



## **Determination S10: Investors Subscribing for Convertible Notes in Company and Units in Unit Trust**

This determination may be cited as “Determination S10: Investors Subscribing for Convertible Notes in Company and Units in Unit Trust”.

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

- (1) This determination applies to holders of Convertible Notes denominated in New Zealand Dollars issued by ABC Limited (“the Issuer”) and Units in the XYZ Unit Trust (“the Unit Trust”).

The arrangement involves Investors subscribing for Convertible Notes issued by the Issuer (which bear interest at the rate of 2% per annum) and Units issued by the Unit Trust. These will be subscribed for on the basis of two Convertible Notes for every Unit subscribed for. The Issuer will lend the proceeds from the issue of the Convertible Notes to the Unit Trust at interest at the rate of 2% per annum. The Unit Trust will use the total funding subscribed by Investors to contribute towards the purchase of a commercial property.

The Unit Trust will repay the loan from the Issuer by way of regular repayments of principal. The Issuer will use the money received from the repayment of the loan to repay the principal amount of the Convertible Notes on issue.

An Investor has the option to convert the Convertible Note into Units in the Unit Trust. The conversion of the Convertible Note extinguishes the Issuer’s liability to repay the principal amount owing to the holder of a Convertible Note.

- (2) The form of the investment structure used to issue the Convertible Notes and Units to the Investors involves a number of financial arrangements which together form a “wider” financial arrangement. These financial arrangements include:
- (i) the Units in the Unit Trust;
  - (ii) the Convertible Notes issued by the Issuer;
  - (iii) the loan of the proceeds received by the Issuer from the issue of the Convertible Notes to the Unit Trust.
- (3) These financial arrangements can be analysed in the following way.
- (a) The Units in the Unit Trust are deemed to be shares by section HE 1(b) of the Income Tax Act 1994. Section OB 1 of the Act therefore classifies the Units as excepted financial arrangements.
  - (b) The Convertible Notes have a debt and equity component. The debt component is the loan to the company with repayment being made in cash or units. The equity component is the option to convert repayment to Units in the Unit Trust and is also an excepted financial arrangement under section OB 1.



- (4) In relation to the Convertible Notes, the coupon interest payments made by the Issuer to the Investors in respect of the Convertible Notes are below a “market” interest rate, but are nevertheless income or expenditure subject to the Qualified Accruals Rules.

When calculating income or expenditure in relation to the Convertible Notes the repayment in instalments of the principal amount of the Convertible Notes does not constitute income or expenditure subject to the Qualified Accruals Rules.

There is no amount attributable to the option to convert the Convertible Notes into Units in the Unit Trust because the conversion from the Convertible Notes into Units in the Unit Trust is made on a market value basis.

- (5) The Units in the Unit Trust are not excluded from the application of the Qualified Accruals Rules because they form part of a “wider” financial arrangement. The fact that the proceeds of the issue of the Convertible Notes are lent by the Issuer to the Unit Trust and that the interest payable on this loan is below a “market” interest rate means that any gain on Units is not solely attributable to an excepted financial arrangement.
- (6) The gain on Units is, in part, attributable to the low rate of interest that is payable on the loan from the Issuer to the Unit Trust and the correspondingly low rate of interest that is payable on the Convertible Notes. Therefore, part (or possibly all) of any gain on Units will be income for the purposes of the Qualified Accruals Rules.
- (7) This Determination prescribes the method to be used to determine how much of the increase of the value of a Unit is solely attributable to an excepted financial arrangement and therefore excluded from the Qualified Accruals Rules as well as the method for spreading the accrual income, gain or loss, or expenditure under the Qualified Accruals Rules.

## **2. Reference**

This determination is made pursuant to sections 90(1)(c), 90(1)(g) and 90(3) of the Tax Administration Act 1994.

## **3. Scope of Determination**

- (1) The Determination will apply to the Convertible Notes issued by the Issuer and the Units issued by the Trust. Investors will subscribe for these on the basis of two Convertible Notes for one unit subscribed for in the Unit Trust.
- (2) The terms of the Convertible Notes are that they will bear interest at a rate of 2% per annum. The Convertible Notes will be convertible at the option of the Investor. The Convertible Notes will convert on a market value and not on the basis of some pre-determined ratio.
- (3) The proceeds of the Convertible Note issue made by the Issuer will be lent to the Unit Trust. This loan will be secured by a second mortgage over the properties held by the Unit Trust. The loan made to the Unit Trust of the proceeds from the Convertible Note issue will be made at the rate of 2% interest per annum. The Unit Trust will repay this loan through regular repayments. The Issuer will use these funds to pay the interest on



the Convertible Notes, and to repay in regular instalments the principal amount of the Convertible Notes.

- (4) Investors may elect to convert their Convertible Notes into Units in the Unit Trust. Once such an election has been made by an Investor it will be irrevocable. On receipt of a Unit in the Unit Trust, the Issuer's liability under the Convertible Note will be extinguished.
- (5) When the Issuer receives a request from an investor to convert one of the Convertible Notes, the Issuer will elect to convert the relative amount of the loan to the Unit Trust into Units in the Unit Trust. Therefore, the Unit Trust will issue Units to the Issuer and the loan from the Issuer will be reduced by the value of the units issued by the Unit Trust.
- (6) The value attributed to the Units when Convertible Notes are converted by the Issuer will be determined by calculating a "unit value" for each unit so converted. The "unit value" shall be determined by dividing the market value of the Unit Trust's net assets by the number of units currently issued by the Unit Trust.
- (7) The effect of this conversion mechanism is intended to be that the balance of the Convertible Notes outstanding with the Issuer will equal the balance of the loan between the Issuer and the Unit Trust. When the Unit Trust makes regular repayments of the loan to the Issuer, the Issuer will use these amounts to redeem or partially redeem the Convertible Notes, and when an Investor wants to convert some of the Convertible Notes into Units in the Unit Trust, the liability of the Unit Trust to the Issuer will be discharged by reducing the balance of the loan outstanding. Therefore, regardless of whichever procedure occurs, the amount of the loan between the Issuer and the Unit Trust and the amount of the Convertible Notes outstanding with the Issuer will always be maintained in equilibrium.
- (8) This Determination applies to all Investors and prescribes the method for determining the part of the income, gain or loss, or expenditure in respect of the growth in value of the Units that is solely attributable to an excepted financial arrangement as well as the method for spreading the accrual income, gain or loss, or expenditure under the Qualified Accruals Rules.
- (9) For the avoidance of doubt, this Determination does not apply to persons other than Investors, being the plural of the term "Investor" as that is defined in the Interpretation section of this Determination.

#### **4. Principle**

- (1) The low interest rate payable on the loan of the proceeds of the Convertible Note issue to the Unit Trust means that any increase in the value of a Unit is not solely attributable to an excepted financial arrangement. As the Convertible Note and the Unit are both part of a wider financial arrangement, part (or possibly all) of any increase in the value of a Unit is income attributable to the Convertible Notes for the purposes of the Qualified Accruals Rules.
- (2) The amount of growth in value of a Unit that is solely attributable to an excepted financial arrangement is determined by deducting the part of the increase in value of the



Unit that can properly be attributed to the non-market interest rate payable on the loan by the Issuer to the Unit Trust.

## 5. Interpretation

- (1) In this Determination, unless the context otherwise requires:
  - (a) the "Act" means the Income Tax Act 1994.
  - (b) "Convertible Note" means any of the notes to be issued by the Issuer with the following terms:
    - (i) The Convertible Notes are not redeemable for cash;
    - (ii) The Convertible Notes entitle the holder to elect, by giving 10 days' notice to the Issuer prior to 31 July in any year, to elect to convert the Convertible Note into Units in the XYZ Unit Trust as at 31 July;
    - (iii) Any conversion will be at the unit value at the preceding 31 March;
    - (iv) Interest will accrue on a daily basis at a rate of 2% per annum on the principal amount outstanding from time to time;
    - (v) Payments of interest will be made annually and repayments of principal will be made by equal annual instalments of one quarter of the initial principal.
  - (c) "Investor" means a person who subscribes for Convertible Notes issued by the Issuer and Units issued by the Unit Trust.
  - (d) "Qualified Accruals Rules" means the accruals rules and sections EH 9 and FF 2 of the Act.
  - (e) "Units" means the units in the Unit Trust.
- (2) For convenience, words and phrases defined in this Determination are indicated by initial capital letters, but the absence of a capital letter shall not alone imply that the word or phrase is used with a meaning different from that given by its definition.
- (3) A determination to which this Determination refers may be changed or rescinded by a new determination made by the Commissioner. In such a case, a reference to the old determination is taken to be extended to the new determination.

## 6. Method

- (1) The amount of increase in value of a Unit that is not solely attributable to an excepted financial arrangement, and is therefore subject to the Qualified Accruals Rules, is calculated as follows:
  - (a) The increase in value of the Unit is the amount by which the market value of the Unit exceeds the cost of the Unit (the "Gain"). If the cost of the Unit is greater

than or equal to the market value of the Unit, then there will be no Gain and any difference between the cost and market value will be solely attributable to an excepted financial arrangement. There will be no amount which will be included as gross income under the Qualified Accruals Rules.

- (b) Where there is a Gain, part of the Gain will be attributable to the low rate of interest. The amount that is attributable to the low rate of interest (the “Interest Advantage”) is the difference between the specified rate and 2% multiplied by the amount of principal outstanding. However, there may be difficulties in determining the daily balance in cases where part repayment of the principal outstanding occurs during the income year rather than on 31 March. These difficulties may be avoided by using the amount of interest payable during the year divided by 2% as a substitute for the weighted average of the amount of principal outstanding during the income year. The Interest Advantage is therefore calculated using the following formula:

$$\frac{SR - R}{R} \times AI ; \text{ where:}$$

“SR” is the specified rate prescribed by Determination G23: Specified Rate, calculated in accordance with Determination G13A: Prices or Yields based on the term of the loan between the Issuer and the Unit Trust;

“R” is the interest rate of 2% per annum; and

“AI” is the sum of the amounts for each income year since the Convertible Notes and Units were issued calculated in accordance with the formula:

$$I \div U ; \text{ where:}$$

“I” is the total interest payable by the Unit Trust on the loan from the Issuer to the Unit Trust, for the relevant income year or part year; and

“U” is the number of Units on issue from the Unit Trust at the end of the relevant income year or part year calculated on a weighted average basis to take into account any Units arising from the conversion of Convertible Notes.

- (c) Where the Gain is greater than the Interest Advantage, then any amount over and above the Interest Advantage will be solely attributable to the excepted financial arrangement (being the Units) and not subject to the Qualified Accruals Rules. The Interest Advantage will not be solely attributable to an excepted financial arrangement and will be subject to the Qualified Accruals Rules.

Where the Interest Advantage is greater than the Gain, all of the Gain will be subject to the Qualified Accruals Rules.

- (d) To determine the amount deemed to be gross income under the Qualified Accruals Rules, an adjustment must be made to the amount subject to the



Qualified Accruals Rules under clause 6(1)(c) of this Determination. The following amount must be subtracted from the amount subject to the Qualified Accruals Rules referred to in clause 6(1)(c) of this Determination. The amount to be subtracted comprises the total of all amounts previously deemed to be gross income under clause 6(1)(d) of this Determination less any amounts previously allowed as a deduction under clause 6(1)(d) of this Determination.

- (2) Any interest payment received by an Investor on the Convertible Notes is attributable to the Convertible Notes and is therefore not solely attributable to any excepted financial arrangement. As such, it will be included as gross income under the Qualified Accruals Rules.
- (3) Any distribution paid by the Unit Trust to an Investor is solely attributable to an excepted financial arrangement (being the Units) and not subject to the Qualified Accruals Rules.

## 7. Examples

### Example One

An Investor who is a cash basis holder invests in Convertible Notes and Units on the following terms:

- the Investor subscribes for and receives 4,000 \$1 Units and 8,000 \$1 Convertible Notes which bear interest at a rate of 2% per annum on 1 April 1998
- the total number of \$1 Convertible Notes issued by the Issuer is 80,000, with the number of \$1 Units issued by the Unit Trust being 40,000. The proceeds from the issue of the Convertible Notes (being \$80,000) is loaned from the Issuer to the Unit Trust for a period of four years bearing interest at 2% per annum (meaning that the Unit Trust will repay to the Issuer \$20,000 on 31 March each year starting on 31 March 1999), plus interest on the balance of the loan calculated on a daily basis
- the Convertible Notes held by the Investor are redeemed at a rate of 2,000 Notes per year (meaning the Investor receives \$2,000 on 31 March each year)
- the market value of the Units in the Unit Trust at the end of each of the four income years are as follows:

31 March	Market Value of Unit
1999	\$1.15
2000	\$1.25
2001	\$1.35
2002	\$1.50

- on 31 March 2002, an income distribution of \$0.25 per Unit is paid to Investors by the Unit Trust
- no Investors exercise the option to convert the Convertible Notes



- the “specified rate” is to be determined in accordance with Determination G23 and Determination G13A, based on the term of the loan between the Issuer and the Unit Trust. The term of the loan is from 1 April 1998 to 31 March 2002. Applying Determination G23, the specified rate will be the yield for New Zealand Government Stock of a similar term to the loan determined in accordance with Determination G13A. Under Determination G13A, for the purposes of this example the yield as at 31 March 1998 for New Zealand Government Stock maturing on 15 March 2002 will be taken as being 7.35% and so, the specified rate is 7.35%
- the Units are sold by the Investor on 1 April 2002 for an amount of \$6,000.

### ***Taxation consequences of the financial arrangement***

*For the year ending 31 March 1999:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 1999 will be \$160. This equates to the initial investment in the Convertible Notes of \$8,000 at interest of 2% per annum. This will be gross income.

*For the year ending 31 March 2000:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 2000 will be \$120. This equates to the balance of the investment in the Convertible Notes outstanding of \$6,000 at interest of 2% per annum. This will be gross income.

*For the year ending 31 March 2001:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 2001 will be \$80. This equates to the balance of the investment in the Convertible Notes outstanding of \$4,000 at interest of 2% per annum. This will be gross income.

*For the year ending 31 March 2002:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 2002 will be \$40. This equates to the balance of the investment in the Convertible Notes outstanding of \$2,000 at interest of 2% per annum. This will be gross income.

The distribution of \$1,000 (including withholding tax) received by the Investor from the Unit Trust in respect of the Units held on 31 March 2002 is solely attributable to an excepted financial arrangement. Therefore, it does not have to be considered under the Qualified Accruals Rules, but is gross income as being a dividend.

*For the year ending 31 March 2003:*

The Investor has not received any further interest on the Convertible Notes as they have been fully repaid and has not received any further distributions on the Units prior to the Units being sold on 1 April 2002.

- (a) The 4,000 Units were sold for \$6,000. This represents a selling price of \$1.50 per Unit. The Gain in the value of the Unit will be the value received of \$1.50 per Unit less the original cost of \$1.00 per Unit. Therefore, the Gain on a per Unit basis is \$0.50. As this



is a positive amount, some of the Gain will be attributable to the low rate of interest and will be subject to the Qualified Accruals Rules.

- (b) The Interest Advantage per Unit at the end of the fifth year is calculated using the following formula which uses the mathematical convention of using the Greek letter “sigma” to indicate that the formula “ $I \div U$ ” is to be summed for the appropriate number of periods:

$$\text{Interest Advantage per Unit} = \frac{SR - R}{R} \times \sum_{t=1}^5 (I_t \div U_t)$$

In this case, the formula will become:

$$\begin{aligned} \text{Interest Advantage per Unit} &= ((7.35\% - 2\%) \div 2\%) \times ((\$1,600 \div 40,000) + (\$1,200 \\ &\quad \div 40,000) + (\$800 \div 40,000) + (\$400 \div 40,000) + \\ &\quad (\$0 \div 40,000)) \\ &= 2.675 \times \$0.10 \\ &= \$0.2675 \end{aligned}$$

- (c) As the Gain in the value of the Unit is greater than the Interest Advantage, the maximum amount per Unit subject to the Qualified Accruals Rules will be the amount of the Interest Advantage, being \$0.2675. As the Investor holds 4,000 Units, this equates to an amount of \$1,070. The further amount of the Gain of \$0.2325 per Unit is solely attributable to an excepted financial arrangement and not subject to the Qualified Accruals Rules.
- (d) As the Investor is a cash basis holder, there will not have been any amounts previously included as gross income under clause 6(1)(d) of this Determination so there will not be any amounts to deduct from the amount calculated above of \$1,070. This is the amount which will need to be included as gross income.



## Example Two

In this example the facts are the same as for the first example, but the Investor is not a cash basis holder. It is not necessary to realise the Units in order to consider the accrual treatment for a non-cash basis holder as gross income will have to be returned on a yearly basis.

### *Taxation consequences of the financial arrangement*

*For the year ending 31 March 1999:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 1999 will be \$160. This equates to the initial investment in the Convertible Notes of \$8,000 at interest of 2% per annum. This will be gross income.

The Investor will also need to consider the part of the increase in the value of the Unit which is attributable to the low interest rate paid on the loan by the Issuer to the Unit Trust.

- (a) The Gain in the value of the Unit will be the market value of \$1.15 less the original cost of \$1.00. Therefore, the Gain on a per Unit basis is \$0.15.
- (b) The Interest Advantage per Unit at the end of the first year is calculated using the following formula:

$$\text{Interest Advantage per Unit} = \frac{SR - R}{R} \times \sum_{t=1}^1 (I_t \div U_t)$$

In this case, the formula will become:

$$\begin{aligned} \text{Interest Advantage per Unit} &= 2.675 \times (\$1,600 \div 40,000) \\ &= \$0.107 \end{aligned}$$

- (c) As the Gain in the value of the Unit is greater than the Interest Advantage, the maximum amount per Unit subject to the Qualified Accruals Rules will be the amount of the Interest Advantage, being \$0.107 per Unit. As the Investor holds 4,000 Units, this equates to an amount of \$428. The difference between the Gain and the Interest Advantage will be an amount which is solely attributable to an excepted financial arrangement.
- (d) The Investor has not previously included any amounts as gross income under clause 6(1)(d) of this Determination and so there is no amount to be deducted from the amount of \$428. This amount will need to be included as gross income.

*For the year ending 31 March 2000:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 2000 will be \$120. This equates to the balance of the investment in the Convertible Notes outstanding of \$6,000 at interest of 2% per annum. This will be gross income.

- (a) The Gain in the value of the Unit will be the current market value of \$1.25 less the original cost of \$1.00. Therefore, the Gain on a per Unit basis is \$0.25.



- (b) The Interest Advantage per Unit at the end of the second year is calculated using the following formula:

$$\text{Interest Advantage per Unit} = \frac{SR - R}{R} \times \sum_{t=1}^2 (I_t \div U_t)$$

In this case, the formula will become:

$$\begin{aligned} \text{Interest Advantage per Unit} &= 2.675 \times ((\$1,600 \div 40,000) + (\$1,200 \div 40,000)) \\ &= \$0.18725 \end{aligned}$$

- (c) As the Gain in the value of the Unit is greater than the Interest Advantage, the maximum amount per Unit subject to the Qualified Accruals Rules will be the amount of the Interest Advantage, being \$0.18725. As the Investor holds 4,000 Units, this equates to an amount of \$749. The difference between the Gain and the Interest Advantage will be an amount which is solely attributable to an excepted financial arrangement.
- (d) The Investor has previously included as gross income under clause 6(1)(d) of this Determination an amount of \$428 and so this amount will need to be deducted from the amount of \$749. The amount to be included as gross income will be \$321.

*For the year ending 31 March 2001:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 2001 will be \$80. This equates to the balance of the investment in the Convertible Notes outstanding of \$4,000 at interest of 2% per annum. This will be gross income.

- (a) The Gain in the value of the Unit will be the current market value of \$1.35 less the original cost of \$1.00. Therefore, the Gain on a per Unit basis is \$0.35.
- (b) The Interest Advantage per Unit at the end of the second year is calculated using the following formula:

$$\text{Interest Advantage per Unit} = \frac{SR - R}{R} \times \sum_{t=1}^3 (I_t \div U_t)$$

In this case, the formula will become:

$$\begin{aligned} \text{Interest Advantage per Unit} &= 2.675 \times ((\$1,600 \div 40,000) + (\$1,200 \div 40,000) + \\ &\quad (\$800 \div 40,000)) \\ &= \$0.24075 \end{aligned}$$

- (c) As the Gain in the value of the Unit is greater than the Interest Advantage, the maximum amount per Unit subject to the Qualified Accruals Rules will be the amount of the Interest Advantage, being \$0.24075. As the Investor holds 4,000 Units, this equates to an amount of \$963. The difference between the Gain and the Interest Advantage will be an amount which is solely attributable to an excepted financial arrangement.



- (d) The Investor has previously included as gross income under clause 6(1)(d) of this Determination amounts of \$428 and \$321 so these amounts will need to be deducted from the amount of \$963. The amount to be included as gross income will be \$214.

*For the year ending 31 March 2002:*

The coupon interest payment received by the Investor from the Issuer for the year ended 31 March 2002 will be \$40. This equates to the balance of the investment in the Convertible Notes outstanding of \$2,000 at interest of 2% per annum. This will be gross income.

- (a) The Gain in the value of the Unit will be the current market value of \$1.50 less the original cost of \$1.00. Therefore, the Gain on a per Unit basis is \$0.50.
- (b) The Interest Advantage per Unit at the end of the second year is calculated using the following formula:

$$\text{Interest Advantage per Unit} = \frac{SR - R}{R} \times \sum_{t=1}^4 (I_t \div U_t)$$

In this case, the formula will become:

$$\begin{aligned} \text{Interest Advantage per Unit} &= 2.675 \times ((\$1,600 \div 40,000) + (\$1,200 \div 40,000) + \\ &\quad (\$800 \div 40,000) + (\$400 \div 40,000)) \\ &= \$0.2675 \end{aligned}$$

- (c) As the Gain in the value of the Unit is greater than the Interest Advantage, the maximum amount per Unit subject to the Qualified Accruals Rules will be the amount of the Interest Advantage, being \$0.2675. As the Investor holds 4,000 Units, this equates to an amount of \$1,070. The difference between the Gain and the Interest Advantage will be an amount which is solely attributable to an excepted financial arrangement.
- (d) The Investor has previously included as gross income under clause 6(1)(d) of this Determination amounts of \$428, \$321 and \$214 so these amounts will need to be deducted from the amount of \$1,070. The amount to be included as gross income will be \$107.

The distribution of \$1,000 (including withholding tax) received by the Investor from the Unit Trust in respect of the Units held on 31 March 2002 is solely attributable to an excepted financial arrangement. Therefore, it does not have to be considered under the Qualified Accruals Rules, but is gross income as being a dividend.

As can be seen through the two examples, the total amount which is included as gross income is the same between the two Investors, except that the cash basis holder does not have to include the amount until realisation through making a base price adjustment.

This determination is signed by me on the 18th day of June 1998.



**Martin Smith**

General Manager (Adjudication & Rulings)