Article

Budget gives a tax reprieve to securitization, replaces distribution tax with tax deduction at source

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Securitisation, a process that involves packaging of loans and receivables by financial institutions into securities for onward sale to capital market investors, will get a major impetus due to Budget 2016. The Finance Minister has proposed to remove the distribution tax imposed on such transactions by Finance Act 2013.

As a matter of fact, this is like correcting a mistake that was made 3 years ago. The-then Finance Minister, while admittedly wanting to give a tax transparency to securitization transactions, exempted securitization SPVs from tax, but while doing so, introduced tax on distribution of income made by such SPVs, thereby imposing a tax on the gross income of the investors in such transactions. As a result, the securitization markets in India crashed.

Over the years, the performance of the securitisation market has been deteriorating and the same is evident from the figures depicted in the table below:

	FY 2009-10		FY 2010-11		FY 2011-12		FY 2012-13		FY 2013-14		FY 2014-15	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
ABS	21497	50%	21819	69%	27344	71%	27230	90%	23504	82%	16453	96%
RMBS	6254	14%	5029	16%	7680	21%	3025	10%	5296	18%	747	4%
Total Retail Securitisation	27751	64%	26848	84%	35024	92%	30255	100%	28800	100%	17200	100%
LSO	14581	34%	4441	14%	2217	6%	-	-	-	-	-	-
Others	787	2%	536	2%	635	2%	-	-	-	-	-	-
Overall Total	**43118**	**100%**	**31825**	**100%**	**37876**	**100%**	**30255**	**100%**	**28800**	**100%**	**17200**	**100%**
Growth	(20%)		(26%)		19%		(20%)		(5%)		(40%)	
Average Deal Size	231		200		174		151		149			

Source: ICRA estimates

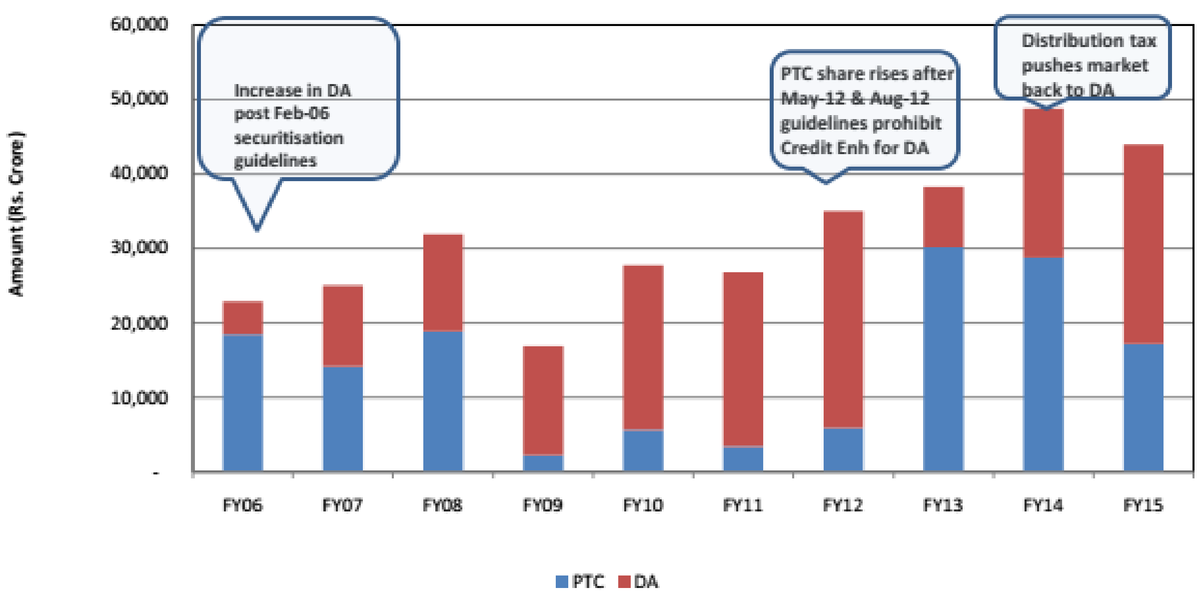
However, while granting the tax transparency, the FM has replaced the distribution tax by deduction of tax at source, thereby adversely affecting the cashflows of securitization investors. Securitsation investors may include banks, and mutual funds, who otherwise do not suffer deduction of tax at source.

Securitization and direct assignments:

While securitization in its strict sense is packing of the financial assets of the bank/NBFC into securities, commonly known as "pass through certificates" (PTCs), the Indian market reverted to an extremely anachronistic form, whereby there are no such securities or PTCs – instead, one player simply sells the entire portfolio to another player. This process, known as direct assignment, does not attract the distribution tax referred to above. However, since the process of whole-portfolio transfer does not result into any capital market transaction, the process lacks liquidity.

Largely owing to distribution tax, the markets in India have been largely been confined to the market for priority-sector loans (PSLs). This PSL trade virtually becomes a compulsion for many banks which fail to fulfill their minimum requirements for PSL assets, and therefore, are forced to acquire such portfolios from other originators, primarily NBFCs. Thus, while securitization markets globally are driven by economic benefits of securitization, in terms of lower funding costs, the markets in India simply search for a regulatory arbitrage.

The figure below shows the change in the proportion of securitisation transactions and direct assignment and how the latter has dominated in the last few years –



Source: Presentation made by representative of ICRA at the Innovative Bonds and Securitisation Summit, 2015[1]

Budget changes 2016

The Budget 2016 corrects the anomaly. It exempts distribution tax applicable to securitization transactions for all distributions made on or after 1st June 2016.

The impact of this provision is that there is a complete tax transparency to securitization transactions. The investors will pay tax on the income received by the investors, while there will be no tax on the securitization trust or the SPV.

[1] http://vinodkothari.com/wp-content/uploads/2015/09/Indian-Securitisation-Market-impact-of-distribution-tax.pdf

New scheme of tax:

The Finance Minister enacts the principle of pass-through tax in case of securitization trusts, where the tax on income earned by the SPV is taxed in the hands of the investors. The principles of tax may be summed as follows:

- The nature of income, for example, business profits or capital gains, in the hands of the investors will be the same as the nature of income in the hands of the SPV.
- The income is taxed at the time of distribution of the income, or, if the income is not distributed, that is, accumulated, then, at the time of crediting the income to the credit of the investor.
- Income remaining undistributed will be deemed credited to the investors in accordance with the respective investors' entitlement. That is to say, there is no possibility of using the securitization SPV as a tax shelter.

Incidentally, while the new scheme of tax has been introduced, as proposed, in sec. 115TCA for income-year 2016-17, the distribution tax under the original section 115TA becomes inapplicable only from 1st June 2016. Also, sec. 10 (35A) which was granting the tax exemption to distributed income has not been deleted. Therefore, for distributions made till 1st June 2016, there will be confusion as to whether sec 115TA applies, or sec 115TCA. Sec 115TCA starts with a *non-obstante* clause, giving it supremacy over the old distribution tax regime. It may make eminent sense for existing schemes of securitization to may be consider distributing after 1st June 2016, to avoid the confusion and take advantage of the new dispensation.

Ton of deduction of tax at source:

No amount of relief from the government comes without its pains – while the FM has extended the tax transparency to the SPVs, he has imposed the same rates of deduction of tax at source on the investors [sec. 194LBC]. The rate of TDS is the same as was the case with the distribution tax – 25% in case of individuals and firms, and 30% in case of corporate tax payers. So much so, that even in case of mutual funds, who are expected to be major investors in such transactions, there is no respite from the tax deduction at source.

The whole premise of tax deduction of source is the revenue leakage that may otherwise happen, in absence of an at-source taxation. Such is not the case with securitization, as the investors are mostly qualified institutional buyers. It is unfortunate that the Finance Minister seems to have been wrongly briefed on this issue.

Deduction of tax at source is not as bad as suffering distribution tax, for several reasons:

- The investor gets full credit for tax paid.

- The investor may seek a certificate for deduction of tax at lower rate. If the investor is tax exempt, say, in case of a mutual fund, the investor may apply for certification at NIL rate of deduction of tax at source.

However, the rates of deduction of tax at source securitization income are highly unreasonable, and may be, the FM may be inclined to review the same.

Extending the benefit of tax transparency to ARC trusts:

Not only this, the Budget has also extended the tax transparency to trusts set up for securitization of non-performing assets, typically set up by asset reconstruction companies (ARCs). Earlier, there was no clarity on as to the taxability of these trusts. The Budget now extends the same provisions as applicable to securitization trusts to ARC trusts as well. Thus, at the time when Indian financial system is reeling under NPA burden, hopefully, ARCs may be able to stay clear of tax burden.

In fact, for the ARCs, the issue in the past has been more of being able to liquidate the bad assets by disposing them off. They are struggling for profits, not so much for tax exemption. Therefore, the tax exemption may provide a little reprieve to the ARCs, but nevertheless, clarity is, any day, better than confusion.

Enabling foreign investments in securitization transactions:

The Finance Minister has also acceded to one of the persistent demands of the securitization industry, as promulgated by the Indian Securitisation Foundation, by permitting foreign portfolio investors (FPIs) to invest in securitization vehicles. So far, FPIs were permitted to invest in security receipts issued by ARCs, but not in securitization transactions.

In short, there is a major impetus expected in securitization markets in time to come.

Read more at:	http://vinodkothari.com/wp-content/uploads/2014/03/Securitisation_distribution_tax_-Frequently_asked_questions.pdf
	http://vinodkothari.com/wp-content/uploads/2014/03/Analysis-of-the-new-provisions-for-securitisation.pdf
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