TD 2004/D76 - Income tax: for the purposes of Division 974 of the Income Tax Assessment Act 1997 , does an issuing company have an effectively non-contingent obligation to provide a financial benefit by way of periodic interest returns on an interest bearing convertible note from the time that it can be converted at the issuing company's option into ordinary shares in that company?

Draft Taxation Determination

Income tax: for the purposes of Division 974 of the *Income Tax Assessment Act 1997*, does an issuing company have an effectively non-contingent obligation to provide a financial benefit by way of periodic interest returns on an interest bearing convertible note from the time that it can be converted at the issuing company's option into ordinary shares in that company?

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. No, unless the option to convert should be disregarded in the light of the full consideration of the pricing, terms and conditions of the scheme under which the convertible note was issued.

2. Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) contains measures that are to be applied to classify interests as either debt interests or equity interests for certain taxation purposes.

3. A note that is convertible into ordinary shares in the issuer company, and that is issued under a scheme that is a financing arrangement, will be an equity interest pursuant to item 4 in the table in subsection 974-75(1) of the ITAA 1997 unless the debt test is also satisfied [paragraph 974-70(1)(b)]. If the debt test is satisfied, the convertible note will be treated as a debt interest and not an equity interest [subsection 974-5(4)].

4. Section 974-20 of the ITAA 1997 specifies five key tests that a scheme must satisfy before it gives rise to a debt interest in an entity. These tests are to be applied to a scheme at the time that it comes into existence or is changed (sections 974-15 and 974-110 respectively).

5. One of the tests is that the entity must have 'an effectively non-contingent obligation' under that scheme to provide a financial benefit or benefits (paragraph 974-20(1)(c) of the ITAA 1997).

6. An 'effectively non-contingent obligation' to take an action under a scheme is one where, having regard to the pricing, terms and conditions of the scheme, there is in substance or effect a non-contingent obligation to take that action (subsection 974-135(1) of the ITAA 1997).

7. A 'financial benefit' is, subject to certain exclusions, anything of economic value (subsection 974-160 of the ITAA 1997). For example, periodic interest payments will be a financial benefit, but the provision of a share in the entity that issues the interest will not be a financial benefit [subsection 974-30(1)].

8. Another of the five key tests of a debt interest is that it is substantially more likely than not that the value of the financial benefits to be provided by a relevant entity will be at least equal to the value received [paragraph 974-20(1)(d) of the ITAA 1997].

9. If the issuer of convertible notes has an option exercisable at some time or times in the future to convert the notes into shares in the issuer company, at the time of issue of the notes it is apparent that the issuer has the ability to cease having to pay periodic interest from the earliest possible time that it can convert the notes. The provision of periodic interest after the first time that any exercise of its conversion option could take effect is contingent upon the issuer not exercising that option and not having the notes converted into shares. Accordingly, the issuer has a contingent obligation to pay interest from the time that the notes can be converted at its option into shares. Unless the proper consideration of additional factors in the pricing, terms and conditions of the scheme requires that the identified contingency be disregarded, the issuer will not have an effectively non-contingent obligation to provide a financial benefit by way of periodic interest on the convertible notes from the earliest time that any exercise of its option to convert the notes into shares can take effect.

10. However, the issuer might have an effectively non-contingent obligation to provide periodic interest payments before the convertible note can be converted into a share. Whether any obligation to make such payments would be sufficient to satisfy the debt test, so that the convertible notes would be debt interests, will depend on the value of those financial benefits, and the satisfaction of other elements of the debt test.

Example

11. *A company issues convertible notes on 1 July 2004 for $9 each. Under the terms and conditions of issue of the notes, the issuer is to pay 7% interest on the issue price of the notes on 1 July of each year. The obligation to pay the interest on the notes cannot be deferred or waived. The company may, at its option, convert the notes into ordinary shares at any time after 1 July 2009. Interest is not payable after conversion. At the time of issue, proper consideration of the substance or effect of the pricing, terms and conditions does not lead to the conclusion that the company will not exercise its option to convert after 1 July 2009.*

12. *The debt test is applied as at the time the scheme comes into existence – in this case, when the convertible notes are issued on 1 July 2004.*

13. *At that time, if the issuer converts the notes into shares at any time after 1 July 2009, the issuer will not have to pay interest after any conversion. Thus, the payment of interest at any time after 1 July 2009 is contingent upon the issuer not converting the shares at any time after that date.*

14. *Accordingly, the issuer company does not have an effectively non-contingent obligation to pay interest beyond 1 July 2009. The possibility that interest payments might be made after 1 July 2009 is not taken into account in applying the debt test as at 1 July 2004.*

Date of Effect

15. 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 21 and 22 of Taxation Ruling TR 92/20).

Your comments

16. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

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Commissioner of Taxation
17 November 2004

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
TR 92/20

Subject references:
- convertible notes
- debt interest
- effectively non-contingent obligation
- equity interest
- financial benefit

Legislative references:
- TAA 1953 Pt IVAAA
- ITAA 1997 Div 974
- ITAA 1997 974-5(4)
- ITAA 1997 974-15
- ITAA 1997 974-20
- ITAA 1997 974-20(1)(c)
- ITAA 1997 974-20(1)(d)
- ITAA 1997 974-30(1)
- ITAA 1997 974-70(1)(b)
- ITAA 1997 974-75(1)
- ITAA 1997 974-110
- ITAA 1997 974-135(1)
- ITAA 1997 974-160

ATO references
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