Thoughts on Convertible Notes

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There is continuing pressure in Australia for a restoration of the deduction by companies of interest paid on convertible notes as an expense for company tax purposes. Since the law was changed the issue of such notes has ceased. Were they formerly issued only as a means of tax avoidance without net benefit to the community? Or have companies been unwisely discouraged from adopting a financing medium that has no reasonable alternative?

The Company Tax Background:

A feature of the taxation laws of a number of advanced Western-type economies is that companies as such are subject to a tax related to profits quite independently of, and without diminution of, the liability of individual recipients of benefits from companies to pay personal income tax on such benefits. For fiscal, as well as legal, purposes the company is regarded as an entity separate from the individual persons who directly or indirectly provide its capital, labour and organisational resources. Ignoring the complications that arise through the existence of intermediary companies and non-resident beneficiaries, the simple situation is that ultimately individual persons pay personal income tax on the benefits they receive from companies, by whatever name they may be called and whether they take the form of dividends, interest, salaries, wages, fees or commissions.

It is not the purpose of this study to discuss the desirability or otherwise of this situation, but it is accepted as a fact of life that we have a company tax independent of personal income tax. Theoretically a company tax could be based on turnover or even total resources employed, but again as a fact of life it is accepted that we have one related to profits. In brief, taxable income is equal to gross receipts less certain outgoings, and what we are really concerned with is what the legislature is prepared to allow to be included in these outgoings.

Interest as an Allowable Expense:

In general, interest paid on borrowed funds is allowed as such an outgoing. There is some artificiality in the clear cut division between interest paid on funds provided by way of loans and dividends paid on funds provided in the form of ordinary and preference capital. Interest is treated as an expense in the earning of the company income to be taxed whilst dividends are treated as a disbursement of the net profits left after payment of company tax. There is a case for the common treatment of interest and dividends, but should this be through the general dis-allowance of interest as an expense or through the allowance of dividends paid as an expense for company tax purposes?

A company that trades in money, that borrows at one rate and lends at a higher rate of interest, is in an entirely different position to, say, a manufacturing company that supplements the resources provided by its shareholders with limited short or long term borrowings from banks, institutional investors or the public. In the former case a logical company taxation system based on profits requires interest outgo to be allowed as an expense. This is not necessarily so in the second case and it is possible to imagine a system under which interest is not so allowed; present contrary practice has the effect of encouraging companies to borrow, and this could be against the interests of the community.

A manufacturing enterprise may need a certain volume of resources to carry out its activities, and logically these resources (apart from seasonal fluctuations) should be wholly provided by shareholders. The present company tax system almost forces the enterprise to borrow as much as possible of the needed resources, and this can introduce a degree of instability into its operations and financial results.

It may well be possible to develop a consistent profit-based theory of company taxation that could be logically applied to both financial and manufacturing companies, but this again is not the purpose of this study. The reference to this aspect is primarily to emphasize that the present system of company taxation is not altogether logical in its treatment of interest and dividend outgo, either in general or as between different types of companies.

Types of Convertible Notes:

There are many possible variations, but basically there are two types of convertible notes:—

a. Those that are automatically and compulsorily converted into ordinary shares at the end of a period. At worst these are merely a vehicle for tax avoidance — the company really needs additional share capital but makes a temporary saving in annual taxation through this subterfuge. The company as a whole makes a gain, but to an extent this is indirectly at the expense of those of its shareholders who are—

   1. Australian companies receiving taxable interest instead of rebatable dividend income or forced because of this taxation situation to de-

cline to invest in notes and so to reduce their ultimate equity percentage, as against,

2. individuals and foreign companies not relatively disadvantaged by the tax position.

b. Those that are really a borrowing for a term of years but which have an associated option or conversion right that could be exercised by the holder at the end of the period. The rate of interest paid does not indicate the true cost of the borrowing in so far as the "sweetener" has any actual or potential value — at the expense in any case of the original shareholders — and some fortunate noteholders may receive this value as an untaxed capital profit either through sale during the period or on exercise at its end.

Type a. was commonly used in Australia and its apparent abuse for tax avoidance purposes led to a degree of official distaste that culminated in the 1960/61 amendments to the taxing legislation.

Interest on Convertible Notes:

In its simplest and most objectionable form, the convertible note was an acknowledgement of a borrowing on which interest was paid for a number of years and which was then converted into share capital with a right to participation in profits. The real purpose was to increase the company's capital, but by adopting this procedure,

a. the interest paid during the deferred period was allowed as an expense for company tax purposes so that the "cost of capital" appeared to be cheap, and

b. the raising of the capital was facilitated in that during the deferred period the noteholders were not only in a preferred position in relation to shareholders but, as the debt was not subordinated, they ranked equally with unsecured creditors.

In so far as notes were held by other parties, the existing shareholders had to bear extra risk during the deferred period and an endwatering of their equity interest; on the other hand they had a chance of gaining temporarily through additional leverage and ultimately through increase in size and stability of the company.

The present Section 51AB, inserted in the Commonwealth Income Tax Assessment Act in 1960, provides that an outgoing consisting of interest, or a payment in the nature of interest, under convertible notes shall be deemed not to be an allowable deduction from the assessable income of a company. The definition of convertible note is very wide and includes the situation where its consequences are attained through the operation of two or more instruments. Issues of convertible notes, loans with options, etc., were not made illegal; the change in law simply meant that interest paid on convertible notes as defined in the Act fell to be treated in the same way as dividends paid on share capital.

This of course is looking at the position from the point of view of the company desiring funds. There was no change in the situation of a company receiving payment for the provision of funds, and interest received on an investment in convertible notes continued to be treated for tax purposes as a receipt of interest and not as a receipt of dividends. A recipient company incorporated in Australia does not therefore get the benefit, in relation to convertible note interest, of the Section 46 rebate applicable to dividends received. The effect of Section 51AB in inhibiting the issue of convertible notes, including grants of share options as sweeteners for loans, was thereby reinforced.

Arguments for Change:

Whilst some critics of the present situation seek a complete repeal of Section 51AB, the old abuses are usually acknowledged and a change is sought only in respect of what has been referred to above as Type b. The case made for the change is often based upon the financial needs of a development project, coupled with a view that if the venture is successful the fixed-interest lender who made it possible should be entitled to participate in subsequent profits. This argument is not a satisfactory one in that it must set its face against the normal dichotomy between the equity shareholder running the risk and entitled to his full reward if the venture is successful, and the fixed-interest lender merely lending money and entitled only to his priority for interest and capital.

Greater publicity has been given to arguments for change based on supposed relative disadvantages being suffered by Australian companies and the Australian economy as compared with overseas companies and overseas economies. However, these arguments appear to greatly overstate their cases and it is not clear just why—

a. Australian companies should want or be permitted to borrow in Europe and give valuable options or conversion rights to promote ultimate overseas ownership of Australian industry, or

b. wholly-owned subsidiaries of foreign companies should want or be permitted to issue convertible notes in Australia to facilitate their local borrowings in competition with Australian companies.

On the whole the case for restoration in Australia of tax-deductibility of interest paid on convertible notes is not a convincing one, but are there any circumstances in which companies

a. should be permitted by the community to borrow without security,

b. could do so through the medium of convertible notes only if the interest was deductible as an expense, and

c. have no satisfactory alternative

means of raising the funds sought?

Deferred-Dividend Ordinary Shares:

A frequently quoted case is that of an existing company wishing to engage in a new project from which profits will not emerge for some time. It would be a convenience if the additional long term capital resources required could be obtained on terms involving low cost during that period. If interest were allowed as an expense for tax purposes, convertible notes could be issued and the cost of the additional capital minimized. It would not, however, be **eliminated** during that period, and a better theoretical solution would lie in the issue of ordinary shares under which payment of dividends was deferred for an appropriate period.

An example of this alternative approach can be found in the three for eight rights issue at par, made in 1963 by Ampol Petroleum Limited to its shareholders, of deferred-dividend ordinary shares entitled to participate in dividends declared after June 30, 1967. The funds required for a new oil refinery, not expected to contribute to profits for about four years, were raised through

a. relatively short term bank loans,
b. longer term institutional borrowings, and
c. perpetuities in the form of deferred-dividend shares.

The rights to the latter, and the shares themselves until they became pari passu with other ordinary shares, provided an active market — being particularly attractive to individuals and companies not taxed as traders and to whom immediate income was not important.

Theoretically, the difference in market value between normal and deferred-dividend shares would have been less than the anticipated dividend difference by an average recipient tax-saving component.

A more recent example is the issue by Meggitt Limited to Mowbray Industries Pty. Ltd. of a block of deferred-dividend ordinary shares entitled to rank for dividends as from June 1, 1970. By coincidence this issue could also be described as being for an "oil refinery" although of a different type. The underlying principles of the issue were the same, and illustrate circumstances in which deferred-dividend shares provide a more logical solution to a capital raising need than do convertible notes. In each case the market value of existing ordinary shares was sufficiently above par to cover the dividend difference and permit the issue of deferred-dividend ordinary shares at or above par. Had this not been so the alternative would not have been available unless the deficiency in market value were so small that it could have been overcome through the introduction of a preference element.

Final Thoughts:

There are certainly companies that are not in a position to raise funds through the issue of deferred-dividend or convertible preference shares. Some of these are weak or poorly regarded and need not be considered, but are there any types of companies that should, in the interests of the community generally, be positively encouraged to issue convertible notes? The answer to this question, and not mere ease in attractive money from subscribers, should be the critical test in any movement for restoration of tax-deductibility of interest paid on convertible notes. If there are such companies their types should be identified and the superiority of convertible notes over other forms of financing clearly demonstrated.

This would not quite be the end of the road. Any proposals put forward for restoration would, to have any real chance of success, have to be limited in their application to such worthy types of cases. Could this be done by rigorous definition or would it be necessary to leave some area for the exercise of a discretion by the Commissioner of Taxation?

Invitation to U.S. Conference

The Financial Analysts' Federation of America will hold its twenty-second Annual Conference from May 11th to 14th, 1969, at St. Louis, Missouri. Melvin C. Bahle, General Chairman of that Conference, has extended an invitation to members of the Australian Society of Security Analysts to attend. The possibility of participation of the Society's members in the educational program has been raised with the suggestion that the subject matter for discussion could be the operations of the Australian Stock Markets, outlook and characteristic stock recommendations.

The Federal President, Mr. T. P. Keene, through whom the invitation was extended, is most anxious that the Society should be represented, if possible. Members who are planning a visit to America and who may wish to represent the Society at this Conference should contact the Federal President, Box 5085 G.P.O., Sydney 2001.

The Conference Program would be a most extensive one embracing lectures, field trips, subject forums, discussion and workshop groups. For example, the 1968 Annual Conference Program offers field trips to twenty-one companies.

To enable the planners of the Conference sufficient time to consider Australian members' participation it is essential that advice of attendance be forwarded to reach the above address prior to 31st December, 1968.