IT 2336 - Income tax : treatment of gains arising from convertible notes

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TAXATION RULING NO. IT 2336

INCOME TAX : TREATMENT OF GAINS ARISING FROM CONVERTIBLE NOTES

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1209720	CONVERTIBLE NOTES	23J
	- GAINS ON SALE	25
	- GAINS ON REDEMPTION	25A
	- GAINS ON CONVERSION	26AAA
	TAX TREATMENT	

PREAMBLE Convertible notes combine two features. First, they are a type of security evidencing a loan. Second, they embody rights to shares. Convertible notes are issued by companies on terms as to the period of the notes, the interest payable (if any), and the rate at which (and dates on which) conversion of the notes into shares of the company may take place. The value of the notes may vary from time to time, reflecting changes in interest rate levels or the value of the shares into which the notes may convert. The variations influence decisions to sell, redeem or convert the notes.

2. This Ruling deals with general income tax implications of sale, redemption or conversion of convertible notes. Details of the operation of the income tax provisions relating to capital gains and losses not subject to tax under other income tax provisions were given in the Treasurer's Press Release No. 24 issued on 20 March 1986.

3. Convertible notes can be valued from time to time in two ways. They have a value considered purely as a security ("the security value"). They also have a value as options to acquire the shares into which they may be converted ("the conversion value"). Their present market value will reflect both the security value and the conversion value.

4. In practice convertible notes have not been frequently issued in Australia. Issues have commonly been made with a face value approximating the then market price of the shares into which a note could convert with interest at a rate above the then rate of dividends on the shares but below the current market rates of interest.

RULING Sale or Redemption

5. Where convertible notes are acquired at a discount,

either by original subscription or otherwise, any profit derived by the holder from their subsequent sale or redemption is considered to be assessable income to the extent of the difference between the acquisition price of the notes and the par value or the sale price where that is below par value, i.e. it is part of the reward for the investment in the notes. Any amount received in excess of the par value would also be assessable if the terms of the notes require redemption at a figure in excess of the par value.

6. The general rule expressed in the preceding paragraph is modified to an extent by the operation of section 23J. The section operates to exempt from income tax profits arising from the sale or redemption of securities, including convertible notes, acquired at a discount before 1 July 1982. There are a number of exceptions made to the operation of section 23J. The section does not apply to any element of accrued interest which may be reflected in the sale or redemption price of the securities nor does it apply where profits on the sale of securities are assessable under sections 25, 25A or 26AAA nor does it affect the operation of section 26C.

7. Where convertible notes are not issued or acquired at a discount any profit arising on sale would not, as a rule, be assessable income of an ordinary investor. Traders in shares, financial institutions, insurance companies, etc. would be liable to tax on profits made in these circumstances.

8. Where the interest rate on a convertible note issued at par is unduly low it may be that part of the reward for investing in the notes is an expected increase in their value. The income tax liability of profits arising from the sale or redemption of convertible notes of this type would be determined in the light of the facts of the particular case.

9. Profits realised on the purchase of convertible notes and their resale within 12 months of purchase are assessable income by virtue of section 26AAA. The acquisition of a convertible note by way of subscription is not regarded as a purchase for the purposes of section 26AAA.

Conversion and Sale of Shares

10. As has been stated earlier, the terms of conversion of convertible notes into shares of the issuing company are settled at the date of issue of the notes. In the generality of cases it would seem that the terms of conversion do not depend on or are not affected by the value of the notes at the date of conversion. In these circumstances there would not be any realisation of profit or loss at the date of conversion. It would be different, however, if the terms of conversion were dependent upon the value of the notes at the date of conversion - there may be a realisation of profit or loss.

11. Whether or not any profit made on the sale of conversion shares is to be treated as assessable income will depend upon particular circumstances. The acquisition of

convertible notes, their conversion into shares and the subsequent sales of the shares may be transactions ordinarily undertaken by share traders, financial institutions, insurance companies, etc. Profits arising from the transactions would represent proceeds of carrying on the respective businesses. In other situations the transactions may be a profit-making undertaking or scheme, the profit on which would be assessable under section 25A. The cost to be taken into account for the purpose of ascertaining any profit would be the amount paid for the convertible notes plus any additional consideration paid for the shares at the date of conversion. It should be noted that section 25A does not apply in respect of the sale of property acquired on or after 20 September 1985.

12. The income tax liability of ordinary investors who convert notes into shares, i.e. persons who acquired the notes for investment purposes as distinct from profit-making purposes, will also depend upon particular circumstances. If the converted shares are held for investment purposes liability to income tax will be limited to any dividends paid or credited in respect of the shares. For the purposes of section 26AAA the conversion of the notes into shares is deemed to be a purchase of the shares. If the shares are sold within 12 months of the date of conversion any profit made would be liable to tax under section 26AAA. For the purposes of section 25A the conversion of notes into shares would be an acquisition of the shares. If the converted shares were acquired for the purposes of profit-making by resale or for carrying out a profit-making undertaking or scheme the resultant profit would be liable to tax under section 25A. As a general rule the cost of the converted shares for the purposes of sections 26AAA or 25A would be the same as that expressed in the preceding paragraph.

COMMISSIONER OF TAXATION
15 July 1986

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