(d) *An alternative method*—At the Cut-off Time on 30 September 1991 the Reuters Multicontributor Page, NZGS, had quotes of 16.42% (buy) and 16.38% (sell).

The corporate investor uses the mid point between the buy and sell rate for financial reporting purposes and a rate of 16.40% would be appropriate for the valuation of this holding as at 30 September 1991 in accordance with clause 6 (3) (a), clause 6 (4) (b) and clause 6 (7) (a) of this determination.

Note: To obtain the value of the Government Stock it is necessary to use this rate in an appropriate valuation formula.

This determination is signed by me on the 24th day of October in the year 1990.

R. D. ADAIR, Deputy Commissioner of Inland Revenue.
go12596

Determination G22: Optional Conversion Convertible Notes Denominated in New Zealand Dollars Convertible at the Option of the Holder

This determination may be cited as "Determination G22: Optional Conversion Convertible Notes Denominated in New Zealand Dollars Convertible at the Option of the Holder".

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

(1) An optional conversion Convertible Note is a financial arrangement. The note is evidence that the holder has provided money to a company. This money is repayable at a future date in either cash or company shares. Coupon Interest Payments may be made between the date of issue and the redemption date. The amounts payable in relation to the Convertible Note may be in New Zealand currency or a foreign currency.

This determination applies to those optional conversion Convertible Notes where conversion into company shares is at the option of the holder and the convertible note is denominated in New Zealand dollars.

This determination allows a person to calculate income or expenditure in relation to such a note.

(2) A Convertible Note has a debt and equity component. The accruals regime is not intended to deal with equity and therefore classifies a share (which is equity in a business) as an excepted financial arrangement. In the case of a Convertible Note, the equity component is the option to convert repayment to shares.

Any income or expenditure that is attributable to an excepted financial arrangement is not included when calculating income or expenditure under the accruals regime.

(3) Thus, when calculating income or expenditure as it relates to a Convertible Note, it is necessary to separate the debt and equity components of the note. This is done for two purposes:

(a) Firstly, this determination sets out the method to separate the acquisition price into debt and equity components for the purpose of calculating income or expenditure during the term of the note.

(i) The method used isolates the amount of the core acquisition price attributable to the option to convert to shares. The core acquisition price minus the present value of the person's cashflows equals the amount attributable to the option to acquire shares. This amount, being the equity component, is excluded from the calculations to determine income or expenditure.

(ii) Income or expenditure for all years, bar the final year, of the financial arrangement can then be calculated. The calculation uses the yield to maturity method (or an alternative method producing not materially different results) and the cashflows in relation to the debt component of the Convertible Note.

(b) Secondly, the determination sets out the method for separating the amount of the consideration payable by the issuer or receivable by the holder into debt and equity components as required for the base price adjustment. This is done in three stages:

(i) The amount of consideration payable by the issuer or receivable by the holder is isolated.

(ii) The equity component of the consideration is distinguished from the debt component.

(iii) The amounts relating to the debt component are used when calculating the base price adjustment.

(4) This determination states when calculating consideration for the purposes of the base price adjustment:

(i) All Coupon Interest Payments are attributable to the debt component of the note and are included in the amount of consideration.

(ii) All of the Cash Redemption Amount is attributable to the debt component and is to be included in the amount of consideration.

(iii) If a Convertible Note is converted into, redeemed or paid by the issue or delivery of shares, the value of the shares is presumed to be equal to or greater than the Cash Redemption Amount.

(iv) If a Convertible Note is converted into, redeemed or paid by the issue or delivery of shares, and the value of the shares is more than the Cash Redemption Amount, then this excess belongs to the equity component and is not included in the amount of consideration.

(5) It is assumed that the holder of the Convertible Note, when ddeciding whether to redeem the note in shares or cash will only decide on shares if the value of the shares is greater than or equal to the Cash Redemption Amount.

If this is not the case, any loss made by the holder is attributable to the equity component. That is, the loss is excluded from calculations to determine the holders income or expenditure in relation to the financial arrangement.

The treatment of Convertible Notes, therefore, is the same whether the shares or the Cash Redemption Amount is taken.

(6) If Convertible Notes are sold or otherwise disposed of before Redemption Date, the seller must calculate how much of the price rreceived for the notes is attributable to that part of the Convertible Note which is subject to the accruals regime. The seller achieves this by calculating the acquisition price of the Convertible Note as if:

(a) He or she were the buyer (that is, the new holder); and

(b) The sale price was the only consideration provided by the buyer.

The amount so calculated is included in variable "a" of the base price adjustment. Any brokerage paid by the seller will be included in variable "b" of the base price adjustment, as brokerage is an amount paid in respect of the financial arrangement.

(7) The effect of this determination is that the holder and issuer of the Convertible Note are taxed as if the Convertible Note were a bond which:

(a) Is issued at a price which excludes an amount paid or received for the option to convert to shares (equity component); and

(b) Is redeemable in cash (the Cash Redemption Amount); and

(c) May have Coupon Interest Payments paid during the term of the note.

2. *Reference*—This determination is made pursuant to section 64E (1) (e) of The Act.

3. *Scope*—This determination shall apply to any Convertible Note in relation to which a person is a holder or an issuer where—