


TD 2007/D3 - 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 document has been finalised by TD 2007/26.



Draft 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*?

❶ 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.

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*¹ will also be a convertible interest if it satisfies item 4 of the table.

Date of effect

2. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will 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

28 March 2007

¹ Unless otherwise specified all legislative references are to the *Income Tax Assessment Act 1997* (ITAA 1997).

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.*

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 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 go to the quality of rights rather than their legal form and indicate 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 (i.e. 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 which converts into another share will fall within item 1 of the table and also qualify as a convertible interest because of item 4.

Appendix 2 – Your comments

11. We invite you to comment on this draft Taxation Determination. 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.)

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- convertible interest
- equity interest
- share

Legislative references:

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

Other references:

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

ATO references

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