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Use of convertible notes for seed and early stage investment in New Zealand



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Investors have a wide variety of instruments available to invest in companies – from plain vanilla debt to ordinary shares, and many options in between. As there are advantages and disadvantages to all of these instruments, the most appropriate instrument depends on the facts and commercial circumstances of the investor and company.

Hybrid instruments (those with both debt and equity features) are commonly used by investors to invest in seed and early stage companies. Convertible notes are a type of hybrid instrument. This note outlines the general tax implications of using convertible notes to provide funding.

A key issue for consideration is whether, or when, a particular convertible note gives rise to taxable interest for the investor and an important conclusion of this paper is that it is very difficult (without complex and potentially costly structuring) to structure a convertible note which does not give rise to taxable interest at some point. Companies issuing such notes should also consider the accounting treatment (e.g. accounting bifurcation). We have summarised the tax implications arising from convertible notes with different features that could be considered to achieve the desired commercial objectives.

Hybrid instruments have been used in corporate financing arrangements over recent years and Inland Revenue Department ('IR') is currently reviewing the tax treatment of many of those instruments. Indications are that IR may seek to challenge some of the arrangements on tax avoidance grounds. IR is paying particular attention to hybrid instruments issued by NZ companies to non-resident investors.

The comments in this paper are general in nature and should not be relied upon or used as a substitute for professional advice. Professional advice should be sought in relation to any particular situation or circumstance.

What is a convertible note?

Convertible notes are a debt instrument with a right or obligation to convert into an equity instrument (generally shares in the borrowing company). The conversion into equity can be mandatory (e.g. upon a specific event happening or after a certain time period) or at the option of the lender or borrower (occasionally the rights are triggered by the achievement or non achievement of specific performance hurdles).

Convertible notes are either mandatory convertible notes ('MCNs') or optional convertible notes ('OCNs'). A MCN is like a loan with a repayment in shares, or a forward purchase of shares, and an OCN is like a loan with an option or warrant over shares attached.

Conversion of an OCN can be at the option of the company, the investor or both. Conversion at the option of the company allows the company to convert the note to equity when there is insufficient cash to repay the OCN, whereas conversion at the option of the investor allows the investor to share in equity upside. There is no cash payment by the company upon conversion of an MCN.

What do investors need to think about?

Commercial considerations likely to be important when considering the type of funding instrument include:

- **priority.** Investors generally prefer their ranking to be as high as possible to maximise the level of security (although this is normally a trade off with potential economic return). Investors can choose between demanding repayment or converting to equity and, depending on how the company is performing, one option may be preferable to the other. Investors who hold debt have priority over non-creditor shareholders from the outset. Investors holding a debt instrument can register a financing statement on the Personal Property Securities Register over the assets of the company (in which case they should typically also have priority over any subsequent secured or unsecured creditors).
- **cash flow.** Seed and early stage companies generally have a desire to retain cash for working capital and expansion. A funding instrument which minimises cash outflow from the borrowing company is therefore preferable.
- **tax.** Key considerations include whether tax deductions result in cash tax savings, whether cash withholding tax obligations arise, and whether investors derive taxable income at the same time as cash returns are paid. Investors prefer for taxable income not to arise until the company is cash flow positive/in profits and, if taxable income arises, for the tax liability to arise at the same time that cash returns are paid (ie to avoid instruments under which a tax liability is triggered without a corresponding cash return). The tax implications on exit depend on the individual circumstances and method of investment of each investor.
- **adequate return.** Return should be determined taking into account both the stated interest rate and the terms of conversion, e.g. the interest rate could be low but the conversion ratio high. There can be competing interests for investors between wanting a return (on what is essentially bridge funding) and not necessarily wanting to set an equity price for the next round, or locking in a favourable conversion rate.
- **whether the instrument incentivises the company.** Some lenders perceive debt funding (rather than funding through equity) as providing a greater incentive for the borrower to remain focused on project and delivery milestones. For example, missing a project or delivery milestone may cause the loan to go into default and the loan principal to be called (which would not arise if equity were used instead).

Using convertible notes in seed and early stage companies

Convertible notes are popular because they are flexible and can be structured to meet the key commercial objectives. This flexibility makes them attractive for seed and early stage companies, particularly as bridge funding between equity raising rounds. In particular, convertible notes:

- **preserve priority.** A convertible note starts out as, and remains, legal form debt until conversion. Conversion of the note can be into ordinary shares or preference shares.
- **provide cash flow flexibility.** Notes can be structured with or without payment of cash coupons.
- **provide a return to investors.** This can be achieved due to the flexibility of convertible notes as to the coupon and/or conversion mechanism. This allows investors to benefit from any increase in value of the company's shares when the shares are converted. The benefit can be determined by the timing and terms of the conversion.
- **can act as an incentive** depending on a company's ability to appreciate the commercial difference between debt and equity. The impact is reduced if the company does not see a practical difference between the two.

Tax may not be such an issue as seed and early stage companies are often commercially indifferent as to whether deductions are available as they are unlikely to be a profit position.

We have summarised the commercial issues with convertible notes and other instruments in Appendix 2.

Tax treatment of convertible notes

New Zealand taxes debt instruments on an accrual (unrealised) basis and equity instruments on a realised (cash) basis. There are no special rules for convertible notes, however as with most other hybrid instruments it is necessary to separate them into their debt and equity components.

Amounts paid by a company in relation to the debt component are treated as interest and are generally tax deductible to the company and taxable to the investor on an accrual basis.

Other gains and losses on hybrid instruments are generally attributable to the equity component of the instrument. These gains and losses are unlikely to be taxable/deductible to the company, but may be taxable/deductible to the investor, depending on the investor's individual circumstances (e.g. whether the instrument is held on capital/revenue account).

The use of a non-market rate of interest may affect the company's tax deduction and the investor's income. For example, a low interest rate is generally a trade off for greater potential upside on conversion. This means that there may be value in the conversion feature that should be attributed to the debt part of the convertible note. This could increase both the tax deduction available to the company and the taxable income to the investor.

IR has issued general determinations which set out the approach to identify the debt and equity parts in OCNs and MCNs, although these only apply to specific circumstances. Taxpayers can apply for individual determinations, although these are costly (both in terms of time and money). Without a general or specific determination, taxpayers must determine the tax treatment of the instrument under general tax principles.

Withholding tax obligations (e.g. RWT, NRWT or AIL) should also be considered in relation to interest paid. Withholding tax obligations generally arise when the interest is 'paid' (which includes 'payment-in-kind') and this might be different from when the interest is taxable. For example, interest might be taxable on an accrual basis over the life of the loan but withholding tax obligations may not arise until conversion or repayment occurs. This would be undesirable for investors as they may also be taxable on an accrual basis with no cash return to fund the tax liability.

Upon exit, the tax implications for an investor will depend on both the nature of the instrument and the investor's individual circumstances.

There are special rules that apply to notes that are considered to be 'stapled' to equity instruments. If applicable, the rules deem the note to be a share and any interest paid on the note to be a non-deductible dividend.

The likely tax implications of some commonly used convertible notes are summarised in Appendix 1.

Angel Industry Standard convertible notes

The angel industry standard (Industry Standard) long and short form convertible notes meet some of these objectives. They are debt instruments so priority is preserved and convertibility allows investors to benefit from any equity upside. Cash is preserved within the company as interest and principal are only payable upon demand. However, interest does accrue on a monthly basis and is added to the principal if unpaid. While this does provide the investor with an enhanced return (i.e. on the compounding interest), it could result in a tax cost for both the company and the investor:

- the company may need to account for withholding tax on the interest that is “paid” monthly. This depends on the legal documentation and whether the interest has been “credited to the lender’s account”; and
- the interest may also be taxable to the investor on an accruals basis and, if so, the investor does not receive any cash from the company (unless demanded).

We have summarised the tax implications of the Industry Standard notes, and other convertible instruments, in Appendix 1. Our comments are based on a review of the long form and short form Industry Standard documentation approved by the Angel Association of New Zealand.

Non-resident investors

Additional tax issues can arise if non-resident investors hold convertible notes issued by a New Zealand company. New Zealand’s thin capitalisation rules and transfer pricing regime may need to be considered. Professional advice should be sought in relation to the potential tax implications arising if non-resident investors are involved.

Other risks

While convertible notes can be structured to achieve key commercial objectives the borrower’s ability to claim interest deductions on the note increases the risk of IR scrutinising the transaction.

The IR is currently reviewing the tax treatment of certain hybrid instruments, and the future treatment of some hybrid instruments may change as a result of this review. To date the focus of this review has mainly been on cross-border circumstances. Generally in seed / early stage financing both the investors and the company are usually New Zealand resident and therefore it is less likely the IR would challenge the use of convertible notes on tax avoidance grounds.

Other instruments

Convertible Preference Shares

Convertible preference shares are equity instruments with priority over ordinary shares, but not creditors. Distributions are treated as dividends (not interest) and no tax deduction is available to the company. Distributions are generally taxable to the investor, although tax relief is available to the extent of imputation credits attached or withholding tax deducted. There is considerable flexibility in relation to distributions to decide if and when they are made.

Preference shares generally have a lower priority than debt, although priority is always relative, i.e. if there is no debt or creditors, then preference shares may have the highest priority. However the shares allow investors to maintain some form of priority while still benefiting from the equity upside of owning shares. This also means that the company is not required to expend cash until it is able to.

It is important that imputation credits are not being streamed to certain shareholders in preference to others. Generally seed and early stage companies are not in a tax paying position, i.e. do not have imputation credits, and so this risk should be mitigated.

The recent extension of the thin capitalisation rules could result in an amount of taxable income being attributed to the company where fixed rate shares are used to provide funding. The circumstances to which these rules apply are limited and require the company to be controlled by a non-resident or to be holding a controlling interest in an offshore subsidiary. Professional advice should be sought in these circumstances to determine if such a risk arises.

Optional redeemable preference shares

Optional redeemable preference shares ('ORPS') are equity instruments that convert to debt at the option of the holder. Being preference shares they will have priority over ordinary equity (but not debt) and, once converted to debt, they will have priority over all equity.

Distributions prior to conversion are treated as dividends and no tax deduction is available to the company for the distribution. There is considerable flexibility in relation to the timing of dividends that could be used to mitigate any deemed income arising to the investors. The company may therefore have no cash cost at this stage if distributions are not paid.

The option to convert to debt can be triggered upon certain economic or commercial events. Tax issues can be triggered on conversion, although these can generally be managed, provided the legal documentation is appropriately structured.

Once converted the instrument is a debt and has priority to all equity. This should preserve priority for the investors if the company is not performing as expected. Once converted the instrument should be treated as vanilla debt.

Profit participating loans

Interest under a profit participating loan is calculated by reference to the profits of the company or dividends paid by the company. While the loan is legal form debt, and therefore has a high priority, it is treated as equity for tax purposes. Interest paid on the loan is treated as a dividend to the company and no tax deduction is available to the company for the interest paid. Profit participating loans provide flexibility to defer the payment of any interest until profits are realised and do not give rise to taxable income to the investor until interest payments are made.

Conclusion

Whether a structure or instrument is appropriate for any given investor or company depends on both the commercial circumstances and tax position of the parties.

Convertible notes provide considerable flexibility. There are no special tax rules for convertible notes. However as with most other hybrid instruments it is necessary to separate the instrument into its debt and equity components. This can create complexity and uncertainty in relation to the tax treatment of the instrument for the company and investors. Much depends on the legal terms of the particular instrument. Therefore it is important that professional advice is obtained when the instrument is issued and that the terms are properly documented.

It should be noted though that it is very difficult (without complex and potentially costly structuring) to structure a convertible loan to avoid any taxable interest (whether it be deemed interest on conversion, accrued interest, or interest actually paid).

Convertible notes are a popular instrument for investment into seed and early-stage companies because they are flexible and can be structured to meet many key commercial objectives of investors. However, other convertible instruments are available as well and, again, the decision as to which instrument is appropriate for any given investor or company depends on both the commercial circumstances and tax position of the parties.

Our comments are based on tax law and practice as at the above date. Changes in law, changes in interpretation and subsequent legal decisions may impact on the tax consequences outlined in this memorandum. Professional advice should be sought in all instances.

Our contact details are on page 8 if you would like to discuss any of the above.

Type of convertible note									
	Cash paid interest <i>(Regular cash interest paid to investors)</i>	Non-cash interest <i>(Interest accumulates until the note is repaid or converted)</i>	Zero coupon <i>(Note issued at a discount to face value)</i>	Industry Standard long form	Industry Standard short form	Convertible preference shares <i>(Preference shares which convert into ordinary shares)</i>	Profit participating loans <i>(Loan for which interest is calculated by reference to profit)</i>	Optional redeemable preference shares <i>(Preference shares which convert to a loan)</i>	
Company									
Tax relief	Tax deduction for interest on accrual basis (generally consistent with cash interest payments)	Tax deduction for interest accrued	Tax deduction for unwind of discount on accrual basis. Discount typically calculated based on market yield on Government stock.	Tax deduction for interest accrued	Tax deduction for interest accrued	No tax deduction is available for interest paid as it is treated as a dividend for tax purposes	No tax deduction is available for interest paid as it is treated as a dividend for tax purposes	No tax deduction is available for interest prior to conversion as it is treated as a dividend for tax purposes. Post conversion a tax deduction is available	
Withholding tax	Withholding tax payable when cash interest paid	Withholding tax payable when interest credited to account of investor or redemption/ conversion	Withholding tax payable on redemption/ conversion	Withholding tax is payable monthly as interest is compounded and added to the principal of the loan on a monthly basis	Withholding tax is payable monthly as interest is compounded and added to the principal of the loan on a daily basis.	Withholding tax is payable when distributions credited to the account of an investor. The amount of withholding tax payable depends on whether imputation credits are available (unlikely) and on whether the investor is a non-resident	Withholding tax is payable when interest credited to the account of an investor. The amount of withholding tax payable depends on whether imputation credits are available (unlikely) and on whether the investor is a non-investor	Withholding tax is payable when distributions, and post-conversion interest, is credited to the account of an investor.	
Cash flow	Regular cash interest and withholding tax payments	Interest payable at repayment and withholding tax payable when interest paid/ credited to investor's account	Interest payable at repayment and withholding tax payable at repayment/conversion	Interest and principal are repayable on demand. Interest must be separately demanded	Interest and principal are repayable on demand.	Distributions can be payable regularly, or may be deferred until profits are realised	Interest and principal may be deferred until profits are realised	Distributions and interest to the extent these are 'paid', plus withholding tax	
Investor									
Interest income	Taxable on an accrual basis (generally consistent with cash interest payments)	Taxable on an accrual basis	Unwind of discount taxable on an accrual basis	Taxable on an accrual basis – not consistent with cash interest payment	Taxable on an accrual basis – not consistent with cash interest payment	Receipts are treated as dividends for tax purposes and are taxable when received	Receipts are treated as dividends for tax purposes and are taxable when received	Receipts are treated as dividends and are taxable when received. Interest is taxable on an accruals basis.	
Gains from conversion	Depends on the investor's individual circumstances	Depends on the investor's individual circumstances	Depends on the investor's individual circumstances	Notes can convert to ordinary or preference shares. The tax treatment will depend on the investor's individual circumstances	Depends on the investor's individual circumstances	Depends on the investor's individual circumstances	The loan does not convert into shares.	Depends on the investor's individual circumstances	

Commercial considerations

	Preserve priority?	Cash flow for company while issued?	Tax deduction for the company?	Cash interest income to investors?	Deemed interest income to investors?	Interest return vs equity upside?	Exit considerations?
Type of instrument							
Cash paid convertible note – where cash paid at regular intervals	Yes – to all equity	Yes - interest and withholding tax	Yes	Yes	N/A	Split between interest and equity conversion can be set	Depends on timing, i.e. debt or equity, and investor profile
Cash paid convertible note – where cash payment deferred until called	Yes – to all equity	Yes - withholding tax if interest “paid”	Yes	No – unless called	Yes	Split between interest and equity conversion can be set	Depends on timing, i.e. debt or equity, and investor profile
PIK note – “interest” rolled up into principal	Yes – to all equity	Yes – withholding tax on roll-up	Yes	No	Yes	Split between interest and equity conversion can be set	Depends on timing, i.e. debt or equity, and investor profile
Zero-coupon note	Yes – to all equity	Only at repayment of conversion	Yes	No	Yes	Split between interest and equity conversion can be set	Depends on timing, i.e. debt or equity, and investor profile
Convertible preference shares	Yes – to ordinary equity	Only if there are distributions	No	No	No	Dividend income if paid	Equity return
Profit participating loans	Yes – to all equity	Only if there are distributions	No	No	No	Dividend income if paid	Disposal of a debt
Optional redeemable preference shares	Yes – to ordinary equity or to all equity if converted	Only if there are distributions	No – unless converted to debt	No	No – unless converted to debt	Dividend income if paid or interest if converted	Depends on timing, i.e. debt or equity

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