TAXATION RULING NO. IT 2427

INCOME TAX : CONVERTIBLE NOTES - MEANING OF CONVERTIBLE NOTE, NOTE AND RELATED INSTRUMENTS

F.O.I. EMBARGO: May be released

REF H.O. REF: 87/1725-7 DATE OF EFFECT:

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1206451	CONVERTIBLE NOTES	82L DIV 3A

OTHER RULINGS ON TOPIC IT 2204, IT 2334

PREAMBLE Taxation Ruling No. IT 2334 deals with the operation of Division 3A, Part III of the Income Tax Assessment Act, "the convertible note provisions", in relation to a proposed financing arrangement involving the contemporaneous issue of Eurobonds and share options. Since the issue of the Ruling two comparable financing arrangements have been brought to the attention of this office and the advice given in relation to them is contained in this Ruling.

FACTS 2. In one case the arrangements provided for the issue of Eurobonds at par bearing variable interest rates. They were due to mature 10 years after the date of issue.

3. Attached to the Eurobonds were option bonds the subscription price for which was one cent each. The option bonds entitled holders to subscribe for shares in the issuing company at a price notified in the offer documents. The option to subscribe for shares was exercisable after 5 years and before the expiry of 10 years from the date of issue of the option bonds.

4. The subscription price of one cent was necessary to satisfy the requirements of the Companies Act. Section 132 of that Act provides that an option granted by a public company that enables a person to take up unissued shares in the company after a period of 5 years from the date the option was granted is void. To validate such an option there must be consideration passing from the grantee of the options to the company (unless the grant is by way of deed) although the consideration need only be of a nominal amount.

5. The one cent subscription price for the option bond would be offset against the subscription price of the shares when the option was exercised by the holder and would not attract interest. Where an option bond holder did not exercise the option the issuing company would repay the one cent at maturity of the option bond, i.e. after 10 years.

6. The Eurobond and option bond were to be issued under the same instrument. The option bond would be detachable and could be sold by the Eurobond subscriber separately from the Eurobond. In other words the right of the option bond holder to subscribe for shares in the holding company was not contingent upon the option bond holder simultaneously being a Eurobond holder.

7. In the second case a company issued a Eurobond and a non-detachable option bond - the latter being paid up to one cent per one thousand dollars of principal. The amount paid up did not attract interest. The principal amount of both the Eurobonds and the option bonds was the same. Eurobond holders were entitled to redeem the Eurobonds at the principal amount and to direct the issuer to apply the proceeds in paying the balance of principal owing on the option bonds. Upon payment the option bonds would be converted into ordinary shares of the company. The conversion bonds could not be traded in a secondary market and the conversion could only be exercised by the holder of the Eurobond on redemption of both the option bond and the Eurobond.

RULING

8. In the first case advice was given that the option bonds came within paragraph (b) of the definition of convertible note contained in sub-section 82L(1) of Division 3A. That paragraph operates to include in the definition of "convertible note" a "note" issued by a company that provides for the note holder to have a right or option to acquire shares in the company. A "note" is defined to mean a note or other instrument evidencing etc. a "loan" to the company while "loan" is defined to include the various forms of company's indebtedness. The option bonds provided a right to subscribe for shares and evidenced an interest-free loan to the company, i.e. the subscription price for the option bond until maturity of the bond or until the exercise of the option whichever occurred first.

9. Although the Eurobonds themselves evidenced a loan they did not provide the holders or owners with a right or option to have shares allotted to them. Accordingly, they did not constitute a convertible note within the meaning of sub-section 82L(1).

10. Sub-section 82L(2) of Division 3A provides that, where the combined effect or operation of two or more related instruments, whether issued at the same time or not, would have the effect or operation of a convertible note, the instruments shall be deemed to be together a convertible note. The Eurobonds and the option bonds when read together could not be construed as relieving the company, in whole or part, of its obligations to pay interest and repay capital by the issue of shares. Whether options under the option bonds were exercised or not, or whether by subscribers to the Eurobonds or subsequent holders of the option bonds, the company's indebtedness to the Eurobond holders would still stand. Accordingly, the Eurobonds and option bonds were not considered to be related instruments

for the purposes of sub-section 82L(2) and the convertible note provisions did not apply to them.

11. In the second case the combined effect of the two instruments did confer on the holders a right or option to have shares allotted to them. Together they constituted a convertible note subject to the convertible note provisions.

COMMISSIONER OF TAXATION
9 July 1987