Analytical Speaking

Taxing time for securitisation in India: tax officers' questions expose weak structures

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History of financial innovation has several examples of this – people overdo things, and regulators keep watching that from a distance, until the market collapses – and exactly then, all regulators swoop on. There are several instruments one may name – leasing, repos, gold loans, and now, securitisation. Not much is happening in the securitisation market over the last few years. In 2006, RBI guidelines virtually killed the rated and tradable securitisation market (in India, commonly called the pass-through certificate or PTC market), and redirected the entire market to transactions for bilateral sales of loans or portfolios (commonly called "direct assignments"). From 2010 until now, the market has been in a state of uncertainty due to RBI's draft guidelines laying down minimum risk retention requirements and minimum holding period requirements, both for bilateral assignments as also for tradable securitisation paper. Microfinance was one major source for securitisation transactions to flow, and that was basically for the priority sector treatment in the hands of the buying banks. Other sources were gold loans and so-called agricultural loans (which may have, actually, been nothing but loans for commercial vehicles). Microfinance has been in its own problems for some time now, gold loans lost priority status, and probes into priority sector treatment for so-called agri loans has demotivated many banks from buying such portfolios from originating NBFCs. In short, the securitisation market has been highly inactive in the recent period.

And that is exactly when the tax officers have struck. Reportedly, tax officers have served notices and demands on trustees of securitisation vehicles (SPVs) taxing the entire income of such vehicles. The implications of this demand are huger – first, because the gross income of the SPVs is being sought to be taxed. Second, what is sought to have be taxed has already been distributed by the SPVs, and in fact, the investors in the SPVs were mostly mutual funds, which, in turn, have distributed money to who all were unit holders of the mutual funds. Some of the schemes might have, in fact, been completely wound up by now.

Understanding the issue:

To understand the claim of the tax officers, we need to note a few points on the structure of securitisation transactions in India.

- Almost all (one would have said all, but for lack of confirmed data) securitisation transactions in India, other than the bilateral assignments, have been done through SPVs organised as trusts. Practices differ in different

countries, but India has made the most of the common law vehicle – trust, which is least regulated.

- Trusts raise funding by issuing pass-through certificates. A pass through certificate is a certificate of beneficial interest, making the holder thereof the beneficial owner of the assets in the trust. Thus, the trust Is the legal owner of the assets; the holders of the PTCs become the beneficial owners. Clearly, a PTC is an ownership instrument. Unlike bonds, it is not an instrument witnessing debt. Unlike equity shares, it is not instrument witnessing ownership of the entity: it indicates beneficial ownership of assets of the entity.
- As the legal owner of the assets (say, a pool of loans), the SPV receives the income. The income is passed-through to the holders of the PTCs. It is commonplace practice in India for PTCs to have multiple classes – there might be two or more classes. There may be a senior class entitled to a fixed coupon rate, and a residual class that sweeps the entire remaining income of the vehicle.
- As the income is received by the SPV, there are essentially 3 options for taxing the SPV:
- Taxation as a regular tax paying entity: this is commonly called entity level or corporate tax principle – similar to a company. The recipient of the income is taxed as if the income was the income of the entity. Against this, the entity seeks to offset whatever is admissible as "expenses". If the securities that the SPV issues are treated as debt of the SPV, the SPV may still be tax-neutral, as SPVs do not retain any income – they distribute all that they receive. However, if the securities of the SPV are treated as ownership instruments akin to equity, then the payments made by the SPV are treated as "distribution", which is not tax deductible, leaving the SPV to have to pay on its entire income.
- Taxation as a representative tax payer: This may be called the AOP tax principle, or the partnership firm tax principle, under which tax is paid by the vehicle, but it not paid by the investors. There are principles of representative tax in India, but consultants have, in general, been believing that if the tax chargeable from the beneficiaries of the trust is the same as the tax charged from the trustee, a tax officer may have no motivation to tax the trustee, if the beneficiaries have already been charged to tax.
- Taxation as a see-through or pass-through entity: Here, the tax officer sees-through the SPV, and taxes investors rather than the trustee. The principle is called conduit tax principle, or pass-through tax principle, on the ground that

if the SPV is nothing but a distributive device, rateably passing through all that it receives, the vehicle should qualify as a dormant, substantively neutral tax vehicle. Such vehicles cannot be taxed.

- The market in India in general believed that SPVs in India will be treated as see-through or pass-through vehicles. Practitioners had sought succour by relying on section 61 of the Income-tax Act which lays down that in case of a revocable transfer of an asset, the income from the property will continue to be taxed in the hands of the transferor. Thus, the trust deeds provided that the beneficiaries of the SPVs had made a "revocable transfer".

Practices in other countries:

Taxation of securitisation transactions in the USA relies mainly on two alternatives – either the pass-through exemption, or the REMIC exemption. In order for a transaction to qualify for a pass-through treatment, there are several IRS procedures. The essential theme of the pass-through exemption is that the entity must proportionally distribute all its income. Therefore, RMBS transactions that seek exemption under the pass-through route have a common "pass through rate" for all the securities issued by the vehicle and seek exemption under "grantor trust" rules. The other option is to structure the transaction as a REMIC, which has a regular income classes, and a residual income class, normally a nominality. In essence, the US taxation of securitisation vehicles is based on clear rules.

In countries such as UK, the commonplace practice is to offer a securitisation SPV to tax under entity level tax principle, ensuring that the securities of the SPV may be treated as "debt", thereby entitling the SPV to deduct what is pays to the investors as expenses. If the servicing fees and coupons paid by SPVs are treated as expenses, there is nothing left in the SPV to pay tax on, which is the essence of tax neutrality.

Countries other than UK also generally go by the entity level taxation option, unless the tax rules have specifically exempted securitisation SPVs from tax.

Structural weakness in India:

While the USA might have elaborate tax rules concerning taxation of SPVs, securitisation structures in India went ahead without any clear tax rules at all. There were some rulings relating to see-through or pass-through treatment of non-discretionary trusts. But the structuring of SPVs in India hardly adhered to the well-

known rules of pass-through taxation in the USA. For example, if there is a class that is entitled to a fixed rate of return, and another class that takes all residual income, the transaction cannot be said to be a pass-through transaction. A transaction that not merely redistributes income but differentiates in income cannot be said to be a distributive device.

This author, in workshops and forums, consistently stated that the tax issue in India is far bigger tan the true sale problem. Law firms were blowing miniscule legal issues such as commingling and clawback risks out of proportion, whereas the million dollar question of taxation of the SPV was given a short shrift by hiding behind section 61 of the Income-tax Act. It would be juvenile to contend that an investor who invested money allowing trustees to buy receivables with the money was making a revocable transfer. Transfer of money cannot, in essence, be said to be revocable transfer, as money is completely fungible.

In Vinod Kothari's Securitisation Asset Reconstruction and Enforcement of Security Interests, 2010 edition, p. 92, this is what this author stated: "Though the PTCs might be multi-class, and a large part may be residual income certificates in effect, the market believes, though with no reliable precedent, that there will no tax at the SPV level and the investors will be taxed on their share of income. The scenario is, however, far from clear and the current thinking may be short-lived". [emphasis added here].

Magnanimity of the problem:

Tax officers have reportedly served notices on some of the common trustees of securitisation transactions. Tax officers contend that the trusts cannot claim a pass-through status, and the certificates issued by the trusts cannot be said to be the debt of the SPV as PTCs are essentially similar to equity. If the notices succeed, the SPVs would be called upon to pay tax on their gross incomes, disallowing the distributions altogether. This is, however, the worst scenario. In an optimal scenario, the payment made by the SPVs to fixed income classes will be allowed as expenses, but that would still leave the SPVs to pay tax on the residual income which typically goes back to the originators.

However, in the worst scenario, if SPVs have to pay tax on their gross income, the income would have been distributed long time back. Assuming the investor in the PTC was a mutual fund, the fund in turn would have also distributed what came to

the fund. In essence, there will be no trace of the income now sought to be taxed at all.

But that the trustee cannot recover the tax from its beneficiaries cannot be a defence to a tax notice. The trust deeds may allow the trustees the right of indemnity against taxation, but first, the trust deeds may not be specific as to which beneficiaries to claim such tax on, and two, the beneficiaries may also have gone out of the trust. If the beneficiary ceases to be a beneficiary altogether, it would be questionable whether the trustees' indemnity at all extends.

Is the trust route ideal?

Indian transactions have been using trust structure primarily due to the simplicity and lack of regulation on trusts. But trusts, unlike companies, are not limited liability entities. One may note from the history of company form that originally, companies were also "deeds of settlement" or trusts: the move to the corporate form with limited liability is said to be one of the innovations of the 19th century, comparable to the steam engine. Using the trust form for business transactions may be bargaining away the certainty of limited liability for the ease and convenience involved in trusts.

For instance, if the beneficiaries of the trust have changed, and the trust is called upon to pay taxes on current and past income, the trustee may be saddled with a tax liability that exceeds its assets. Trustees may still be safe, as they have the right to indemnify themselves. If the right of indemnity is unlimited – the present beneficiaries face tax liability exceeding their capital. If the right of indemnity is limited, then the trustees have to bear the brunt. In any event, there is a scope for unpleasant consequences. On the other hand, the certainty of limited liability may make the corporate form preferable – of course, one needs to live with the regulations that affect companies, including those of the SEBI and RBI. But problems such as the present tax demand may perhaps bring a cognition that it is better to be regulated and certain, rather than unregulated and uncertain.