Analytical Speaking

Analysis of the new provisions for securitisation

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How does it sound like saying, we take the credit for it, but we are not responsible for the goof-up that has happened? While it may be so very irresponsible, it is so very true.

We did take the lead and formulated the representation, along with KPMG, on the tax problems of the securitisation industry, and therefore, we take a fair share of credit for getting this provision into the Budget.

However, while we sought a tax transparency, here is even a worse form of representative tax, much worse than paying tax at maximum marginal rate! Here is an analysis of the original problem, the sought solution, and the new provision.

What was the problem?

Securitisation transactions involve creation of special purpose vehicles (SPV), to whom receivables are transferred. The SPV subsequently distributes the collections from such receivables to investors. Therefore, technically, the income passes through the SPV.

For tax purposes, there have been questions in the past as to why the income should not be taxed in the hands of the SPV, as the income is legally received by the SPV. There are 2 approaches to taxing an SPV, which is a trust. The tax is imposed at par with the tax on recipients of the income, or tax at maximum marginal rate (MMR). In the former case, the tax officer collects the tax from the SPV, but such tax is no different from the tax that he could have collected from the investors. Hence, there is no incremental tax, and therefore, no reason for the tax officer to adopt this approach. The second option is tax at MMR, where the respective investors' taxability or tax rates are disregarded, and the tax is imposed at the maximum slab rate. This is real where the source of problem lies.

What was represented:

On behalf of the securitisation industry, what was represented was that the securitisation vehicle is nothing but a conduit, or a mere distributive device. There is no aggregation of income, investment of income or reinvestment of income at the SPV level. The SPV is a mere legal device in the whole exercise, and not a real life entity such as a mutual fund carrying on a substantive business activity. Hence, the representation was to completely exclude the tax on the SPV, and tax the recipients.

This is what is internationally known as the pass-through principle.

While that was the intent, words don't meet the intent:

However, the actual wording of the provisions of law may give a completely different implication, notwithstanding the fact that the intent of the lawmaker was clearly to remove the snag currently affecting securitisation transactions.

The provisions:

The provisions pertaining to securitisation are contained at 3 different places in the law – sec 10 (23DA), sec. 10 (35A), and sections 115TA to 115TC.

Section 10 (23DA) grants tax exemption to the securitisation trust or SPV (let's call it "qualifying SPV").

Section 10 (35A) grants tax exemption to the income of the recipient.

Sections 115TA to 115TC lay a special scheme for imposition of tax in respect of distribution of income by securitisation trusts.

The language of sections of 115TA to 115TC is clearly based on the template of sections 115R, 115S and 115T. Sections 115R to 115T pertain to mutual funds.

First of all, let us understand qualifying SPVs, and qualifying transactions. From the language of the provision, it appears that all the following transactions of securitisation fall under the special scheme of the law:

- **Transactions of securitisation of standard assets as regulated by the RBI**: The RBI has guidelines on standard securitisation for banks and NBFCs. This regulation is mandatory – there is no option that banks and NBFCs have.
- **Transaction of securitisation where the securities are listed on a stock exchange**: While the wording of this part may not be very clear, this will cover all transactions of securitisation where the securities are listed on a stock exchange. Note that the SEBI's listing norms for asset backed securities include both publicly offered as well as privately placed securitisation transactions[1].

Strangely, securitisation of mortgage receivables under NHB norms has been left out. However, one easy way to have the same covered is to go for listing under SEBI listing norms, but prima facie, there was no reason to omit out NHB. In fact, in terms of significance, mortgage backed transactions are far more important for the nation than securitisation structures.

Now, if a transaction falls under the qualifying category, then the implications are as follows:

1. There will no tax on the income of the trust, by virtue of sec. 10 (23DA)
2. There will be no tax on the income of the investors, by virtue of sec. 10 (35A).
3. However, there will be a tax on distributed income, in terms of sections 115TA.

There are several implications of this are several:

1. First, the law says that there will be an "additional tax"[2] on "amount of income distributed by the securitisation trust". Notably, a securitisation trust distributes both income and principal. There is no question of tax being imposed on distribution of principal. Hence, to the extent the distribution is the repayment of principal invested by the investor, there is no question of tax on the same.
2. Second, there is a tax on income distributed, but not on income accumulated. While revolving securitisation structures are not very common in India, but it is quite possible, and permissible within RBI guidelines too, to do a revolving securitisation structure. In such a case, the income may just get accumulated.

[1] So far, there has been only 1 case of listed asset backed security.

[2] The use of the words "additional tax" is from the history of tax on distributed income. It is not additional in the sense of being additional to some other tax.

There is nothing in the law, unlike in case of venture capital funds under sec. 115U, to say that there will be a tax on income retained by the vehicle too.

3. Third, the rate of tax depends on category of the recipient – individual, entity exempt from tax, and other entities. Obviously, the determination of the category is relevant only at the time of distribution of the income – hence, irrespective of who was the holder of the asset backed security over time, the tax rate will depend on the category in which the recipient falls at the time of receipt of the income.
4. In case of recipient being a mutual fund, the problem is not there –as a mutual fund is exemption from tax. However, in case of any other assessee, the provision results into tax on gross incomes. The problem is particularly intensive in case of banks or corporate investors, who, without getting any deduction for their own expenses, end up paying tax at flat rates laid in the law.

Applicable date:

There is a conflict between the applicable dates for sections 10 (23DA), section 10 (35A) and sections 115TA – 115TC. The former two sections are applicable from 1st April 2014 – hence; apply for income year 2013-14. However, the new tax scheme on distributed income applies from 1st June 2013. Hence, any distribution made on or after 1st June 2013 will have to pay distribution tax. This would mean, in case of distributions made prior to 1st June 2013, neither the investors nor the trust is liable to any tax.

However, the bigger problem is that the new scheme of distribution tax is applicable to existing securitisation transactions too. There is nothing in the provision to exempt existing structures.

Transactions worth Rs 20000 crores approximately have been done during this financial year alone. There are subsisting transactions of securitisation – the total amount of money involved is not less than Rs 70000 – 80000 crores. Past transactions were covered by RBI guidelines of 2006. There is nothing in the proposed law to exclude those transactions. Hence, all transactions of securitisation by banks and financial institutions are covered by the new law, once it gets implemented. For mutual fund investors, this is the resolution of the problem, but if there are other investors, the distribution tax catches them completely unawares.

What about withholding tax:

On top of the distribution tax, will there be any deduction of tax at source when the securitisation trust distributes income? To this, our answer is no, since the income itself becomes exempt in the hands of investors.

What about expenses of the trust:

The trust has various expenses – such as servicing fees, legal costs, trustee fees, etc. Will these expenses be disregarded, and the tax will be imposed on gross income?

The language of section 115TA (4) gives such an impression, but really speaking, that is not the case. Obvious enough, the trust will only be distributing the “income” that remains. Hence, there is no disallowance of expenses.

Who determines what is income?

It will be a very complex question as to whether, what the trust distributes is income or principal, and how exactly is the income determined? The normative principle is – income is excess over investment. However, income in the hands of the investors is not the same as income in the hands of the trust. In the present case, by a special scheme of law, tax is imposed on the distribution by the trust – hence, income has to be determined in the hands of the trust, after giving full effect to the provisions of the income tax law. Going by this, our prima facie view is that the tax u/s 115TA is applicable only in case of pass through instruments. In case of bonds, the payment of interest on a bond is not a case of "distribution" – it is a charge against income.

Applicability of sec 14A:

Clearly, as the income so distributed in the hands of investors is tax free, the provisions of section 14A on proportional disallowance of expenditure of the investors applies.

Problems with the proposed scheme:

First of all, the proposed scheme has used the mutual fund template in case of securitisation trusts, which is wholly inappropriate. Mutual funds are vehicles that collect small investors' money, and invest the same on a recurring, revolving basis. There is a hard core business called mutual fund business. There is no substantive business called securitisation business. There is no real world existence of SPVs – SPVs exist legally but not substantively. The money that is collected and distributed in the name of the SPV never sees the bank account of the SPV at all. There are no sponsors, shareholders or persons behind the SPV. There is no asset manager in case of securitisation SPVs. The securitisation SPV is a mere passive conduit. The money is collected by the servicer, and passed-through to the investors. Hence, the receipt of money by or in the name of the SPV is mere legal fiction.

The Table below shows that the law has in fact tried to apply the mutual fund framework to securitisation trusts:

Income distribution tax u/s 115R : Tax on distributed income to unit holders by mutual funds		
Type of investors	**Rate of tax**	
	before Finance Act, 2013	**after Finance Act, 2013**
On Money Market MFs		
Individuals and HUFs	25% plus surcharge @5% plus cess @3%	25% plus surcharge @10% plus cess @3%
Any other person	30% plus surcharge @5% plus cess @3%	30% plus surcharge @10% plus cess @3%
On any other MFs		
Individuals and HUFs	12.5% plus surcharge @5% plus cess @3%	25% plus surcharge @10% plus cess @3%

Any other person	30% plus surcharge @5% plus cess @3%	30% plus surcharge @10% plus cess @3%
In case of IDFs On payment made to non-residents	No special provision	5% plus surcharge as applicable

Worse than tax at representative tax?

A very pertinent question is – is this worse that paying tax at on representative tax principles? If the tax was applicable at MMR, surely the tax outflow at SPV level would have been higher, but if the trust were to be treated as a regular tax paying entity, claiming exemption on account of its funding costs, and the investors were likewise to claim their own expenses and pay their own tax, it is quite likely that the actual outflow of tax would be less than having to pay distribution tax.

Would bond structures find a favour?

In light of this, do pass through structures become less attractive than a bond structure? In a bond structure, the amount of interest paid on the bonds is allowed to the trust as an expense, and the trust is charged to tax only on residual income. The residual income of the trust can be minimised if the bonds sweep almost all of the income of the trust. Therefore, the trust pays minimal tax, and thereafter, the investors take the interest income to their books, and pay tax on their incomes after deducting their own funding costs. The total tax burden on this structure is far lesser than under the distribution tax.

Complex choice between direct assignments and securitisation:

The new taxing scheme will once again leave originators in quandary as to whether to opt for direct assignments or securitisation. Obviously, in case of banks being investors, the proposed tax regime will completely rule banks out as investor class. This will push transactions back into direct assignment mode, which has its own problems under the RBI guidelines. Direct assignments are more of an aberration than something to encourage.

What the lawmakers have failed to realise:

- That financial transaction is not comparable to individuals pooling money into a bank or mutual funds. Financial transactions run through series of financial intermediaries – securitisation trust is merely a passive intermediary. As long as income is taxed in the hands of a substantive tax payer, there is no drain on revenue. Hence, focus should be on taxing the substantive tax payer rather than a fictional entity called an SPV.
- The present structure is almost like a fire fighting measure – it simply resolves the problem that currently, mutual fund investors are facing in securitisation

transactions, but in the process, creates problems for all investors other than mutual funds. After all, securitisation is not limited or intended to be limited to mutual fund investors only.

Hope survives:

However, we are sure that the Ministry of Finance is prepared to listen and appreciate the problem. We are hopeful that post-Budget discussions should yield something tangible.