TIB Appendix

Volume Five, No. 9 February 1994

Determination G5C: Mandatory conversion convertible notes

This determination may be cited as "Determination G5C: Mandatory Conversion Convertible Notes".

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

(1) This determination replaces Determination G5B: Mandatory Conversion Convertible Notes for notes entered into on, or after, the date of publication of this determination in the Gazette.

(2) A Mandatory Conversion Convertible Note is a financial arrangement in which the holder of the Note provides money to a company, and the debt is discharged at a future date by the issue of shares (or stock) in any company. Interest may be payable for the period between the issue of the Note and conversion into shares. Such payments are called Coupon Interest Payments.

(3) As a share is an excepted financial arrangement under section 64B of the Act, only the Coupon Interest Payments and amount attributed to those payments by this determination are regarded as income or expenditure for the purposes of calculating accrual income or expenditure.

(4) Determination G5C prescribes the method to be used when calculating for accrual purposes the income derived or expenditure incurred in respect of a Mandatory Conversion Convertible Note. It also details which amounts are to be included for this calculation, and which are attributable to an excepted financial arrangement.

(5) Determination G5C differs from Determination G5B by

(a) broadening the scope of the determination so that it applies to a Mandatory Conversion Convertible Note converting into shares in a company other than the company that issued the Note; and

(b) narrowing the scope of the determination so that it only applies to a Mandatory Conversion Convertible Note where the interest rate is not less than 5% pa (or half of the interest rate the issuer would have paid on cash repayment borrowings if lower) nor more than 15% pa (or double of the interest rate the issuer would have paid on cash repayment borrowings if higher).

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, Determination G5C applies to every Mandatory Conversion Convertible Note which:

(1) Is entered into on, or after, the date of publication in the Gazette (however, it does not apply to notes which are issued pursuant to a binding contract entered into before the date of publication); and

(2) Meets the following criteria:

(a) conversion into shares of a company is at a predetermined ratio; and

(b) Coupon Interest Payments are payable at regular intervals of not more than 12 months; and

(c) Coupon Interest Payments are of equal amount, or are set in relation to a market interest rate indicator (if this condition is not satisfied because of the issue date or conversion date of the Note, but the rate at which the payment is calculated is consistent with the other Coupon Interest Payments required under the Note, this determination shall apply as if the condition were met); and

(d) the constant annual rate R calculated using Determination G3: Yield to Maturity Method, applied to the Mandatory Conversion Convertible Note is:

(i) not less than the lesser of:

(A) 5% pa; or

(B) half the annual coupon which the company issuing the Note would have had to pay on similarly secured borrowings of similar amount as at the date of issue; and

(ii) not more than the greater of:

(A) 15% pa; or

(B) twice the coupon which the company issuing the Note would have had to pay on similarly secured borrowings of similar amount as at the date of issue; and

taking into account the amount or amounts payable by the holder consequent upon issue and assuming that -

(iii) Coupon Interest Payments will be paid to the holder in accordance with the terms of the Note provided that if the Coupon Interest Payments are set in relation to a market interest rate indicator, the value of that indicator as at the issue date shall be assumed to apply for the term of the Note; and

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(iv) the only payment (other than a coupon payment) made to the holder on the conversion of the Note is a cash payment equal to the issue price of the Note; and

(e) the Note is not part of another financial arrangement.

4. Principle

(1) A Mandatory Conversion Convertible Note has both debt and equity components. It can be regarded alternatively as:

(a) a loan to a company with repayment in shares (debt component); or

(b) a forward purchase of shares (in which case the holder of the Note is buying a share of a business and has equity in it).

The accruals regime is not intended to deal with equity, and therefore classifies a share (equity in a business) as an excepted financial arrangement (see section 64B).

(2) As a Mandatory Conversion Convertible Note has this dual character, when calculating income/ expenditure in relation to the Note it is first necessary to separate the debt and equity components of the Note.

(3) This determination specifies that, apart from the Coupon Interest Payments and amounts attributed to those payments by this determination, all amounts relate to the underlying shares (equity component), and will not be dealt with under the accruals regime (section 64B to 64M) when calculating assessable income.

(4) Income and expenditure in respect of the Note is calculated by pro-rata daily apportionment of the Coupon Interest Payment to income years.

(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 the Note 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.

(6) This approach may not be appropriate where the coupon interest rate is so much above or below market rates at the time of issue that it may represent an adjustment between the acquisition price of the Mandatory Conversion Convertible Note and the expected value, as at the time of issue, of the underlying shares at the time of conversion. This determination has therefore been limited as set out in paragraph (d) of subclause 3(2).

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 2 and section 64B of the Income Tax Act 1976.

(a) the "Act" means the Income Tax Act 1976.

(b) "Coupon Interest Payment" means any amount payable on the Note by the Note issuer (borrower) to the Note holder (lender) other than payments relating to the redemption or conversion of the Note.

(c) "Income Year"

(i) when a taxpayer furnishes a return of income under section 15 of the Act 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.

(d) "Mandatory Conversion Convertible Note", or "Note" means any debenture, bond, certificate, document, note or writing issued or given by a company:

(i) which provides evidence that the company is indebted to the holder of the Note, whether for a loan to the company, money subscribed to the company or any other liability of the company (whether or not the amount for which the company has issued the Note is secured over the undertaking or any of the assets of the company); and

(ii) which provides for the debt to be discharged only by the issue of shares in the capital of any company. This may be pursuant to a trust deed.

(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.

(2) A determination to which Determination G5C 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 a Mandatory Conversion Convertible Note:

(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/expenditure consist of:

(i) Coupon Interest Payments;

(ii) amounts attributed to Coupon Interest Payments as set out in subclause 6(3).

(b) in respect of the acquisition price, the amounts to be included when calculating income/expenditure are those attributed to Coupon Interest Payments as set out in subclause 6(4).

(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. For the method, see Determination G1A: Apportionment of Daily Income and Expenditure.

(3) If a Mandatory Conversion Convertible Note on which interest is payable is sold part way through an interest period, then it is necessary to apportion the Coupon Interest Payment between the seller and the purchaser. The seller is allocated interest, on a daily straight line basis, that accrues before the date of sale. (See Example C).

Note: If the Coupon Interest Payment is not known until after the date of sale, it shall be assumed to be equal to the Coupon Interest Payment for the previous period (adjusted for any difference in the length of the period).

(4) The portion of the sale price thus attributed to accrued interest and allocated to the seller is, in turn, treated as the purchaser's acquisition price of the financial arrangement. If the purchaser later receives the Coupon Interest Payment for the sale period, then this portion attributed to accrued interest may be immediately offset against the amount received when calculating the amount of income derived from the financial arrangement in that year. (See Example C).

7. Example

Example A

On 13 September 1987 a convertible Note is issued for $100 with an interest coupon of 12% pa payable half-yearly in arrears. The Note is mandatorily convertible on 13 September 1988 to 10 shares in the issuing company.

The market value of each share at issue date is $9.00. By conversion date this has risen to $15.00.

Both the issuer and the holder use a 31 March balance date and apply Determination G1A on a 365 day basis when apportioning daily income and expenditure.

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

Apportionment of coupon payment due on 13/9/88. There are 18 days between 13 March and 31 March 1988, and 184 days between 13 March and 13 September 1988

18/184 x $6.00	<u>$0.59</u>
Income/Expenditure	$6.59

(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.

a = the sum of all amounts paid ($12.00)

b = acquisition price

c = income/expenditure in previous years ($6.59).

As all amounts other than the coupon payments are attributable to the underlying shares, the issue price and sharemarket value can be ignored for the purposes of calculating income and expenditure. This effectively gives the Note an acquisition price of nil (for accrual purposes). Therefore, in this example "b" has a value of zero.

Income/Expenditure = a - (b + c)
= $12.00 - (0 + $6.59)
= $5.41

Example B

On 13 November 1992 a convertible Note is issued for $100 with an interest coupon of 10% pa payable half-yearly in arrears. The first period is only for 5 months. The Note is mandatorily convertible on 13 October 1994 to 10 shares in the issuing company.

The market value of each share at issue date is $9.00. By conversion date this has risen to $15.00.

Both the issuer and the holder use a 31 March balance date and apply Determination G1A on a 365 day basis when apportioning daily income and expenditure.

The Coupon Interest Payments are made as follows:

13 April 1993	$4.15
13 October 1993	$5.00
13 April 1994	$5.00
13 October 1994	$5.00

(a) Year Ended 31 March 1993

Apportionment of coupon payment due on 13/4/93. There are a total of 151 days in the first period. Of these, 138 are in the Income Year ended 31 March 1993.

138/151 x $4.15	$3.79
Income/Expenditure	$3.79

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(b) Year Ended 31 March 1994

Apportionment of coupon payment due on 13/4/94. There are a total of 151 days in the first period. Of these, 13 are in the year ended 31 March 1994.

13/151 x $4.15	$ 0.36
Coupon Payment due on 13/10/93	$ 5.00

Apportionment of coupon payment due on 13/4/94. There are a total of 182 days in the period between payments. Of these, 169 are in the year ended 31 March 1994

169/182 x $5.00	$ 4.64
Income/Expenditure	$10.00

(c) Year Ended 31 March 1995

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:

a = sum of all amounts paid ($19.15)

b = acquisition price

c = income/expenditure in previous years ($13.79)

As all amounts other than the coupon payments are 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 in this example “b” has a value of zero.

Income/Expenditure = a - (b + c)
= $19.15 - (0 + $13.79)
= $5.36

Example C

The original holder of the Note described in Example B sells the Note on 20 December 1992, for $120, to a new holder who holds the Note to maturity. The sale of the Note takes place part way through an interest period, so it is necessary to apportion the Coupon Interest Payment between the seller and the purchaser.

The Coupon Interest Payment for this period amounts to $4.15. Using a straight-line apportionment, $1.01 of the $4.15 is attributable to that portion of the period ending 20 December 1992 during which the Note is owned by the original holder ($4.15 x 37/151). There are 151 days in the coupon period, and there are 37 days from the beginning of the period until the day that the Note is sold. This amount of $1.01 is income to the original holder and acquisition price to the new holder. The original holder would be considered to have sold the equity portion of the convertible Note for $118.99.

(a) Income For The Original Holder: Year Ended 31 March 1993

Since this is the final year of the arrangement from the point of view of the original holder, the base price adjustment is applied, using the following values:

a = the sum of all amounts paid ($1.01)

b = acquisition price

c = income/expenditure in previous years ($0)

Income = a - (b + c)
= $1.01 - (0 + 0)
= $1.01

(b) Income For The New Holder: Year Ended 31 March 1993

Apportionment of coupon payment 13/4/93. There are a total of 151 days in the first period. Of these, 138 are in the year ended 31 March 1993.

138/151 x $4.15	$3.79
From this, the holder can subtract the acquisition price	$1.01
Income/Expenditure	$2.78

(c) Year Ended 31 March 1994

As for Example B.

Income	$10.00

(d) Year Ended 31 March 1995

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:

a = the sum of all amounts paid ($19.15)

b = acquisition price ($1.01)

c = income/expenditure in previous years ($12.78)

Income/Expenditure = a - (b + c)
= $19.15 - ($1.01 + $12.78)
= $5.36

This determination is signed by me on the 18th day of February in the year 1994.

P Barrand
Deputy Commissioner of Inland Revenue