

Determination S7: Morgan Stanley OPALS – Financial Arrangement Income or Expenditure from Morgan Stanley OPALS

This Determination may be cited as “Determination S7: Morgan Stanley OPALS – Financial Arrangement Income or Expenditure from Morgan Stanley OPALS.”

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

- (1) This Determination applies to Optimised Portfolios as Listed Securities ("OPALS") issued by Morgan Stanley Capital (Cayman Islands) Limited ("MSC").
- (2) OPALS is a financial arrangement in which the holder of the OPALS provides money to MSC and the obligation is discharged at a future date by the issue of shares (or stock) in any company or companies. The holder is also entitled to an Income Stream which is based on the dividends derived from the shares and income earned by the party which holds the shares prior to the shares being transferred to 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 a financial arrangement.
- (4) As a share is an excepted financial arrangement under section OB 1 of the Income Tax Act 1994, only the Income Stream and amount attributed to those payments by this Determination are regarded as income or expenditure for the purposes of calculating accrual income or expenditure.
- (5) This Determination prescribes the method to be used when calculating for accrual purposes the income derived or expenditure incurred in respect of OPALS. It also details which amounts are to be included for this calculation, and which are attributable to an excepted financial arrangement.
- (6) This Determination does not provide for, negate or vary the application of the Foreign Investment Fund regime to the excepted financial arrangement component of an OPALS, in respect of those series of OPALS which relate to shares in countries not listed in Part A of Schedule 3 of the Income Tax Act 1994.

2. Reference

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

3. Scope of Determination

- (1) This Determination shall apply to the issue, as more particularly set out in the relevant Offering Circular and Pricing Supplement, by Morgan Stanley Capital (Cayman Islands) Limited, of series of an investment product called OPALS.
- (2) OPALS are hybrid securities issued by a special purpose Cayman Island's company (Morgan Stanley Capital (Cayman Islands) Limited, the "Issuer"), and listed on the Luxembourg Stock Exchange. OPALS are not shares in the Issuer. They are unsecured obligations ranking pari passu with all other unsecured obligations of the Issuer.
- (3) OPALS provide investors with a return which tracks within agreed parameters the movement in a specified equity index (such as the S&P 500). This return is provided as follows. The issue proceeds from OPALS are indirectly invested in shares of companies making up the relevant index. The dividends received on these share baskets (net of any applicable withholding taxes) plus a percentage of any fees generated from the lending of the shares are paid to the OPALS holder as an annual coupon. Similarly any gains made through adjusting the composition of the share baskets are paid out as a component of this coupon. These adjustments are made without the intention of attempting to outperform the relevant index.
- (4) OPALS have a stated maturity of between one and seven years. Redemption is effected by the delivery to the investor of the physical shares then comprising the basket. In certain circumstances investors with a prescribed minimum holding of OPALS can elect to redeem early, but redemption is always by delivery of shares and never by cash.
- (5) The actual hedging mechanism involves the holding of the share baskets in a Morgan Stanley group company resident in Luxembourg ("Counterparty"). The Counterparty issues an equity linked note to the Issuer thus hedging the Issuer's position. Therefore, the balance sheet of the Issuer is composed of Counterparty notes on the asset side and the OPALS on the liability side balanced by share capital. The notes issued by the Counterparty are redeemable in cash or through the delivery of shares.
- (6) Except where its application is specifically excluded in another determination, this Determination applies to every OPALS which:
 - (a) Are acquired in the 1998 or later income years; and
 - (b) Meet the following criteria:
 - (i) Are issued at a price which is between 95% and 105% of the market value of the Underlying Shares. Any discrepancy between the price and the market value of the Underlying Shares will be due to transactional costs relating to the acquisition of the Underlying Shares, e.g. stamp duty and brokerage; and
 - (ii) Income Stream payments are payable at regular intervals of not more than 12 months; and

- (iii) Income Stream payments are equal to or greater than the amount of all dividends received by the Issuer in respect of the Underlying Shares less all fees, taxes, charges, duties and expenses which are permitted to be deducted under the terms and conditions of the OPALS; and
- (iv) Those Income Stream payments are based on amounts which cannot be predicted at the time the financial arrangement is entered into; and
- (v) The OPALS are not part of another financial arrangement.

4. Principle

- (1) OPALS have both debt and equity components. They can be regarded alternatively as:
 - (a) a loan to the Issuer with repayment in shares and interest payable at a variable rate (debt component); or
 - (b) a forward purchase of shares (in which case the holder of the OPALS is buying shares in businesses and has equity in them).

The accruals rules are not intended to deal with equity, and therefore classify a share (equity) as an excepted financial arrangement (see section OB 1).
- (2) As OPALS have this dual character, when calculating income/expenditure in relation to the OPALS it is first necessary to separate the debt and equity components of the OPALS.
- (3) This Determination specifies that, apart from the Income Stream and amounts attributed to those payments by this Determination, all amounts relate to the Underlying Shares (equity component), and will not be included when calculating gross income or expenditure under the qualified accruals rules.
- (4) Income from OPALS in any income year will be the sum of the Income Stream actually received and the Accrued Income. The Accrued Income is to be ascertained from the relevant Reuters or Bloomberg financial information service page for the balance date of the holder.
- (5) For the purposes of this Determination it is assumed that any change in the market value of the shares between the issue date of OPALS and the conversion into shares is due to the equity component. Therefore the difference in share price can be ignored when calculating income and expenditure under the qualified accruals rules.

5. Interpretation

In this Determination, unless the context otherwise requires:

- (1) Expressions used, except the expression "Income Year", have the same meaning as in section OB 1 of the Income Tax Act 1994.
 - (a) "Accrued Income", in relation to any date, means the product of (a) the number of OPALS held by the holder and (b) the amount showing on the Reuters Multicontributor page "OPALS" or the Bloomberg Multicontributor page "OPAL" as "coupon" at the close of trading in relation to that date.
 - (b) the "Act" means the Income Tax Act 1994.
 - (c) "Income Stream" means any amount payable on the OPALS by the issuer to the holder and includes both cash received and Accrued Income, but does not include payments relating to the redemption or conversion of OPALS.
 - (d) "Income Year"
 - (i) when a taxpayer furnishes a return of income under section 38 of the Tax Administration Act 1994 for an accounting year ending with a balance date other than the 31st day of March, "Income Year" means the period of twelve months ending on that balance date;
 - (ii) for any other person, "Income Year" means the year ending on the 31st day of March in which the income has been derived or expenditure has been incurred by that person.
 - (e) "OPALS" means the hybrid financial arrangements issued by Morgan Stanley Capital (Cayman Islands) Limited called Optimised Portfolios as Listed Securities.
 - (f) "Underlying Shares" in relation to an OPALS means the shares or stock into which the OPALS is convertible, or in which it may be redeemed or paid.
- (2) 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.
- (3) 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.

6. Method

- (1) Amounts to be included when calculating income or expenditure with regard to OPALS to which this Determination applies:
 - (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:
 - (i) Income Stream Payments;
 - (ii) Accrued Income:
 - (b) in respect of the acquisition price, the amounts to be included when calculating income or expenditure are those attributed to Income Stream Payments as set out in subclause 6(3).
- (2) The income derived or expenditure incurred in any Income Year, in respect of OPALS to which this Determination applies shall be calculated using the formula:

$$a - b + c \text{ where:}$$
 - a is the amount of cash received in the Income Year;
 - b is the amount of Accrued Income included as item c in this calculation for the preceding Income Year, if the OPALS in relation to which this calculation is carried out were held at the end of that year, or the amount of Accrued Income as at the date of acquisition of the OPALS, if the OPALS were acquired in that Income Year; and
 - c is the amount of Accrued Income as at the last day of the Income Year.
- (3) For the purposes of the base price adjustment, the amount of the acquisition price of each OPALS shall be determined in accordance with the acquisition price definition as provided in section OB 1 of the Act, with no part of the core acquisition price being attributable to the excepted financial arrangement component of that OPALS.
- (4) If the OPALS on which an Income Stream is payable are sold part way through an Income Stream period, then it is necessary to apportion the income amount between the seller and the purchaser. The seller's income will include Accrued Income as at the date of sale.

7. Examples

Example A

On 13 September 1997, OPALS are issued for \$100 with rights to a variable Income Stream payable half-yearly in arrears. The OPALS will mature on 13 September 1998.

The market value of the share basket at issue date is \$90.00. By conversion date this has risen to \$150.00.



Both the issuer and the holder use a 31 March balance date.

The Income Stream payments are made as follows:

13 March 1998	\$6.00
13 September 1998	\$6.00

Year Ended 31 March 1998

On 31 March 1998 the Reuters financial information service page shows that to date the Accrued Income on the OPALS is \$0.59.

The income derived in respect of the OPALS is to be calculated using the formula in subclause 6(2):

$$a - b + c$$

a = \$6.00 (amount received on 13 March 1998)

b = \$0.00 (OPALS were only issued in the current financial year)

c = \$0.59 (Accrued Income)

Income/Expenditure	\$6.59
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The aggregate amount, if the OPALS run full term, attributable to the debt component of the OPALS and therefore to be taken into account under the accruals rules, is \$12, comprised of the Income Stream Payments. All fluctuations in the value of the Underlying Shares relate to the equity component of the OPALS and should not be taken into account in calculating income or expenditure.

Example B

On 13 November 2002, OPALS are issued for \$100 with a variable income amount payable half-yearly in arrears. The first period is only for 5 months. The OPALS will mature on 13 October 2004.

The market value of the basket of shares at issue date is \$90.00. By conversion date this has risen to \$150.00.

Both the issuer and the holder use a 31 March balance date.

The Income Stream Payments are made as follows:

13 April 2003	\$4.15
13 October 2003	\$5.00
13 April 2004	\$5.00
13 October 2004	\$5.00

(a) *Year Ended 31 March 2003*

On 31 March 2003 the Reuters financial information service page shows that to date the Accrued Income on the OPALS is \$3.79.

The income derived in respect of the OPALS is to be calculated using the formula in subclause 6(2):

$$a - b + c$$

a = \$0.00 (no Income Stream yet received)

b = \$0.00 (OPALS were only issued in the current financial year)

c = \$3.79 (Accrued Income)

Income/Expenditure	\$3.79
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(b) *Year Ended 31 March 2004*

On 31 March 2004 the Reuters financial information service page shows that to date the Accrued Income on the OPALS is \$4.64.

The income derived in respect of the OPALS is to be calculated using the formula in subclause 6(2):

$$a - b + c$$

a = \$9.15 (\$4.15 received 13 April 2003 + \$5.00 received 13 October 2003)

b = \$3.79 (amount of Accrued Income in previous Income Year)

c = \$4.64 (Accrued Income)

Income/Expenditure	\$10.00
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(c) *Year Ended 31 March 2005*

The aggregate amount, if the OPALS run full term, attributable to the debt component of the OPALS and therefore to be taken into account under the accruals rules, is \$19.15, comprised of the Income Stream Payments. All fluctuations in the value of the underlying shares relate to the equity component of the OPALS and should not be taken into account in calculating income or expenditure. As \$13.79 has already been taken into account in previous income years, when undertaking the base price adjustment, the holder will be left with \$5.36 to take into account in the last year of the OPALS.

Example C

On 20 December 2002, the original holder of the OPALS described in Example B sells the OPALS for \$120 to a new holder who holds the OPALS to maturity. The sale of the OPALS takes place part way through an interest period, so it is necessary to apportion the Income Stream Payment between the seller and the purchaser.

On 20 December, the Reuters financial information service page shows that to date the Accrued Income on the OPALS is \$1.01. This amount of \$1.01 is income to the original holder and acquisition price to the new holder and will have to be taken into account under the accruals rules. The original holder would be considered to have sold the equity portion of the OPALS for \$118.99.

Income for the New Holder Year Ended 31 March 2003



On 31 March 2003 the Reuters financial information service page shows that to date the Accrued Income on the OPALS is \$3.79.

The income derived in respect of the OPALS is to be calculated using the formula in subclause 6(2):

$$a - b + c$$

a = \$0.00 (No Income Stream yet received)

b = \$1.01 (amount of Accrued Income as at the date of acquisition)

c = \$3.79 (Accrued Income)

Income/Expenditure	\$2.78
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Year Ended 31 March 2004

As for Example B.

Income \$10.00

Year Ended 31 March 2005

The aggregate amount, if the OPALS run full term, attributable to the debt component of the OPALS, and therefore to be taken into account under the accruals rules, is \$19.15 comprised of the Income Stream Payments. All fluctuations in the value of the underlying shares relate to the equity component of the OPALS and should not be taken into account in calculating income or expenditure. As \$13.79 has already been taken into account in previous income years (\$1.01 by the original holder and \$12.78 by the new holder), when undertaking the base price adjustment, the new holder will be left with \$5.36 to be taken into account in the last year of the OPALS.

This Determination is signed by me on the 10th day of October 1997

Martin Smith

General Manager (Adjudication & Rulings)