
TIB Appendices

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Determination G5A: Mandatory Conversion Convertible Notes

This determination may be cited as “Determination G5A: Mandatory Conversion Convertible Notes”

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

This determination rescinds and replaces Determination G5: Mandatory Conversion Convertible Notes, made on 5 August 1987.

Apart from minor amendments, this determination differs from Determination G5: Mandatory Conversion Convertible Notes only by expanding the Scope of the Determination. This amendment allows an initial or final coupon interest payment to be ignored for the purpose of determining whether the coupon interest payments under the note are payable at regular intervals and are of equal amounts.

A mandatory conversion convertible note is a financial instrument which is redeemable only in company shares. Coupon interest may be payable on the note for the period between issue and redemption.

This determination details the manner in which income derived and expenditure incurred in respect of a mandatory conversion convertible note is to be calculated. It also prescribes the method for calculating the part of the income or expenditure that is attributable to an excepted financial arrangement.

2. Reference

This determination is made pursuant to section 64E(1)(b) and (e) and section 64E(6) of the Income Tax Act 1976.

3. Scope of Determination

Except where its application is specifically excluded in another determination, this determination applies to every mandatory conversion convertible note where -

- (a) Conversion is at a predetermined ratio into shares of a company; and
- (b) Coupon interest payments, if any, are payable at regular intervals of not more than twelve months and are either of equal amount or are set in relation to a market interest rate indicator:

Provided that for the purposes of this paragraph, where, by reason only of -

- (i) The issue date of the convertible note;
- (ii) The conversion date of the convertible note -

the condition set out in this paragraph is not met in respect of any coupon interest payment and the rate at which the payment is calculated is consistent with the other coupon interest pay-

ments required under the convertible note, this determination shall apply as if the condition were met; and

- (c) The market value of the underlying shares at the date of issue of the note is not less than eighty percent of the acquisition price of the note on that date; and
- (d) The note is not part of another financial arrangement.

4. Principle

A mandatory conversion convertible note is a hybrid of debt and equity. It can be regarded alternatively as a loan with repayment in shares or as a forward purchase of shares. As a share is an excepted financial arrangement (section 64B of the Act) it is necessary to arbitrarily separate the debt and equity components of the note.

This determination treats all amounts in respect of a note other than the coupon interest payments as relating to the underlying shares. Income and expenditure in respect of the note is calculated by pro rata daily apportionment of the coupon interest payments to income years.

Changes in market conditions may impact on the value of a note on a secondary market. Due to the difficulty in accurately attributing the effects of such market changes between the debt and equity components of the note it is assumed that any changes in value on a secondary market are due to the equity component.

5. Interpretation

In this determination, unless the context otherwise requires -

- (a) Expressions used, except the expression “income year”, have the same meanings as in section 2 and section 64B of the Income Tax Act 1976;
- (b) “Coupon interest payment” means any amount payable on the note by the note issuer to the note holder other than payments relating to the redemption or conversion of the note;
- (c) “Income year” means -
 - (i) Where a taxpayer furnishes a return of income under section 15 of the Income Tax Act 1976 for an accounting year ending with a balance date other than the 31st day of March, the period of twelve months ending on that balance date; or
 - (ii) In respect of any other person, the year in which the income has been derived by the person:

(d) "Mandatory conversion convertible note", or "note", means any debenture, bond, certificate, document, note, or writing issued or given by a company -

(i) Evidencing, acknowledging, creating, or relating to a loan to the company or any money subscribed to the company or any other liability of the company, whether or not there is a charge over the undertaking or any of the assets of the company securing the whole or any part of the amount in respect of which the company has issued or given the note; and

(ii) Providing, pursuant to a trust deed or otherwise, and whether exclusively or not, for that amount, with or without interest thereon and whether at par or otherwise, to be converted into, or to be redeemed or paid by the issue of, shares or stock in the capital of a company, where the conversion, redemption, or payment by the issue of shares or stock is mandatory.

(e) "Underlying shares", in relation to a note, means the shares or stock into which the note is convertible, or in which it may be redeemed or paid.

6. Method

(1) The part of a mandatory conversion convertible note that is attributable to the underlying shares shall be -

(a) In respect of income, gain or loss, or expenditure, and also in respect of consideration receivable by the holder or payable by the issuer: all amounts other than coupon interest payments;

(b) In respect of the acquisition price: the acquisition price of the note.

(2) The income derived or expenditure incurred in respect of a mandatory conversion convertible note shall be calculated by daily apportionment of the coupon interest payments to income years pursuant to Determination GIA: Apportionment of Daily Income and Expenditure.

7. Example

Example A

On 13 September 1987 a convertible note is issued for \$100 with an interest coupon of 12 percent payable semi-annually in arrears. The note is mandatorily convertible to ten shares in the issuing company on 13 September 1988. The market value of each share at issue date is \$9 and by conversion date this has risen to \$15. Both the issuer and holder use a 31 March balance date and apply Determination GIA on a 365 day basis.

The coupon interest payments are made as follows:

13 March 1988	\$6.00
13 September 1988	\$6.00

(a) Year ended 31 March 1988

Coupon payment 13/3/88	\$6.00
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Apportionment of coupon payment 13/9/88	
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There are 18 days between 13 March and 31 March 1988, and 184 days between 13 March and 13 September 1988

$18/184 \times \$6.00 =$	<u>\$0.59</u>
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Income/Expenditure	\$6.59
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(b) Year ended 31 March 1989

As the note matures in this year the base price adjustment (section 64F of the Act) is required. The formula $a - (b + c)$ is applied using the following values:

a (all consideration paid)	=	\$12.00
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b (acquisition price)	=	0
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c (amounts in previous years)	=	\$ 6.59
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Income/Expenditure	=	$a - (b + c)$
	=	$\$12.00 - (0 + \$6.59)$
	=	\$5.41

As all amounts other than the coupon payments are deemed to be attributable to the underlying shares, the issue price and share market values can be ignored for the purposes of calculating income and expenditure. This effectively gives the note an acquisition price of nil (for accrual purposes) hence the zero value of "b" in the above base price adjustment.

Example B

On 13 November 1991 a convertible note is issued for \$100 with an interest coupon of 10 percent payable semi-annually in arrears with the exception of the first period which is of five months. The note is mandatorily convertible to ten shares in the issuing company on 13 October 1993. The market value of each share at issue date is \$9 and by conversion date this has risen to \$15. Both the issuer and holder use a 31 March balance date and apply Determination GIA on a 365 day basis.

The coupon interest payments are made as follows:

13 April 1992	\$4.15
13 October 1992	\$5.00
13 April 1993	\$5.00
13 October 1993	\$5.00

(a) Year ended 31 March 1992

Apportionment of coupon payment 13/4/92	
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There are a total of 152 days in the first period. Of these 139 are in the year ended 31 March 1992.

$$139/152 \times \$4.15 = \$3.80$$

Income/Expenditure \$3.80

(b) Year ended 31 March 1993

Apportionment of coupon payment
13/4/92

$$13/152 \times \$4.15 = \$0.35$$

Coupon payment 13/10/92 \$5.00

Apportionment of coupon payment
13/4/93

There are a total of 182 days in the period between payments. Of these 169 are in the year ended 31 March 1993.

$$169/182 \times \$5.00 = \$4.64$$

Income/Expenditure \$9.99

(c) Year ended 31 March 1994

As the note matures in this year the base price adjustment (section 64F of the Act) is required. The formula a D (b + c) is applied using the following values:

$$a \text{ (all consideration paid)} = \$19.15$$

$$b \text{ (acquisition price)} = 0$$

$$c \text{ (amounts in previous years)} = \$13.79$$

$$\begin{aligned} \text{Income/Expenditure} &= a - (b + c) \\ &= \$19.15 - (0 + \$13.79) \\ &= \$5.36 \end{aligned}$$

As all amounts other than the coupon payments are deemed to be attributable to the underlying shares, the issue price and share market values can be ignored for the purposes of calculating income and expenditure. This effectively gives the note an acquisition price of nil (for accrual purposes) hence the zero value of "b" in the above base price adjustment.

This determination is signed by me on the 7th day of November in the year 1991.

R D Adair
Deputy Commissioner of Inland Revenue

TIB Appendix B

Exemption D3: Exemption from the Requirements to Disclose Interrelated Arrangements under Section 64H(1) of the Income Tax Act 1976

Overview of Exemption D3

1. Introduction

The Commissioner has issued an exemption from the obligation to disclose interrelated arrangements under section 64H(1) of the Income Tax Act 1976 ("the Act"). This exemption, D3, applies to the income years commencing 1 April 1991 and 1 April 1992. The full text of the exemption is provided later in this Appendix.

This item sets out the background to the exemption, and gives a description of its provisions.

2. Background

(a) Section 64H(1) of the Act requires taxpayers to disclose details of interrelated arrangements to the Commissioner.

(b) The Commissioner has power under section 64H(2) of the Act to exempt a person or class of persons from this disclosure obligation. Such an exemption can apply to particular financial arrangements or classes of financial arrangements where the making of that type of financial arrangement is a generally accepted commercial practice.

(c) To date the Commissioner has issued two exemptions under section 64H(2). The first exemption was for the income year commencing 1 April 1985 and the succeeding four years. The second exemption, D2, was for the income year commencing 1 April 1990.

(d) These two exemptions exempted all taxpayers from the obligation to disclose an interrelated financial arrangement where:

(i) the making of the interrelated arrangement was a generally accepted commercial practice; and

(ii) the interrelated arrangement was of a type specified in the schedules to the exemptions.

(e) The Commissioner has issued a further exemption, D3, which applies to the income years commencing 1 April 1991 and 1 April 1992. This exemption exempts all interrelated arrangements from disclosure where:

(i) the making of the interrelated arrangement is a generally accepted commercial practice; and

- (ii) the interrelated arrangement is not of a kind specified in the schedule to the exemption.

3. Exemption D3

The exemption, after defining various terms for the purposes of the exemption, then states that -

Any person who in an income year is party to an interrelated arrangement shall be exempt from the requirements of section 64H(1) of the Income Tax Act 1976 in respect of the interrelated arrangement and the income year where -

- (a) The making of the interrelated arrangement is a generally accepted commercial practice; and
- (b) The interrelated arrangement is not of a kind specified in the Schedule hereto.

The important point to note is that the previous exemptions exempted from disclosure the interrelated arrangements that were listed in the schedules to the exemptions. The new exemption takes the reverse approach. The new exemption exempts all interrelated arrangements from disclosure unless they are one of the types listed in the schedule to the exemption (or the making of the interrelated arrangement is not a generally accepted commercial practice).

4. Generally Accepted Commercial Practice

It is important to note that the Commissioner has power to issue an exemption under section 64H(2) only in respect of a financial arrangement the making of which is a generally accepted commercial practice. It follows from this that any interrelated arrangement the making of which is not a generally accepted commercial practice must be disclosed, regardless of whether it is of a type referred to in the schedule to the exemption.

In the Commissioner's view tax avoidance is not a generally accepted commercial practice. Any interrelated arrangement that has a purpose or effect of tax avoidance must be disclosed under section 64H(1).

5. The Schedule to the Exemption

The schedule to the exemption describes 5 categories of interrelated arrangements that must be disclosed. The wording of the schedule is set out below together with a discussion of the scope of each category.

Residents and Non-residents

Any interrelated arrangement where:

- a) The parties to one of the arrangements making up the interrelated arrangement include both a resident of New Zealand and a non resident of New Zealand;

- b) The value of the interrelated arrangement exceeds \$2 million at any time in the income year; and
- c) The interrelated arrangement has a purpose other than only to achieve the exchange of a sum of money in one currency for an equivalent sum of money in another currency, such exchange not being subject to any agreement to reverse the exchange at some future date.

Points to note in relation to this category are that -

- a) It does not apply to arrangements to exchange one currency for another (except where there is an arrangement to reverse the exchange at a later date).
- b) A person is a New Zealand resident for the purposes of the exemption in respect of an activity or arrangement carried on through a fixed establishment in New Zealand (see the interpretation section of the exemption). The term fixed establishment is defined in section 2 of the Act as being:

in relation to any person, means a fixed place of business in which substantial business is carried on by that person; and includes-

- (a) A branch, factory, shop, or workshop in which in each case substantial business is carried on; and
- (b) A mine, quarry, oil well, or other place of natural resources subject to exploitation; and
- (c) An agricultural, pastoral, or forestry property;- but does not include-
- (d) The use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to a business; or
- (e) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information or for advertising for a business;

For example A Co, an Australian company that operated through a branch in New Zealand, would have a fixed establishment in New Zealand. For the purposes of this exemption, A Co would therefore be deemed to be a resident of New Zealand in relation to any interrelated arrangement it entered into in respect of that fixed establishment. If A Co entered into an interrelated arrangement in respect of the fixed establishment with a New Zealand resident, the interrelated arrangement would be between two New Zealand residents and would not require disclosure. On the other hand if A Co entered into an interrelated arrangement in respect of the fixed establishment with B Co, another Australian company, that interrelated arrangement would be between a resident (A Co) and a non-resident (B Co) and would need to be disclosed.

- c) A person is not a New Zealand resident for the purpose of the exemption in relation to an activity or arrangement carried on through a fixed establishment outside New Zealand. For example NZ Co, a New Zealand company which operated a manufacturing business in Australia, has a fixed establishment in Australia. NZ Co would therefore be a non-resident for the purposes of the exemption in respect of any interrelated arrangement entered into in relation to that Australian fixed establishment. An interrelated arrangement between NZ Co and a non-resident in relation to the Australian manufacturing business would be an interrelated arrangement between two non-residents and would not be subject to disclosure. On the other hand an interrelated arrangement between NZ Co and a New Zealand resident in relation to the Australian manufacturing business would be an interrelated arrangement between a resident and a non-resident (NZ Co) and would be subject to disclosure.
- d) Only interrelated arrangements with a value in excess of \$2 million at any time during the income year must be disclosed. The rules for valuing interrelated arrangements are set out in the Interpretation section of the Exemption.

Perpetual Notes

Any interrelated arrangement where one of the arrangements making up the interrelated arrangement is a perpetual note and the value of the interrelated arrangement exceeds \$2 million at any time in the income year.

The following arrangement would fall into this category:

- a) A Co issued perpetual notes with a face value of \$2.5 million to B Co.
- b) The perpetual notes pay coupon interest of 10% p.a. in arrears in perpetuity.
- c) B Co sold the right to receive interest from the perpetual notes for years 6 to infinity to C Co a subsidiary of A Co.

Only interrelated arrangements with a value in excess of \$2 million at any time during the income year must be disclosed. The rules for valuing interrelated arrangements are set out in the Interpretation section of the Exemption.

Preference Shares

Any interrelated arrangement where:

- a) One of the arrangements making up the interrelated arrangement is a share in a company which does not rank equally with the ordinary shares in the company in terms of voting rights and rights to distributions; and
- b) The value of the interrelated arrangement ex-

ceeds \$2 million at any time in the income year.

The following arrangement would fall into this category:

- a) A Co lent \$1 million to B Co for 5 years at 10% interest p.a.
- b) It was a term of the arrangement that B Co issue \$1.1 million in redeemable preference shares to A Co. The shares were to be redeemed in 5 years and pay a fixed dividend of 12% p.a.

Only interrelated arrangements with a value in excess of \$2 million at any time during the income year must be disclosed. The rules for valuing interrelated arrangements are set out in the Interpretation section of the Exemption. In the above example the value of the interrelated arrangement is found by adding the amount of the loan to the value of the redeemable preference shares. The value of the interrelated arrangement therefore exceeds \$2 million and it must be disclosed.

Related Pricing

Any interrelated arrangement where -

- a) In respect of one of the arrangements ("the sub-arrangement") making up the interrelated arrangement, the amount of consideration provided or received by one of the parties under the sub-arrangement is influenced by the fact that the sub-arrangement is part of an interrelated arrangement; and
- b) The value of the interrelated arrangement exceeds \$2 million at any time in the income year:

Provided that this provision shall not apply to an interrelated arrangement where the amount of consideration to be provided or received by one of the parties to the sub-arrangement is influenced only by the existence of a security arrangement as part of the interrelated arrangement.

The following interrelated arrangement would fall into this category:

- a) Company A leased a building from company B for a term of 3 years for a rental of \$200,000 p.a. A normal market rental for the premises would be \$250,000 p.a.
- b) It was a term of the arrangement between the parties that Company A lend \$2 million to Company B at 7.5% interest for 3 years. The normal market rate of interest for a loan of the type in this arrangement would be 10% p.a.

This interrelated arrangement requires disclosure under this category because the amount of consideration provided under the sub-arrangements is influenced by the fact that the sub-arrangements are part of the interrelated arrangement. The rental for the building (to be received by Company B) was set at \$50,000 below a normal market rental because the interest on the loan (to be paid by Company B) was

\$50,000 p.a. below the market rate. The pricing of one sub-arrangement was influenced by the pricing of the other sub-arrangement.

The proviso to this category removes the need to disclose interrelated arrangements where the pricing of a sub-arrangement is influenced only by the existence of a security arrangement. For example, a lender may be prepared to lend money at 15% interest unsecured. On the other hand the same lender will lend money at 12% if the loan is secured by a mortgage given over a related party's property. In this situation the loan and the mortgage make up an interrelated arrangement and the consideration that is paid under the loan is influenced by the existence of the interrelated arrangement. If the loan was not part of an interrelated arrangement (i.e., if the mortgage was not given) the interest rate would have been higher. The proviso makes it clear that this type of interrelated arrangement does not have to be disclosed.

Large Arrangements

Any interrelated arrangement with a value which exceeds \$20 million at any time in the income year.

The rules for valuing interrelated arrangements are set out in the Interpretation section of the Exemption. If the value of the interrelated arrangement exceeds \$20 million it must be disclosed.

6. Disclosure Return

Where an interrelated arrangement is not exempted from disclosure by this exemption (i.e., it is one of the types of interrelated arrangements referred to in the schedule or the making of the interrelated arrangement is not a generally accepted commercial practice) details of it must be provided to the Commissioner. These details are to be provided to the Commissioner on the prescribed Disclosure Return, the IR 4A. This return is to be filed together with the taxpayer's annual income tax return.

Reference: HO Accrual T 185
Technical Rulings Chapter 14.12.3

Exemption D3

1. Explanation

Section 64H(1) of the Income Tax Act 1976 requires the disclosure of all financial arrangements that are interrelated arrangements.

This exemption removes the disclosure requirement in respect of all interrelated arrangements, the making of which is a generally accepted commercial practice, except for those interrelated arrangements referred to in the Schedule to this exemption.

2. Reference

This exemption is made pursuant to section 64H(2) of the Income Tax Act 1976.

3. Scope of exemption

This exemption shall apply to the income years commencing 1 April 1991 and 1 April 1992.

4. Interpretation

In this exemption, unless the context otherwise requires -

- (a) Expressions used have the same meaning as in the Income Tax Act 1976:
- (b) Every reference to an income year shall, where a person furnishes a return of income under section 15 of the Income Tax Act 1976 for an accounting year ending with a day other than the 31st day of March, be deemed to be a reference to the accounting year corresponding with that income year:

- (c) "Interrelated Arrangement" means a financial arrangement that consists of two or more arrangements, whether or not those arrangements are themselves financial arrangements:
- (d) "Liability" includes a contingent liability:
- (e) A person shall be deemed not to be a resident of New Zealand in relation to any activity or arrangement carried on through a fixed establishment outside New Zealand.
- (f) A person shall be deemed to be a resident of New Zealand in relation to any activity or arrangement carried on through a fixed establishment in New Zealand.
- (g) "Value", in relation to any arrangement, means -
 - (i) In relation to any variable principal debt instrument, other than an interrelated arrangement, the amount of money owing to the holder pursuant to the arrangement:
 - (ii) In relation to any fixed principal debt instrument, other than an interrelated arrangement or an instrument involving a notional principal, the greater of the acquisition price of the arrangement or the nominal or face value of the arrangement:
 - (iii) In relation to any security arrangement, the greater of -
 - (A) The amount of the maximum liability of the surety under the security arrangement:

(B) The sum of the values of the financial arrangements wholly or partially secured by the security arrangement:

(iv) In relation to any financial arrangement involving a notional principal (for example, certain types of interest rate or currency swaps, forward rate agreements, certain futures contracts), the amount of the notional principal:

(v) In relation to any arrangement which is not a financial arrangement, the total amount of consideration required to be provided under the arrangement by the person having the greatest liability under the arrangement:

(vi) In relation to any interrelated arrangement, the sum of the values of the arrangements that constitute the interrelated arrangement:

Provided that where, under an interrelated arrangement, consideration is required to be passed between persons more than once and as a consequence an amount would, but for this proviso, be required to be taken into account more than once in calculating the value of an inter-related arrangement, that amount shall not be taken into account more than once in calculating the value of the financial arrangement:

Provided also that where the value can be ascertained pursuant to more than one of the foregoing subparagraphs, the value shall be ascertained pursuant to the subparagraph that provides the greatest value.

5. Exemption

Any person who in an income year is party to an interrelated arrangement shall be exempt from the requirements of section 64H(1) of the Income Tax Act 1976 in respect of the interrelated arrangement and the income year where -

(a) The making of the interrelated arrangement is a generally accepted commercial practice; and

(b) The interrelated arrangement is not of a kind specified in the Schedule hereto.

This exemption is signed by me on the 7th day of November in the year 1991.

R D Adair
Deputy Commissioner of Inland Revenue

Schedule

1. Any interrelated arrangement where:

a) The parties to one of the arrangements making up the interrelated arrangement include both a resident of New Zealand and a non resident of New Zealand;

b) The value of the interrelated arrangement exceeds \$2 million at any time in the income year; and

c) The interrelated arrangement has a purpose other than only to achieve the exchange of a sum of money in one currency for an equivalent sum of money in another currency, such exchange not being subject to any agreement to reverse the exchange at some future date.

2. Any interrelated arrangement where one of the arrangements making up the interrelated arrangement is a perpetual note and the value of the interrelated arrangement exceeds \$2 million at any time in the income year.

3. Any interrelated arrangement where:

a) One of the arrangements making up the interrelated arrangement is a share in a company which does not rank equally with the ordinary shares in the company in terms of voting rights and rights to distributions; and

b) The value of the interrelated arrangement exceeds \$2 million at any time in the income year.

4. Any interrelated arrangement where -

a) In respect of one of the arrangements ("the sub-arrangement") making up the interrelated arrangement, the amount of consideration provided or received by one of the parties under the sub-arrangement is influenced by the fact that the sub-arrangement is part of an interrelated arrangement; and

b) The value of the interrelated arrangement exceeds \$2 million at any time in the income year:

Provided that this provision shall not apply to an interrelated arrangement where the amount of consideration to be provided or received by one of the parties to the sub-arrangement is influenced only by the existence of a security arrangement as part of the interrelated arrangement.

5. Any interrelated arrangement the value of which exceeds \$20 million at any time in the income year.