


# ***IT 2653 - Income tax: convertible notes issued as part of takeover arrangement***

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## TAXATION RULING IT 2653

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### FOI INDEX DETAIL

<u>Reference no.:</u>	<u>Subject :</u>	<u>Legislative :</u>
<b>I 1012848</b>	<b>CONVERTIBLE NOTES TAKEOVER ARRANGEMENTS WHETHER NEW LOAN DEDUCTIBILITY OF INTEREST</b>	<b>82M 82SA</b>

### OTHER RULINGS ON THIS TOPIC:

**TITLE:        INCOME TAX: CONVERTIBLE NOTES ISSUED AS PART OF  
TAKEOVER ARRANGEMENT**

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

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

### PREAMBLE

This Ruling considers :

- (i) the circumstances in which a loan relating to a convertible note issued as part of a takeover arrangement should be treated as a "new loan" for the purposes of the convertible note provisions of the Income Tax Assessment Act 1936 ("ITAA"); and
- (ii) whether the "new loan" provisions contained in subsection 82M(1) apply to takeover arrangements where moneys received by vendor shareholders from an offeror company are to be used to subscribe to a note issued by a company associated with the offeror.

### Legislative provisions

- 2. Interest paid on convertible note loans made on or after 1 January 1976 qualify for an income tax deduction under subsection 51(1) only if the requirements of Division 3A of Part III of the ITAA are satisfied.
- 3. One of these requirements is that the loan to the company to which the convertible note applies is, under section 82M, to be treated as a new loan or an

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approved replacement loan for the purposes of the Division (paragraph 82SA(1)(a)). This Ruling does not deal with the approved replacement loan provisions in the law. It is confined to a consideration of the new loan provisions.

4. Subsection 82M(1) provides that, where the following two conditions are satisfied, a loan shall be treated as a new loan:
  - (a) a loan to a company is made, and is wholly made, by money being paid to the company at the time when the loan is made; and
  - (b) the loan is not part of, or related to, a transaction or is not one of a series of related transactions under which the person making the loan (e.g. a noteholder) is to receive or has received for the purpose of enabling him or her to make (or of assisting him or her in making) the loan, any money or other property from the company (i.e. the borrowing company issuing the notes) or from another company or person as a result of arrangements made with that other company or person by the issuing company.
5. These tests are designed to ensure, among other things, that:
  - (a) the loan in respect of which the notes are issued involves an amount of money rather than some other form of property; and
  - (b) the lender does not receive any money or other property from the company or some other entity as part of a transaction or series of transactions undertaken in respect of the making of the loan in order to enable or assist the lender to make the loan to the borrowing company.

### Explanatory Memorandum

6. The explanatory memorandum accompanying the amending legislation which inserted Division 3A into the ITAA cites an example of a situation falling outside paragraph 82M(1)(a), and therefore, of a loan not being treated as a new loan. The example given is that of a convertible note issued as consideration for shares that are acquired under a takeover scheme i.e., the borrowing company is receiving shares rather than an amount of money for issuing the notes.
7. An example cited of the kind of situation at which paragraph 82M(1)(b) is directed, where the loan would again not be treated as a new loan, also involves a takeover. The example given is that of an offeror company arranging with the members of the company being taken over to acquire their shares for cash on the understanding that the members are to use the cash (or part of it) to make a loan to the offeror company.

### RULING

Has the loan to the company been made, and wholly made, by money being "paid" to the company at the time when the loan was made?

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8. If a loan has not been made to a company wholly by money being paid to the company at the time the loan was made, the requirements of paragraph 82M(1)(a) are not satisfied and the loan would not be treated as a new loan for the purposes of Division 3A.
9. Whether a loan is wholly made to a company by money being paid to the company at the time the loan is made for the purposes of paragraph 82M(1)(a) is a question of fact. Paragraph 82M(1)(a) does not specify who must make the payment to the company. However, it requires that the loan to the company be made by the payment of money to the company. In other words, more is required under that paragraph than the mere payment of money to the company by any entity, including a related entity. For the paragraph to be satisfied, it is necessary that there be a relationship between the payment and the loan such that the payment in itself constitutes the making of the loan to the company.
10. Clearly, a loan made to a company by the transfer of property other than money would not satisfy paragraph 82M(1)(a). Nor would a loan made to a company by the payment of money if the money is paid at a time earlier or later than the time when the loan was made.
11. In the case of a convertible note issued to a vendor shareholder in the context of a takeover, the offeror company may issue the note (which evidences the loan made by the shareholder to the offeror company) to the shareholder as the price, in effect, for the shareholder selling its shares to the offeror company. The question arises in these circumstances whether the loan made by the vendor shareholder to the offeror company has been made by money being paid to the company in terms of paragraph 82M(1)(a). The answer to this question, as indicated in the explanatory memorandum (see paragraph 6 above), is that an exchange or setting-off of a convertible note for shares in these circumstances does not constitute the making of a loan by the payment of money in terms of paragraph 82M(1)(a).

Have the requirements of paragraph 82M(1)(b) been satisfied?

12. The main elements of paragraph 82M(1)(b) that need to be satisfied are :
  - (a) Whether the loan is - part of; or - related to a transaction; or- one of a series of related transactions.
  - (b) Whether under the transaction or series of transactions the person making the loan (the lender) is to receive or has received any money or other property.
  - (c) Whether under the transaction or series of transactions the receipt or prospective receipt of money or other property is for the purpose of enabling the lender to make (or of assisting the lender in making) the loan.

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(d) Whether the lender received or is to receive the money or other property from :

- the borrowing company; or

- any other company or person as a result of arrangements made with that other company or person by the borrowing company.

13. Where all of these elements are satisfied, the loan would not come within the scope of paragraph 82M(1)(b) and would not be treated as a new loan for the purposes of Division 3A.
14. The four elements referred to in paragraph 12 largely involve questions of fact. The application of elements (a) and (b) are not likely to cause difficulty. No elaboration of these elements is proposed in this Ruling. Elements (c) and (d), on the other hand, are more difficult to resolve and need further clarification.

### **Whether there is a transaction or a series of transactions under which the lender received (or is to receive) money or other property for the purpose of enabling the lender to make the loan**

15. Under paragraph 82M(1)(b), it is not necessary that the purpose of enabling the lender to make the loan to the borrower be the sole or even the dominant purpose of the transaction under which the lender receives the money or other property. It is sufficient if it is a substantial purpose.
16. Whether the lender receives the money or other property under the transaction for the purpose of enabling the lender to make a loan to the borrower is a question of fact to be decided on the basis of all the surrounding circumstances.
17. Any relationship (business or otherwise) between the parties, and the degree of that relationship, would be factors to be taken into account and may suggest a common purpose in the transaction.

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18. In a takeover, the terms of the takeover documentation may also be examined. The presence of a takeover provision offering an alternative between cash or cash to be subscribed for notes, would indicate an underlying purpose (in the case of the cash for notes alternative) of enabling the vendor shareholders who subscribe for the notes to effectively make a loan to the offeror company.
19. The relevant purpose to be considered is not the subjective purpose of the borrowing company or of the person making the loan. The relevant purpose is the purpose of the transaction and this is to be determined objectively on the basis of all the circumstances surrounding the transaction. In a takeover, if the purpose of the transaction is to enable or to assist a vendor shareholder to subscribe for convertible notes and hence to make the loan to the borrower company, the loan is not to be treated as a new loan within the meaning of subsection 82M(1).
20. This Office does not accept the view that, in the case of convertible notes issued to vendor shareholders in the context of a takeover, the purpose of the payment to the shareholders is to acquire their shares rather than to enable them to make the loan to the offeror company. Essentially, this Office does not accept that paragraph 82M(1)(b) cannot apply to takeover situations. That interpretation would be contrary to the legislative intention expressed in the explanatory memorandum - see paragraphs 6 and 7.
21. In the context of a takeover, the "purpose" of enabling the lender to make the loan to the borrower will be present if, for example :
  - (a) there is an understanding between the borrower and the lender that the cash received by the lender as consideration for the shares (or part of the cash) will be used to subscribe for the convertible notes (see paragraphs 24 and 27 - example 1); or
  - (b) there is an element of influence or coercion (including in a commercial sense), compelling the vendor shareholder to invest the cash in the note issue (e.g. there is a cash offer with an alternative option to subscribe for the notes, and the cash offer is substantially lower than the value of the notes) (see paragraph 27 - example 3)
22. Where a vendor shareholder, on an objective consideration of the facts, is not affected by any prior understanding or agreement or by any influence or coercion and decides to purchase convertible notes by using cash or other property which he or she has received from an offeror company in respect of the shares in the target company, he or she is not considered to have received the cash or other property for the purpose of making the loan. In this case, the loan to which the convertible note relates is to be treated as a "new loan" in terms of subsection 82M(1) (see paragraph 27 - example 1).

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23. The test in paragraph 82M(1)(b) also covers the situation where an offeror company enters into a series of transactions under which moneys received by vendor shareholders from the offeror company are to be used to subscribe to a note issue by a company associated with the offeror as a result of an arrangement made with the offeror company by the associated company. The loan would not satisfy the requirements of paragraph 82M(1)(b) and the loan would not be treated as a new loan in terms of Division 3A.

### **Whether the lender received or is to receive the money or other property from :**

- **the borrowing company ; or**

- **any other company or person as a result of arrangements made with that other company or person by the borrowing company**

24. If the lender is to receive or has received the money or other property from the borrowing company, it is sufficient to establish that it is to be received or was received under the relevant transaction or series of transactions. It is not necessary to also establish that it is to be received or was received as a result of any arrangements made between the relevant parties. This is clear from the terms of paragraph 82M(1)(b) itself in that the only arrangement of which it speaks is one made between the borrowing company and another company or person. Where the money or other property is to be received or was received from the borrowing company, there is no other company or person involved in the transaction(s).
25. It is only where the lender is to receive or has received money or other property from a company other than the borrowing company or from some other person that it is necessary to establish that it is to be received or was received :
- (a) under the relevant transaction or series of transactions; and
  - (b) as a result of arrangements made with the other company or person by the borrowing company.

### **Examples**

26. The following examples illustrate when this Office would regard the requirements of subsection 82M(1) as satisfied and whether each of the loans considered would be treated as a new loan for the purposes of Division 3A :

**Example 1:**

Company A wholly owns two subsidiary companies, Company X and Company Y. Company Y proposes to make a takeover offer for a publicly listed Australian company (Company T). The consideration offered to company T shareholders under the takeover bid is:

(a) cash; or

(b) cash to be applied towards the purchase of finance bonds and non-detachable share warrants issued by Company X and Company A respectively.

The share warrants are in respect of shares held by Company A in another listed company. The finance bonds and share warrants, when read together, constitute a convertible note for the purposes of Division 3A. In all other respects, the issue would satisfy the terms and conditions of section 82SA.

**Result:**

If company T shareholders accept option (a) and they independently invest the cash they receive in the notes, the purpose of the transaction is not to enable them to make the loan in terms of paragraph 82(1)(b) and therefore the loan to which the notes relate is considered to be a new loan. Paragraph 82SA(1)(a) is satisfied.

If company T shareholders accept option (b), there is an understanding that the cash will be applied towards the purchase of the notes. In this case, there is no new loan and the requirements of paragraph 82SA(1)(a) are not satisfied.

**Example 2:**

In the same circumstances described in Example 1, there are a series of transactions under which Company Y is to pay Company A and Company X the money payable by the shareholders in respect of the bonds and warrants respectively. This payment is allegedly made on behalf of the shareholders and at their direction under the takeover offer document. However, there is evidence that Company A and Company X repay to Company Y the amounts received from it.

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### **Result:**

In this case the payment to the companies issuing the notes is not considered to be a payment of money as envisaged under paragraph 82M(1)(a) and that paragraph is not satisfied.

### **Example 3:**

Company A makes a takeover offer to Company T shareholders at \$10 per share. As part of the offer it is ready to apply the cash towards the purchase at \$10 each of convertible notes valued \$15 each.

### **Result:**

There is an element of influence or coercion (in a commercial sense) compelling the shareholder in Company T to invest the cash in the note issue because the cash offer is substantially lower than the note issue option. The required purpose is present and there is no new loan.

### **Example 4:**

Company A offers the shareholders in Company T cash in return for their shares in Company T. There is an understanding that the shareholders will apply the cash they receive from A to purchase the convertible notes that A is in the process of issuing.

### **Result:**

The required purpose is present and there is no new loan for the purposes of section 82M.

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