


***TR 2007/D11 - Income tax: debt/equity - identification of any 'effectively non-contingent obligation' of an issuer of a convertible note to provide 'financial benefits' for the purposes of Division 974 of the Income Tax Assessment Act 1997 if the note can be converted at any time at the issuer's discretion into shares that are equity interests in the issuer company***

 This cover sheet is provided for information only. It does not form part of *TR 2007/D11 - Income tax: debt/equity - identification of any 'effectively non-contingent obligation' of an issuer of a convertible note to provide 'financial benefits' for the purposes of Division 974 of the Income Tax Assessment Act 1997 if the note can be converted at any time at the issuer's discretion into shares that are equity interests in the issuer company*

This document has been finalised by TR 2008/3.



## Draft Taxation Ruling

Income tax: debt/equity – identification of any ‘effectively non-contingent obligation’ of an issuer of a convertible note to provide ‘financial benefits’ for the purposes of Division 974 of the *Income Tax Assessment Act 1997* if the note can be converted at any time at the issuer’s discretion into shares that are equity interests in the issuer company

### Contents Para

#### **PROPOSED LEGALLY BINDING SECTION:**

**What this Ruling is about** 1

**Previous Ruling** 6

**Ruling** 7

**Date of effect** 8

#### **NOT LEGALLY BINDING SECTION:**

**Appendix 1:**

**Explanation** 9

**Appendix 2:**

**Alternative views** 51

**Appendix 3:**

**Your comments** 137

**Appendix 4:**

**Detailed contents list** 138

### **ⓘ This publication provides you with the following level of protection:**

This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation 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.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don’t have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

## **What this Ruling is about**

1. This draft Ruling considers whether the issuer of a convertible note has an ‘effectively non-contingent obligation’ to provide ‘financial benefits’ for the purposes of the debt test in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997)<sup>1</sup> if the issuer can, at any time of its choosing after issue, exercise a discretion to convert the note into an equity interest in the issuer company.

<sup>1</sup> All legislative references in this draft Ruling are to the ITAA 1997 unless otherwise indicated.

## Class of entities/scheme

2. Division 974 was introduced into the ITAA 1997 by the *New Business Tax System (Debt and Equity) Act 2001*. It generally applies from 1 July 2001 to interests issued on or after that date, and from 1 July 2004 to interests that were issued before 1 July 2001 (unless the issuer elected that the Division apply from some time between 1 July 2001 and 30 June 2004).

3. This draft Ruling applies to issuers of a convertible note that is subject to Division 974 where the convertible note is issued by a company to a lender for a fixed or indefinite term, with the following features:

- for the purposes of Division 974, the convertible note is issued under a scheme that is a financing arrangement for the issuer and is issued by a company for an issue price;
- the issuer has the right to terminate the convertible note at any time by providing shares that are 'equity interests' under Division 974 in the issuer; and
- alternatively, the issuer must return the issue price to the lender at the end of the life of the convertible note.

4. The issuer of the convertible note will usually be required to make periodic payments of interest to the holder while the convertible note is on issue.

5. This draft Ruling should be read as including a scheme under which financial benefits might be received or provided by a 'connected entity' of the issuer for the purposes of Division 974.

## Previous Ruling

---

6. Draft Taxation Determination TD 2004/D76 is withdrawn on and from 28 November 2007, the issue date of this draft Ruling. To the extent that our views in that draft Taxation Determination still apply, they have been incorporated into this draft Ruling.

## Ruling

---

7. The issuer of a convertible note that can be converted at any time, at the issuer's discretion, into a share that is an equity interest in the issuer, will not have an effectively non-contingent obligation to provide financial benefits for the purposes of paragraph 974-20(1)(c), unless that option to convert should be disregarded in light of the full consideration of the pricing, terms and conditions under which the note was issued.

## **Date of effect**

---

8. It is proposed that when the final Ruling is issued, the Ruling will apply to years commencing both before and after its date of issue. However, the Ruling 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 Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

---

**Commissioner of Taxation**

28 November 2007

---

## Appendix 1 – Explanation

**①** *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

9. A convertible note that might be converted into an equity interest in the issuer may – before any conversion at the issuer's option into an equity interest – give rise to an interest that is classified by Division 974 as an equity interest or a debt interest. The classification of a convertible note as a debt interest or an equity interest will have certain taxation consequences. In particular, returns paid on a convertible note that is an equity interest may be frankable, but will not be deductible, while returns paid on a convertible note that is a debt interest may be deductible, but not frankable.

10. This draft Ruling considers an element that is critical to the classification of a particular type of convertible note as a debt interest under Division 974: does the issuer of this type of convertible note have an 'effectively non-contingent obligation' to provide 'financial benefits' to the holder for the purposes of the debt test if the issuer can – at any time after issue, at its discretion – convert the note into an equity interest in the issuer?

### Division 974 overview

11. The objects of Division 974 are set out in section 974-10. Subsections 974-10(1) and (2) provide as follows:

- (1) An object of this Division is to establish a test for determining for particular tax purposes whether a scheme, or the combined operation of a number of schemes:
  - (a) gives rise to a debt interest; or
  - (b) gives rise to an equity interest.
- (2) Another object of this Division is that the test referred to in subsection (1) is to operate on the basis of the economic substance of the rights and obligations arising under the scheme or schemes rather than merely on the basis of the legal form of the scheme or schemes.

12. Note 1 to subsection 974-10(2) states:

The basic indicator of the economic character of a debt interest is the non-contingent nature of the returns. The basic indicator of the economic character of an equity interest, on the other hand, is the contingent nature of the returns (or convertibility into an interest of that nature).

13. The Second Reading Speech and the Explanatory Memorandum (at paragraph 1.9) to the New Business Tax System (Debt And Equity) Bill 2001 (the EM) both contain the following statement:

The test for distinguishing debt interests from equity interests focuses on a single organising principle - the effective obligation of an issuer to return to the investor an amount at least equal to the amount invested.

14. The 'single organising principle' is further reflected in the following extract from paragraph 1.10 of the Supplementary Explanatory Memorandum and Correction to the Explanatory Memorandum to the New Business Tax System (Debt And Equity) Bill 2001 (the Supplementary EM):

The emphasis on the economic substance of the rights and obligations is designed to provide a robust approach to determining, for example, whether there is an effective obligation of an issuer to return to the investor an amount at least equal to the amount invested.

15. The debt test is set out in Subdivision 974-B and reflects this 'single organising principle'. Under the debt test, a convertible note will not be a debt interest if the issuer does not have an 'effectively non-contingent obligation' to provide any 'financial benefits'. Further, if the issuer of a convertible note does have an 'effectively non-contingent obligation' to provide financial benefits, the convertible note will not be a debt interest if it is not substantially more likely than not that the aggregate of the values of all financial benefits that the issuer is effectively obliged to supply is equal to or greater than the value of financial benefits received by the issuer on issue of the convertible note.

16. A 'financial benefit' is defined as anything of economic value (subsection 974-160(1)). However, it is important to note that the issue of an equity interest in the issuer does not count as the provision of a financial benefit by the issuer (subsection 974-30(1)). The provision of a share that is an equity interest on conversion of a convertible note is therefore not the provision of a financial benefit for the purposes of Division 974.

17. The Division contains special rules that apply in valuing financial benefits for the purposes of the debt test. If the issuer of a convertible note must provide all the financial benefits that it is effectively obliged to provide within 10 years of the instrument being issued, all of those financial benefits are valued in nominal terms, and compared with the value of the financial benefits received by the issuer on issue of the interest. If the issuer might provide financial benefits that it is obliged to provide for a period greater than 10 years from the date of issue, all the financial benefits to be provided by the issuer are to be valued in terms of their present values (subsection 974-35(1)). The aggregated value of all the financial benefits to be provided by the issuer is compared with the value of the financial benefits received by the issuer on issue of the convertible note.

18. The valuation of financial benefits is discussed in greater detail at paragraphs 56 to 82 of this draft Ruling.

19. The tests in Division 974 for determining whether a scheme gives rise to a debt interest or an equity interest in effect apply such that, for example, an instrument will not be a debt interest if the issuer only has effectively contingent obligations to provide financial benefits that might return the issue price of an instrument to the holder.

20. Thus a convertible note could not be classified as a debt interest if the issuer only has effectively contingent obligations to provide any financial benefits.

## Classification rules

### ***Equity test***

21. The test for an equity interest in a company is in Subdivision 974-C. Section 974-70 sets out the meaning of an equity interest in a company. Subsection 974-70(1) states as follows:

A scheme gives rise to an ***equity interest*** in a company if, when the scheme comes into existence:

- (a) the scheme satisfies the equity test in subsection 974-75(1) in relation to the company because of the existence of an interest; and
- (b) the interest is not characterised as, and does not form part of a larger interest that is characterised as, a debt interest in the company, or a connected entity of the company, under Subdivision 974-B.

22. Paragraph 974-70(1)(b) ensures that an interest will not be an equity interest if it is a debt interest (see also subsection 974-5(4)).

23. The 'equity test' is in subsection 974-75(1) which provides:

A scheme satisfies the equity test in this subsection in relation to a company if it gives rise to an interest set out in the following table:

<b>Equity interests</b>	
<b>Item</b>	<b>Interest</b>
1	An interest in the company as a member or stockholder of the company.
2	<p>An interest that carries a right to a variable or fixed return from the company if either the right itself, or the amount of the return, is in substance or effect contingent on the economic performance (whether past, current or future) of:</p> <ul style="list-style-type: none"> <li>(a) the company; or</li> <li>(b) a part of the company's activities; or</li> <li>(c) a connected entity of the company or a part of the activities of a connected entity of the company.</li> </ul> <p>The return may be a return of an amount invested in the interest.</p>

3	An interest that carries a right to a variable or fixed return from the company if either the right itself, or the amount of the return, is at the discretion of: (a) the company; or (b) a connected entity of the company. The return may be a return of an amount invested in the interest.
4	An interest issued by the company that: (a) gives its holder (or a connected entity of the holder) a right to be issued with an equity interest in the company or a connected entity of the company; or (b) is an interest that will, or may, convert into an equity interest in the company or a connected entity of the company.

This subsection has effect subject to subsection (2) (requirement for financing arrangement).

24. Subsection 974-75(2) provides:

A scheme that would otherwise give rise to an equity interest in a company because of an item in the table in subsection (1) (other than item 1) does not give rise to an equity interest in the company unless the scheme is a financing arrangement for the company.

25. A scheme is defined for the purposes of Division 974 in subsection 974-150(1) and has the meaning given in section 995-1.<sup>2</sup> A scheme will be a financing arrangement if it is undertaken to raise finance for the company (paragraph 974-130(1)(a)). The type of convertible note that is the subject of this draft Ruling satisfies both of these requirements.

26. A convertible note that can be converted into an equity interest in the issuer at any time at the issuer's discretion will satisfy the equity test in subsection 974-75(1). Item 3 in the table in subsection 974-75(1) will be satisfied because the amount of the return on or of the amount invested in the note will be at the discretion of the issuer: the amount of the return will depend on whether and when the issuer exercises its discretion to convert the note. The amount of any interest payable on the note will depend on the issuer's discretion to convert. Item 4 in the table will also be satisfied because the note is an interest that may convert into an equity interest in the issuing company.

27. While a convertible note will be within the description of one or more items in the table in subsection 974-75(1), by operation of paragraph 974-70(1)(b) it will not be an equity interest if it also satisfies the test for a debt interest: the convertible note will instead be a debt interest.

<sup>2</sup> Section 995-1 provides that a scheme means: (a) any arrangement; or (b) any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.



**Debt test**

28. Subsection 974-15(1) provides that a scheme will give rise to a debt interest in an entity if the scheme, when it comes into existence, satisfies the debt test in subsection 974-20(1). The debt test is to be applied to the convertible note when it is first issued.

29. Relevant provisions of the debt test in section 974-20 are reproduced below:

**SECTION 974-20 The test for a debt interest****Satisfying the debt test**

974-20(1) A scheme satisfies the debt test in this subsection in relation to an entity if:

- (a) the scheme is a financing arrangement for the entity; and
- (b) the entity, or a connected entity of the entity, receives, or will receive, a financial benefit or benefits under the scheme; and
- (c) the entity has, or the entity and a connected entity of the entity each has, an effectively non-contingent obligation under the scheme to provide a financial benefit or benefits to one or more entities after the time when:
  - (i) the financial benefit referred to in paragraph (b) is received if there is only one; or
  - (ii) the first of the financial benefits referred to in paragraph (b) is received if there are more than one; and
- (d) it is substantially more likely than not that the value provided (worked out under subsection (2)) will be at least equal to the value received (worked out under subsection (3)); and
- (e) the value provided (worked out under subsection (2)) and the value received (worked out under subsection (3)) are not both nil.

The scheme does not need to satisfy paragraph (a) if the entity is a company and the interest arising from the scheme is an interest covered by item 1 of the table in subsection 974-75(1) (interest as a member or stockholder of the company).

**Note:** Section 974-30 tells you when a financial benefit is taken to be provided to an entity.

974-20(2) The **value provided** is:

- (a) the value of the financial benefit to be provided under the scheme by the entity or a connected entity if there is only one; or
- (b) the sum of the values of all the financial benefits provided or to be provided under the scheme by the entity or a connected entity of the entity if there are 2 or more.

**Note:** Section 974-35 tells you how to value financial benefits.

- 974-20(3) The **value received** is:
- (a) the value of the financial benefit received, or to be received, under the scheme by the entity or a connected entity of the entity if there is only one; or
  - (b) the sum of the values of all the financial benefits received, or to be received, under the scheme by the entity or a connected entity if there are 2 or more.
- 974-20(4) For the purposes of paragraph (1)(b) and subsections (2) and (3):
- (a) a financial benefit to be provided under the scheme by the entity or a connected entity is taken into account only if it is one that the entity or connected entity has an effectively non-contingent obligation to provide; and
  - (b) a financial benefit to be received under the scheme by the entity or a connected entity is taken into account only if it is one that another entity has an effectively non-contingent obligation to provide.

30. The convertible note that is the subject of this draft Ruling will be a debt interest, and not an equity interest, if the note satisfies the debt test at the time that it comes into existence. That is, at the time that the convertible note is issued, the issuer has an effectively non-contingent obligation to provide a financial benefit or benefits, and it must be substantially more likely than not that the sum of the values of all of the financial benefits that the issuer must provide is an amount that is at least equal to the issue price.

***Effectively non-contingent obligation to provide financial benefits***

31. One of the key elements of the debt test is that a relevant entity – and, in practice, this will usually be the issuer – must have an ‘effectively non-contingent obligation’ under the scheme to provide a financial benefit or benefits (paragraph 974-20(1)(c)).

32. As noted at paragraph 16 of this draft Ruling, the issue of a share that is an equity interest in the issuer is not the provision of a financial benefit by the issuer. A share of that type that could be issued to the holder on conversion of the note does not count for the purposes of the debt test as a financial benefit that is to be provided by the issuer of the note.

33. Any periodic interest payments by the issuer to the holder, and a payment by the issuer to the holder to return the amount invested in the interest will be relevant financial benefits, if the issuer is under an effectively non-contingent obligation to provide them.

34. 'Effectively non-contingent obligation' is defined at section 974-135, and relevant parts of that section provide as follows:

974-135(1) There is an **effectively non-contingent obligation** to take an action under a scheme if, having regard to the pricing, terms and conditions of the scheme, there is in substance or effect a non-contingent obligation (see subsections (3), (4) and (6)) to take that action.

974-135(2) Without limiting subsection (1), that subsection applies to:

- (a) providing a financial benefit under the scheme; or
- (b) terminating the scheme.

974-135(3) An obligation is **non-contingent** if it is not contingent on any event, condition or situation (including the economic performance of the entity having the obligation or a connected entity of that entity), other than the ability or willingness of that entity or connected entity to meet the obligation.

974-135(4) The existence of the right of the holder of an interest that will or may convert into an equity interest in a company to convert the interest does not of itself make the issuer's obligation to repay the investment not non-contingent.

974-135(5) An obligation to redeem a preference share is not contingent merely because there is a legislative requirement for the redemption amount to be met out of profits or a fresh issue of equity interests.

974-135(6) In determining whether there is in substance or effect a non-contingent obligation to take the action, have regard to the artificiality, or the contrived nature, of any contingency on which the obligation to take the action depends.

**Note:** The artificiality, or the contrived nature, of a contingency would tend to indicate that there is, in substance or effect, a non-contingent obligation to take that action.

974-135(7) An obligation of yours is not **effectively non-contingent** merely because you will suffer some detrimental practical or commercial consequences if you do not fulfil the obligation.

**Note:** For example, a contingent obligation to make payments in respect of an income security issued by an approved deposit-taking institution (ADI) is not effectively non-contingent merely because of the detrimental effect non-payment would have on the ADI's business.

35. The concept of an 'effectively non-contingent obligation to take an action under a scheme' has apparently been adopted to facilitate consideration of the economic substance of arrangements, by reference to the pricing, terms and conditions of the scheme. The EM explains at paragraph 2.2:

The new rules classify an interest in a company as equity or debt according to the economic substance of the rights and obligations of an arrangement rather than its mere legal form in a more comprehensive way than the current law. Relevant to the classification is the pricing, terms and conditions of the arrangement under which the interest is issued.

36. Paragraphs 2.174 and 2.175 of the EM note as follows:

2.174 Debt in a formal sense involves obligations which are non-contingent in legal form (e.g. a legal obligation to pay interest and to return principal). However, if the debt test were to focus solely on obligations which are non-contingent in legal form, schemes that are equivalent in economic substance might give rise to different tax outcomes. This would encourage tax arbitrage and open up tax avoidance opportunities.

2.175 The debt test therefore uses the concept of an *effectively* non-contingent obligation as opposed to a *legally* (or formally) non-contingent obligation. Thus a scheme under which an entity has a right but not a legal obligation to provide a financial benefit could nevertheless be debt if, having regard to the pricing, terms and conditions of the scheme, the entity is in substance or effect inevitably bound, to exercise that right. ...

37. Paragraph 2.176 of the EM notes as follows:

2.176 The concept of an effectively non-contingent obligation is, however, not intended to displace regard to legal rights and obligations. This is particularly so where those rights and obligations are consistent with arms length transactions of commercial substance and reflect the clear intention of the parties.

38. The reason for having an effectively non-contingent test rather than simply a formal contingency test is further explained at paragraph 2.178 of the EM as follows:

2.178 ... In this regard, reliance solely on a formal non-contingent test would enable taxpayers to easily impose artificial contingencies in order to prevent an interest being debt. In addition, consistent with the principle inherent in the debt test of focusing on economic substance rather than legal form, where a contingency is so remote as to be effectively inoperative (immaterially remote) it is as if the contingency did not exist and it should be disregarded.

39. Therefore, where the provision of a financial benefit on an instrument is formally subject to a contingency, that formal contingency may be disregarded if, upon consideration of the pricing, terms and conditions of issue of an instrument, the substance or effect of the arrangement is that the financial benefit will be provided by the issuer, despite the formal contingency. Artificial or contrived contingencies may be disregarded (subsection 974-135(6)). A contingency that is immaterially remote, as explained above, will be disregarded.

40. On the other hand, if the formal terms of issue do not contain an express formal contingency, but it is apparent (again, from consideration of the pricing, terms and conditions of the scheme) that there is, in substance or effect, an effective contingency that could prevent the provision of financial benefits, the obligation to provide financial benefits would be considered to be effectively contingent: the obligation will therefore not be 'effectively non-contingent'.

41. If there is a formal contingency that could affect the issuer's obligation to provide a financial benefit, and that contingency is not to be disregarded for the reasons noted above, the ostensible intention of the provisions is that the obligation is to be considered to be contingent unless a specific statutory exception applies.

42. Subsection 974-135(4) provides one such statutory exception. It provides a specific exception where a holder of a convertible interest has a right to convert the interest into an equity interest in a company. But for that exception, the issuer's obligation to return the issue price of an interest where the holder has a right to convert that interest into an equity interest in the issuer would be *prima facie* contingent upon the holder not exercising its right to convert the interest. The terms of subsection 974-135(4) provide that the existence of the right of the holder to convert an interest '...does not of itself make the issuer's obligation to repay the investment not non-contingent.'

43. The issuer's obligations to repay the issue price will thus not be considered to be effectively contingent because of the mere existence of the holder's right to convert. However, consideration of the prescribed matters in addition to the mere existence of the holder's right to convert might mean that the issuer's obligation to repay the issue price is effectively contingent.

44. Section 974-135 does not contain a similar exception that applies where the issuer has the discretion to convert the note into an equity interest in the issuer. Thus an issuer's right to convert the convertible note is ostensibly a relevant contingency for the purposes of the debt test: it relevantly affects the obligations of the issuer to repay the investment, and to make any periodic payments on the investment. The discretion that an issuer has about converting the note into an equity interest in the issuer, and bringing to an end any obligations of the issuer to provide any financial benefits that would repay the investment, is regarded as a formal contingency that could of itself preclude a finding that there is an 'effectively non-contingent obligation' to provide a financial benefit after the time that the conversion option could be exercised.

45. If the issuer of the convertible note can exercise its discretion at any time to convert the note into an equity interest in itself, the issuer can terminate at any time any requirement to provide financial benefits. Therefore, at the time of issue the provision of any financial benefits by the issuer in the future will be contingent upon the exercise of the issuer's discretion to convert. Unless additional matters are identified (that is, matters that are evident from consideration of the pricing, terms and conditions of the scheme under which the instrument was issued) that would lead one to conclude that, as a matter of substance or effect, the issuer would never exercise that discretion to convert in that way, the issuer will only have effectively contingent obligations to provide financial benefits, rather than effectively non-contingent obligations.

46. However, as indicated at paragraph 39 of this draft Ruling, in some circumstances it might be that – on consideration of the pricing, terms and conditions of the scheme under which the notes are issued – the ostensibly contingent obligation in form to provide financial benefits is found to be non-contingent in substance or effect. For example, the terms on which the conversion is to take place may be such that conversion is merely a theoretical rather than a real possibility. In those circumstances, the financial benefits that the issuer must provide are taken into account for the purposes of the debt test.

47. The proper consideration of pricing, terms and conditions might lead to a conclusion (despite the issuer's formal ability to convert at any time of its choosing) that, in substance or effect, the conversion contingency would not be exercised before a certain time. In that event, the formal conversion contingency that allows the issuer to convert at any time would be disregarded, and financial benefits might be identified that the issuer is effectively obliged to provide before it would exercise its conversion option. The issuer could therefore have, for example, an effectively non-contingent obligation to provide financial benefits as payments of periodic interest before that earliest time. Whether those financial benefits are sufficient to satisfy the debt test depends on the application of other provisions of the debt test.

48. But unless the formal conversion contingency can in substance or effect be properly disregarded, the issuer will not have an effectively non-contingent obligation to provide financial benefits on the convertible note where, at its discretion, the issuer can at any time convert the note into a share or shares that are equity interests in the issuer.

49. The essential features of the convertible note that is the subject of this draft Ruling are quite different from arrangements where the issuer does have an effectively non-contingent obligation to repay the amount of an investment, and to pay periodic returns on that amount as interest until the amount of the investment is repaid in form. In those arrangements, the obligation to pay the interest attaches to or follows the effectively non-contingent obligation to repay the outstanding principal.

50. In the convertible note considered in this draft Ruling, the issuer only ever has a contingent obligation under section 974-135 to repay the issue price of the note, because at any time it can choose not to repay that amount by instead converting the note into a share that is an equity interest in the issuer. The obligation to pay interest on the convertible note is similarly contingent. In these circumstances, there is no effectively non-contingent obligation at any time under section 974-135 to provide relevant financial benefits in any form that (for the purposes of Division 974) are substantially more likely than not to repay the investment.

## Appendix 2 – Alternative views

**❶** *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

51. It has been suggested that the operations of subsection 974-35(2), and section 974-40 and/or section 974-45 require that an issuer's conversion option is to be disregarded in working out the length of the life of a convertible note unless the issuer has an effectively non-contingent obligation to exercise that option, and therefore the same assumption should also be made to identify all financial benefits that the issuer is under an effectively non-contingent obligation to provide. As a consequence, it is claimed, financial benefits that are truly contingent upon the issuer choosing not to exercise its discretion to convert are to be assumed to be financial benefits that the issuer is under an effectively non-contingent obligation to provide, unless the issuer is under an effectively non-contingent obligation to exercise its conversion option.

52. Therefore, so the suggestion goes, unless the issuer of the convertible note is effectively obliged to exercise its conversion option, the issuer will be assumed to have an obligation to repay the issue price, and any periodic interest that would be paid if the note continued for the whole of its nominal life.

53. The proponents of this alternative view claim support from some passages in the EM (and in particular, from Example 2.26 in the EM) and the terms of section 974-100.

54. On this alternative view, a convertible note that is convertible into an equity interest in the issuer at the issuer's discretion at any time (that is, the type of convertible note that is the subject of this draft Ruling) would almost always be a debt interest unless it was clear at the time of issue that the issuer had an effectively non-contingent obligation to convert the note before the investment is repaid.

55. The Commissioner does not accept this alternative view for the reasons set out below.

### **The valuation provisions: sections 974-35, 974-40 and 974-45**

56. Sections 974-35, 974-40 and 974-45 are, as the headings to each of those sections suggest, only concerned with the valuation of financial benefits. Where the financial benefits are to be provided by the issuer, the financial benefits that are to be valued are those that the issuer of a financing arrangement is under an effectively non-contingent obligation to provide. This requirement is discussed in greater detail at paragraphs 128 to 136 of this draft Ruling.

57. The note to subsection 974-20(2) confirms that 'Section 974-35 tells you how to value financial benefits.'

58. Subsections 974-35(5) and (6) are not relevant to the instant matter. Subsections 974-35(1) to (4) are relevant and provide as follows:

**SECTION 974-35 Valuation of financial benefits – general rules**

**Value in nominal terms or present value terms**

- 974-35(1) For the purposes of this Subdivision:
- (a) the value of a financial benefit received or provided under a scheme is its value calculated:
    - (i) in nominal terms if the performance period (see subsection (3)) must end no later than 10 years after the interest arising from the scheme is issued; or
    - (ii) in present value terms (see section 974-50) if the performance period must or may end more than 10 years after the interest arising from the scheme is issued; and
  - (b) the regulations may make provisions relating to the valuation of a financial benefit.

**Assume scheme runs its full term**

- 974-35(2) The value of a financial benefit received or provided under a scheme is calculated assuming that the interest arising from the scheme will continue to be held for the rest of its life.

**Note 1:** Section 974-40 makes specific provision for cases in which there is a right or option to terminate the interest early.

**Note 2:** Section 974-45 makes specific provision for cases involving convertible interests.

**Performance period**

- 974-35(3) The **performance period** is the period within which, under the terms on which the interest is issued, the effectively non-contingent obligations of the issuer, and any connected entity of the issuer, to provide a financial benefit in relation to the interest have to be met.
- 974-35(4) An obligation is treated as having to be met within 10 years after the interest is issued if:
- (a) the issuer; or
  - (b) the connected entity of the issuer;
- has an effectively non-contingent obligation to terminate the interest within that 10 year period even if the terms on which the interest is issued formally allow the obligation to continue after the end of that 10 year period.



59. Sections 974-40 and 974-45 provide as follows:

**SECTION 974-40 Valuation of financial benefits – rights and options to terminate early**

974-40(1) This section deals with the situation in which a party to a scheme has a right or option to terminate the scheme early (whether by discharging an obligation early, converting the interest arising from the scheme into another interest or otherwise).

**Note 1:** An example of terminating a *scheme* early by discharging an obligation early is terminating a loan by discharging the obligation to repay the principal (and any outstanding interest) early.

**Note 2:** In certain circumstances, conversion of an interest into another interest can terminate its life (see section 974-45).

974-40(2) The existence of the right or option is to be disregarded in working out the length of the life of the interest arising from the scheme for the purposes of this Subdivision if the party does not have an effectively non-contingent obligation to exercise the right or option.

974-40(3) If the party does have an effectively non-contingent obligation to exercise the right or option, the life of the interest ends at the earliest time at which the party will have to exercise the right or option.

974-40(4) This section does not limit subsection 974-35(2).

**SECTION 974-45 Valuation of financial benefits – convertible interests**

974-45(1) This section deals with the situation in which a scheme gives rise to an interest that will or may convert into an equity interest in a company.

974-45(2) The life of the interest ends no later than the time when it converts into that equity interest.

974-45(3) The possibility of the conversion is to be disregarded in working out the length of the life of the interest arising from the scheme for the purposes of section 974-35 if it is uncertain:

- (a) whether the interest will ever convert; or
- (b) when the interest will convert.

**Note:** Section 974-40 deals with the situation in which a party to the scheme may exercise a right or option to convert the interest.

974-45(4) This section does not limit subsection 974-35(2).

60. The note to subsection 974-45(3) confirms that 'Section 974-40 deals with the situation in which a party to the scheme may exercise a right or option to convert the interest'. Section 974-45 does not apply where the conversion of an interest might come about by the exercise of a right or option by a party to the scheme. Accordingly, section 974-45 does not apply to the circumstances considered in this draft Ruling (that is, where any conversion is at the discretion of the issuer).

61. Section 974-45 is apparently intended to apply where the conversion comes about other than by the exercise by a party to the scheme of a right or option – for example, it could apply where a note would convert only if some specified event were to occur at some time over the life of the note. The operation of section 974-45 accordingly turns on the certainty of the conversion, rather than (as section 974-40 requires) any effectively non-contingent obligation of a party to exercise the relevant right or option.

62. The fundamental operation of subsections 974-35(1) to (4), and sections 974-40 and 974-45, is to direct when the value of financial benefits should be calculated in their nominal values, and when they should be calculated in their present values for the purposes of paragraph 974-20(1)(d). And if a financial benefit is to be valued in its present value, these provisions apply to determine the time from which the financial benefit should be discounted.

63. The provisions are thus primarily concerned with ensuring that financial benefits that must be provided are appropriately valued.

64. The valuation provisions require that the value of a financial benefit that an issuer must provide is to be calculated at its nominal value for the purposes of the debt test if all the financial benefits must be provided under the scheme within 10 years from the date of issue. If the financial benefits to be provided might be provided over a period greater than 10 years, each of the financial benefits – including any financial benefit that is to be provided in the first 10 years of the life of the interest – is to be valued in terms of its present value (subsections 974-35(1) and (3)).

65. Section 974-50 sets out a formula that is to be applied to determine the present value of each individual financial benefit that must be valued in present value terms. The present values of all those financial benefits that the issuer must provide are aggregated and compared with the financial benefits received by the issuer on issue of the note for the purposes of paragraph 974-20(1)(d). For example, each payment of periodic interest that an issuer is effectively obliged to make is to be valued as a separate financial benefit.

66. Subsections 974-35(2) and (4) and sections 974-40 and 974-45 provide rules that apply in valuing financial benefits when it is clear that a financial benefit must be provided, but it is not entirely certain when the benefit will be provided.

### ***Subsection 974-35(2)***

67. The value of a financial benefit that must be provided under a scheme, and that must therefore be calculated under the valuation provisions for the purposes of paragraph 974-20(1)(d), is to be calculated on the assumption that the interest will continue to be held for the rest of its life (subsection 974-35(2)).

68. Consider, then, a loan that is granted for a period of 10 years in circumstances where the issuer (that is, the borrower) has an effectively non-contingent obligation to repay the principal, but also has an option to extend the term of the loan for up to 5 years. The financial benefit that is comprised of the repayment of principal (the 'principal' financial benefit) will be valued in present value terms on the statutory assumption required by subsection 974-35(2) that the interest is held for 15 years rather than 10 years. In the absence of that statutory assumption, it could be claimed that the life of the interest under the terms of the scheme was only 10 years so that the benefit should be valued in its nominal amount. Any extension could be said to represent a new arrangement. If it were to be assumed that the loan would be held for its initial term of 10 years, the financial benefit would be valued in nominal terms. By application of subsection 974-35(2), the value of the financial benefit that the issuer has an effectively non-contingent obligation to provide – the repayment of the principal sum – will therefore be calculated for the purposes of paragraph 974-20(1)(d) as the present value of the principal sum, on the statutory assumption that the principal that must be repaid (and that obligation to repay has been identified independently of the operation of subsection 974-35) is to be repaid 15 years from the date of issue.

69. In the terms of subsection 974-35(2), the value of the 'principal' financial benefit that is to be provided under the scheme is calculated assuming that the interest will continue to be held for the rest of its life. In this way, the 'principal' financial benefit that the issuer is effectively obliged to provide will not be inappropriately valued in nominal terms in the above circumstances as if it were to be repaid within 10 years of issue. Because the issuer might choose to repay the principal (that is, that it is effectively obliged to repay) more than 10 years from the date of issue, the interest is to be valued in present value terms.

70. Therefore, the application of subsection 974-35(2) in the above circumstances ensures that the 'principal' financial benefit is valued:

- in present value terms rather than nominal terms; and
- in present value terms on an assumption that it is to be repaid in year 15. That is, the present value formula in section 974-50 is to be applied on an assumption that the principal is repaid after 15 years rather than some other year between year 10 and year 15.

#### ***Subsection 974-35(4)***

71. If, however, the life of an interest might extend beyond 10 years (as in the above circumstances), but the issuer has an effectively non-contingent obligation to terminate the interest within 10 years, all the financial benefits that the issuer must provide are to be treated as having to be met within 10 years

(subsection 974-35(4)), and are therefore valued in their nominal amounts.

72. If it were clear in the above circumstances that the issuer would not exercise its option to repay principal in 15 years, but would repay the principal at year 10, subsection 974-35(4) would ensure that the 'principal' financial benefit that it must provide would be appropriately valued in nominal terms.

73. It might be noted that subsection 974-35(2) will not always materially affect the valuation of a financial benefit. If it is clear in a particular case that all the financial benefits will be supplied within 10 years of issue, the application of subsection 974-35(2) would not affect the valuation of each financial benefit in terms of its nominal values.

### **Section 974-40**

74. Similarly, the ostensible role of section 974-40 is to determine the appropriate life of an interest for the purposes of valuing a financial benefit where the interest might be terminated early by the exercise of a right or option by a party to the scheme. The 'early termination' might be effected by some party exercising a discretion to redeem the principal and any outstanding interest, or by exercising an option to convert the interest into an equity interest in the issuer before the maximum or nominal term of the interest. While subsection 974-35(2) provides that an interest is to be held 'for the rest of its life', and section 974-40 is consistent with that, subsection 974-40(3) performs the important function of moderating that 'length of the life' of the interest for the purpose of calculating the value of a financial benefit if it is certain that a relevant party to the scheme will exercise its option to terminate the scheme early.

75. For example, consider a simple loan of money with a nominal term to maturity of 15 years, where a party to the arrangement can terminate the arrangement 12 years after issue, and has an effectively non-contingent obligation to terminate the arrangement at that time, and the issuer has an effectively non-contingent obligation to repay the principal sum on termination.

76. The application of subsection 974-35(2) to those facts would determine that the life of the interest should be taken to be 15 years. However, the operation of subsection 974-40(3) would ensure that the life of the interest is taken to end at year 12 rather than 15.

77. Accordingly, the principal that must be repaid at some time will be valued in its present value on the basis that it is to be repaid in year 12 rather than year 15. By operation of the formula in section 974-50, the present value of the principal that is to be payable in year 12 will be a greater amount – and therefore make a greater contribution to satisfying the element of the debt test in paragraph 974-20(1)(d) – than the present value of the principal amount that would be calculated if it were to be assumed that it was repayable in year 15.

78. Subsection 974-35(4) has no application in those circumstances, because the interest will not be terminated within 10 years from issue.

79. Section 974-40 therefore provides a complementary rule for valuing financial benefits that an issuer is under an effectively non-contingent obligation to provide where the formal terms create some uncertainty about the time of provision of the financial benefits, because a relevant party has a discretion to terminate the interest early.

80. However, the terms of these valuation provisions are primarily concerned with the appropriate length of the life of an interest for the purposes of valuing a financial benefit that the issuer has an effectively non-contingent obligation to provide. The terms of those provisions do not explicitly deem effectively contingent obligations to provide financial benefits to be effectively non-contingent obligations. The alternative view relies on finding (by implication only) that those provisions do perform that function of deeming effectively contingent obligations to provide financial benefits to be effectively non-contingent obligations.

81. It should be noted that the terms of subsection 974-35(2) and section 974-40 can apply to a convertible note where the issuer has an effectively non-contingent obligation to repay the issue price. For example:

- The issuer of a convertible note that is convertible at any time at the **holder's** discretion could have an effectively non-contingent obligation to repay the issue price (by operation of subsection 974-135(4), as discussed at paragraph 42 of this draft Ruling).
- The issuer of a convertible note that is convertible at any time at the **issuer's** discretion could nonetheless have an effectively non-contingent obligation to repay the issue price. If the issuer's conversion contingency should be disregarded by operation of section 974-135 as discussed at paragraphs 39 and 46 of this draft Ruling, the issuer might have an effectively non-contingent obligation to repay the investment.

82. The valuation provisions would apply in valuing the effectively non-contingent obligations to repay the issue prices in both of these circumstances.

## The alternative view and section 974-100

83. Subsection 974-100(1) provides as follows:

If a debt interest is an interest that will or may convert into an equity interest, the conversion is taken, for the purposes of this Division to give rise to a new interest (and is not treated merely as a continuation of the debt interest).

84. Subsection 974-100(2) applies in a similar manner when an equity interest is converted into a debt interest.

85. Proponents of the alternative view suggest that the operation of subsection 974-100(1) supports their view. A convertible note should, the argument goes, be treated as a debt instrument unless the issuer is effectively obliged to convert the note into an equity interest in itself: on conversion, the interest is to be re-assessed because the interest after conversion is taken to be a new interest by operation of subsection 974-100(1) rather than the continuation of an existing interest.

86. It has also been suggested that the approach adopted in the alternative view, in its interpretation and application of the valuation provisions, is supported by the terms of sections 974-100. It is said that this provision indicates that the conversion of a convertible note is treated as giving rise to a new interest under a new scheme.

87. Section 974-100 does not provide that the classification of an interest will necessarily change on conversion – when, for example, the legal form of the interest changes on conversion – or that conversion is always treated as giving rise to a new interest. In particular, subsection 974-100(1) only applies if, as a consequence of a relevant circumstance, an antecedent interest does in fact change from a ‘debt interest’ to an ‘equity interest’ on conversion.

88. Note also that item 4 of the equity table in subsection 974-75(1) clearly contemplates that an interest that might convert into an equity interest can be classified as an equity interest before conversion. On conversion, the pre-conversion equity interest might take a different legal form, but its classification as equity would not change. The interest would be a continuing equity interest by operation of section 974-70, and section 974-100 would have no application.

89. The support claimed for the alternative view by operation of section 974-100 is not apparent.

### **The alternative view and explanatory material in the EM**

90. While the terms of the valuation provisions and section 974-100 do not obviously support the alternative view, it has been suggested that the alternative view is supported by certain explanatory material in the EM. That material will now be considered.

91. Paragraph 2.194 of the EM notes as follows:

When calculating the total value of financial benefits received, it is necessary to assume that the scheme will continue to be held for the rest of its life. Thus the fact that the issuer may have an option to terminate the scheme early does not prevent the consideration of financial benefits to be provided after that optional termination time. **[Schedule 1, item 34, subsection 974-35(2)].**

92. It has been suggested that the statement that ‘...an option to terminate the scheme early does not prevent the consideration of financial benefits to be provided after that optional termination time’ supports the alternative view. This means, it has been claimed, that the issuer’s option to terminate early by converting at any time should be ignored in identifying the financial benefits that must be provided and that are to be valued. Note also that the first sentence of that paragraph commences by referring to financial benefits **received**, but the second sentence (while ostensibly directed at the same subject) refers without explanation to financial benefits **provided**.

93. However, ‘...financial benefits to be provided after that optional termination time ...’ can reasonably be interpreted to mean the financial benefits that the issuer has an effectively non-contingent obligation to provide, despite that early termination option. For example, in the case of a convertible note, such financial benefits would be found after the optional conversion time if the holder held the conversion option, or an issuer was found to have effectively non-contingent obligations to provide financial benefits, despite the formal early termination option, by application of section 974-135 (see, for example, the discussion at paragraphs 39, 46 and 81 of this draft Ruling).

94. Paragraph 2.194 of the EM does not advance the alternative view.

95. Example 2.21 in the EM is now reproduced:

**Example 2.21: Benefits to be provided calculated in present value terms**

A company issues convertible notes for \$9 each on 1 July 2001. The notes provide a coupon of 7% paid once a year (on 1 July). Each of the notes may be converted into 2 ordinary shares on 30 June 2016. Assume that the benchmark rate of return of the company is 8%.

On the assumption that the convertible note will be held until maturity, there will be 15 coupon payments of \$0.63 (\$9 x 7%) and a return of the principal of \$9 at maturity. The value of the financial benefit provided will be the sum of the present value of these benefits discounted using an adjusted benchmark rate of return of 6% (8% x 75%) and 15 interest periods.

Using present value calculation methods, the value of financial benefits to be provided is calculated as follows:

$$\begin{aligned} & \$0.63 / (1.06)^1 + \$0.63 / (1.06)^2 \dots + \$9.63 / (1.06)^{15} \\ & = \$9.87 \end{aligned}$$

Therefore, because the present value of the financial benefits to be provided in the future exceeds the issue price of the notes, the notes constitute debt interest.

96. There are insufficient details in this example about the conversion option to determine whether it could support the alternative view. The conversion option could easily be the holder’s option, and thus attract the operation of subsection 974-135(4). There is nothing in the example to indicate that the effectively non-contingent obligations to provide financial benefits are not found solely by operation of section 974-135.

97. Neither Example 2.21 nor paragraph 2.194 of the EM unambiguously supports the alternative view.

98. Example 2.26 of the EM will now be considered. That example appeared in the EM as follows:

**Example 2.26: Perpetual convertible notes**

A company issues perpetual convertible notes on 1 July 2001 for \$9 each. The notes have coupons of 7% which are paid annually on 1 July. The obligation to pay the coupons is not subject to any contingency and cannot be deferred or waived in any circumstance. The company may, at its option, redeem the notes, or convert them into ordinary shares, at any time after 1 July 2007. The company's benchmark rate of return is 8% per annum.

Because the notes are convertible, they will represent an equity interest unless the debt test is satisfied (the scheme is a commercial arrangement at arm's length).

Under the relevant scheme, the company has received a financial benefit – the issue price of \$9. Making the required assumption that the notes are held for the rest of their lives, the company has an effectively non-contingent obligation to pay 7% annually in perpetuity to the note holder. The value of this benefit to be provided is calculated in present value terms as the performance period is more than 10 years (it is assumed that, while there is an option to redeem, there is no effective non-contingent obligation to do so).

The total present value of the financial benefit to be provided by the company in relation to each note is calculated as follows:

- the coupon amount per coupon period is \$0.63 ( $\$9 \times 7\%$ );
- the adjusted benchmark rate of return per period is 6% per annum compounded annually ( $8\% \times 75\%$ ) or 0.06; and
- therefore, the value of the financial benefit to be provided by the company is \$10.50 ( $\$0.63 \div 0.06$ , which is an approximation of the present value formula in subsection 974-50(4) for a perpetuity).

Since the value of the financial benefit to be provided (\$10.50) exceeds the value of the financial benefit received (\$9), the convertible note is a debt interest. Therefore, the returns to the note holder will not be frankable and will be deductible if they satisfy the general deduction provisions of the income tax law.

99. The second sentence of the third paragraph of the example states that 'Making the required assumption that the notes are held for the rest of their lives, the company has an effectively non-contingent obligation to pay 7% annually in perpetuity to the note holder.' The example recognises an 'effectively non-contingent obligation' of the issuer to provide financial benefits as periodic interest beyond the time at which an issuer can elect to convert the interest into an ordinary share (which might be intended to be an equity interest in the issuer). This has been said to support the alternative view, and to be inconsistent with the position taken in this draft Ruling.



100. Example 2.26 focuses on the operation of the present value test in relation to perpetual instruments. It does not discuss the circumstances surrounding the issuer's conversion option in any detail.

101. The third sentence of the first paragraph of the example states that 'The obligation to pay the coupons is not subject to any contingency and cannot be deferred or waived in any circumstance.' This unqualified statement – ostensibly of fact – is given before any reference is made to the issuer's conversion option.

102. Clearly, as a matter of fact, whether or not any amounts that could contribute to the recovery of the issue price will be paid after the issuer's optional conversion date (1 July 2007) depends upon whether or not the issuer exercises its option to convert after 1 July 2007.

103. *Prima facie* then, as a matter of fact, repayments after the optional conversion date are contingent, and the statements of fact in the third and fourth sentences of the first paragraph (which apparently only sets out the facts of the example) are in conflict.

104. The example provides no firm guidance in resolving those ostensibly conflicting facts. Nor does it provide any clear reasoning or analysis of why the obvious conversion contingency should be dismissed. The example does not explicitly detail any legislative provisions to support the conclusions.

105. If, as a matter of fact, the statement that 'The obligation to pay the coupons is not subject to any contingency ...' is to prevail despite, as another fact, the issuer having an option to convert or redeem after 1 July 2007, it could be that some other undisclosed fact negated the issuer's conversion and redemption option, so that there were effectively non-contingent obligations to provide financial benefits (the periodic interest payments) in perpetuity.

106. That third sentence of the first paragraph of the example could be justified in two circumstances. Firstly, it could have been intended that the conversion contingency was to be disregarded because (on the basis of unspecified facts) the conversion contingency was (on consideration of the pricing, terms and conditions, as required by section 974-135) in substance or effect artificial or contrived, or immaterially remote. That view would accord with this draft Ruling. Secondly, and on the other hand – if the alternative view outlined at paragraphs 51 and 52 of this draft Ruling is to be preferred – the conversion contingency could only be disregarded if (as subsection 974-40(2) requires) the issuer did not have an effectively non-contingent obligation to exercise that conversion option – but the example does not specify this, as a fact. Therefore Example 2.26 does not set out the critical facts to determine which of these circumstances applies. In other words, whichever view one takes of the operation of the debt test on the convertible note that is considered in this draft Ruling, Example 2.26 requires further facts to be assumed.

107. It is therefore reasonably arguable that the example contains insufficient facts to conclude that it necessarily supports the alternative view.

108. Example 2.26 seems to have limited explanatory value. On its face, it demonstrates an application of the present value calculation prescribed in the valuation provisions to perpetual instruments. Example 2.26 does not conclusively support the alternative view.

### **Some implications of the alternative view**

109. There are additional compelling reasons why the alternative view should not be preferred. If the alternative view was correct, it would give rise to ostensibly inappropriate consequences.

110. For example, if the alternative view was correct, the following consequence would also seem to necessarily apply: Assume that a company issues a convertible note for \$20. The note must be redeemed by the issuer 10 years after the issue date at the issue price, unless the note is converted at the issuer's discretion into an ordinary share that is an equity interest in the issuer 9 years after issue. The share is to return an annual amount of 8%, but the obligation to pay this amount is subject to the availability of uncertain profits. At the time of issue of the convertible note, there is nothing in the pricing, terms or conditions that would establish whether, in substance or effect, the issuer will exercise its option to convert the note into an equity interest.

111. The convertible note in the above example will not be a debt interest unless it is sufficiently clear at the time of issue that the issuer is under an effectively non-contingent obligation to provide adequate financial benefits that will effectively return the issue price to the holder, in the form of periodic returns and/or the return of the issue price.

112. For the purposes of the debt test in Division 974, the company is not under an effectively non-contingent obligation to pay the annual returns – the issuer's obligation to provide any periodic returns is contingent on profits being available.

113. The only other potential financial benefit that might count for the purposes of the debt test is the redemption amount that could be paid on performance of any obligation to redeem the note in year 10. However, that obligation to return the issue price on redemption is clearly contingent upon whether the issuer exercises its option to convert the interest into an ordinary share that is an equity interest. And, as discussed above, for the purposes of the debt test the provision of an equity interest in the issuer (the ordinary share provided on conversion of the note) is not the provision of a relevant financial benefit.

114. It would thus seem that – on considering both the legal form and economic substance of the pricing, terms and conditions of the note at the time of issue – the issuer does not have an effectively non-contingent obligation as defined in section 974-135 for the purposes of the debt test to provide any financial benefits. Any benefits that it might provide are subject to real contingencies: a profit contingency, and a conversion contingency.

115. However, if the alternative view is accepted, the application of section 974-40 and/or subsection 974-35(2) means that the issuer's option to convert is to be disregarded in applying the debt test. It would therefore be assumed that the convertible note will not be converted. On the alternative view, it follows that the interest must also be assumed for the purposes of the debt test to be redeemed at the conclusion of year 10. On that assumption, the issuer would have an effectively non-contingent obligation to repay the issue price no later than 10 years from the time of issue, and the interest would be a debt interest.

116. Therefore, on the alternative view, an interest that can only pay periodic returns that are contingent on profits, and where any obligation to return the issue price by redemption is contingent upon the issuer not deciding to convert the note into an equity interest should be classified as a debt interest.

117. A similarly inappropriate debt classification would seem to arise on an application of the alternative view to the operation of section 974-45 where a convertible note is to pay periodic returns in the form of interest, but subject to the availability of profits, and the note is to convert into a share that is an equity interest in the issuer company if there are insufficient profits to pay the periodic return.

118. The Commissioner does not accept that Division 974 operates to bring about those results.

## **Reasons for not accepting the 'alternative view'**

119. The valuation provisions, as explained earlier (at paragraphs 56 to 82 of this draft Ruling), do not operate in the way that the alternative view suggests. They do not, in their terms, provide that any obligations of an issuer to provide financial benefits that are not effectively non-contingent under section 974-135 are effectively non-contingent.

120. The consequence of the provisions operating in the way suggested by the alternative view is inconsistent with the objects of the Division and the single organising principle discussed at paragraphs 13 to 15 of this draft Ruling. That is, in the circumstances of the example set out at paragraph 110 of this draft Ruling, the pricing, terms and conditions of issue do not in substance or effect impose any obligation on the issuer to provide financial benefits to the holder that would return the issue price. Whether the issue price is returned to the holder is at the issuer's discretion, and subject to the economic performance of the issuer.

Any returns payable by the issuer are clearly contingent: it cannot be said that the issuer has an effective obligation to return an amount to the investor that is at least equal to the issue price.

121. Further, it was noted at paragraph 43 of this draft Ruling that the Division provides an explicit exception in subsection 974-135(4) to ensure that an issuer's effectively non-contingent obligations to repay an investment are not considered contingent merely because a holder has an option to have its interest converted into an equity interest in the issuer. This exception is contained in the provision that specifies the relevant meaning of 'effectively non-contingent obligation'. However, there is no explicit exception in that provision that is to apply where an **issuer** has a conversion right. This strongly indicates that an issuer's conversion right was intended to be a relevant contingency.

122. In addition, if it had been intended – and the 'alternative view' depends upon this intention – that section 974-40 was to provide an exception that is to apply, so that an issuer's mere conversion option is to be disregarded, subsection 974-135(4) would be otiose. That is, if the terms of section 974-40 have the meaning that the alternative view relies upon, that meaning is clearly capable of equal application to both a holder's and an issuer's right to convert an interest. And if they do take that meaning, there would be no need for subsection 974-135(4). The evident task of subsection 974-135(4) would be performed by section 974-40.

123. As subsection 974-135(4) is one of very few explicit exceptions in a provision that is both directly concerned with the meaning of 'effectively non-contingent obligation' and fundamental to the operations of the debt test, it seems unlikely that subsection 974-135(4) was intended to merely restate a rule that was apparent elsewhere in the Division.

124. The better view would seem to be that the exception that is provided by subsection 974-135(4) is intended to apply only if there is a mere right of a holder to convert, and that it is intended that an issuer's right to convert is a relevant contingency (unless it is apparent at the time of issue that the right will not be exercised).

125. Another important reason for rejecting the alternative view is this: the evident scheme of Division 974 is that the valuation provisions are concerned with the valuation of financial benefits that the application of other provisions of Division 974 has determined are to be provided or received pursuant to an effectively non-contingent obligation or obligations. The effective obligation to provide financial benefits is to be established before the valuation provisions are considered. The calculation of the value of the financial benefits is then performed in accordance with the valuation provisions, for the purposes of the test at paragraph 974-20(1)(d). This evident scheme is now explained.

126. As noted at paragraph 29 of this draft Ruling, paragraph 974-20(1)(d) requires that ‘...it is substantially more likely than not that the value provided (worked out under subsection (2)) will be at least equal to the value received (worked out under subsection (3));’.

127. These requirements reflect the single organising principle discussed at paragraphs 13 to 15 and 120 of this draft Ruling.

128. Subsection 974-20(2) – which is referred to in paragraph 974-20(1)(d) – in turn provides as follows:

The value provided is:

- (a) the value of the financial benefit to be provided under the scheme by the entity or a connected entity if there is only one; or
- (b) the sum of the values of all the financial benefits provided or to be provided under the scheme by the entity or a connected entity of the entity if there are 2 or more.

**Note:** Section 974-35 tells you how to value financial benefits.

129. The issue price paid by the holder to the issuer on the issue of the convertible note will usually be the financial benefit received by the issuer for the purposes of paragraph 974-20(1)(d) – see subsection 974-20(3).

130. Importantly, subsection 974-20(4) provides as follows:

For the purposes of paragraph (1)(b) and subsections (2) and (3):

- (a) a financial benefit to be provided under the scheme by the entity or a connected entity is taken into account only if it is one that the entity or connected entity has an effectively non-contingent obligation to provide; and
- (b) a financial benefit to be received under the scheme by the entity or a connected entity is taken into account only if it is one that another entity has an effectively non-contingent obligation to provide.

131. Subsection 974-20(4) applies specifically for the purposes of subsection 974-20(2). Subsection 970-20(4) was introduced as an amendment during the passage of the Bill that became the *New Business Tax System (Debt and Equity) Act 2001*. The Supplementary EM addresses this particular subsection (at paragraph 1.18) and states:

These amendments clarify that for the purposes of applying the debt test the relevant financial benefits to be received are those where another entity has an effectively non-contingent obligation to provide those financial benefits. The relevant financial benefits to be provided are those that an entity or connected entity has an effectively non-contingent obligation to provide.

132. Paragraph 974-20(4)(a) thus makes it clear that financial benefits that might be provided by the issuer are only taken into account for the purposes of subsection 974-20(2) and therefore for the purposes of paragraph 974-20(1)(d) if the issuer has an effectively non-contingent obligation to provide those financial benefits.

133. That is, in calculating the value of financial benefits to be provided by the issuer of the convertible note as prescribed by subsection 974-20(2) for the purposes of paragraph 974-20(1)(d), only financial benefits that the issuer is under an effectively non-contingent obligation to provide are taken into account. As the note to subsection 974-20(2) indicates, the financial benefits that the issuer has an effectively non-contingent obligation to provide are valued by application of section 974-35. The identification of the financial benefits that the issuer is effectively obliged to provide is to be determined before recourse to the provisions that are concerned with valuing those financial benefits.

134. Subsection 974-20(4) is therefore intended to act as a 'gateway' into subsection 974-20(2) (and into subsection 974-20(3), in the case of financial benefits received) and, subsequently, into the valuation provisions.

135. It would be inconsistent with that apparent gateway function if the valuation provisions subsequently also supplanted the evident function of section 974-135. That is, it is unlikely that the valuation provisions are intended to operate to deem obligations to provide financial benefits to be effectively non-contingent in circumstances where the prior application of section 974-135 had found them to be effectively contingent.

136. Therefore, if the issuer of a convertible note has an effectively contingent obligation (as discussed earlier at paragraphs 44 to 48 of this draft Ruling) to provide a financial benefit or benefits because the note can be converted by the issuer at any time into shares that are equity interests in the issuer, the effectively contingent financial benefit or benefits will **not** be valued and taken into account for the purposes of the debt test.

## Appendix 3 – Your comments

---

137. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

<b>Due date:</b>	<b>25 January 2008</b>
<b>Contact officer:</b>	<b>Tony Persichelli</b>
<b>Email address:</b>	<b>tony.persichelli@ato.gov.au</b>
<b>Telephone:</b>	<b>(03) 9285 1408</b>
<b>Facsimile:</b>	<b>(03) 9285 1761</b>
<b>Address:</b>	<b>Australian Taxation Office Casselden Place 2 Lonsdale Street MELBOURNE VIC 3000</b>

## **Appendix 4 – Detailed contents list**

138. The following is a detailed contents list for this draft Ruling:

	<b>Paragraph</b>
<b>What this Ruling is about</b>	<b>1</b>
Class of entities/scheme	2
<b>Previous Ruling</b>	<b>6</b>
<b>Ruling</b>	<b>7</b>
<b>Date of effect</b>	<b>8</b>
<b>Appendix 1 – Explanation</b>	<b>9</b>
Division 974 overview	11
Classification rules	21
<i>Equity test</i>	21
<i>Debt test</i>	28
<i>Effectively non-contingent obligation to provide financial benefits</i>	31
<b>Appendix 2 – Alternative views</b>	<b>51</b>
The valuation provisions: sections 974-35, 974-40 and 974-45	56
<i>Subsection 974-35(2)</i>	67
<i>Subsection 974-35(4)</i>	71
<i>Section 974-40</i>	74
The alternative view and section 974-100	83
The alternative view and explanatory material in the EM	90
Some implications of the alternative view	109
Reasons for not accepting the 'alternative view'	119
<b>Appendix 3 – Your comments</b>	<b>137</b>
<b>Appendix 4 – Detailed contents list</b>	<b>138</b>



## References

---

*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

TR 2006/10

*Previous Rulings/Determinations:*

TD 2004/D76

*Subject references:*

- convertible notes
- debt/equity borderline
- effectively non-contingent obligation

*Legislative references:*

- ITAA 1997 Div 974
- ITAA 1997 974-5(4)
- ITAA 1997 974-10
- ITAA 1997 974-10(1)
- ITAA 1997 974-10(2)
- ITAA 1997 Subdiv 974-B
- ITAA 1997 974-15(1)
- ITAA 1997 974-20
- ITAA 1997 974-20(1)
- ITAA 1997 974-20(1)(c)
- ITAA 1997 974-20(1)(d)
- ITAA 1997 974-20(2)
- ITAA 1997 974-20(3)
- ITAA 1997 974-20(4)
- ITAA 1997 974-20(4)(a)
- ITAA 1997 974-30
- ITAA 1997 974-30(1)
- ITAA 1997 974-35
- ITAA 1997 974-35(1)
- ITAA 1997 974-35(2)
- ITAA 1997 974-35(3)
- ITAA 1997 974-35(4)
- ITAA 1997 974-35(5)
- ITAA 1997 974-35(6)
- ITAA 1997 974-40
- ITAA 1997 974-40(1)
- ITAA 1997 974-40(2)
- ITAA 1997 974-40(3)
- ITAA 1997 974-40(4)
- ITAA 1997 974-45
- ITAA 1997 974-45(1)
- ITAA 1997 974-45(2)
- ITAA 1997 974-45(3)
- ITAA 1997 974-45(4)
- ITAA 1997 974-50
- ITAA 1997 974-50(4)
- ITAA 1997 Subdiv 974-C
- ITAA 1997 974-70
- ITAA 1997 974-70(1)
- ITAA 1997 974-70(1)(b)
- ITAA 1997 974-75(1)
- ITAA 1997 974-75(2)
- ITAA 1997 974-100
- ITAA 1997 974-100(1)
- ITAA 1997 974-100(2)
- ITAA 1997 974-130(1)(a)
- ITAA 1997 974-135
- ITAA 1997 974-135(1)
- ITAA 1997 974-135(2)
- ITAA 1997 974-135(3)
- ITAA 1997 974-135(4)
- ITAA 1997 974-135(5)
- ITAA 1997 974-135(6)
- ITAA 1997 974-135(7)
- ITAA 1997 974-150(1)
- ITAA 1997 974-160(1)
- ITAA 1997 995-1
- New Business Tax System (Debt and Equity) Act 2001

*Other references:*

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

---

ATO references

NO: 2005/14641

ISSN: 1039-0731

ATOLaw topic: Income Tax ~~ Taxation of financial arrangements  
(TOFA) ~~ debt equity