

Is the interest paid on convertible notes deductible or a franked dividend?

Classifying a convertible note

From a tax perspective, it is important to correctly classify whether a convertible note is a debt interest or an equity interest. The reason being that where the note is treated as a debt interest, for tax purposes the returns paid under the note may be allowable as deductions. However, where the note is treated as an equity interest, for tax purposes the returns paid under the note may be frankable as dividends.

A recent taxation ruling issued by the Australian Taxation Office (ATO) states that in order to classify whether a convertible note is a debt or equity interest, it is necessary to determine whether the issuer of a convertible note has an "effectively non-contingent obligation" to provide a financial benefit.

Financial benefits can be anything of economic value, but would usually take the form of repayments of principal and interest. However, the issue of a share that is an equity interest on conversion of a convertible note is not the provision of a financial benefit for the purposes of the Tax Act.

Consider pricing, terms and conditions

As any particular convertible note may, by their nature, contain different terms from other convertible notes it is difficult to generalise whether a note should be classified as a debt or equity interest for the purposes of Division 974. Therefore it is necessary to have full consideration of the pricing, terms and conditions under which a particular note is issued in order to determine how it should be classified for tax purposes.

Reference: TR 2008/3

Corporate Limited Partnership must carry on business

The ATO recently issued a final tax determination stating that in order for a "limited partnership" to be treated as a corporate limited partnership, the partnership must be carrying on business. If the partnership is only a passive investor, the ATO considers that it cannot be a corporate limited partnership.

The ATO explains their view by saying that an association of persons can only be a corporate limited partnership if it is a "limited partnership". One of the requirements of a "limited partnership" is that the liability of at least one of the associates is limited. This can only be achieved by the operation of the Australian State laws relating to limited partnerships.

However, merely registering a "limited partnership" under Australian State law does not conclusively establish that there is a partner with limited liability. A "limited partnership" under Australian State law requires that it first qualify as a "partnership". The definition of "partnership" requires that the partners must carry on a business in common with a view to profit to be a "partnership".

Tax planning strategy?

Apart from the commercial merits, corporate limited partnerships have become an important tax planning vehicle e.g. for Division 7A purposes. However, this ruling indicates that the effectiveness of using a "limited partnership" as a tax planning vehicle may be limited.

If the structure does not qualify as a corporate limited partnership, taxpayers need to be aware of the following issues:

1. the partnership will be ineligible to be the head company of a consolidated group;
2. the net income of the limited partnership will be assessed directly to the partners;
3. the partnership will not receive exemption on foreign dividends or exemption on foreign branch income; and
4. loans made to the partnership by a private company may be subject to Division 7A deemed dividend rules.

Reference: TD 2008/15

Withholding tax rate reduced for managed investment fund income

The Government has introduced a new withholding tax regime in respect of certain distributions of Australian managed investment trust income made to foreign residents.

The new regime is aimed at enhancing the global competitiveness of Australian managed investment trusts and improving the ability of managed investment trusts (particularly property trusts) to attract foreign investment.

The existing 30 per cent **non-final** withholding regime applying to certain distributions from Australian managed investment trusts paid to foreign residents will be replaced by a reduced rate of withholding tax. However, the withholding tax will become a **final tax** so taxpayers will not be able to claim any tax deductions to reduce the tax

The new withholding tax rate is determined with regard to the place of payment, address of the recipient or, in some cases, the residency of the recipient. If the place, address or country of residence is in a jurisdiction with which Australia has effective exchange of information on tax matters, withholding will be required at the following rates:

- 22.5 per cent (non-final tax) for fund payments in relation to the first income year following Royal Assent (most likely to apply in the 2010 income year);
- 15 per cent (final tax) for fund payments in relation to the second income year (2011 income year); and
- 7.5 per cent (final tax) for fund payments in relation to later income years (2012 and later income years).

In any other case, withholding will be required at the rate of 30 per cent (final tax from 2011 income year).

Reference: Taxation Laws Amendment (Election Commitments No. 1) Bill 2008

Should you require assistance additional information, **contact your PKF tax adviser** or:

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