

Determination S8: Issue of TC Finance Convertible Capital Notes Denominated in United States Dollars Convertible at the Option of the Issuer

This determination may be cited as "Determination S8: Issue of TC Finance_Convertible Capital Notes Denominated in United States Dollars Convertible at the Option of the Issuer".

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

- (1) The Capital Notes, to be issued by TC Finance on the terms and conditions set out in the US Indenture, constitute a financial arrangement or series of financial arrangements.
- (2) Each Capital Note evidences that the Noteholder has provided money to TC Finance. Subject to the terms of the Capital Note, this money is repayable at a future date in either cash or Telecom Shares or ADRs. Where Capital Notes are redeemed by an issue of Telecom Shares or ADRs, the number of shares or ADRs issued will be calculated in accordance with section 12.4 of the US Indenture. Coupon Interest Payments may be made between the date of the issue of each Capital Note and the redemption date.
- (3) Each Capital Note has a debt and an equity component. The equity component is the option for TC Finance to redeem the Capital Note by procuring the issue of Telecom Shares or ADRs.
- (4) 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.
- (5) This determination sets out the method for determining the amount of any income, gain or loss, or expenditure, in relation to each Capital Note that is solely attributable to the excepted financial arrangement (the equity) component of the Capital Note. In particular, where Capital Notes are converted into, redeemed or paid by the issue or delivery of, Telecom Shares or Telecom ADRs, the income, gain or loss, or expenditure that is solely attributable to the excepted financial arrangement component of the Capital Notes equals any amount by which the value of the Telecom Shares or ADRs (expressed in US Dollars) is above, or below (as the case may be) the Cash Redemption Amount of the Capital Notes that are redeemed for Telecom Shares or ADRs.
- (6) The amount of any gross income, or expenditure for any Capital Note under the qualified accrual rules is therefore the same whether the Capital Note is redeemed for Telecom Shares or ADRs or for cash.
- (7) This determination does not deal with the spreading of accrual income or expenditure under the qualified accruals rules in relation to the issuing and holding of the Capital Notes. In this regard reference should be made to section EH 1 of the



Income Tax Act 1994. Nor does this determination deal with the foreign currency movements in respect of the Capital Note. In this regard reference should again 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.

(2) "Determination G5C: Mandatory Conversion Convertible Notes" does not apply to the Capital Notes because it only applies to mandatory conversion convertible notes. The Capital Notes are not mandatory convertible notes. "Determination G22: Convertible at the Option of the Holder" does not apply to the Capital Notes. The Capital Notes are convertible at the option of the issuer, and denominated in US Dollars.

3. Scope of Determination

(1) This determination shall apply to the Capital Notes issued by TC Finance on the terms and conditions set out in the US Indenture, to the extent that such Capital Notes are denominated in US Dollars, where:

- (a) The Capital Notes are subordinated and otherwise have the ranking provided in Article XI of the US Indenture, but rank ahead of TC Finance's ordinary shares.
- (b) Noteholders do not benefit from any capital growth in Telecom's shares and do not participate in any dividends, or any other distributions made in respect of those shares. No voting rights (in TC Finance or Telecom) attach to the Capital Notes.
- (c) Capital Notes will be issued with an election date for redemption of up to 15 years, and not less than four years, from the relevant date of issue.
- (d) Prior to each election date, Noteholders may elect to retain some or all of their Capital Notes for a further period on new terms and conditions as determined by TC Finance, or to redeem some or all of their Capital Notes. Subject to being solvent (in the opinion of its directors) and the obligations of the pari passu provisions in Article XI of the US Indenture, TC Finance has the option as to whether to redeem the Capital Notes for cash or Telecom Shares (or ADRs). In the event that TC Finance elects to redeem any of the Capital Notes for Telecom Shares (or ADRs), TC Finance will procure the issue by Telecom of such number (fractions being rounded to the next whole number) of Telecom Shares as are equal in value to the Cash Redemption Amount of the Capital Notes which are being redeemed by the issue of Telecom Shares. The value of Telecom Shares or ADRs in such a case means 90% of the average market price of Telecom Shares on the New Zealand Stock Exchange ("NZSE") where applicable, or 90% of the average market price of the Telecom ADRs on the New York Stock Exchange ("NYSE"), as

more particularly determined in accordance with clause 12.4 of the US Indenture.

- (e) The 10% discount to the current average market price at the time of issue of the Telecom Shares, as described in paragraph 3(1)(d) of this determination, only relates to the discount to current market price that may occur if Noteholders sought to realise cash by selling such Telecom Shares or ADRs. In particular, the intention of the discount is that the Noteholder suffers no detriment from any election by TC Finance to redeem the Capital Notes for Telecom shares or ADRs due to the costs of having to exchange such shares or ADRs for cash, and the risk that large scale selling of Telecom Shares or ADRs on the market at that time will put downward pressure on their price.
- (f) To the extent that any Capital Note is redeemed for Telecom Shares (or ADRs), the decision that TC Finance will elect to redeem such Capital Note for Telecom Shares (or ADRs) (as opposed to cash) will not be as a result of any contract, agreement, plan or understanding (whether enforceable or unenforceable) between TC Finance and/or Telecom and any other person to provide a further return or further benefit to that Noteholder.
- (g) Irrespective of any election by a Noteholder, but subject to the subordination and pari passu provisions in Article XI of the US Indenture, TC Finance may (at its option and on a pro rata or non-pro rata basis) purchase or redeem some or all of the Capital Notes for cash.
- (h) If TC Finance cannot redeem the Capital Notes for cash or Telecom Shares (or ADRs) because it would, in the opinion of its directors, not be solvent if it did so, then the election date is reset for a period not exceeding two years. If TC Finance is still unable to redeem the Capital Notes for the same reason, then the Trustee of the Capital Notes is entitled to apply to appoint a liquidator.
- (i) If TC Finance cannot redeem the Capital Notes for Telecom Shares (or ADRs) (because Telecom cannot lawfully issue the shares, or the shares and ADRs are no longer listed, or TC Finance cannot lawfully subscribe for the shares) then the election date is reset for a period not exceeding two years. If TC Finance is still unable to redeem the Capital Notes for Telecom Shares (or ADRs) (for any of the stated reasons) then another election date is set, again for a period not exceeding two years.
- (j) During the period between issue and the relevant election date, each Capital Note will bear interest at a prescribed fixed rate determined as at the time the issue is priced by reference to the relevant US Treasury yield rate and being at the time the issue is priced no more than 60 basis points above the rate at which TCNZ Finance Limited as the primary funder for the Telecom group could issue a similar volume of senior fixed rate bonds denominated in the same currency as the Capital Note and with a maturity equivalent to the term until the initial election date for redemption of that Capital Note, and being no less than such senior fixed rate bond rate. Interest is payable

six-monthly. Unpaid interest bears interest itself and is compounded on each subsequent date for payment of interest.

(2) This determination does not deal with the spreading of accrual income or expenditure under the qualified accruals rules in relation to how those rules apply to the issuing and holding of the Capital Notes. Nor does this determination deal with the translation into New Zealand dollars of the US Dollar denominated Capital Notes.

(3) For the avoidance of doubt, this determination also does not deal in any respect with the manner in which the number, or value, of Telecom Shares (or ADRs) issued, in the event that any Capital Note is redeemed for Telecom Shares (or ADRs), is actually calculated. In this regard, reference should be made to section 12.4 of the US Indenture. (A copy of the US Indenture is available for inspection at the registered office of TC Finance, Telecom Networks House, 68 Jervois Quay, Wellington).

4 Principle

(1) The Capital Note is a hybrid financial arrangement which has a debt and an equity component. The equity component is the option available to TC Finance to procure the issue of Telecom Shares (or ADRs) to Noteholders in lieu of payment in cash of the Cash Redemption Amount.

(2) Any income, gain or loss, or expenditure that is solely attributable to an excepted financial arrangement is not included when calculating gross income or expenditure under the qualified accruals rules.

(3) The effect of this determination is that income and expenditure under the qualified accruals rules will be calculated, in respect of TC Finance, and to the extent applicable the Noteholder of the Capital Note, on the basis that only the difference between the value of the Telecom Shares (or ADRs) (denominated in US Dollars) received by the Noteholder, and the Cash Redemption Amount, is solely attributable to the excepted financial arrangement.

5 Interpretation

In this determination (and the Explanation), unless the context otherwise requires:

Words and expressions used shall have the same meaning as in the Act, except that where there is a conflict between the meaning of an expression used in the qualified accruals rules as defined in section OZ 1 of the Act, and the meaning of the expression elsewhere in the Act, the expression shall have the meaning as in the said qualified accruals rules.

"the Act" means the Income Tax Act 1994.

"ADRs" means Telecom American Depository Receipts.

"Capital Note" or "Capital Notes" means the capital note or capital notes issued by TC Finance on the terms and conditions set out in the US Indenture.

"US Indenture" means the trust deed between TC Finance and The Bank of New York as Trustee dated February 1998.

"Cash Redemption Amount", in respect of Capital Notes to be redeemed by the issue of Telecom Shares or ADRs, means the cash amount expressed in the US Dollars in which the Capital Notes are denominated that, according to the terms of the Capital Notes, the Noteholder of those Capital Notes would receive upon the redemption for cash of the Capital Notes (such amount being the same as the aggregate of the "Redemption Amount" as defined in the US Indenture for those Capital Notes).

"Coupon Interest Payment" or "Coupon Interest Payments" in respect of a Capital Note means any cash amount or amounts expressed in the US Dollars in which the Capital Notes are denominated, paid on the Capital Note by TC Finance to or on behalf of the Noteholder, other than the Cash Redemption Amount.

"Noteholder" or "Noteholders" means a person or person investing in a Capital Note or Capital Notes.

"TC Finance" means Telecom New Zealand Finance Limited.

"Telecom" means Telecom Corporation of New Zealand Limited.

"Telecom Shares" means ordinary shares issued by Telecom.

6 Method

(1) Where any Capital Notes are converted into, redeemed or paid by the issue or delivery of Telecom Shares (or ADRs), the income, gain or loss, or expenditure that is solely attributable to the excepted financial arrangement component of such Capital Notes equals any amount by which the aggregate market value of the number of Telecom Shares (or ADRs) (expressed in the US Dollars in which the Capital Notes are denominated) issued on redemption of those Capital Notes (the number of shares (or ADRs) issued being determined in the manner described at paragraph 3(1)(d) of this determination) is above, or below, (as the case may be) the Cash Redemption Amount for those Capital Notes.

(2) For the purposes of the base price adjustment, the amount of the acquisition price of each Capital Note 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 Capital Note.

(3) No part of the Coupon Interest Payments are attributable to the excepted financial arrangement component of any Capital Note.

7 Examples

Any reference in the following examples to the quantum of any Cash Redemption Amount and the value of Telecom ADRs issued is illustrative only.

Example 1

Investor A notifies TC Finance that Investor A wishes to redeem \$US5,000 of Capital Notes.

TC Finance elects to redeem the Capital Notes by procuring the issue of Telecom ADRs rather than for cash. The Capital Notes to be redeemed for Telecom ADRs have a Cash Redemption Amount of \$US5,400 (being the principal amount of the Capital Notes (\$US5,000) and accrued interest, less any withholding taxes (\$US400)).

Investor A receives Telecom ADRs in accordance with the formula prescribed in the US Indenture. For the purposes of this example those ADRs are assumed to have a market value of \$US5,600 on the date that the Capital Notes are redeemed.

In accordance with the method prescribed in paragraph 6 of this determination, for TC Finance, and to the extent applicable Investor A, the amount solely attributable to the excepted financial arrangement is:

\$US5,600 (being the market value of the ADRs expressed in the US Dollars in which the Capital Notes are denominated) - \$US5,400 (being the Cash Redemption Amount) = \$US200 (being the amount solely attributable to the excepted financial arrangement).

Therefore, where TC Finance elects to redeem the Capital Notes by procuring the issue of Telecom ADRs the result for TC Finance, and to the extent applicable Investor A, is that the relevant amount required to be included in calculating the gross income, or expenditure for the purposes of the qualified accruals rules, is the Cash Redemption Amount.



Example 2

Investor B notifies TC Finance that Investor B wishes to redeem \$US5,000 of Capital Notes.

Of the \$US5,000 Capital Notes to be redeemed, TC Finance elects to redeem \$US2,000 of the Capital Notes by procuring the issue of Telecom ADRs rather than for cash. The Capital Notes to be redeemed for Telecom ADRs have a Cash Redemption Amount of \$US2,200 (being the principal amount of those Capital Notes (\$US2,000) and accrued interest, less my withholding taxes, in respect of those Capital Notes, (\$US200)).

Investor B receives Telecom ADRs in accordance with the formula prescribed in the US Indenture. For the purposes of this example those ADRs are assumed to have a market value of \$US2,300 on the date that the Capital Notes are redeemed.

In accordance with the method prescribed in paragraph 6 of this determination, for TC Finance and to the extent applicable Investor B, the amount solely attributable to the excepted financial arrangement is:

\$US2,300 (being the market value of the ADRs expressed in the US Dollars in which the Capital Notes are denominated) - \$US2,200 (being the Cash Redemption Amount) = \$US100 (being the amount solely attributable to the excepted financial arrangement).

Therefore, where TC Finance elects to redeem some of the Capital Notes by procuring the issue of Telecom ADRs, the result for TC Finance and to the extent applicable Investor B, is that the relevant amount required to be included in calculating the gross income, or expenditure for the purposes of the qualified accruals rules in respect of those Capital Notes redeemed for Telecom ADRs, is the Cash Redemption Amount.

This determination is signed by me on the 2nd day of February 1998.

Martin Smith
General Manager (Adjudication & Rulings)