

PRODUCT RULING - BR Prd 11/05

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Telecom Corporation of New Zealand Limited (Telecom).

Taxation Laws

All legislative references are to the Income Tax Act 2007 (Act) unless otherwise stated.

This Ruling applies in respect of the Act, in particular ss BD 1, BG 1, part C, ss DA 1, DB 23, DB 49, ED 1, and GA 1 and the Estate and Gift Duties Act 1968, in particular ss 61 and 63.

This Ruling uses the following term defined in the Telecommunications Act 2001: "Demerger Distribution".

This Ruling uses the following term defined in s 2 of the Estate and Gift Duties Act 1968: "dutiabie gift".

This Ruling uses the following terms defined in s YA 1: "assessable income", "dividend", "identical share", "original share", "returning share transfer", "share-lending arrangement", "share supplier" and "share user".

The Arrangement to which this Ruling applies

References in this Ruling to:

- "Telecom Group" or "Telecom companies" mean Telecom and its subsidiaries at the relevant time.
- "Chorus Group" or "Chorus companies" mean Chorus Limited (Chorus), the listed parent of the Chorus group of companies to be demerged from the Telecom Group, and its subsidiaries at the relevant time.

The Arrangement is the demerger of Chorus (including the Chorus Group and Chorus companies) from Telecom (including the Telecom Group and Telecom companies) (Demerger) to bring about the structural separation of the Telecom Group's network infrastructure businesses (Chorus Businesses) from its other retail-focused businesses to meet the independence requirement of the Ultra-Fast Broadband (UFB) Initiative the Government announced in September 2009. The Demerger will involve the following steps (which are described further in paragraph 19):

- On 1 July 2011 Telecom established the Chorus companies, being Chorus, and Chorus's wholly-owned subsidiary Chorus New Zealand Limited (Chorus New Zealand), with nominal ordinary share capital.
- To enable Chorus New Zealand to purchase the Chorus assets from the Telecom companies, Chorus will, on or around the date on which that

purchase is to be completed, issue additional share capital to Telecom, and will borrow under a loan facility from third party banks. Chorus New Zealand will similarly issue additional share capital to Chorus and will also borrow from Chorus under an inter-company loan. (Chorus may also be entitled to receive an amount from a Telecom company in connection with the issue of bonds to be exchanged for bonds currently on issue by a Telecom company, and for agreeing to assume liability under related swap transactions. To that extent, the amount Chorus is required to draw-down under its loan facility will be reduced.)

- Chorus New Zealand will purchase the Chorus assets and liabilities from the Telecom companies for an amount to be determined (but expected to fall within a range of NZ\$2 billion to NZ\$2.5 billion).
- Telecom will distribute its shares in Chorus to Telecom's existing shareholders, or to a sale agent in the case of ineligible overseas shareholders.

Further details of the Arrangement are set out in the paragraphs below.

Background to the Ultra-Fast Broadband Initiative

Objective of the Ultra-Fast Broadband Initiative

1. The Government announced the UFB Initiative in September 2009. In October 2009, the Government released *New Zealand Government Ultra-Fast Broadband Initiative: Invitation to Participate in Partner Selection Process* (Ministry of Economic Development, October 2009) (Invitation to Participate) setting out the process and terms and conditions for the selection of government partners in the UFB Initiative. The Invitation to Participate sets out the Government's overall objective for the UFB Initiative (UFB Objective) as follows (footnotes omitted):

1.1 Ultra-fast Broadband Initiative

- (a) The government's overall objective for the ultra-fast broadband investment initiative (**UFB Initiative**) is:

To accelerate the roll-out of ultra-fast broadband to 75 percent of New Zealanders over ten years, concentrating in the first six years on priority broadband users such as businesses, schools and health services, plus greenfield developments and certain tranches of residential areas (**UFB Objective**).

2. The Government intends to invest up to NZ\$1.5 billion towards achieving the UFB Objective, with the expectation that this will be at least matched by private sector investment.

Structure of investment in the Ultra-Fast Broadband Initiative

3. Crown Fibre Holdings Limited (Crown Fibre) will manage the Government's investment in the UFB Initiative. Crown Fibre is a wholly-owned Crown investment company incorporated on 29 October 2009. Crown Fibre was responsible for conducting the partner selection process, and will manage the Government's investment in the fibre-optic communications network in the future.

4. One of Crown Fibre's core roles was to select parties with which to co-invest in the UFB Initiative (Partners). Telecom was a participant in this partner selection process. On 24 May 2011, the Communications and Information Technology Minister, Steven Joyce, announced that an agreement had been reached with Telecom under which Telecom would build a fibre-optic network in Auckland, the eastern and lower North Island, and most of the South Island.
5. The Government's investment in the UFB Initiative is to be effected through local fibre companies. Local fibre companies will deploy the fibre networks and sell access to products on those networks. In the case of Telecom's proposal, Chorus will in effect be the local fibre company, although the terms of the arrangements between Crown Fibre and Chorus are not identical to the terms envisaged by the Invitation to Participate.

Requirement for independence

6. The *New Zealand Government Ultra-Fast Broadband Initiative: Overview of Initiative* (Ministry of Economic Development, September 2009) outlined the requirements that local fibre companies operate on an independent basis and provides as follows (footnotes omitted):

66. The following principles will apply:

...

- independence - LFCs [local fibre companies] will be prohibited from providing retail services.

67. In terms of independence, in the event that a prospective LFC partner currently owns a retail operation, the party either:

- must divest itself of the retail operation (or alternatively alter governance arrangements so that it does not control the retail operation); or
- will not have the right to appoint the majority of directors to the Board of the relevant LFC, and the chair of the LFC Board must be an independent chair agreed to by all shareholders.

7. This condition is repeated as one of the UFB Initiative's "open access requirements" in the Invitation to Participate, which provides as follows:

13. Open Access Requirements

...

These are the **Open Access requirements**.

13.4 Impact of current telecommunications operations

In the event that a prospective Partner, or a related or associated entity of the Partner, currently (or at any time while a Partner) owns or controls a business which provides any Telecommunications Service other than the Permitted Services, the Partner:

- (a) must fully divest, or must ensure that the Partner's related or associated entity fully divests, itself of that business; or
- (b) may not appoint the majority of directors to the Board of the relevant LFC [local fibre company], and the chair of the LFC Board must be an independent chair agreed to by all shareholders.

8. "Permitted Services" are services of the type that will be provided in relation to the fibre optic network infrastructure. Permitted Services (and related terms) are defined in the Invitation to Participate as follows:

7. DEFINITIONS AND INTERPRETATION

7.1 Definitions

The terms used in this document shall have the following meanings:

...

Layer 1 means layer 1 of the OSI Model, which is normally associated with passive fibre optic network infrastructure;

Layer 1 Service means any service which operates at Layer 1;

Layer 2 means layer 2 of the OSI Model, which is normally associated with active fibre optic network infrastructure;

Layer 2 Service means any service which operates at Layer 2;

...

OSI Model means the seven-layer model of network architecture known as the Open Systems Interconnection Model;

...

Permitted Services means the services that may be provided by an LFC [local fibre company], being any Layer 1 Services and, subject to CFH [Crown Fibre] consent, any Layer 2 Service;

...

Application to the Telecom Group

9. The Telecom Group has a significant operating business unit devoted to the provision of retail telecommunications services to the household and business markets. Because these retail services are not Permitted Services, a member of the Telecom Group would have been prevented from being a Partner unless it was prepared to comply with the requirement not to appoint the majority of the directors of the board of the local fibre company and to accept an independent board chair. Telecom considered that option commercially unacceptable, because it would not have given it the requisite degree of control over the local fibre company. Therefore, Telecom formed the view that the only way it could realistically participate in the UFB Initiative would be to structurally separate.
10. Telecom decided that for its network and wholesale business units (which do provide Permitted Services) to participate as a bidder in the UFB Initiative, it would (subject to its bid being successful and receiving relevant approvals, including shareholder approval) demerge and structurally separate those business units (ie, the Chorus Businesses) from its other business units, which predominantly involve the provision of retail telecommunications services. The entities carrying on the Chorus Businesses following the Demerger (ie, the Chorus companies) will be eligible to participate in the UFB Initiative without breaching the specific requirements imposed by the Government and in a way that does not unduly restrict the Chorus Group's governance arrangements.

Regulatory implications of structural separation

11. The *Discussion Document: Regulatory Implications of Structural Separation* (Ministry of Economic Development, September 2010) sets out the regulatory implications of the structural separation of Telecom as follows:

2 Overview

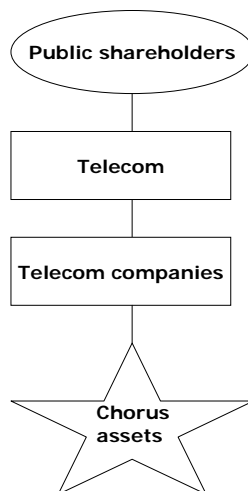
- 14 Structural separation would represent a significant change to the structure of the New Zealand telecommunications industry. Historically, the industry has been dominated by a vertically integrated incumbent operating at all levels of the market, which has given rise to issues regarding the effectiveness of competition. The new split would affect both legacy and next generation access infrastructure.

...

The Demerger

12. The following diagram summarises the current structure of the Telecom Group.

Current Structure of Telecom Group



Overview

13. Effecting the Demerger requires the following:
- The establishment of the Chorus companies to separately hold and carry on the Chorus Businesses.
 - The transfer of assets and liabilities of the Chorus Businesses (designated assets and liabilities), by the Telecom companies that hold or are party to those assets and liabilities immediately before the transfer to Chorus New Zealand and the entering into of certain transitional and long-term commercial arrangements between one or more Telecom companies and one or more Chorus companies. (The designated assets and liabilities will be described in the Separation

Deed (see paragraph 14) and in a proposal approved by Order in Council made under s 46 of the Telecommunications (TSO, Broadband, and Other Matters) Amendment Act 2011 (Broadband Act).)

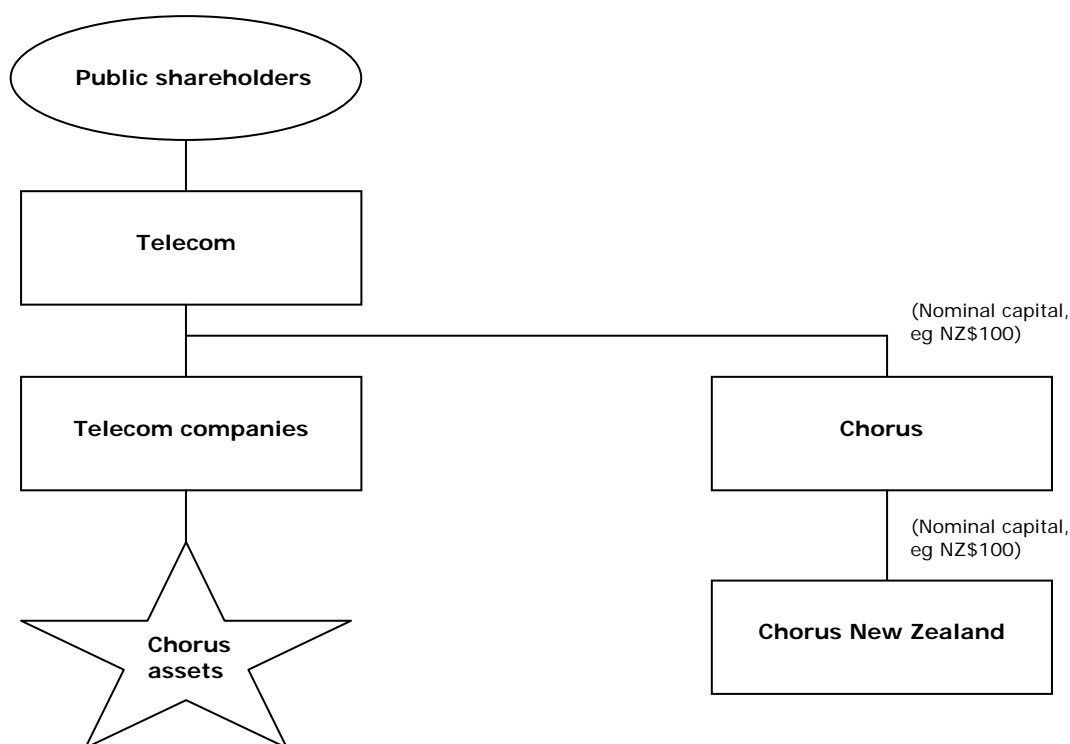
- The capitalisation of and provision of interim funding to Chorus and Chorus New Zealand to enable Chorus New Zealand to acquire the assets and liabilities of the Chorus Businesses.
 - The distribution, to each holder of ordinary shares in Telecom, of ordinary shares in Chorus under an arrangement approved by the High Court under part 15 of the Companies Act 1993 (Companies Act) (subject to the position of ineligible overseas shareholders discussed in paras 22 and 23).
14. The Demerger will be carried out in accordance with:
- the Broadband Act;
 - a scheme of arrangement approved by the High Court;
 - a separation deed between the relevant companies (Separation Deed).
15. The Broadband Act amends the Telecommunications Act 2001. The Broadband Act contains measures to reform certain regulatory provisions currently applicable to the Telecom Group to reflect the structural separation of the Telecom Group and the Government's UFB Initiative. The legislation deals with aspects of the Demerger that are affected by existing legislation and provides for certain outcomes different from those that would otherwise result (eg, in respect of public works and resource management matters). The Broadband Act also contains measures providing for the application of the Inland Revenue Acts to the Demerger.
16. The scheme of arrangement approved by the High Court under part 15 of the Companies Act will use a procedure for corporate reorganisations that involves obtaining shareholder approval, and consideration by the High Court of the interests of certain parties. The scheme will describe and give legal effect to the steps by which Chorus shares are to be distributed to Telecom shareholders, and will give legal effect to the Separation Deed.
17. The Separation Deed will provide for the transfer of the designated assets and liabilities to the Chorus Group, the assignment or novation of certain contracts related to the Chorus Businesses to the Chorus Group, and certain transitional arrangements between the Telecom Group and the Chorus Group.
18. Following the Arrangement, Telecom and Chorus will exist and operate as separate entities with separate ownership and management structures. Telecom will remain listed on the New Zealand stock exchange (NZSX) and Australian Securities Exchange and it is intended that Chorus will be listed on both the NZSX and Australian Securities Exchange. Telecom American Depository Shares (ADSs) will continue to be listed on the New York Stock Exchange. Chorus shares or ADSs are not intended to be listed in the United States, but it is expected that Chorus ADSs will trade on an over-the-counter basis in the United States.

Capitalisation of Chorus and Chorus companies and distribution to Telecom shareholders

19. The four steps by which the Demerger will occur are summarised in the text and diagrams that follow (all figures are approximate, and amounts payable may be settled by payment direction in some cases).
20. References to the "Demerger Date" are to the date on which Chorus New Zealand acquires the Chorus Businesses under the Separation Deed and on which the Demerger Distribution is provided to Telecom shareholders. This date is expected to be 30 November 2011 or such other date as is determined by the board of directors of Telecom and notified by Telecom to the NZSX, Australian Securities Exchange and New York Stock Exchange.

Step 1: Telecom establishes the Chorus companies with nominal ordinary share capital.

Step 1: Telecom Demerger



Before Telecom applies for initial court orders

- (i) On 1 July 2011, the Chorus companies (being Chorus and Chorus New Zealand) were incorporated with nominal share capital. As at the date of this ruling, Telecom holds all of the shares in Chorus and Chorus in turn holds all of the shares in Chorus New Zealand.

Following receipt of final court orders

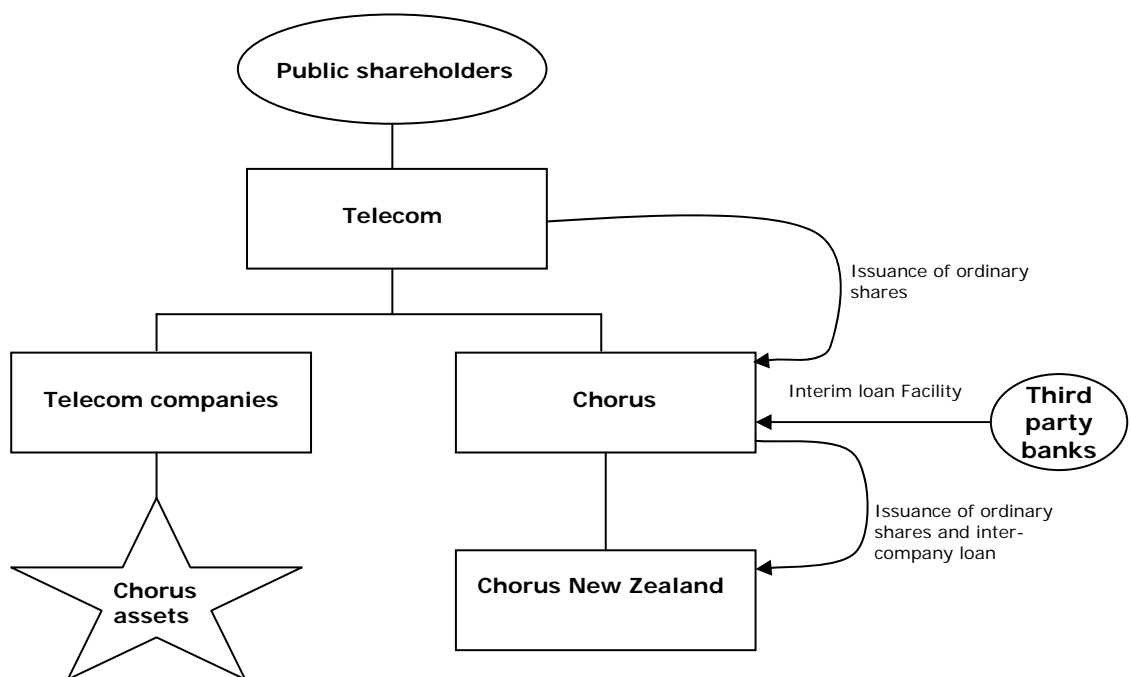
- (ii) For a certain period of days before the Demerger Date (expected to be seven business days in the case of trading on the Australian Securities Exchange, and five business days in the case of trading on the NZSX):

- Telecom will trade on an “ex-demerger entitlements” basis;
- Chorus will trade (initially on a deferred settlement basis).

On the Demerger Date

Step 2: Telecom capitalises Chorus and Chorus in turn capitalises Chorus New Zealand in an equal amount. Chorus borrows an amount under an interim loan facility from third party banks.

Step 2: Telecom Demerger

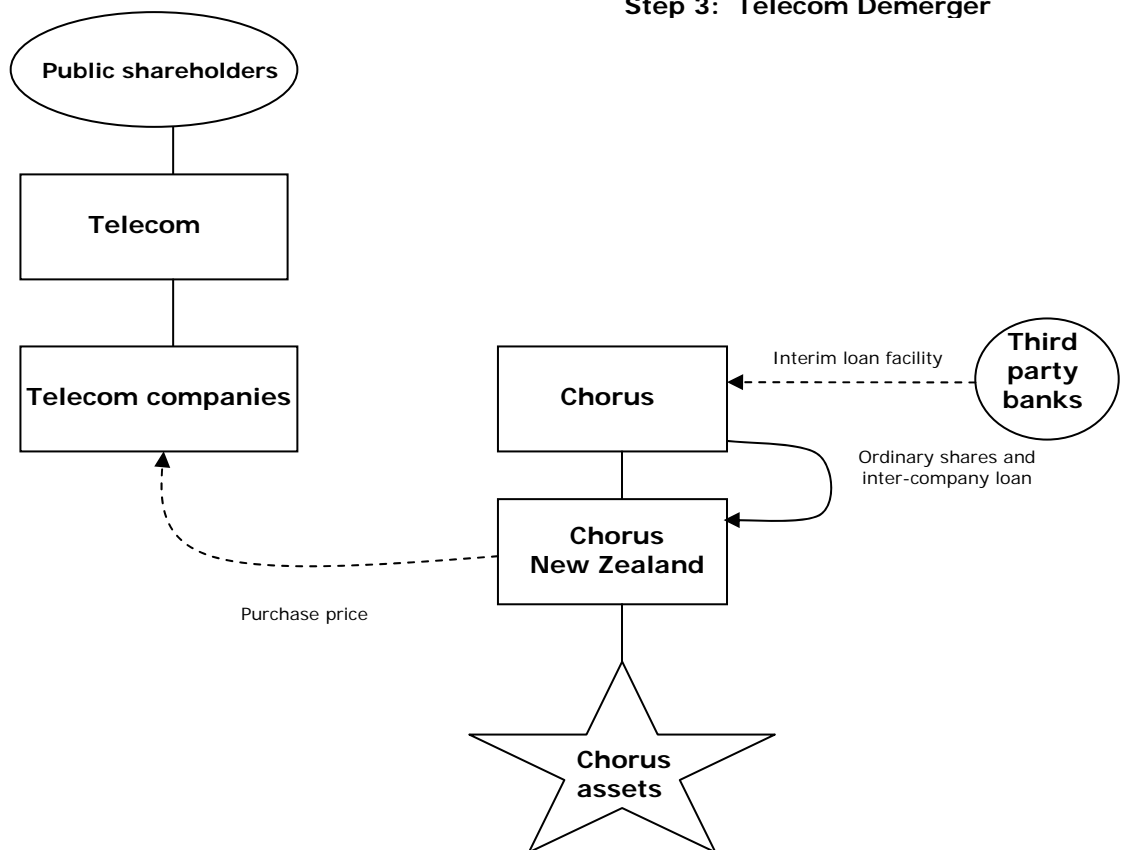


- (iv) On the Demerger Date, Telecom will subscribe for such number of Chorus shares as will, together with the existing Chorus shares, enable Telecom to make the pro rata distribution referred to in Step 4 below, in consideration for an aggregate issue price to be determined having regard to each of the purchase price payable by Chorus New Zealand under the Separation Deed and the amount Chorus will have available from borrowings.
- (v) Chorus will in turn subscribe for an equivalent number of Chorus New Zealand shares in consideration for an equivalent aggregate issue price.
- (vi) Chorus will provide a loan to Chorus New Zealand of an amount sufficient (when considered together with the subscription amount received for the Chorus New Zealand shares) for Chorus New Zealand to pay the purchase price under the Separation Deed. Chorus will obtain the funds for the loan to Chorus New Zealand

from sources which include a drawdown under an interim loan facility of an amount expected to fall within a range of NZ\$1.5 billion to NZ\$2 billion. (Chorus may also be entitled to receive an amount from a Telecom company in connection with the issue of bonds to be exchanged for bonds currently on issue by a Telecom company, and for agreeing to assume liability under related swap transactions. To that extent, the amount Chorus is required to draw-down under its loan facility will be reduced.)

Step 3: Chorus New Zealand purchases the Chorus assets from the Telecom companies.

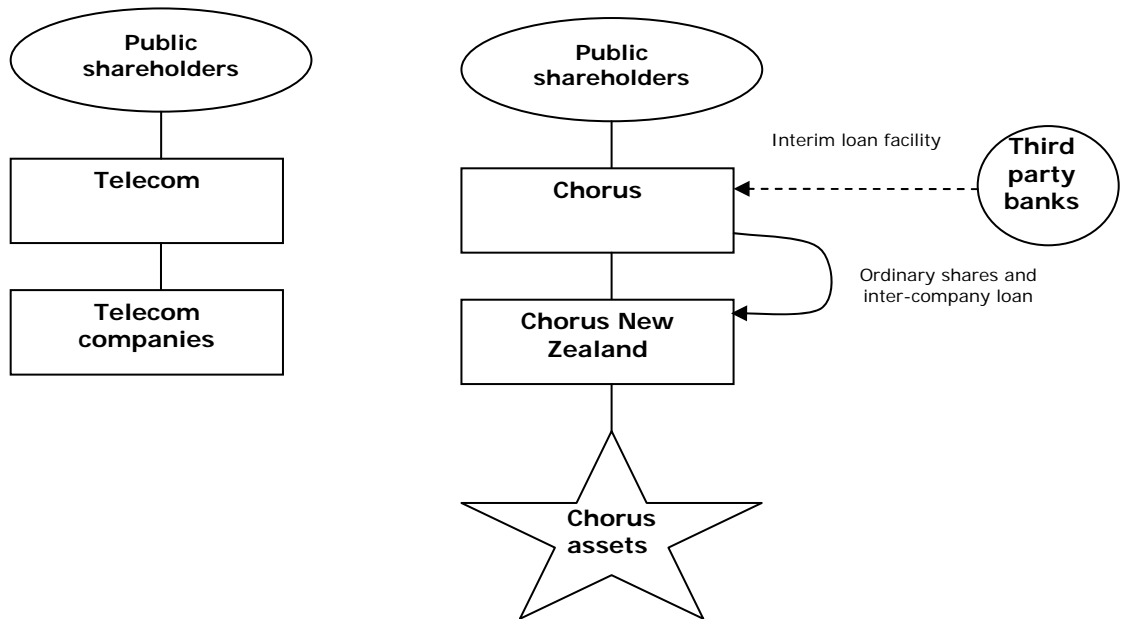
Step 3: Telecom Demerger



- (vii) The designated assets and liabilities will transfer to Chorus New Zealand from the relevant Telecom companies.
- (viii) Using the proceeds of the share issues and the funds borrowed under the interim loan facility and received in connection with the bond exchange and assumption of swaps as described in (vi) above, if any (and on-lent by Chorus to Chorus New Zealand), Chorus New Zealand will pay to the relevant Telecom companies an aggregate amount that is to be determined (but expected to fall within a range of NZ\$2 billion to NZ\$2.5 billion) in consideration for the transfer of the assets and liabilities under the Separation Deed.

Step 4: Telecom distributes its shares in Chorus to Telecom's existing shareholders

Step 4: Telecom Demerger



- (ix) On the Demerger Date, Telecom will make the Demerger Distribution by the following mechanism:
- (a) Telecom will make a pro rata distribution (the Demerger Distribution) to Telecom shareholders, conferring on such holders an entitlement to an amount to be ascertained by reference to the volume weighted average price of the Chorus shares as traded on the NZSX over the last five trading days before the Demerger Date (and in accordance with the ratio of Telecom shares to Chorus shares and the approach to rounding described in (b) below).
 - (b) Each Eligible Shareholder's entitlement to the pro rata distribution amount will be automatically applied to acquire from Telecom the relevant number of Chorus shares to be distributed to that Telecom shareholder. Each Eligible Shareholder will receive a distribution of one Chorus share for every five Telecom shares held, with the number of Chorus shares to be rounded if necessary to the nearest whole number in circumstances where there may otherwise be fractional interests in Chorus shares.
 - (c) In the case of ineligible overseas shareholders (being a shareholder other than an Eligible Shareholder), the Chorus shares that such holders would otherwise have been entitled to receive as a result of the Demerger Distribution will be transferred to a sale agent, who will then sell them and pay to each ineligible overseas shareholder its share of the net proceeds of sale of those Chorus shares.
- (x) Telecom will record the distribution in its accounts (for accounting purposes) partly as a return of capital and partly as a distribution of

retained earnings. The amount of the return of capital part will be calculated by:

- (a) dividing an amount "A" (being the number of Chorus shares on issue immediately following the Demerger Distribution multiplied by the volume weighted average price of the Chorus shares as traded on the NZSX over the last five trading days before the Demerger Date); by
- (b) the sum of amount "A" referred to in subparagraph (a) and an amount "B" (being the number of Telecom shares on issue immediately following the Demerger Distribution multiplied by the volume weighted average price of Telecom shares as traded on the NZSX over the last five trading days before the Demerger Date, on the basis that the Telecom shares trade on an ex-demerger entitlements basis on the NZSX for the whole of this period); and
- (c) multiplying the result by the balance of Telecom's share capital account immediately before the distribution.

The part of the distribution that is not a return of capital (as calculated above) will be recorded in Telecom's accounts (for accounting purposes) as a dividend.

21. After the Demerger, the Telecom Group and the Chorus Group will exist and operate as separate corporate groups with separate ownership and management structures. Before the Demerger a transitional governance structure will be established in respect of the Telecom Group and the Chorus Group. The Telecom Group and the Chorus Group will enter into transitional and long-term commercial arrangements involving supplies being made between both groups after the Demerger.

Ineligible overseas shareholders

22. Certain Telecom shareholders will not be eligible to participate in the Demerger Distribution in the same way as other shareholders. Ineligible overseas shareholders are those Telecom shareholders who are not, on the record date for the demerger, Eligible Shareholders. "Eligible Shareholders" are Telecom shareholders whose registered address as at 7:00 pm on the record date is in:
 - New Zealand, Australia, the United States, the United Kingdom, Canada, Germany, Hong Kong, Japan, Luxembourg, Norway, the Netherlands, Singapore or Switzerland; or
 - a jurisdiction in which Telecom reasonably believes that it is not prohibited and not unduly onerous or impracticable to distribute Chorus shares to a Telecom shareholder pursuant to the demerger.
23. The shares in Chorus that the ineligible overseas shareholders would otherwise have been entitled to receive as a result of the Demerger Distribution, will be transferred to a sale agent, who will sell them on the NZSX and pay to each ineligible overseas shareholder its share of the net proceeds of sale of those Chorus shares.

Relevant Documents

24. The following documents are relevant to the Arrangement:
- Telecommunications Act 2001, as amended by the Telecommunications (TSO, Broadband, and Other Matters) Amendment Act 2011;
 - draft Scheme Booklet dated 26 August 2011, provided to Inland Revenue on 26 August 2011;
 - draft Separation Arrangement Plan, provided to Inland Revenue on 29 August 2011.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

- a) Subpart 2 of Part 2 of the Broadband Act has come into force. This condition will be satisfied:
- (i) if an Order in Council has been made under s 36 of the Broadband Act; and
 - (ii) from and including the date on which the Demerger Distribution is made.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any condition stated above, the Taxation Laws apply to the Arrangement as follows:

- For each holder of a Telecom ordinary share or shares, the Demerger Distribution will not constitute:
 - a dividend under subpart CD of the Act;
 - any other form of assessable income under s BD 1 or part C of the Act; or
 - a dutiable gift under the Estate and Gift Duties Act 1968.
- For the purposes of ss CA 1, CB 1, CB 3, CB 4, CB 5, CH 1, DB 49 and ED 1, a holder of a Telecom ordinary share or shares who receives a share or shares in Chorus as a result of the Demerger Distribution, is treated as having acquired that Chorus share or shares for the same purposes and at the same time as the Telecom shareholder acquired the Telecom share or shares in respect of which that Demerger Distribution was made.
- For the purposes of ss CH 1, DA 1, DB 23, DB 49 and ED 1, a holder of a Telecom ordinary share or shares who receives a share or shares in Chorus as a consequence of the Demerger Distribution shall be treated as having paid an amount given by the following formula, for the acquisition of the Chorus share or shares received and the corresponding Telecom ordinary share or shares (as applicable):

$$\frac{\text{pre-calculation amount paid}}{\text{combined MV}} \times \text{individual MV}$$

Where the:

- (i) **pre-calculation amount paid** is the person's expenditure or loss incurred in acquiring the relevant Telecom ordinary share or shares (ignoring the provisions of the Broadband Act);
- (ii) **individual MV** is the market capitalisation on the implementation date of the demerger of either Chorus or Telecom, as applicable;
- (iii) **combined MV** is the total market capitalisation, on the implementation date of the demerger of the Chorus and Telecom.

For these purposes, "market capitalisation on the implementation date of the demerger" means the number of Chorus shares or Telecom shares (as applicable) on issue immediately following the Demerger Distribution multiplied by the volume weighted average price of Chorus shares or Telecom shares (as applicable) as traded on the NZSX over the first five trading days, starting on the date from which Chorus is listed (provided that an alternative method of calculating market capitalisation has not been prescribed by an Order in Council made under s 46 of the Broadband Act).

- If, on or before the date on which the Demerger Distribution occurs, and ignoring the effect of the Broadband Act, an arrangement is, or would but for the Demerger Distribution, be a returning share transfer under which a Telecom share is an original share, and under the arrangement the share user is required to transfer a Chorus share to the share supplier (a "Telecom Securities Lending Arrangement"):
 - (i) that arrangement will continue to be a returning share transfer after the Demerger Distribution; and
 - (ii) a Chorus share will be treated as forming part of a Telecom share for the purposes of s ED 1 and the definitions of "identical share" and "original share" in s YA 1.
- For a Telecom Securities Lending Arrangement that meets the definition of "returning share transfer" or "share-lending arrangement" in s YA 1 (taking into account the ruling set out in the fourth bullet point above), the rulings in the second and third bullet points above apply equally to the relevant share supplier under that Telecom Securities Lending Arrangement as if that share supplier were the shareholder referred to in those rulings.
- Sections BG 1 and GA 1 will not apply to vary or negate any of the above ruling bullet points.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 July 2011 and ending on 30 June 2014.

This Ruling is signed by me on the 30th day of August 2011.

Dinesh Gupta

Manager (Taxpayer Rulings)