Project) involving the finance, design, construction and on-going provision of operation and maintenance services in respect of the Facility by the Partnership under a public-private partnership agreement (the Project Agreement) with the Crown. The Holding Partnership will be the sole limited partner in the Partnership, holding 100% of the Partnership. The limited partners in the Holding Partnership are Limited Partners A, B and C. This determination does not apply to Limited Partner C.
3. The Project Agreement comprises three basic components:
 - a) a design and construction phase (the D&C Phase) under which the Partnership agrees to design and construct the Facility for the Crown in consideration for a fixed lump-sum payment (the Original D&C Payment), payable on completion of the D&C Phase;
 - b) a Facility Lease in which the Partnership and the Crown enter and under which the Partnership pays an amount representing the rental under the Facility Lease to the Crown (the Rental Prepayment); and
 - c) an operations and maintenance phase (the O&M Phase) under which the Partnership will provide operation and maintenance services to the Crown over a 25 year term in consideration for monthly payments (the Unitary Charge).
4. The Partnership has entered into:
 - a) a Construction Agreement with a contractor (the Contractor), under which the Contractor will design and construct the Facility in consideration for monthly and milestone payments; and

- b) an Operation and Maintenance Contract (the O&M Contract) with a service provider (the Service Provider), under which the Service Provider will provide the on-going operation and maintenance (and other) services in consideration for monthly payments.
5. Under the original arrangements:
 - The Partnership raised external debt from a range of third-party financiers (the Bank Debt) and Limited Partner C provided a term debt facility (the Term Debt Facility) to the Partnership to supplement the Bank Debt.
 - The Holding Partnership received funding from Limited Partner C during the D&C Phase in the form of a convertible debt instrument (the Convertible Note). Limited Partners A and B provided investment support during the D&C Phase in the form of a letter of credit to the external lenders.
 - The Partnership entered into Interest Rate Swaps in respect of the Bank Debt.
 6. The Facility Lease, O&M Phase of the Project Agreement, Construction Agreement and O&M Contract are all excepted financial arrangements. The D&C Phase of the Project Agreement, Bank Debt, Term Debt Facility and Swaps are financial arrangements to which the Partnership is a party. The Project, including all of these agreements, is a wider financial arrangement.
 7. In 2020, the Partnership and the Crown entered into the 2020 Amendments that (among other things):
 - extended the duration of the D&C Phase and provided for additional payments to be made for the design and construction work (the Additional D&C Payments); and
 - provided for certain Unitary Charge payments to be paid by the Crown to the Partnership before the O&M Phase commences.
 8. The 2020 Amendments included various additional amendments to the Project, as described in the Private Rulings.
 9. *Special Determination S27B: Convertible Notes in Respect of a Limited Partnership* applies to the Convertible Notes. *Special Determination S29B: Application of the Financial Arrangement Rules to a Public-Private Partnership* applies to arrangements in the wider financial arrangement, excluding the D&C Phase.
 10. This determination prescribes the portion of the Original D&C Payment treated as income under the financial arrangement rules (the Interest Component) and the method for spreading that income. This determination also prescribes that no part of the Additional D&C Payments is income under the financial arrangements rules.

2 Reference

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

This determination varies and replaces *Special Determination S28A: Application of the financial arrangements rules to the D&C Phase in a public-private partnership*.

3 Scope of determination

1. This determination applies to the Partnership in respect of the Project (which is set out in detail in the Private Rulings), including the D&C Phase of the Project Agreement, under which the Partnership agrees to design and construct the Facility for the Crown and will receive a fixed lump-sum payment (the Original D&C Payment) once the Facility is ready for operation and Additional D&C Payments periodically from the Effective Date of the 2020 Amendments.
2. This determination is made subject to the following conditions:
 - The design and construction costs of the Facility are agreed between the Partnership and the Crown on an arm's length basis and the original design and construction costs are set out in the Base Case under the Project Agreement as referenced to in the definition of "Original Design and Construction Payment" in clause 1.1 of the Project Agreement (as amended in December 2020).
 - Limited Partner A and Limited Partner B use IFRSs to prepare financial statements and to report for financial arrangements.
 - The Private Rulings continue to apply.

4 Principle

1. During the D&C Phase of the Project Agreement, the Partnership will receive consideration from the Crown (in the form of the Original D&C Payment and the Additional D&C Payments) and will in turn provide consideration to the Crown (in the form of the completion of the Project and the transfer of its rights, set out in clause 11.2(c) of the Project Agreement, in the Facility). The D&C Phase of the Project Agreement is a "financial arrangement" under s EW 3 and an "agreement for the sale and purchase of property or services" under s YA 1.
2. The Partnership and the Crown have agreed that the Original D&C Payment includes capitalised interest (clause 12.5(c) of the Project Agreement). The Additional D&C Payments do not include any capitalised interest. The Interest Component of the

original D&C Payment will be income under the financial arrangements rules under subpart EW. No part of the Additional D&C Payments will be income under the financial arrangement rules in subpart EW.

3. During the D&C Phase, the Partnership has accrued variable expenditure commitments. The capitalised interest component of the original D&C Payment is intended to offset the expected funding costs incurred in relation to these commitments.
4. The Interest Component was calculated with reference to expected funding costs. No adjustment is made for variances between actual and expected costs as the original D&C Payment, including capitalised interest, was agreed in advance.
5. The Interest Component needs to be spread over the term of the D&C Phase.

5 Interpretation

In this determination, unless the context otherwise requires:

- All legislative references are to the Income Tax Act 2007, unless otherwise stated.
- Capitalised terms have the same meaning as set out in the Project Agreement.
- **IFRS** means International Financial Reporting Standards as defined in s YA 1
- **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.

6 Method

Calculation of Interest Component

1. At the time the Project Agreement was entered into, the value of the completion of the Project and transfer of the Partnership's rights to the Crown, set out in clause 11.2(c) of the Project Agreement, was the agreed design and construction costs of the Facility (excluding Fitout) set out in the Base Case under the Project Agreement.
2. The Original D&C Payment less the agreed design and construction costs of the Facility (excluding Fitout) set out in the Base Case under the Project Agreement, is the Interest Component that is income under the financial arrangements rules.

3. No part of the Additional D&C Payments is income under the financial arrangements rules.
4. The Private Rulings apply to the Additional D&C Payments and the portion to the D&C Payment that is not income under the financial arrangements rules. Those amounts are not considered in this Determination.

Spreading of Interest Component

5. The method for determining the amount of income that is to be allocated to each income year is as follows:
 - a) The expected design and construction costs of the Facility (excluding Fitout) as set out in the Base Case are treated as having been incurred at the beginning of each of the six income years (the Annual Expenditure). No adjustment will be made to the Annual Expenditure in any income year to reflect actual expenditure in that year, the extension of the D&C Phase or the Additional D&C Payments.
 - b) The interest allocated to each income year is then calculated in accordance with the following formula:

$$\text{Interest} = \text{OB} \times \text{R}$$

Where:

OB is the sum of the Annual Expenditure for that income year, plus the Annual Expenditure and interest attributable to any previous income year.

R is the internal rate of return (based on annual rests) calculated at the time the Project Agreement was signed using the notional cash flows in paragraph (a) above at the beginning of each income year as outflows, and the Original D&C Payment at the end of the original term of the D&C Phase as the only inflow.

7 Example

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

The Partnership and the Crown agree to the Original D&C Payment under the Base Case sheet that the Original D&C Payment equals \$1,200,000. The Base Case sets out that the agreed design and construction costs of the Project (excluding Fitout) are to be \$970,748.

The value of the "completion of the Project and the transfer of the rights set out in clause 11.2(c)" of the Project Agreement, as set out in Clause 12.3 of the Project Agreement, is equal to \$970,748.

The Partnership and the Crown subsequently agree that Additional D&C Payments will be made from the Effective Date of the 2020 Amendments until completion of the Facility. No part of the Additional D&C Payments will be treated as income under the financial arrangements rules.

The Interest Component of the D&C Payment is \$229,252 by implication of the valuation under this determination. The Limited Partners will spread the Interest Component over the original term of the D&C Phase of the Project Agreement, as follows.

The Annual Expenditure incurred and treated as having been incurred at the beginning of the relevant income year is as follows

Year	Actual D&C costs
1	(\$190,494)
2	(\$296,488)
3	(\$245,464)
4	(\$173,759)
5	(\$62,168)
6	(\$2,376)
Original D&C Payment	\$1,200,000
	(\$970,748)

Based on expected receipt of the \$1,200,000 D&C Payment in Year 6 the Project has an internal rate of return of 4.9171%.

The Interest Component is therefore spread as follows:

Year	Actual D&C costs	Cumulative	Interest income
1	(\$190,494)	(\$190,494)	\$9,367
2	(\$296,488)	(\$496,348)	\$24,406
3	(\$245,464)	(\$766,218)	\$37,675

4	(\$173,759)	(\$977,652)	\$48,072
5	(\$62,168)	(\$1,087,892)	\$53,492
6	(\$2,376)	(\$1,149,761)	\$56,239
Original D&C Payment		\$1,200,000	
Total	(\$970,748)		\$299,252

This Determination is signed by me on the 17th day of December 2020.

Howard Davis
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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.