Inland Revenue
Te Tari Taake

Special Determination [S6]: Financial Arrangement Income or Expenditure from Certain Mandatory Conversion Convertible Notes

This Determination may be cited as Special Determination [S6]: "Financial Arrangement Income or Expenditure from Certain Mandatory Conversion Convertible Notes".

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

(1) This Determination relates to mandatory conversion convertible notes ("MCNs") issued by the Issuer to the Holder for $51 million. The Issuer will apply the moneys borrowed to purchase the Holder's 100% shareholding in another company .

(2) The MCNs constitute financial arrangements in which the Holder of the MCNs provides money to the Issuer, with the debt to be discharged at a future date by the issue of shares in the Issuer. Interest will be paid in the period between the issue of the MCNs and the conversion of the MCNs into shares in the form of a Cash Interest Component and Increments (being shares in the Issuer). The parties expected that the shares in the Issuer would have a market value of $3.13 at the time the MCNs were issued and this is the value of the shares on which the transaction between the parties was priced for the purpose of providing the desired commercial return for the Holder.

(3) Pursuant to section EH 2 of the Income Tax Act 1994, the amount of the gross income deemed to be derived or the expenditure deemed to be incurred by a person in respect of a financial arrangement under the Qualified Accruals Rules shall not include the amount of any income, gain or loss, or expenditure that is solely attributable to an excepted financial arrangement that is part of the financial arrangement.

(4) As a share is an excepted financial arrangement under section OB 1 of the Income Tax Act 1994, only the Cash Interest Component and Increments are regarded as income or expenditure for the purposes of calculating aggregate income or expenditure. Any fluctuation in market value of the Underlying Shares is disregarded.

(5) This Determination prescribes the method to be used when calculating for accruals purposes the aggregate income derived or aggregate expenditure incurred in respect of the MCNs for both the Holder and the Issuer. It details which amounts are to be included for this calculation, and which are attributable to an excepted financial arrangement.

(6) This Determination does not deal with the spreading of income or expenditure under the Qualified Accruals Rules in relation to the issuing and holding of the MCNs. In this regard, reference should be made to section EH 1 of the Income Tax Act 1994.

2. Reference

(1) This Determination is made pursuant to section 90(1)(g) of the Tax Administration Act 1994.

3. Scope of determination

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(1) This Determination applies only to the MCNs described as follows:

(a) The Issuer will borrow money from the Holder by issuing 19.2 million MCNs to the Holder for $51 million. The MCNs will be convertible into differing numbers of ordinary shares, depending on the length of time for which the MCNs have been outstanding. On the issue date, the MCNs will be convertible into 16,300,000 ordinary shares and thereafter the Holder's entitlement to convert into ordinary shares will increase yearly on 1 January in each year from 1998 to 2002 in accordance with the following table:

Calendar year in which conversion falls	Incremental Issuer Shares	Total Issuer Shares
On or before 31 December 1997		16,300,000
1998	580,000	16,880,000
1999	580,000	17,460,000
2000	580,000	18,040,000
2001	580,000	18,620,000
2002, up to 31/03/02	580,000	19,200,000

Provided that if the Ordinary Shares in the Issuer are consolidated or subdivided, the number of Ordinary shares to be issued on the conversion of the MCNs will be adjusted in the manner necessary to reflect the consolidation or subdivision.

Provided also that if the Issuer prior to the conversion of all the MCNs makes any bonus issue of shares, notes, debentures, or other instruments or obligations to its shareholders (other than an issue made in substitution for a cash dividend which its shareholders would otherwise have received) then the Holder will be allotted such instruments calculated as if it had converted the MCNs held by it into Ordinary Shares at the rate of conversion provided in the Table applicable on or after 1 January 2002 but if the Holder elects after this calculation to convert any of the MCNs prior to 31 March 2002, then at the time of conversion of the last of the MCNs, the Holder's entitlement will be recalculated on the basis of the MCNs actually converted by the Holder, and any excess entitlements to the Holder will be cancelled or forfeited as the case may be.

(b) If the Holder elects to convert some but not all of the MCNs, then the number of fully paid ordinary shares into which such MCNs will convert will be calculated as follows:

$$A = \frac{B}{19{,}200{,}000} \times C \quad \text{where}$$

A = the number of fully paid ordinary shares to be issued to the Holder;

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B = the number of MCNs which the Holder has elected to convert; and

C = the number of fully paid ordinary shares that the Holder would have received if at that time it had converted all the MCNs determined from the above table.

(c) If the Holder converts some but not all of the MCNs then the Increments accruing on each subsequent 1 January will decrease. The relevant Increment will be reduced as follows:

$$A = \frac{B}{19{,}200{,}000} \times C \quad \text{where}$$

A = the revised Increment;

B = the number of MCNs then held by the Holder; and

C = the Increment as determined from the table in paragraph (a) of subclause 3(1) (ie as if all the MCNs had remained outstanding).

(d) Based on the market value of the Underlying Shares (that being $3.13) at the time the MCNs are issued, the MCNs have a market value of approximately $51 million at the time they are issued (16,300,000 shares, if converted, x $3.13 market value per share). Nevertheless, the principal amount of the MCNs will be based on a face value of $2.25 each. In that regard, the face value arose from an early stage of the negotiation process and now bears no relationship to the true worth of the notes at the time the arrangement between the Issuer and the Holder was entered into, except that if the Issuer were to be liquidated in circumstances where there was a shortfall of assets, the Holder would be entitled, as creditor, to a maximum of $2.25 per MCN. There is no present likelihood that a liquidation scenario in respect of the Issuer will arise.

(e) The MCNs will mandatorily convert on 31 March 2002 (unless renewed by agreement), and may be converted earlier, in accordance with the above schedule, at the option of the Holder.

(f) The MCNs will be issued together with a special voting share which will entitle the Holder to exercise 30.35% of the voting rights in the Issuer (based on the number of shares on issue immediately after completion of the transaction). If the MCNs were to be converted immediately after issue, the special voting share would lose its rights and the resulting shares would only carry approximately 27% of the voting rights in the Issuer, as those shares would rank *pro rata* with all other shares.

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(g) In addition to the Increments the MCNs will bear a Cash Interest Component. In calculating these amounts, regard has been had to future profit projections, but nevertheless the amounts have been fixed and will not vary, irrespective of future profitability. The amounts are as follows:

Year ending	Annual Rate (% on opening market value of shares- $51 million issue price)	Amount
31 March 1997		Nil
31 March 1998	5.15	2,624,400
31 March 1999	5.48	2,797,200
31 March 2000	6.04	3,078,000
31 March 2001	6.46	3,294,000
31 March 2002	6.78	3,456,000

(h) However, where prior to the payment date of any Cash Interest Component the Holder has converted some but not all of the MCNs, then the relevant payment will be reduced as follows:

$$A = \frac{B}{19{,}200{,}000} \times C \quad \text{where}$$

A = the revised Cash Interest Payment to be made;

B = the number of MCNs then held by the Holder; and

C = the Cash Interest Payment determined from the above table.

Provided, where some or all of the MCNs are converted prior to the payment date of any Cash Interest Component then, in respect of those MCNs which have been converted, interest will be paid on the conversion date of those MCNs on a pro-rata basis for each completed quarter they were held since the last cash interest payment date of any Cash Interest Component.

For this purpose, in the case of a partial conversion of the MCNs, the amount of the interest to be pro-rated on the above basis shall be determined by multiplying the Cash Interest Component applicable for the relevant year by the proportion that the converted MCNs bear to 19,200,000.

(i) The MCNs will be non-transferable, except to a 100% Holder owned Local Authority Trading Enterprise.

(2) This Determination does not deal with the attribution or spreading, under the Accruals Rules, of the aggregate income or expenditure to particular income years. Nor does this Determination apply to:

- any subsequent disposal of the MCNs by the Holder; or

- any subsequent holders of the MCNs.

(3) This Determination shall cease to apply in the event that a reduction occurs in the Issuer's ordinary share capital.

4. Principle

(1) The MCNs have both debt and equity components and comprise a loan by the Holder to the Issuer with repayment in shares (debt component) or alternatively a forward purchase of shares in which case the Holder of the notes is buying shares in a company and has equity in it.

(2) As the MCNs have this dual character, when calculating income or expenditure in relation to the MCNs it is first necessary to separate the debt and equity component of the MCNs.

(3) This Determination specifies that the Cash Interest Component and Increments relate to the debt component of the MCNs, and that changes in value of the Underlying Shares (except in the case of a consolidation or subdivision of the Underlying Shares), relate to the equity component and will be excluded from the application of the Accruals Rules when calculating income or expenditure for the Holder and the Issuer.

(4) The value of the Increments to be taken into account in calculating income or expenditure will be determined by reference to the market value of the Underlying Shares in the Issuer at the time the MCNs are issued, that being $3.13 (except in the case of a subdivision or consolidation of the Underlying Shares as provided for in subclause 6(4)).

(5) For the purposes of this Determination any change in the market value of the Underlying Shares between the issue date of the MCNs and the conversion into shares is solely attributable to the equity component of the MCNs. Therefore the difference in share price can be ignored when calculating the aggregate income and expenditure. However, in the event of a subdivision or consolidation, the share price is to be adjusted in terms of the formula in subclause 6(4).

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5. Interpretation

(1) In this Determination, the following expressions (which have not been defined elsewhere within the Determination) have the following meanings:

(a) "Accruals Rules" means the rules referred to in section OZ 1 of the Income Tax Act 1994.

(b) "Base Number of Shares" means 16,300,000 shares into which the MCNs will convert if the Holder converts the MCNs on or before 31 December 1997.

(c) "Cash Interest Component" means the cash interest amounts paid on an annual basis by the Issuer to the Holder pursuant to the MCNs as set out in paragraph (g) of subclause 3(1).

(d) "Holder" means the person holding the MCNs.

(e) "Increments" or "Increment" means the additional shares accruing each year to the Base Number of Shares in the Issuer into which the MCNs will convert on conversion in accordance with the Table in paragraph (a) of subclause 3(1), adjusted in the case of a partial conversion as required in terms of the formula in paragraph (c) of subclause 3(1) and adjusted in the event of a consolidation or subdivision, at the appropriate consolidation, or subdivision ratio as provided in the first proviso to paragraph (a) of subclause 3(1).

(f) "Issuer" means the issuer of the MCNs.

(g) "Local Authority Trading Enterprise" means a "local authority trading enterprise" as defined by section 594B of the Local Government Act 1974.

(h) "Market Value" means the quoted price of listed shares on the New Zealand Stock Exchange or any other unofficial market for shares.

(i) "Qualified Accruals Rules" means the rules referred to in section OZ 1 of the Income Tax Act 1994.

(j) "Underlying Shares" in relation to the MCNs means the shares into which the MCNs are convertible from time to time.

6. Method

(1) Amounts to be included when calculating the aggregate income or expenditure with regard to the MCNs:

(a) in respect of income, gain or loss, or expenditure, and also of any other consideration receivable by the Holder or payable by the Issuer, the amounts taken into account to calculate income or expenditure consist of the:

(i) Cash Interest Component; and

(ii) Increments.

(b) the amount to be attributed to the Increments for the purpose of determining the aggregate income or expenditure shall be $3.13 per share, provided that this amount will be adjusted for the purposes of the aggregate expenditure or income calculations in the case of a subdivision or consolidation of the Underlying Shares, in terms of the formula set out in subclause 6(4).

(2) The income, gain or loss, or expenditure, that is solely attributable to the excepted financial arrangement component of the MCNs equals the amount by which market value of the share price fluctuates above or below the amount of $3.13 (or the adjusted amount in terms of the formula in subclause 6(4), as the case may be), that is attributed to the Increments.

(3) For the purposes of the base price adjustment, the amount of the acquisition price (based on the definitions in section OB 1 of the Income Tax Act 1994 of "acquisition price" and paragraph (e) of the definition of "core acquisition price") of the MCNs is $51 million with no part of the core acquisition price being attributable to the excepted financial arrangement component of the MCNs.

(4) The amount to be attributed to each share comprised in Increments following a consolidation or subdivision shall be item "a" calculated by reference to the following formula:

$$a = b \times \frac{c}{d}$$

Where:

a	=	Amount to be attributed to the shares following a consolidation or subdivision;
b	=	$3.13 (or the adjusted amount as a result of an earlier subdivision or consolidation and the application of this subclause);
c	=	The next Increment which would have been delivered but for the subdivision or consolidation; and
d	=	The next Increment that will be delivered following the consolidation or subdivision.

7. Example A

(1) This example illustrates the application of the method (set out in the Determination) for determining the amounts attributable to both the debt and equity components of the MCNs issued by the Issuer to the Holder.

(2) The example proceeds on the basis that the Holder will continue to hold the MCNs until 31 March 2002 when the MCNs will mandatorily convert into 19,200,000 shares in the Issuer.

(3) The following table sets out :

(a) The Cash Interest Component;

(b) The number of shares in the Issuer into which the MCNs would convert (following a 1 January allotment of Increments) in a particular year, if the election was made to convert them;

(c) The Increment;

(d) The amount of the Increment;

(e) The aggregate income or expenditure for the Holder and the Issuer respectively (comprising of the Cash Interest Component together with the Increment).

Year ending	A = Cash Interest Component	The number of shares in the Issuer into which the MCNs would convert	Increment	B = Increment x $3.13	A + B = Aggregate income or expenditure
31 March 1997	Nil	16,300,000	Nil	Nil	Nil
31 March 1998	2,624,400	16,880,000	580, 000	1,815,400	4,439,800
31 March 1999	2,797,200	17,460,000	580, 000	1,815,400	4,612,600
31 March 2000	3,078,000	18,040,000	580, 000	1,815,400	4,893,400
31 March 2001	3,294,000	18,620,000	580, 000	1,815,400	5,109,400
31 March 2002	3,456,000	19,200,000	580, 000	1,815,400	5,271,400

(4) The aggregate amount, if the MCNs run full term, attributable to the debt component of the MCNs, and therefore to be taken into account under the Accruals Rules is $24,326,600 (4,439,800 + 4,612,600 + 4,893,400 + 5,109,400 + 5,271,400), comprised of the Cash Interest Component together with the Increment. This amount constitutes aggregate income/expenditure, in terms of the Accruals Rules. All fluctuations in value of the Underlying Shares relate to the equity component of the MCNs and should not be taken into account in calculating income or expenditure.

(5) It should be noted that the example only deals with the amounts attributable to the debt and equity components of the MCNs. It does not deal with the attribution or spreading, under the Accruals Rules, of income or expenditure to particular income years.

Example B

(1) This example proceeds on the basis that the Holder will continue to hold all the MCNs until 31 March 2002. However, following its 31 March 1999 year end, the Issuer undertakes a subdivision on a two for one basis.

(2) The following table sets out:

(a) The Cash Interest Component;

(b) The number of shares in the Issuer into which the MCNs would convert (following a 1 January allotment of Increments) in a particular year, if the election was made to convert them;

(c) The Increment;

(d) The amount of the Increment;

(e) The aggregate income or expenditure for the Holder and the Issuer respectively (comprising of the Cash Interest Component together with the Increment).

Year ending	A = Cash Interest Component	The number of shares in the Issuer into which the MCNs would convert	Increment	B = Increment x $3.13 (for 1998-1999 years) B = Increment x $1.565 (for 2000-2002 years)	A + B = Aggregate income or expenditure
31 March 1997	nil	16,300,000	nil	nil	nil
31 March 1998	2,624,400	16,880,000	580,000	1,815,400	4,439,800
31 March 1999	2,797,200	17,460,000	580,000	1,815,400	4,612,600
31 March 2000	3,078,000	36,080,000	1,160,000	1,815,400	4,893,400
31 March 2001	3,294,000	37,240,000	1,160,000	1,815,400	5,109,400
31 March 2002	3,456,000	38,400,000	1,160,000	1,815,400	5,271,400

(3) After the subdivision (ie, for the years 31 March 2000 onwards) the price adjustment calculation is applied. The price adjustment formula takes into account the increased Increment as a result of the subdivision and adjusts the share price for the purpose of calculating the aggregate expenditure or income with the intent that the aggregate amount is the same as if the subdivision had not occurred. The yearly Increments increase to $1,160,000 and the amount attributed to each share comprised in the Increments is decreased to $1.565, in terms of the formula set out in subclause 6(4), as follows:

$$\text{Amount attributed to each share} = \$3.13 \times \frac{580{,}000}{1{,}160{,}000}$$

$$= \$1.565$$

(4) The aggregate amount, if the MCNs run full term, attributable to the debt component of the MCNs, and therefore to be taken into account under the Accrual Rules is $24,326,600 (4,439,800 + 4,612,600 + 4,893,400 + 5,109,400 + 5,271,400), comprised of the Cash Interest Component together with the Increments. This amount constitutes aggregate expenditure/income, in terms of the Accruals Rules. All other fluctuations in value of the Underlying Shares relate to the equity component of the MCNs and should not be taken into account in calculating the aggregate expenditure or income.

(5) It should be noted that the example only deals with the amounts attributable to the debt and equity components of the MCNs. It does not deal with the attribution or

spreading, under the Accruals Rules, of income or expenditure to particular income years.

Example C

(1) This example proceeds on the basis that the Holder will continue to hold all MCNs until 31 March 2002. However, following its 31 March 1999 year end, the Issuer undertakes a consolidation on a one for two basis.

(2) The following table sets out:

(a) The Cash Interest Component;

(b) The number of shares in the Issuer into which the MCNs would convert (following a 1 January allotment of Increments) in a particular year, if the election was made to convert them;

(c) The Increment;

(d) The amount of the Increment;

(e) The aggregate expenditure (comprised of the Cash Interest Component together with the Increment).

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Year ending	A = Cash Interest Component	The number of shares in the Issuer into which the MCNs would convert	Increment	B = Increment x $3.13 (for 1998-1999 years) B = Increment x $6.26 (for 2000-2002 years)	A + B = Aggregate income/expenditure
31 March 1997	Nil	16,300,000	Nil	Nil	Nil
31 March 1998	2,624,400	16,880,800	580,000	1,815,400	4,439,800
31 March 1999	2,797,200	17,460,000	580,000	1,815,400	4,612,600
31 March 2000	3,078,000	9,020,000	290,000	1,815,400	4,893,400
31 March 2001	3,294,000	9,310,000	290,000	1,815,400	5,109,400
31 March 2002	3,456,000	9,600,000	290,000	1,815,400	5,271,400

(3) After the consolidation (ie, for the years 31 March 2000 on) the price adjustment calculation is applied. The price adjustment formula takes into account the decreased Increment as a result of the consolidation, and adjusts the share price for purposes of calculating aggregate expenditure with the intent that aggregate expenditure is the same as if the consolidation had not occurred. The yearly Increments following the consolidation are calculated according to the definition of "Increments" in the Determination which results in yearly Increments decreasing to 290,000. In the case of the 2000 year, for example, the yearly increment will be 290,000. The amount attributed to each share comprised in the Increments is increased to $6.26 in terms of the formula set out in subclause 6(4) as follows:

$$\text{Amount attributed to each share} = \$3.13 \times \frac{580{,}000}{290{,}000}$$

$$= \$6.26$$

(4) The aggregate amount, if the MCNs run full term, attributable to the debt component of the MCNs, and therefore to be taken into account under the Accruals Rules is $24,326,600 (4,439,800 + 4,612,600 + 4,893,400 + 5,109,400 +5,271,400), comprised of the Cash Interest Component together with the Increments. This amount constitutes aggregate income/expenditure, in terms of the Accruals Rules. All other fluctuations in value of the Underlying Shares relate to the equity component of the MCNs and should not be taken into account in calculating expenditure.

(5) It should be noted that the example only deals with the amounts attributable to the debt and equity components of the MCNs. It does not deal with the attribution or

spreading, under the Accruals Rules, of income or expenditure to particular income years.

This Determination is signed by me on the 24th day of June 1997.

Martin Smith
General Manager (Adjudication & Rulings)