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Securitisation distribution tax: Frequently asked questions



Name: Vinod Kothari
Email ID: vinod@vinodkothari.com
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[This version is dated **27th May, 2013**. As we continue to think and dissect the provisions further, the views below may change. There may be further questions considered. Hence, please do come back here to view a latest version of this article.]

1. Broadly what is the structure of the distribution tax?

The broad structure of the distribution tax regime is as follows:

- The income of the securitisation trust from the activity of “securitisation” is exempt u/s 10 (23DA)
- The income of the investors by of income distributed by the securitisation trust is exempt under sec. 10 (35A)
- The income distributed by the securitisation trust is liable to tax on distribution in the hands of the securitisation trust. The rates of distribution tax are as follows:
 - 0%, in case of an investor whose income is exempt from tax.
 - 25%, in case an investor being an individual or HUF
 - 30% in all other cases.

2. Is the transaction of direct assignment covered by the distribution tax?

There is no special purpose vehicle in case of direct assignment transactions. Hence, there is no question of the distribution tax being applicable in case of direct assignments.

3. Is the distribution tax applicable on transactions of securitisation done outside the purview of the RBI Guidelines?

“Securitisation” has been defined in Explanation to sec. 10 (23DA) to include securitisation as defined in reg 2 (1) (r) Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008, or under the Guidelines on Securitisation of Standard Assets, issued by the RBI.

In case of the RBI Guidelines, the section uses the conjunctive “under”, with the implication that only such securitisation transactions which are done under the RBI guidelines are covered by the section.

Likewise, the reference to the SEBI’s Public Offer and Listing of Securitised Debt Instruments Regulations refers to SPDEs regulated under SEBI Regulations. Clearly, unless the transaction is listed under SEBI Regulations, the SPDE does not come for regulation.



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Hence, all transactions of securitisation, done by banks, NBFC and HFCs will be covered by the new scheme of distribution tax.

Of course, our observations above are subject to the rules that may be framed under section 115TC.

4. What is the meaning of “securities” in respect of which the distribution tax is applicable?

The scope of the section includes “investors” in securitised debt instruments or securities. “Securities” are taken to mean “debt securities” as covered by the RBI guidelines and the definition of “securitised debt instruments” has been taken from SEBI regulations. While the expression “debt securities” as used in RBI Guidelines may be loosely worded, the definition of “securitised debt instrument”, referring to sec. 2 (h) (ie) of the Securities Contracts Act. Thereby, all beneficial interests are covered by the definition of “securitised debt instruments”.

The definition of “securitised debt instrument” (SDI) in sec 2 (h) (ie) of the Securities Contracts Regulation Act becomes critical in sec 115TA of the Income-tax Act.

The definition of “securitised debt instrument” in sec 2 (h) (ie) of SCRA is as follows:

(ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case maybe.

It is clear that only “beneficial interest” can be an SDI. There is a clear distinction between debt and beneficial interest. Debt is an obligation; beneficial interest is equity or ownership interest.

“Debt securities” has not been defined in the RBI Guidelines on securitisation. The 2006 Guidelines use the word “debt securities” as a part of the definition of securitisation, as follows:

“Securitisation is a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitisation thus follows a two-stage process. In the first stage there is sale of single asset or pooling and sale of pool of assets to a 'bankruptcy remote' special purpose vehicle

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(SPV) in return for an immediate cash payment and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities. “

Here the word “debt securities” is used in conjunction with “security interests”. In India, the securities that SPVs have issued so far have consistently been “pass through certificates” (PTCs). PTCs are beneficial interests – they are surely not “security interests”. A beneficial interest is ownership interest, and the expression “ownership interest” and “security interest” are mutually exclusive.

In view of the definition of the word “debt securities” in RBI guidelines, it is quite clear that debt obligation of the SPV, in form of bonds or similar instruments will clearly come under definition of “securities”.

To summarise, “securities” include both debt-type securities and equity-type securities. See, however, later below on whether the payment to holders of debt-type securities can at all come for tax u/s 115TA.

Requisites for Distribution Tax under section 115 TA

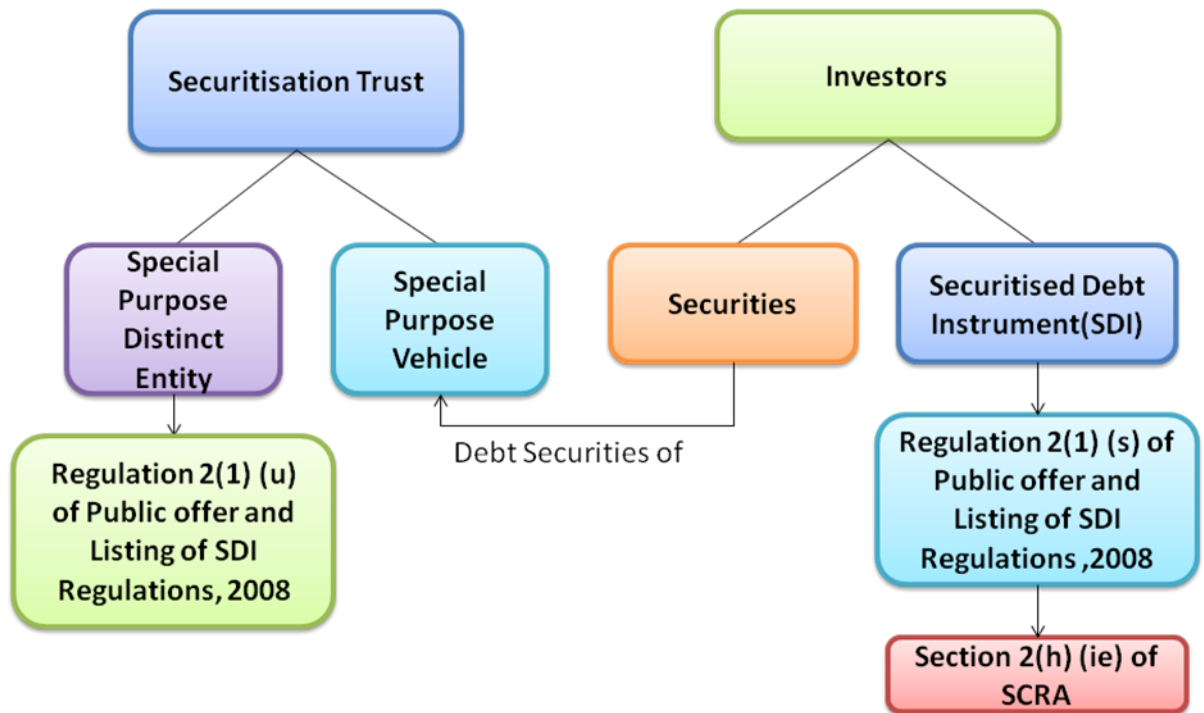


Figure 1: Requisites of distribution tax



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5. What is the meaning of the “special purpose vehicle” on whom distribution tax is applicable?

Operative part of sec 115TA applies the distribution tax on “securitisation trust”. “Securitisation trust” has been defined to mean a trust, being (a) special purpose distinct entity (SPDE) as per SEBI’s Public Offer and Listing of SDI Regulations, 2008; and (b) special purpose vehicle as per RBI Guidelines.

In the 2006 Guidelines of the RBI define “SPV” as follows:

“SPV” means any company, trust, or other entity constituted or established for a specific purpose - (a) activities of which are limited to those for accomplishing the purpose of the company, trust or other entity as the case may be; and (b) which is structured in a manner intended to isolate the corporation, trust or entity as the case may be, from the credit risk of an originator to make it bankruptcy remote;

Accordingly, SPV may either a company, trust or any other form of entity. However, its important feature is that has the sole object of securitisation, and that it is so structured as to be originator-bankruptcy-remote.

SPDE, is Reg 2 (1) (u) of the Public Offer and Listing of SDI Regulations, as follows:

“special purpose distinct entity” means a trust which acquires debt or receivables out of funds mobilized by it by issuance of securitised debt instruments through one or more schemes, and includes any trust set up by the National Housing Bank under the National Housing Bank Act, 1987 (53 of 1987) or by the National Bank for Agriculture and Rural Development under the National Bank for Agriculture and Rural Development Act, 1981 (61 of 1981);

The key elements of this definition are that constitutionally, an SPDE is a trust, and it raises funds by issue of SDIs, and acquires debt or receivables with such funds.

Note that the definition in Explanation (d) to sec. 115TC starts with the words “securitisation trust is a trust..”. Therefore, while as per the RBI Guidelines, an SPV can be any form of entity, the entity which is required to comply with the provisions of sections 115TA to 115TC is only a trust.

6. Is the distribution tax applicable to income credited to the account of the recipient before 1st June 2013, but actually paid out on or after 1st June 2013?



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It is clear from the applicable date of sec 115TA that on and from that date, whatever income is “distributed” by the securitisation trust. If an income is credited by trust before 1st June, to the account of the recipient, but actually distributed on or after 1st June 2013, the question is whether the “distribution” happened before 1st June, or on or after 1st June.

The meaning of the word “distribution” has been discussed at length by the Supreme Court in *Punjab Distilleries*, 1965 AIR 1862. In this case, the SC held” “The expression "distribution" connotes something actual and not notional. It can be physical; it can also be constructive. One may distribute amounts between different shareholders either by crediting the amount due to each one of them in their respective accounts or by actually paying to each one of them the amount due to him.” Therefore, very clearly, crediting an amount to the account of the recipient will be a case of distribution.

If such credit happens on or before 31st May, the fact that the actual payment happens thereafter will not be relevant.

7. Who is obliged to pay the distribution tax?

Very clearly, the obligation is cast upon “person responsible” for the distribution by the trust, which is the trustee. If there is a servicer doing distributions on behalf of the SPV, the obligation does not shift to the servicer, because the servicer is simply the agent of the trustee.

8. What is the effective date of the tax?

The tax becomes effective from 1st June 2013.

9. Does the effective date relate to the date of distribution, or does it relate to the period to which the income pertains?

The tax pertains to the date of distribution. The accrual of income does not matter. Even if the income was accrued prior to 31st March 2013, if it is distributed on or after 1st June 2013, the tax will be applicable. This will be the case if there are any transactions that provide for pooling of excess spread.

10. What is the tax treatment of the income distributed from 1st April 2013 to 31st May 2013?

Section 10 (35A) which grants exemption to the income received by any person from a securitisation trust has been given effect from 1st April 2014, and



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therefore, covers the whole of the income year starting from 1st April 2013. However, the tax on distributed income takes effect from 1st June. Therefore, incomes distributed between 1st April 2013 and 31st May 2013 will enjoy exemption in the hands of the distributor as well as the recipient.

11. Is the tax on the entire distribution by the trust, or merely the income?

The wording of section 115TA is clear – “any amount of income distributed by the securitisation trust”. In other words, it is clear that the tax is applicable only on income distributed by the securitisation trust, and not only the whole of the distribution. Therefore, any distribution of principal will not be liable to tax u/s 115TA.

To reiterate, for applying sec 115TA to any amount, the amount has to be “income” and has to be “distributed”. Both conditions are necessary. If what is distributed is not income, there is no tax. If what is income is not distributed, there is no tax.

12. “Income” refers to whose income?

As the trust receives income in representative capacity, the income is the income of the beneficiaries, though received by the trust. Unlike AOPs, a trust is not an entity of its own – the trust receives income as a collective representative on behalf of its beneficiaries. However, a trustee cannot go to track the income of its beneficiaries, wherever there is a tax on the trustee. On the other hand, if the trust is seen as a pass-through, there is no tax at the trust level and the income is determined by each beneficiary.

By virtue of the exemption granted under sec 10, it seems that the scheme of the law is clear that the income will be determined at trust level in representative capacity.

Hence, “income” must refer to the income of the trust in representative capacity.

13. Who is obliged to determine whether the amount being distributed by the trust is an income or not?

The determination of whether what is being distributed is the income of the trust or not will have to be done by the trust, that is, the trustee.

14. How is income to be determined by the trust?



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The determination of income by the trust will have to be done applying the same principles based on which income is determined under the Income-tax Act.

15. Is the tax applicable on servicing fees?

Servicing fee is an income of the recipient, and an expense of the distributor. Hence, there is no question of distribution tax on servicing fee.

16. Is the tax applicable on excess spread, commonly known in India as EIS?

This will largely depend on the structure of the transaction and the documentation. Excess spread should ideally be construed as seller's retained interest, that is, interest in the asset which is not even transferred. This is how excess spread was envisaged in the RBI guidelines of 2006.

If excess spread is not even transferred to the trust, the seller/originator gets it as legal owner thereof, and not as beneficial owner.

However, if the documentation is flawed, and the seller transfers "all right, title and interest" in the pool of loans, and then acquires beneficial interest in the excess spread, then the excess spread is a "distribution" made by the trust, and hence, becomes taxable¹.

If the seller's interest is not transferred at all, the fact that it flows into the waterfall and then comes back from there does not matter. As we mentioned earlier, the mere fact of distribution by the trust is not relevant – what is relevant is whether what was distributed was the income of the trust to begin with, received on behalf of the beneficiary, in representative capacity. The representative capacity will arise only if there is a trustee-beneficiary relationship on the excess spread.

17. If the excess spread is paid in form of deferred purchase consideration to the seller, is the distribution tax payable?

The payment of deferred purchase consideration is a liability or expense of the trust. Hence, this is not a part of the income of the trust, and hence, question of any distribution tax does not arise there.

¹ Documentation recommended by Vinod Kothari: *Securitisation: The Financial Instrument of the Future* uses concepts of "transferred interest" and "retained interest". Retained interest is what was never transferred.



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- 18. If the securities of the SPV are structured as debt securities, so that the servicing thereof is charge against income and not distribution of income, is there a distribution tax applicable thereon?**

If the securities of the SPV are structured as debt obligations, what is paid to the holder of such security is the expense of the SPV. Hence, there is no question of distribution tax on such payment.

- 19. Can a mutual fund buy “securities” before a distribution date and thus avoid distribution tax?**

Certainly there is no distribution tax on income paid by the trustee to a mutual fund. Therefore, irrespective of who was holding the securities during the reference period, if, on the distribution date, the securities are held by the mutual fund, and the distribution is made to the mutual fund, there is no tax on distribution.

However, please note the provisions of sec. 94 whereby bond-washing transactions are captured to tax in the hands of the person originally holding the securities.

- 20. As the investor receives tax-free income from a securitisation trust, do the provisions of sec. 14A of the Income tax Act apply as regards expenses of the investor?**

Section 14A read with Rule 8D is clearly applicable to the person receiving income exempted u/s 10 (35A).

- 21. Will the distribution tax be applicable for income accrued, but not distributed? What does “distribution” mean?**

The tax is on distribution, which is comparable to dividends. There is no tax on undistributed income. Note, however, that crediting the income to the account of the recipient amounts to distribution, as noted above.

However, if the income is held without crediting to the account of any specific recipient, and is reinvested, there is no question of distribution tax.

It may not be noted that securitisation transactions generally do not reinvest cashflows, except as required for liquidity support or credit support. Any reinvestment beyond what is minimal requirement takes the transaction away from “securitisation” and brings it closer to “corporate finance”.



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22. Is it possible for a securitisation transaction to be structured such that it pays principal only for a certain time, and then distribute interest towards the end?

We have mentioned above that if an income has been earned by the trust, and the income is distributed, the same is liable to be taxed. In finance, it is quite likely sometimes that principal may be reinvested, and the income may be distributed. But the vice versa, that is, reinvestment of interest and repayment of principal, is highly counterintuitive. Such a structure is liable to be challenged as a mere avoidance arrangement.

23. How will principal-only and interest-only strips be treated to distribution tax?

Transactions may create different investor interests – some investors investing in principal only, and some investing in interest only. The references in such structures to “principal only” and “interest only” are references to the payments received from the underlying loans acquired by the trust. These are essentially prepayment risk differentiation devices.

There can be no argument that an investor investing in PO strip does not have an income at all, and the one investing in PO strip has all income. Hence, determination of income will have to be done for all classes, including IO and PO strips.

24. In certain tax rulings, SPVs have been treated as AOPs rather than as representative assessee. In light of this finding, wills sec 115TA have any applicability?

If the securitisation vehicle is an AOP, company, LLP or any other entity assessable to entity-level tax, there is no question of applicability of sections 115TA to 115TC. However, section 115TA starts with a non-obstante clause. Hence, if the securitisation vehicle is a trust, the question of it being treated as an AOP does not arise at all.

25. Is it possible to contend that the provisions of sections 115TA to 115TC apply only where the income of the trust is taxable applying representative tax principles?

No. This contention is not correct. Section 115TA starts with a non-obstante clause. Hence, these provisions override the provisions of law pertaining to representative assesses. It is also possible to contend that the securitisation trust



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does not have to be a “person” as the word “person” is relevant only for sections 115TB and 115TC. Hence, the enactment of sections 115TA to 115TC completely makes the argument of a pass-through status to a securitisation SPV irrelevant.

Implementation issues

26. Is it that post the implantation of the distribution tax provisions, that is, 1st June 2013, every securitisation trust will have to apply for a PAN?

The position of securitisation trusts is the same as that of mutual funds.

In case of mutual funds, rule 12B requires mutual funds charging distribution tax to file a return in form 63. One of the information to be put in Form 63 is PAN no.

It is expected that a similar rule/form will be laid for securitisation trusts too. Hence, PAN will be required.

27. Should there be as many PAN applications as the trusts?

Yes – a PAN will be taken for each trust, even if the trustee is the same.

28. What is the constitutional status of a trust? Is it an AOP?

Sure no. There is a basic and fundamental difference between an AOP and a trust. An AOP is a collective business entity that carries on business by itself. In case of a trust, there is a property/activity done in *fiduciary* capacity. Representative tax principles work in case of trusts; in case of AOP, there is a separate charging section. AOP is a *person* for tax purposes; a trust is not a person at all. The trustee is the person, who pays tax in representative capacity.