TAX TREATMENT OF SECURITISATIONS OF RECEIVABLES

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INTRODUCTION

1.1. Overview of the market

Securitisation is a recent phenomenon in India. In the last ten years, banks and non-banking finance companies have structured and originated asset-backed securitisation transactions. Securitisable assets have been limited to auto loan portfolios, bills receivables, hire-purchase receivables and other receivables.

Recently the National Housing Bank has taken the initiative to popularize mortgage-backed securities. The first mortgage-backed securitisation transaction was that of mortgage loan receivables originated by HDFC, securitised by the National Housing Bank. After that there have been a few transactions originated by housing finance companies for the issuance of mortgage-backed securities in middle of 2002.

The securitisation transactions have been mainly on a one-to-one basis. The pass-through certificates issued to the investors have recently been listed in the wholesale debt market of the National Stock Exchange, as the market for asset-backed and mortgage-backed securities is still developing and is dominated by a few big-name players.

Despite the fact that securitisation can been used as a powerful tool in credit risk management and for raising funds at a low cost, for purposes of the recycling of funds it has not gained wide acceptance due to the absence of a secondary market for the recycling of funds. This is due to a general lack of understanding of the underlying transaction. In addition, a lack of clarity with respect to legal and tax issues has only compounded this problem. The absence of specific regulatory guidelines has also served as a hindrance in the development of the market.

1.2. Overview of the most significant laws

Until recently there was no specific law that governed securitisation transactions. In 1999 the Reserve Bank of India formed a working group to study the issues relating to the securitisation of assets. The working group highlighted some of the critical problems and had made a number of recommendations for changes to existing laws to accommodate securitisation transactions, including amendments to the Transfer of Property Act and the various pieces of stamp legislation. The Narasimham Committee I and II had recommended in the past the creation of asset reconstruction companies and the Andhyarujina Committee Report had recommended the enactment of a specific law regulating securitisation.

On June 21, 2002 the President of India promulgated the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Ordinance 2002 ("**Ordinance**"). The Ordinance deals with three distinct concepts, namely (i) the securitisation of financial assets, (ii) the reconstruction of financial assets of banks and financial institutions and (iii) the perfection and enforcement of security interests by banks and financial institutions. In the interest of time, rather than passing separate legislations governing securitisation transactions[1], the government bundled the provisions of the above-mentioned bills and enacted a combined new legislation in form of the Ordinance.

Unlike the earlier securitisation bill [which vested power with the Securities and Exchange Board of India to regulate entities acting as Special Purpose Vehicle ("**SPV**") in securitisation transactions, as well as related matters], the Reserve Bank of India has been empowered to license and regulate securitisation companies and asset reconstruction companies. However, the Ordinance does not preclude the applicability of other laws, including the rules and regulations enacted by the capital markets regulator (*i.e.* Securities and Exchange Board of India).

The Ordinance defines a securitisation company and an asset reconstruction company, and requires registration with the Reserve Bank of India as a precondition for the creation of a securitisation company or an asset reconstruction company. The Ordinance prescribes the application of prudential norms to securitisation companies in the form of minimum capital requirement. The Ordinance enables banks and financial institutions with non-performing assets to unload the receivables due from borrowers in favour of specialists in recovery (*i.e.* asset reconstruction companies). It also enables secured creditors (including securitisation companies and asset reconstruction companies) to sell the assets of defaulting borrowers without the sanction of courts and enables banks and financial institutions to assume the management of defaulting borrowers by displacing the management.

Typically, the SPV is a thinly capitalized vehicle for holding assets in trust for investors. As there are sufficient credit enhancements already built in by sponsors, there is no need to capitalize the SPV. Thus, the owned-fund requirement is an additional burden on the securitisation company. It is also envisaged that the Reserve Bank of India will prescribe rules, amongst other things, for making provisions for bad and doubtful debts. Under the Ordinance, the sponsors of a securitisation company or a asset reconstruction company may not hold a controlling interest in the securitisation company and therefore, the securitisation companies have an onerous obligation to broaden the shareholding of the securitisation company. Because most of the funds in a SPV are raised in the form of pass-through or debt securities issued to investors, such a broadening of the shareholding base would be difficult to achieve.

However, there is a lack of clarity as to whether it might be possible to interpose an AMC trustee structure in the case of a securitisation company and whether the benefits available to the

[1] As envisaged under the Securitisation Bill 2001 or the Creation and Enforcement of Security Interest by Banks and Financial Institutions Bill 2002, the latter of which granted statutory power of possession and sale of security to banks and financial institutions.

securitisation company relating to rapid enforcement and recovery of assets would be available in the case of an AMC trust structure.

The Ordinance has a non-obstante deeming clause, which mandates dispute resolution by way of arbitration. At the same time, the Ordinance states that the provisions of the Ordinance are not in derogation to other laws, including the Recovery of Debts due to Banks and Financial Institutions Act. Under this legislation, in all cases where there is a debt to banks and financial institutions, the case must be specifically referred to the debt recovery tribunal. This seeming conflict creates confusion as to whether disputes should be referred to arbitration or whether they should be filed with the debt recovery tribunal.

Although the Ordinance comes as a boon for banks and financial institutions saddled with non-performing assets, it creates roadblocks for securitisation transaction by modifying the concepts of a traditional securitisation transaction. It is also not clear whether the government intends this Ordinance to regulate only securitisation and reconstruction transactions to be carried out by banks and financial institution, or whether there will be a separate legislation governing securitisation transaction conducted by companies other than banks and financial institutions.

However, the Ordinance left many questions and ambiguities under Indian law unanswered. The definition of "true sale" under Indian law continues to be unclear. There is a lack of legal case history to provide guidance as to how the courts would view securitisation transaction in the event of the bankruptcy of the originator.

In addition to the Ordinance, the following statutes are applicable to a typical securitisation transaction in India.

- The principles of winding up and liquidation of the originating entity are regulated by the Companies Act 1956 ("**Companies Act**"). If the SPV is structured as a company, the incorporation and the management of the corporate entity is governed by this law.

  If the SPV is structured as a company under the Companies Act, it may fall under the definition of a non-banking financial company requiring registration under Sec. 45-IA of the Reserve Bank of India Act. However, under the existing regulatory framework, only companies holding or accepting public deposits are subject to prudential norms and are also required to comply with the statutory liquidity ratio requirements (which are determined as a percentage of their public deposits).

- The relation between an investor and the SPV is governed by the Indian Trust Act 1882. This law regulates the manner in which a trust is created and sets out the rights, duties and liabilities of a trustee.

- The transfer of interests in immovable property and the transfer of actionable claims (chose in action) are governed by the Transfer of Property Act 1882. This law defines what amounts to an actionable claim, covers claims to lease rentals, hire-purchase receivables and credit card receivables and sets out the procedure for the transfer of actionable claims[2]. It requires that the transfer of an actionable claim be effected only by the execution of an instrument in writing and signed by the transferor, and provides that such a transfer is effective upon the execution of such instrument whether or not a notice to the debtor is given. Under the law, unless a contrary interest is expressed, a transfer of a loan secured by a mortgage on immovable property would transfer the mortgage interest as well[3]. Finally, the property being transferred must exist in the present and therefore the transfer of future receivables is not allowed.

- Stamp legislation (which includes the central stamp act and stamp legislation enacted by various states) levies stamp duty on instruments of transfer, including deeds of assignment and any other agreement or document underlying a securitisation transaction. Stamp laws were devised during the colonial era and were originally designed for individual transactions. The negative impact of high stamp duties on transactions such as asset securitisations could not have been foreseen at the time the laws were enacted. The margins in securitisation transaction are so thin that a high stamp duty can only frustrate attempts at securitisation. With a view to encourage securitisation transactions, some states have reduced the stamp duty on the assignment of receivables as actionable claims. However in the case of a securitisation transaction where the assets are located in a number of states, different rates are applicable in the different states.

- Under the Indian Registration Act, any transfer of interest in immovable property requires the registration of instruments with the appropriate government agency.

- The foreign exchange regulations enshrined in the Foreign Exchange Management Act 1999 and the rules and regulations enacted thereunder restrict full capital account convertibility. The strict foreign exchange regulation acts as a hindrance to cross-border securitisation transactions, as prior governmental approval is required for a non-resident person to invest in the securities issued by an SPV. The current exchange controls and other regulatory provisions do not facilitate cross-border securitisation transactions in which

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[2] Sec. 130 Transfer of Property Act 1882.
[3] Ibid, Sec. 8.

the originator may be located in India and the SPV and the investors are located in another jurisdiction.

2. OVERVIEW OF TAX SYSTEM RELEVANT FOR SECURITISATIONS

The tax laws related to securitisation transactions are not clear because the concept, although rapidly gaining in popularity, is still fairly new in India. There are no specific provisions under the Income Tax Act, 1961 ("**ITA**") addressing the peculiarities of securitisation transactions. Taxation will normally depend on how the documents relating to the transaction are structured, the characterization of the transaction by the income tax authorities and other issues discussed below.

In absence of specific provisions, it is necessary to examine the tax implications of a securitisation transaction in respect of each of the entities involved, namely the originator (normally a company, whether a financial institution, bank or commercial corporation), the SPV and the investors. Additionally, there are tax implications attendant to the servicing and paying agents and other service providers. Income in relation to securitisation transactions could be characterized as business income, interest income, income from capital gains or income from other sources. In the following paragraphs we have briefly discussed the issues relating to the nature of income in a securitisation transaction and its taxability.

3. TAXATION OF THE PARTIES TO A SECURITISATION TRANSACTION

3.1. The originator

Tax liability of the originator would depend on:

- whether the securitisation transaction results in the legal transfer of property (*i.e.* the assets being securitised); and
- whether the gain or loss (in cases where there is a transfer of the property) is treated as a business gain/loss or a capital gain/loss by the tax authorities.

3.1.1. Taxability as capital gains

Where there is a legal transfer of property (a true sale) with respect to the assets to be securitised, the gain, if any, arising on the transfer may be taxed as a capital gain or as business income. Conversely, if such a transfer results in a loss, the same is allowed as a deduction in computing total taxable income for that year.

Capital gains are either long-term or short-term. The rate of tax on long-term capital gains is currently 20[4]% for resident individuals and domestic[5] or foreign companies (or as applicable under the income tax treaty between India and the foreign company's country of residence). The rate of tax for short-term capital gains is 35% for companies incorporated in India; foreign companies are taxed at a rate of 40%.

3.1.2. Taxability as business income

Where the profit or gain on a securitisation transaction is treated as a business profit or gain, it is chargeable to tax as "profits and gains of business". The term "business" has been defined to include any trade, commerce or manufacture, or any adventure or concern in the nature of trade, commerce or manufacture[6].

In a transaction where there is no legal transfer of property with respect to the assets to be securitised, the tax authorities may characterize the securitisation transaction as a method of financing (on the security of the receivables) and levy tax on the originator, on the gain (if any). In such a situation, the discount charged by the SPV on the receivables is a tax-deductible finance expense. The net amount received by the originator is liable to tax as business income. Business income of a domestic company is currently taxed at a rate of 35%; foreign companies are taxed at a rate of 40%.

3.1.3. Taxability of cross-collateralization

Unlike other developed markets, in India there is no mortgage insurance for the purpose of credit enhancement. The market practice currently followed by originators is to provide collateralization in the form of over-collateralisation and financial guarantees. Collateralizations have recently been structured in the form of subordinated units of pass-through certificates held by the originator. The subordinated notes and cash collateral are treated as investments by the originators and income arising out of these investments is taxed as investment income in the hands of the originator.

3.1.4. Timing of income

If a securitisation transaction results in income or loss that is characterized as business income or loss, the entire income or loss is recognized and subject to tax in the year when the transaction takes place. This can be compared to the situation where the income continues to be received by the originator in the normal course, in which case the income is subject to tax as it is received by the

[4] All income tax rates mentioned in this article are to be increased by the currently applicable surcharge of 5% on tax. The Finance Bill, 2003 has proposed to reduce the surcharge applicable to companies and partnerships to 2.5%.
[5] Sec. 22A of the ITA defines a "domestic company" as "an Indian company or any other company which, in respect of its income, is liable to tax under this Act, has made the prescribed arrangements for the declaration and payment, within India, of dividends (including dividends on preference shares) payable out of such income."
[6] Sec. 2(13) of the ITA.

originator. This timing difference may result in a tax advantage to the originator if the transaction gives rise to financing costs, resulting in a deduction from taxable income in the current year. A securitisation transaction resulting in capital gains could also result in a tax advantage because capital gains are taxed at a rate lower as compared to business income.

The above benefits are subject to the anti-abuse provision, whereby income transferred by the originator without transfer of the assets would continue to be taxed in the hands of the originator[7].

3.2. The SPV

There are three alternative approaches to taxing the SPV.

- First, the SPV may be regarded as a conduit between the originator and the ultimate investor. In such case, it receives income flows from the underlying assets and would use the same to service the instruments issued by it. Thus, it would not earn any income nor make any profits, and it would not be liable to tax.

- Second, the SPV, when organized as a trust, generally has a pass-through status and the trustee acts on behalf of the beneficiaries (*i.e.* the investors). In such cases, certain ITA provisions dealing with the concept of a representative assessee may apply to the SPV. A trustee is regarded as an agent of the non-resident or the resident investor/beneficiary for tax purposes. Such an agent is regarded a representative assessee of the beneficiary. A representative assessee is subject to the same duties, responsibilities and liabilities as the beneficiaries, and the tax treatment of such person is the same as if the income received by the beneficiaries were the income received by or accruing to the representative assessee beneficially. Accordingly, the trustee may be taxed on the income received by it on behalf of the investors, and such tax is levied on the trustee in the same manner and to the same extent as it would be levied on the investors. However, if the SPV is held to carry on business, it is liable to tax at the maximum marginal rate applicable to individuals. As a representative assessee, the trustee would generally not bear the tax liability.

- Finally, the SPV may be treated as an independent taxable entity. In this case, any income received by the SPV is treated as the SPV's income and is taxed accordingly. Interest income distributed by the SPV is a tax-deductible expense for the SPV and is income in the hands of the investors. The SPV is taxed on its net income (if any) at a rate of 35%. The SPV must withhold tax at source when paying interest to investors. The investor may be able to claim credit for this withholding tax against its own tax liability on the same income.

  Where payments by the SPV represent a distribution of income, they would not be tax-deductible expense. The SPV must withhold tax at source, in the case of both resident and non-resident investors. An applicable income tax treaty between India and the investor's country of residence may reduce the tax rate applicable to a non-resident.

[7] Section 60 of the ITA.

3.3. The investors

Investors receiving income from an SPV, which is regarded as a pass-through entity, are liable to tax on the income earned in proportion to its investment. Where the SPV is characterized as a representative assessee and is accordingly taxed, the tax paid by the SPV is deemed to be paid by the investors. In this case the investors would again not be required to pay tax individually on the same income.

Where the SPV is characterized as an independent entity and it issues debt instruments to the investors, the investors are taxed on the income from such debt instruments. If the investors receive dividends from the SPV, the same are taxable as ordinary income in the hands of the investors. However, the investors may claim a credit for the taxes withheld at source by the SPV, to be applied against their tax liability on the dividend.

4. WOULD AN SPV HAVE A PERMANENT ESTABLISHMENT IN INDIA?

One should consider the circumstances under which a foreign SPV may be deemed to have a permanent establishment in India, in cases where the originator and the assets being transferred by the originator are both located in India. Non-residents are taxed in India on their Indian-source income. Accordingly any Indian-source income received by an SPV that is located outside India is subject to tax in India. However, the tax liability would depend on the nature and characterization of such income.

Income of an SPV in the nature of interest is subject to withholding tax on a gross basis. However, if the SPV is structured as pass-through entity, the tax rate and characterization would depend on the provisions of an applicable income tax treaty (if any) between India and the investor's country of residence. In general, the SPV or the investor is deemed to have a permanent establishment in India in the following circumstances:

- the non-resident has a fixed place of business in India from which the business activity of the non-resident is carried on;
- the non-resident has an agent in India who has and habitually exercises an authority to negotiate and enter into contracts for and on behalf of the non-resident; or
- the non-resident has an agent in India who acts in the ordinary course of his or her business while acting on behalf of the non-resident, and such agent carries on the activities wholly or almost wholly for the non-resident in India.

An advisor or a collecting and servicing agent in India will constitute a permanent establishment of the SPV or the investor in India only if such a collecting and servicing agent is (1) economically and legally dependent on the SPV or (2) the investor or has and regularly exercises the authority to conclude contract on behalf of the SPV or the investor. If the SPV or the investor has a permanent establishment in India, the income of the investor or the SPV attributable to such a permanent establishment is taxable in India on a net basis at the tax rate applicable to a foreign company (currently 40%). A person responsible for making payments that are chargeable to tax in India must deduct tax at source at the applicable rate and remit the tax so withheld to the government. In a securitisation transaction, there are several situations in which it would be necessary to deduct tax at source, namely:

- When the SPV makes a payment to the originator for the transfer of the assets. However, the income element is unlikely to trigger withholding tax requirements if the structure of the transaction results in the originator realizing capital gains or business income and both the SPV and the originator are residents.
- When the SPV collects payments from the debtors, withholding taxes may be applicable depending on the transaction would not result in a change in the character of the original transaction between the originator and the debtors. Thus withholding tax requirements related to the payments by the debtor to the originator under the original transaction would continue to be applicable.
- When the SPV makes payments to the investors, withholding tax requirements arise if such payments are characterized as interest or dividends to the investor. Where however the SPV is structured as a pass-through entity, the debtor/obligor must comply with the withholding tax provisions while making the payment.

CONCLUSION

As of today there are no special regulated companies, which are used as SPVs or conduits for securitisation transaction. In practice, there are companies, which carry on trustee activities, which become a SPV for a securitisation transaction. However, once the Reserve Bank of India comes out with the rules and regulations under the Ordinance the securitisation companies may have to comply with the registration norms prescribed there under. Formulation of a special tax regime for securitisation would help the development of this very important financial instruments market.