

TR 92/6 - Income tax: whether a non-resident convertible noteholder is a foreign controller for thin capitalisation purposes.



This cover sheet is provided for information only. It does not form part of *TR 92/6 - Income tax: whether a non-resident convertible noteholder is a foreign controller for thin capitalisation purposes.*

Taxation Ruling

Income tax: whether a non-resident convertible noteholder is a foreign controller for thin capitalisation purposes.

other Rulings on this topic

IT 2479

contents para

What this Ruling is about 1

Ruling 5

Date of effect 8

Explanations 9

Test 1 - Substantial control of voting power 10

Test 2 - Beneficial entitlement to dividends or capital 14

Test 3 - Capacity to gain substantial control or beneficial entitlement. 18

Test 4 - Influence of non-resident. 23

General comments 28

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the Taxation Administration Act 1953, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.

What this Ruling is about

1. This Ruling examines the four tests in subsection 159GZE(1) of the *Income Tax Assessment Act 1936* to determine whether a non-resident convertible noteholder who:

(a) is not a shareholder of the resident company issuing the notes; but

(b) would be entitled to at least 15% of the issued shares of that company on conversion of the note to shares

is a foreign controller in relation to the company under the thin capitalisation provisions in Division 16F of Part III of the Act.

2. The issue is important because the thin capitalisation provisions will deny, in certain circumstances, a deduction for interest paid by a resident company to a non-resident convertible noteholder where the holder is a foreign controller.

3. The Ruling examines this specific circumstance in isolation. It does not take into account the effect of any direct or indirect shareholding of the noteholder or of the share or note holding of any associates of the noteholder.

4. The capacity for the conditions attaching to a note to be tailored to suit a noteholder's particular circumstances means that this Ruling

TR 92/6

can only explain the general application of the four tests in subsection 159GZE(1).

Ruling

5. A non-resident convertible noteholder is a foreign controller if any one of the four tests in subsection 159GZE(1) is satisfied.

6. Whether a convertible noteholder is a foreign controller needs to be decided on a case by case basis having regard to the actual terms on which the note was issued. Some of the terms which will have a bearing on whether any one of the tests will be satisfied are:

- (a) the length of any non option period;
- (b) the maturity date;
- (c) the conversion price and premium/discount;
- (d) any restrictive covenants; and
- (e) the voting rights and dividend and capital distribution entitlements attaching to the relevant shares.

7. A non-resident convertible noteholder, in the circumstances addressed in this Ruling:

(a) under Test 1, will not normally have substantial control of the voting power (subparagraph 159GZE(1)(a)(i)).

(b) under Test 2, will not normally be beneficially entitled to receive dividends or distributions of capital (subparagraph 159GZE(1)(a)(ii)).

(c) under Test 3, will normally be capable of gaining the control or entitlement contained in Tests 1 and 2 (subparagraph 159GZE(1)(a)(iii)).

(d) under Test 4, will normally be able to influence the actions of the resident company or its directors (paragraph 159GZE(1)(b)).

Date of effect

8. This Ruling sets out the current practice of the Australian Taxation Office. It applies (subject to any limitations imposed by statute)

for the years of income commencing before and after the date on which it issued.

Explanations

9. A non-resident convertible noteholder is a foreign controller for thin capitalisation purposes if any one of the four tests in subsection 159GZE(1) is satisfied. The noteholder will be a foreign controller for the period that any one of the tests is satisfied.

Test 1 - Substantial control of voting power

10. A non-resident convertible noteholder is a foreign controller of a resident company if the noteholder has 'substantial control' of the voting power of the resident company (subparagraph 159GZE(1)(a)(i)).

11. A noteholder has 'substantial control' of the voting power if the noteholder 'controls' or is 'capable of controlling' at least 15% of the votes in the company (subsection 159GZJ(1)).

12. The words 'control' and 'capable of controlling' refer to existing capacities and not to the ability to obtain those capacities. A noteholder has no voting capacity until such time as the option under the note to convert it to voting shares is exercised.

13. A noteholder, in the circumstances covered in this Ruling, will not normally satisfy this test.

Test 2 - Beneficial entitlement to dividends or capital

14. A non-resident convertible noteholder is a foreign controller of a resident company if the noteholder is beneficially entitled to at least 15% of any dividends or distributions of capital from the resident company (subparagraph 159GZE(1)(a)(ii)).

15. A convertible noteholder does not have an interest in any dividends or distribution of

TR 92/6

capital of the company that issued the note. Before the conversion of the note to shares, the noteholder's interest lies wholly in the debt advanced under the note.

16. A convertible noteholder has a potential right to participate in the distribution of capital of an issuing company on liquidation where the income and profits of the company are insufficient to meet the company's debts. However, the position of a noteholder in this situation is no different to any other creditor of the company and this right is not relevant for this test.

17. A non-resident convertible noteholder, in the circumstances covered in this Ruling, will not normally satisfy this test.

Test 3 - Capacity to gain substantial control or beneficial entitlement.

18. A convertible noteholder is a foreign controller of a resident company if the noteholder is capable, under a scheme, of gaining the control or entitlement described in Tests 1 and 2 (subparagraph 159GZE(1)(a)(iii)).

19. A 'scheme' is widely defined in section 159GZA and includes a legally enforceable arrangement. The holding of a convertible note is a legally enforceable arrangement under which the holder of the note can convert debt to equity. The holding of a convertible note would therefore fall under the definition of a 'scheme'.

20. If a convertible noteholder is capable of gaining the control or entitlement which is the subject of the first two tests by implementing the scheme (to convert the note into shares), the noteholder will be a foreign controller under this test. It is not necessary for the conversion to actually take place. It is sufficient for the noteholder to have the ability, under a scheme, to obtain that control or entitlement.

21. The terms of a note will ultimately determine whether this test is satisfied. For example, a noteholder will not satisfy the test during a period where:

(a) there was no option to convert the note to shares;

(b) the shares to which a noteholder was entitled under an option to convert were

without voting rights and dividend and capital distribution entitlements; or

(c) the noteholder has a right of conversion only in the event of a takeover offer but no takeover action is in train.

22. A non-resident convertible noteholder, in the circumstances covered in this Ruling, will normally satisfy this test.

Test 4 - Influence of non-resident.

23. A non-resident convertible noteholder is a foreign controller of a resident company if the resident company or its directors are accustomed or under a formal or informal obligation, or might reasonably be expected, to act in accordance with the noteholder's directions, instructions or wishes (paragraph 159GZE(1)(b)).

24. The paragraph is written in the widest of terms. The influence a convertible noteholder is able to exert need not be as formal, direct or measurable as the previous three tests. The noteholder does not need the 15% control or entitlement prescribed in the previous three tests. There also does not need to be a past pattern of influence for this test to be satisfied.

25. The terms and conditions of a note would again be a factor in determining whether a noteholder could exert the influence necessary to satisfy this test. A noteholder will, for example, satisfy the test where:

(a) the noteholder can determine the composition of the board of directors;

(b) the noteholder has power to veto decisions of the board of directors or shareholders; or

(c) the noteholder is able to use the investment as a leverage to secure a particular course of action. The leverage may be a threat of converting the note to voting shares or the withdrawal of the investment.

26. In our view, a person who holds at least 15% of the voting rights or dividend or capital distribution entitlements of a company is

TR 92/6

generally able to exercise influence over the actions of the company or its directors.

27. Accordingly, a non-resident convertible noteholder, in the circumstances covered in this Ruling, will normally be regarded as having the capacity to exercise such influence and as satisfying this test.

General comments

Noteholders who are also shareholders

28. While the Ruling specifically examines a noteholder who is not a shareholder, the commentary on the four tests is equally relevant to a noteholder who is also a shareholder. In that case, the noteholder's existing shareholding would also have to be taken into account in determining whether any of the tests are satisfied.

Effect of other noteholders

29. In determining whether test 3 or test 4 is satisfied, other convertible noteholdings, by residents or non-residents, must be taken into account. That is, the ability of a non-resident convertible noteholder to gain the required level of voting power or dividend or capital entitlements or influence over the company or its directors must be examined in the context of the ability of other noteholders.

30. For example, assume the following facts:

(i) there are three convertible noteholders, one non-resident and two residents.

(ii) each holder has a note of identical value and with identical conditions.

(iii) each note, on conversion, entitles the holder to 15,000 shares of the issuing company.

(iv) the shares, on conversion, are the same class as all other issued shares and have full voting, dividend and capital distribution rights.

(v) the company presently has 85,000 issued shares.

31. Looking at the noteholding of the non-resident in isolation, test 3 will be satisfied because the non-resident is capable of gaining 15% (15,000 shares/15,000+85,000 shares) of the control and entitlements prescribed in the first two tests. Consequently, test 4 will also be satisfied because the non-resident will generally be able to exercise influence over the actions of the company or its directors.

32. However, the effect of paragraph 29 is to require that the other noteholders' potential control, entitlements and influence also be taken into account. That is, the potential control and entitlements of the non-resident in these circumstances is only 11.5% (15,000 shares/15,000 shares+15,000 shares+15,000 shares +85,000 shares) and consequently neither test 3 nor test 4 will be satisfied.

33. In the event that the non-resident actually converted the notes to shares, then tests 1 and 2 would need to be considered on the basis of all of the issued shares at the time.

Commissioner of Taxation

9 October 1992

ISSN 0813 - 3662

ATO references

NO 90/6330-7

BOUMG 0001

Previously released in
draft form as EDR 17

Price \$0.60

FOI index detail
reference number
I 1013346

subject references

- convertible notes
- foreign controller
- non-resident convertible noteholder

TR 92/6

- thin capitalisation

legislative references

- ITAA 159GZA; ITAA
159GZE; ITAA 159GZJ

case references