

TAXATION RULING IT 2657

FOI Embargo: May be released

Page 1 of 9

NO Ref.: 87/6075-6

Date of effect: Immediate

BO Ref.:

Date original memo issued:

EDR Ref: Revised EDR 25, 26, 27

FOI INDEX DETAIL

Reference no.:

Subject refs:

Legislative refs:

I 1012903

CONVERTIBLE NOTES

82L 82R 82S

- NOTE

82SA

- ISSUE

- CONVERSION

- REDEMPTION

OTHER RULINGS ON THIS TOPIC: IT 2185, IT 2204

**TITLE: INCOME TAX: DEDUCTIBILITY OF INTEREST PAYABLE ON
CONVERTIBLE NOTES**

NOTE: . Income Tax Rulings do not have the force of law.

- . Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

The purpose of this Ruling is to consider the application of the convertible note provisions contained in Division 3A of Part III of the Income Tax Assessment Act 1936 ("the Act") to two financing arrangements considered by this Office.

Summary of the Ruling

The Ruling concludes as follows:

- (a) **CASE A** - The proposed instrument included an option to redeem or convert the note into shares within the first two years of issue. Noteholders could redeem by taking cash or a substituted form of debt instrument. The proposed instrument constituted a convertible note and the terms of the issue satisfied the requirements of section 82SA (paragraphs 9-18)
- (b) **CASE B** - The arrangement involved the issue of convertible bonds containing a condition providing for the payment of a variable premium in the case of optional redemption by the issuer. The condition was not considered to be a condition dealing with interest rates. Furthermore, as the condition acted

as an inducement to advance the exercise of the noteholder's option to convert, the proposed instruments satisfied the requirements of section 82SA (paragraphs 19-33).

GENERAL BACKGROUND

Deductibility of interest payable under convertible notes

2. The general principle of the income tax law as expressed in section 51 of the Act is that interest on borrowed money is an allowable deduction from the assessable income of a company where the interest is incurred by the company in producing its assessable income, or is necessarily incurred by the company in carrying on business for the purpose of producing such income. By contrast, a dividend paid by a company on its share capital is not an allowable deduction. Interest paid on convertible notes - on the terms on which the notes were being issued before 1960 - had generally more in common with non-deductible dividends on deferred shares than deductible interest on borrowed money. The Act was amended to provide that interest incurred by a company on convertible notes was not to be deductible from the assessable income of the company where the notes were issued after 15 November 1960.

3. That approach was reversed in 1970. Deductibility of interest on convertible notes was restored subject to a number of tests which were designed to eliminate the potential for abuse of the provisions. In recognition of the fact that convertible notes can often be a useful instrument to an enterprise that wishes to raise funds for expansion and development, deductibility of interest was restored for notes issued after 27 October 1970 (by Income Tax Assessment Act 1970) where the issue was made on terms specified in the Act. The tests for deductibility of interest on convertible notes were further relaxed by amendments effected in 1976 (by Income Tax Assessment Amendment Act 1976).

The convertible note provisions of the Act

4. "Convertible note" is defined in subsection 82L(1). Broadly speaking, the expression includes a note issued by a company that provides either:

- (a) that the loan to the company is to be, or may be converted into share capital; or
- (b) that the noteholder has a right or option to acquire shares in the capital of the company or some other company.

"Note" is defined to mean a note or other instrument issued by a company that evidences, acknowledges, creates or relates to a loan

TAXATION RULING IT 2657

FOI Embargo: May be released

Page 3 of 9

to the company. "Instrument" is defined to include debenture, bond, certificate, receipt or any other document or writing.

5. Subsection 82L(2) provides that where the combined effect or operation of 2 or more related instruments would have the effect or operation of a convertible note, the two instruments are deemed to be together a convertible note.

6. Section 82R provides that an outgoing consisting of interest, or a payment in the nature of interest, under a convertible note to which the section applies is not an allowable deduction from the assessable income of the company. Section 82R does not apply:

- (a) in relation to loans made on or after 1 January 1976, if the tests set out in section 82SA are met, nor
- (b) in relation to loans made before 1 January 1976, if the tests set out in section 82S are met.

While some of the requirements contained in sections 82S and 82SA are the same, generally the provisions of section 82SA constitute a relaxation of the earlier tests. This Ruling is limited in its scope to consideration of post 1 January 1976 convertible note issues.

7. The requirements specified in section 82SA include:

- (a) That conversion of the loan into share capital can only take place as a consequence of the exercise of an option by the noteholder (subparagraphs 82SA(1)(d)(i),(ii) and (iii));
- (b) That the earliest date on which the option to convert may be exercised is not later than 2 years after the date of offer (subparagraph 82SA(1)(d)(iv));
- (c) That the rate of interest payable in respect of the loan to which the notes relate is the same throughout the loan period (subparagraph 82SA(1)(d)(vi));
- (d) That the obligations and rights of the holder or owner of the note should not vary in his or her favour by reason of the exercise of the option or any other right in relation to the note, at a later rather than at an earlier time after the issue of the note. In other words that there is no inducement (whether concerning the terms on which shares are to be issued or otherwise) to postpone the exercise of the option to convert (subparagraph 82SA(1)(d)(vii)); and
- (e) That the rights of the noteholder as to the amount payable on repayment, redemption or satisfaction of the

TAXATION RULING IT 2657

FOI Embargo: May be released

Page 4 of 9

loan do not vary according to whether or not the option is exercised (subparagraph 82SA(1)(d)(viii)).

8. Subsection 82SA(4) provides that:

- (a) where the company issuing a convertible note or its directors do any act for the purpose of, or for purposes that include the purpose of, depressing the minimum conversion price (that is the price payable by a noteholder on the exercise of his option to convert); and
- (b) that act has the effect of depressing the minimum conversion price, section 82R applies to the convertible note. Accordingly, interest payable under the note is deemed not to be an allowable deduction from the assessable income of the company.

FINANCING ARRANGEMENTS CONSIDERED BY THIS OFFICE

FACTS OF CASE A

9. A company proposing to raise funds by way of a convertible note issue was, at that time, subject to a takeover bid. At issue was the terms of a proposed conversion/redemption option, included at the request of the underwriter, to avoid any disadvantage it may suffer by the terms of any takeover. The conversion/redemption option would only prevail for the period of two years after the date of offer in respect of the notes and was in addition to an option to convert which would otherwise satisfy the requirements of section 82SA of the Act. The additional option was available to noteholders in the event that:

- (a) more than 35% of the issued share capital of the company became owned by one party;
- (b) the control of the company's board was substantially altered; and
- (c) the "raider" did not make an offer to noteholders comparable with the terms under which it acquired its stake in the company.

10. Face value of the notes was set at \$3.30 per note and redemption and/or conversion would occur at this price irrespective of how redemption or conversion was to occur. No premium would be payable upon conversion.

11. Noteholders who elected to redeem within the first two years of the issue would have a further option to take cash or a substituted form of debt instrument (for example, a promissory note) in satisfaction of full redemption. In all other respects, the terms of the proposed convertible note issue satisfied the requirements of subsection 82SA(1).

ISSUES IN CASE A

12. The issue raised by Case A was whether the additional redemption/conversion option offended the requirements of subsections 82SA(1) and (4).

RULING ON CASE A

Subsection 82SA(1) requirements

13. The proposed conversion or redemption option did not offend the requirements of subparagraphs 82SA(1)(d)(i), (iv), (v), (vii) and (viii). The overall effect of the terms of the issue still conferred on noteholders a right or option to have shares in the capital of the company allotted to them. The condition allowing noteholders who elected to redeem within the first two years of issue to take cash or a substituted form of debt instrument did not prevent the requirements of subsection 82SA(1) being satisfied.

Subsection 82SA(4)

14. Another issue requiring consideration in the context of company directors' defensive actions against takeovers, was whether such actions fell within the operation of subsection 82SA(4), debarring deductibility of the interest payable under the convertible note. The subsection is directed at special arrangements made by a company or its directors to reduce the minimum conversion price required by subparagraph 82SA(1)(d)(xi). The subsection operates only if the relevant actions of the company or its directors have both the purpose and the effect of reducing the minimum conversion price. It is not essential that the purpose be the only or even the dominant purpose of the company's or directors' actions.

15. In a hostile takeover situation, the price of a share normally rises to reflect the premium offered by the raider company. The efforts of the directors of the target company in resisting the takeover generally tend to reduce the price of the shares. This is because, if the takeover is unsuccessful, the price of the share no longer reflects the raider company's preparedness to pay a higher price for the shares in order to take over the target company. A reduction in the price of the share may in turn reduce the conversion price for the purposes of subsection 82SA(4).

16. While company directors' actions in resisting a takeover offer may have the effect of reducing the share price and consequently the conversion price, it cannot be said that, in so resisting, the directors necessarily have the relevant purpose. Whether the directors have the relevant purpose is a question of fact to be determined on the basis of all surrounding

circumstances. Subsection 82SA(4) does not necessarily operate in all cases where a hostile takeover is being resisted.

17. In Case A, there was no evidence that in resisting the takeover offer the company directors' actions would have the purpose of depressing the minimum conversion price. Therefore subsection 82SA(4) did not apply.

DATE OF EFFECT : CASE A

18. The interpretation of the law on the issues involved in Case A applies to all assessments (original or amended) made on or after the date of this Ruling for income years commencing before or after that date (subject to statutory limits such as section 170).

FACTS OF CASE B

19. The proposed arrangement involved the issue of bonds by Company Y which, it was agreed, constituted convertible notes as defined in section 82L. A condition of the issue of the bonds provided for their optional redemption at a premium by the issuer. The issuer could only elect to redeem the bonds under this provision if the price of the shares in Company Y had been at least 130% of the conversion price during a specified 30 day period or at least 95% of the aggregate principal amount of the bonds had already been converted, redeemed, or purchased and cancelled. The amount of the premium reduced by a percentage point each year from 105% of the principal amount in the first year. There was nothing in the terms applying to the issue to prevent the holder or owner of the bond from electing to convert the bonds into shares in the capital of the company during the 5 year period when the premiums may be paid.

ISSUES IN CASE B

20. The issues which arose in Case B were whether the terms of the bonds providing for a reduction in the amount of premium was:

- a term providing for a variation in the rate of interest payable on the note (subparagraph 82SA(1)(d)(vi)); and
- a term under which the obligations and rights of the holder or owner of the convertible note varied in his favour by reason of the exercise of the option at a later rather than at an earlier time after the issue of the note (subparagraph 82SA(1)(d)(vii)).

RULING ON CASE B

21. The proposed arrangement satisfied the requirement contained in subparagraph 82SA(1)(d)(vii). The premium payable under the

transaction did not breach the requirements of subparagraph 82SA(1)(d)(vi).

Subparagraph 82SA(1)(d)(vii)

22. Subparagraph 82SA(1)(d)(vii) requires that the obligations and rights of the holder or owner of the note should not vary in his or her favour if the conversion takes place at a later rather than at an earlier time after the issue of the note. The test is directed at inducements to postpone the exercise of the option to convert notes into share capital. It does not proscribe inducements to advance the exercise of the noteholder's option to convert.

23. In this case, the provision for optional redemption by the issuer at a premium would not act as an inducement to postpone conversion by noteholders. Rather, it was intended to encourage noteholders to exercise their conversion rights earlier in time if the share price substantially increased above its level at the time the notes were issued. A noteholder who elected not to convert in this situation would run the risk of having the notes redeemed at a comparatively reduced premium as each year passed without conversion.

Subparagraph 82SA(1)(d)(vi) not breached by the premium

24. Subparagraph 82SA(1)(d)(vi) requires the rate of interest payable under the convertible note to be the same throughout the loan period, subject to the operation of subsection 82SA(5). Subsection 82SA(5) deems interest rate changes under a convertible note in accordance with changes in the rate of interest payable on certain Commonwealth securities not to be variations in the interest rate in terms of subparagraph 82SA(1)(d)(vi). In other words, the legislation specifically allows for the interest rate under a convertible note to vary in accordance with interest rate changes under Commonwealth securities. Except for this legislative departure from the general rule, subparagraph 82SA(1)(d)(vi) proscribes all other changes in the interest rate payable under a convertible note. It proscribes variations of interest rates whether they would induce a noteholder to postpone or induce a noteholder to advance the exercise of the noteholder's option to convert.

25. The question in Case B was whether the subparagraph was breached and in particular whether the term providing for the payment of a premium on the optional redemption by the issuer was a term dealing with interest rates. This question required consideration of whether the premium constituted interest or an amount in the nature of interest.

26. The term "interest" is not defined in the convertible notes provisions of the Act. It bears its ordinary meaning of "a sum payable for the use of another sum" (Macquarie Dictionary).

In other words, it is the consideration payable by one person for the use of another person's sum of money. In determining whether the amount of premium payable under a convertible note constitutes interest or is in the nature of interest, it is necessary to consider whether it forms part of the consideration payable by the issuer for the use of the noteholder's money.

27. Generally, a premium is considered to be interest for the purposes of subparagraph 82SA(1)(d)(vi) where:

- (a) the rate of interest otherwise payable under the note is lower than the commercial rate of interest;
or
- (b) the amount of the premium increases the later it is paid.

Therefore, in situations where the interest rate payable on the note is lower than the commercial interest rate generally payable on this type of instrument, the premium may be regarded as part of the consideration payable to the noteholder and is considered to be interest or in the nature of interest. Similarly, where the amount of premium increases the longer the instrument is held, i.e. where it is payable by reference to the period of the loan, such premium is treated as interest or in the nature of interest. However, if the amount of interest otherwise payable on the note is equal to or higher than the commercial rate of interest, and the amount of the premium does not increase the later it is paid, the premium is generally considered to be an amount of capital or of a capital nature.

28. In the present case, the notes attracted a commercial rate of interest and the premium did not increase the longer the notes were held. Accordingly, the premium was not considered to be interest or an amount in the nature of interest and it did not breach subparagraph 82SA(1)(d)(vi).

Contrast with Taxation Ruling IT 2204

29. The present case is to be contrasted with the financing arrangements described in Taxation Ruling IT 2204 which provided for the payment of a premium on the exercise of an option to redeem by the noteholder. The premium was calculated so as to give the noteholder a return approximating a specified interest rate. In that case the premium was considered to form part of the consideration payable for the use of the noteholder's investment and therefore to be interest. Consequently, paragraph 82SA(1)(d)(vi) applied. In the circumstances, it was decided that the paragraph was breached by the terms of the particular note issue.

Deductibility of premium

30. It follows from the above discussion of the nature of the premium, that if in view of the application of the two factors referred to in paragraph 27, the premium is considered to be an amount of capital or of a capital nature, no deduction in respect of that amount will be allowable to the issuer in terms of section 51 of the Act. Similarly where such a premium is not considered to be interest or in the nature of interest, but rather is treated as an amount of capital, no withholding tax liability would arise in respect of the amount. Taxation Ruling IT 2185 deals with the case of such a premium of capital or of a capital nature.

DATE OF EFFECT : CASE B

31. The interpretation of subparagraph 82SA(1)(d)(vii) adopted in Case B applies in assessments (original or amended) made on or after the date of this Ruling for income years commencing before or after that date (subject to statutory limits such as section 170).

32. The interpretation of subparagraph 82SA(1)(d)(vi) adopted in Case B applies to convertible notes issued on or after the date of this Ruling.

33. As to convertible notes issued before the date of this Ruling, this Office does not propose to disturb the deductibility of interest claimed on the basis of the interpretation of subparagraph 82SA(1)(d)(vi) that accepted a variation of interest rates that induced a noteholder to advance the exercise of the noteholder's option to convert.

COMMISSIONER OF TAXATION

24 October 1991