# *TR 2002/3 - Income Tax: whether the holding of pre-emptive rights, call options and put options constitute a contingent entitlement to acquire for controlled foreign company (CFC) and foreign investment fund (FIF) purposes*



This document has changed over time. This is a consolidated version of the ruling which was published on *30 January 2002*

# Taxation Ruling
## Income tax: whether the holding of pre-emptive rights, call options and put options constitute a contingent entitlement to acquire for controlled foreign company (CFC) and foreign investment fund (FIF) purposes

Contents Para



***Preamble***

*The number, subject heading,* ***Class of person/arrangement, Date of effect*** *and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of Part IVAAA of the* ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

## What this Ruling is about

1. This Ruling is concerned with:

- the meaning of 'contingently entitled' in section 322 of Part X of the *Income Tax Assessment Act 1936* ('ITAA 1936') (dealing with controlled foreign companies (CFCs)) and section 475 of Part XI of the ITAA 1936 (dealing with foreign investment funds (FIFs));
- the meaning of pre-emptive rights, and instruments known as call options and put options; and
- whether pre-emptive rights, call options and put options constitute contingent entitlements to acquire for the purposes of determining CFC status and determining Australian residents' interests in companies and trusts under the CFC and FIF measures.

2. This Ruling is specifically concerned with the question of whether interests in a foreign company, such as those represented by a percentage of share capital, or interests in the income or corpus of a trust, comprise a contingent entitlement within the scope of sections 322 or 475 where they are subject to a pre-emptive agreement, call option or put option. In answering this question, the Ruling considers the legal meaning of these types of interests.

3. The Ruling applies to Australian residents with interests in foreign companies or trusts.

## Background

### The law

4. Section 322 in Part X states:

> 'For the purposes of this Part, an entity is entitled to acquire anything that the entity is absolutely or contingently entitled to acquire, whether because of any constituent document of a company, the exercise of any right or option or for any other reason.'

5. The corresponding provision in Part XI, section 475, is for practical purposes identical. Sections 317 and 470 of the ITAA 1936 define 'entity' to mean a company, a partnership, a person in the capacity of trustee, or any other person. In determining an entity's interest in a company or trust, in either Parts X or XI, an entity's actual interests as well as an entitlement to acquire an interest are to be taken into account.

### Interests in companies

6. For the purposes of Part X, an entity's direct control interest in a company is determined by reference to six alternative tests set out in section 350. The greater or greatest of the percentages worked out under these tests equals the direct control interest. As already noted, the direct control interest that an entity holds in a company includes interests that the entity is entitled to acquire: subsection 350(1) of the ITAA 1936.

7. In Part XI, an interest in a foreign company may comprise a share in the company or an instrument that confers an entitlement to acquire such a share, such as an option or convertible note: section 483 of the ITAA 1936.

### Interests in trusts

8. In Part X, where the entity is a beneficiary in a trust, the direct control interest is equal to the percentage of the income of the trust, or the percentage of the corpus of the trust, to which the beneficiary is entitled, or entitled to acquire: section 351. Where the income or corpus percentages differ, the higher percentage is the measure of the direct control interest the beneficiary has in the trust.

9. In Part XI, an interest in a foreign trust is an interest in the income or corpus of the trust, or an instrument that confers an entitlement to acquire such an interest, such as an option or convertible note: section 483 of the ITAA 1936.

## Ruling

10. For the purposes of determining interests in foreign companies and trusts:

- pre-emptive rights are not treated as contingent entitlements within sections 322 and 475, until such time as they are able to be exercised, due to their crystallisation or a triggering event;
- call options are either an absolute or a contingent entitlement to acquire within sections 322 and 475; and
- put options are merely a right to impose an obligation on another and do not amount to a contingent entitlement to acquire within sections 322 and 475.

## Date of effect

11. This Ruling applies to years commencing both before and after 30 January 2002. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

## Explanations

### Contingent entitlement

12. Sections 322 and 475 of Part X and Part XI refer to a contingent entitlement to acquire. They make it clear that a contingent entitlement or right is to be counted towards the computation of a taxpayer's interest and attribution percentage.

13. Contingent entitlement is not defined in Part X or Part XI, and the Explanatory Memoranda do not contain much guidance on its scope.

14. The ordinary meanings of 'entitled' cover 'entitled in interest' and 'entitled in possession': *The Will of Borger* [1912] VLR 310 at 313. The Oxford Dictionary defines entitlement as 'a rightful claim

(to a thing)…'. To have a contingent entitlement, one must first have an entitlement. Therefore, a contingent entitlement is an existing entitlement (a rightful claim) which is contingent on an event that may or may not happen: per Nourse J *in IRC v. Sir John Aird's Settlement* [1982] 2 All ER 929 at 940.

### Pre-emptive rights

15. A key issue raised by industry is whether the legal meaning of contingent rights is broad enough to include pre-emptive rights. This is in light of the commercial reality that it is quite common for Australian business entities to engage in joint ventures with foreign firms in overseas business operations or undertakings. Within those business undertakings it is equally common for pre-emptive rights agreements to exist, which prescribe the conditions under which the joint venture parties may dispose of their interests or shareholdings.

16. A pre-emptive right, or first right of refusal, gives the holder the entitlement to purchase the property of the owner who conferred the right. The owner has an absolute discretion whether or not to sell property. In the case of the owner deciding to sell, the property must first be offered to the holder of the right. At that point, the buyer acquires the right of election of whether or not to buy.

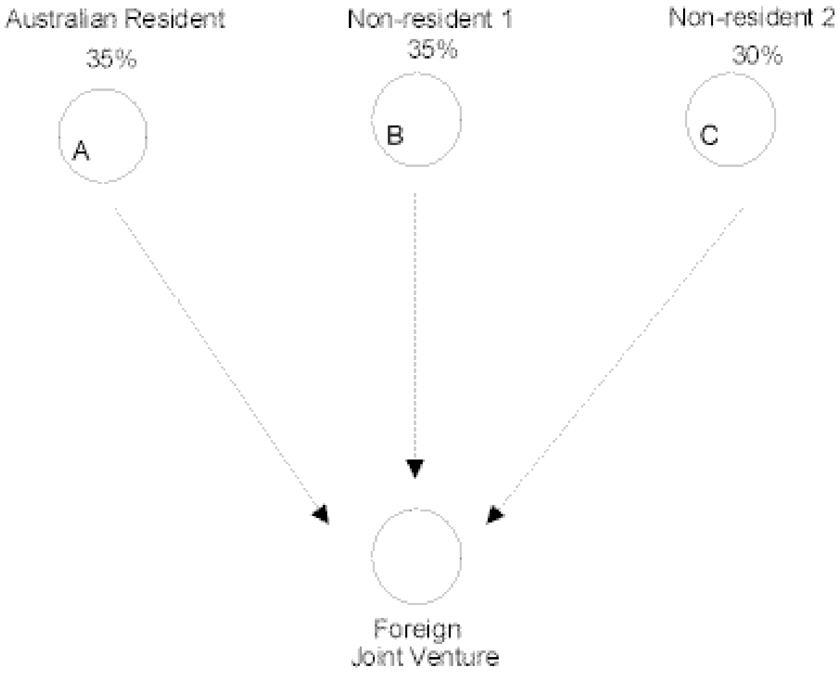
17. The majority view of Templeman and Stephenson LJJ in *Pritchard v. Briggs* (1980) Ch 338 (English Court of Appeal, Chancery Division) held that initially the character of a pre-emptive right is that of a personal contract and, when the first right of refusal is exercised, it changes to confer an interest in property. Conversely, the dissenting view of Goff LJ was that a pre-emptive right was a personal contract not capable of conferring an interest in property.

18. A pre-emptive right can only be triggered by property being offered to the holder of the right, and in absence of that offer cannot be exercised. At the time of commencement of the agreement, the rights are latent and do not exist in practical terms until such time as the property is offered for sale or acquisition, at which point the right crystallises. This means that in the initial agreement stage of a pre-emptive right, there is no exercisable or suable right, but only a mere expectation. The Commissioner's view therefore is that a pre-emptive right at the point of commencement of the applicable agreement, and prior to any opportunity for exercise of the right, will not constitute a contingent entitlement under sections 322 or 475.

19. Once activated or triggered, a pre-emptive right vests in the buyer a contingent entitlement, at the very least, in the property. The Commissioner's further view is that this contingent entitlement continues until either actual acquisition of the subject interest, or

formal decline, rejection, or lapsing of the offer period under the entitlement, which extinguishes any rights of the holder.

***Example of pre-emptive rights agreements in joint venture arrangements***




20. For the purposes of this example, the pre-emptive rights agreement provides for A and B to take C's shares or interest in equal proportion, in the event of C wishing to exit the joint venture.

21. Based on the interpretation provided by this Ruling, A will only have a contingent entitlement to acquire the additional 15% holding or interest from the point of crystallisation, that is, where C actually advises that it wishes to exit.

22. If no such action is taken by C, but it continues as a party to the joint venture, then no contingent entitlement to acquire is held by A over that 15%.

### Call options

23. A call option grants a right to the holder (also the buyer, grantee, or taker of the option) to acquire the underlying asset from the seller (also the grantor or writer of the option). Thus, a call option over issued shares refers to an existing asset which can be delivered at settlement.

24. Call options will constitute either an absolute or contingent entitlement to acquire. They are an absolute entitlement if it is within

the holder's power to exercise the option, but a contingent entitlement if the exercise is dependent upon factors outside the control of both the holder and seller.

25. Call options that are of the straightforward or date-deferred type, whether on a date or time basis, do not give a contingent entitlement but rather an absolute one.

26. Where the option's exercise depends upon such factors as a market price increase or decrease, or approval by an independent regulatory body, then that truly is a contingent entitlement. An example of such an option is one where the exercise requires the prior approval of the Foreign Investment Review Board before it can proceed.

27. From the first inception of such an option agreement, the holder therefore has a current entitlement, either absolute or contingent, to acquire the subject asset to which the call option refers.

28. Accordingly, the Commissioner's view is that at commencement of such an option agreement, a call option will comprise an entitlement of the holder to which sections 322 and 475 apply.

29. Where the option entitlement process consists of several steps, then the existence of either an absolute or contingent entitlement will be determined on a 'look-through' basis, for example an option to acquire an option to acquire shares.

30. The Commissioner's view is that sections 322 and 475 could be wide enough to capture even options over unissued shares. However, for the purpose of sections 350 and 581 of the ITAA 1936, the calculation of the percentage of the relevant ownership interest refers to entitlement to acquire at a particular measurement point in time. In the case of both sections the entitlement is measured with respect to paid-up share capital. Therefore, at this point, the entitlements can only relate to issued shares, or other rights or interests over shares in existence at that particular measurement time. Thus, no actual attribution will occur in option situations where the entitlements, contingent or otherwise, relate solely to unissued shares.

### Put options

31. A put option, in the present context of Parts X and XI, gives the holder (grantee or taker) of the option the right to sell a shareholding or interest in a foreign entity, to the Australian writer or grantor, at or before a specified date for a specified price.

32. The Commissioner's view is that a put option constitutes a right to impose an obligation on another. Accordingly, it does not

amount to a contingent entitlement to acquire on the part of the writer or grantor.

## Detailed contents list

33. Below is a detailed contents list for this draft Ruling:



**Commissioner of Taxation**
30 January 2002

*Previous draft:*
Previously released as TR 2001/D12

*Related Rulings/Determinations:*
TR 91/1; TR 92/20; TR 97/16

*Subject references:*
- absolute entitlement
- call options
- contingent entitlement
- controlled foreign companies
- direct control interest
- foreign investment funds
- pre-emptive rights
- put options

*Legislative references:*
- ITAA 1936 Part X
- ITAA 1936 317
- ITAA 1936 322
- ITAA 1936 350
- ITAA 1936 Part XI
- ITAA 1936 470
- ITAA 1936 475
- ITAA 1936 483
- ITAA 1936 581

*Case references:*
- IRC v. Sir John Aird's Settlement [1982] 2 All ER 929
- The Will of Borger [1912] VLR 310
- Pritchard v. Briggs (1980) Ch 338

ATO references:
NO: T2001/016905
ISSN: 1039-0731