TR 158

Facts

H is raising fund to finance its operating and investment activities. Three types of instruments are to be issued for that purpose. They are as follows:

1) Convertible Bonds
2) Convertible Preference Shares A
3) Convertible Preference Shares B

The "Convertible Bonds" are secured floating rate notes with a tenor of 10 years; the return consists of yearly cumulative interest based on the aggregate of the repo rate and a margin. The bond will rank:

- junior, in all material respects, to the existing senior lenders and existing noteholders;
- pari passu without any preference among themselves; and
- senior to (i) any unsecured creditors of the Issuer and (ii) to holders of all classes of share capital of the Issuer.

The "Convertible Preference Shares A" are unsecured equity instrument with no liability on the issuer to repay capital. The dividend is based on the aggregate of the repo rate and a margin that depends on the level of retained earnings and will step up by 2% p.a. as from tenth anniversary of the issue date. The issuer may in its absolute discretion, as from the tenth anniversary of the issue date, redeem or buy back the preference shares. The redemption/buyback proceeds may, at the absolute discretion of the Issuer, take the form of either cash or ordinary shares of the issuer at the Discounted Value.

The "Convertible Preference Shares B" are also unsecured equity instrument but for a tenor of 10 years. The shareholder will receive cumulative preference dividend based on the repo rate and a margin that will depend on the level of the distributable profits of the issuer. The issuer may in its absolute discretion, as from the 5th anniversary of the issue date, redeem or buy back the preference shares. The redemption/buyback proceeds may, at the absolute discretion of the Issuer, take the form of either cash or ordinary shares of the issuer at the Discounted Value.

For the three types of instruments, the conversion is at the option of the shareholder and this can occur on the third, fifth and seventh anniversary of the issue at the Discounted Value. The three types of instruments are also to be listed within three months of the issue date.

Points at issue

i. Whether the interest payable on the Convertible Bonds will be an allowable expense for H?
ii. Whether in respect of both categories of Preference Shares, the dividend will be treated as an unauthorised deduction and exempt in the hands of the recipient?

Ruling

i. Being given that the proceeds of the Convertible Bonds will be used to fund the Operating and Investing activities of the company, the interest paid thereon qualifies as an allowable deduction under Section 19(1) of the Income Tax Act.
ii. As in the case of ordinary shareholders, dividend paid to preference shareholders is a distribution which depends on the availability of retained earnings. Unlike interest, dividend paid to preference shareholders in the present circumstances is not a cost incurred in the production of gross income. Hence it is an unauthorised deduction and is exempt in the hands of the recipient in accordance with Section 7 and item 1(a) of Sub-Part B of Part II of the Second Schedule to the Income Tax Act.