



Taxation Determination

Income tax: can a share in a company be a convertible interest by satisfying item 4 of the table in subsection 974-75(1) of the *Income Tax Assessment Act 1997*?

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

1. Yes. A share that falls within item 1 of the table in subsection 974-75(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ will also be a convertible interest if it satisfies item 4 of that table.

Date of effect

2. This Determination applies to years commencing both before and after its date of issue. However, the Determination does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

22 August 2007

¹ Unless otherwise specified all legislative references in this Determination are to the ITAA 1997.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Explanation

3. A convertible interest is defined in subsection 995-1(1) to include an interest of the kind referred to in item 4 of the table in subsection 974-75(1). Item 4 of that table refers to, among other things, an interest that will or may 'convert' into an equity interest. Section 974-165 ensures that 'convert' in this context has a very broad meaning.

4. A share which converts (in the broad sense described in section 974-165) into another share nominally falls within item 4 of the table in subsection 974-75(1). Whether it qualifies as a convertible interest depends on whether there is anything in Division 974 (or any other provision of the ITAA 1997) which prevents a share satisfying both item 1 and item 4 of the table. In this regard there are no grounds to conclude that a share within item 1 could not also satisfy item 4 of the table, but there is support for the proposition that it could.

5. Subsection 974-75(3) provides that '[t]he interest referred to in item 2, 3 or 4 in the table in subsection 974-75(1) may take the form of a proprietary right, a chose in action or any other form.' As such, the nature of items 2, 3 and 4 goes to the quality of rights rather than their legal form and indicates an overlap between them and item 1 of the table is possible.

6. Example 2.8 in the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 illustrates this position by providing the following example of a convertible interest:

A company issues a stapled instrument comprising an unpaid preference share and a perpetual note whose terms provide that, if the face value of the note is redeemed, a call is made on the unpaid amount of the preference share (that is, there is an effective, but not an actual, conversion of the note into a preference share).

A variation on this type of instrument is where the redemption of the note triggers an obligation of the holder to acquire an equity interest in the issuer from a connected entity of the issuer.

7. In this example the share, even in unpaid form, would fall within item 1 of the table in subsection 974-75(1). Yet in both cases the interest of which the share is a part is also a converting or convertible interest that falls within item 4.

8. Moreover, Example 2.26 in the Explanatory Memorandum also implicitly recognises that an interest could fall within more than one item in the table:

Item 2 in the table treats as equity interests (subject to the debt test explained in paragraphs 2.124 to 2.209), interests that provide an effectively contingent (i.e. contingent in substance or effect, even if not in legal form) right to a return (whether fixed or variable), or an absolute right to a contingent return. In this context a return is both a return on an investment and a return of an investment. For example, dividends are returns on an equity interest, and the redemption proceeds of a share constitute the return of the investment: either may be contingent on economic performance, and both are returns for the purposes of this definition of an equity interest.

9. This example recognises that an interest under item 2 of the table could be a share that pays contingent dividends or a share that was contingently redeemable. As the 'interest' is a share, it would also fall within item 1 of the table in subsection 974-75(1).

10. There are no ordering rules and, on a plain reading, an interest could fall within more than one item in the table in subsection 974-75(1). As such, a share in a company which will or may convert into an equity interest in the company or a connected entity will fall within item 1 of the table and also qualify as a convertible interest because of item 4. Whether or not the convertible interest will be an equity interest will depend on whether the equity test in section 974-70 is satisfied.

11. Whether a share satisfies the requirements of item 4 of the table in subsection 974-75(1) and thus gives rise to a 'convertible interest' according to the definition of that term in subsection 995-1(1) is relevant for a number of income tax provisions. An example is Subdivision 130-C, dealing with capital gains tax.

References

Previous draft:

TD 2007/D3

Related Rulings/Determinations:

TR 2006/10

Subject references:

- convertible interest
- equity interest
- share

Legislative references:

- ITAA 1997 Subdiv 130-C

- ITAA 1997 Div 974
- ITAA 1997 974-70
- ITAA 1997 974-75(1)
- ITAA 1997 974-75(3)
- ITAA 1997 974-165
- ITAA 1997 995-1(1)
- TAA 1953

Other references:

- Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001

ATO references

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