

### **Taxation of SPV in USA**

Under the U.S. Tax laws, the following situations may find taxation of SPVs:

- Grantor Trust
- Remic

#### **Grantor Trusts**

- A grantor is the part owner of the trust. The grantor retains certain powers and interest over the income and/ or corpus of the trust. Such a trust is called grantor trust. Section 671 to 679 of the 26 U.S. Code Part I, Subpart E<sup>1</sup> contains provisions on grantor trusts.
- For the purposes of income tax, this type of trust is not recognized as a separate taxable entity apart from its grantor/ owner. The owner of the trust is taxed directly in respect of the income earned by the assets of the trust as if the trust did not exist.
- The grantor is not treated as owner in respect of such a share of its income that has already been apportioned to the beneficiaries.
- Income earned by the assets of the trust is directly reported on the grantor or owner's income tax return. A grantor trust is charged to tax on so much of the interest as it does not convey to the beneficiaries.
- In essence Sec. 671<sup>2</sup> provides that when the grantor or another person is deemed "owner" of any portion of a trust, such an owner is then required to include in computing his or her taxable income those items of income, deductions and credits against tax of the trust that are attributable to that portion of the trust. Remaining items of income, deductions and credits against tax are taxed to the beneficiary as applicable, in determining taxable income.
- The trust form may be used in securitisation to eliminate taxation at entity level.

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<sup>1</sup> <http://www.law.cornell.edu/uscode/text/26/subtitle-A/chapter-1/subchapter-J/part-I/subpart-E>

<sup>2</sup> <http://www.law.cornell.edu/uscode/text/26/671>

- Grantor trusts issues pass through certificates, which are the most traditional and in many a way the simplest type of asset-backed security. The pass through certificates represents beneficial interest in a fixed pool of receivables. In pass-through securitization transactions, the holders of the pass-through certificates will be deemed to be the substantive owners of the trust, and so the income will be taxed in the hands of the investors rather than the trust itself. This is a completely see through treatment; even the expenses of the trust are treated as expense rateably apportioned among the investors.

### **Real Estate Mortgage Investment Conduits (REMIC) Rules**

Real Estate Mortgage Investment Conduits (REMICs) were introduced in 2005<sup>3</sup> to the US securitisation market to promote the Collateralised Mortgage Obligations (CMOs) market and to shift the burden of taxation of the whole transaction on the residual income class. A REMIC would have two classes of interests – regular and residuary. The regular interest class is like a conventional bond with fixed coupons. Most REMICs would have a nominal worth of residual class (say USD 100) and the rest of the classes are treated as substantive debt of the REMIC.

A REMIC itself is a tax-transparent entity and there is no entity level tax on the REMIC. Tax is imposed on the holders of interests in the REMIC. The income of the REMIC is taken as the income of the residuary class and the interest paid to the regular interest class is taken as a deductible expense. The residual interest class is very nominal and by treating the regular interest class as debt, tax neutrality is achieved.

The REMIC rules are contained in Section 860A to 860G of U.S. Code Part IV of Subchapter M of Chapter 1 of Subtitle A of the Internal Revenue Services (IRS) Regulations, (26 U.S.C)<sup>4</sup> Most US RBMS transactions would either adopt a pass-through or the REMIC status.

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In order to qualify as a REMIC the following conditions need to be satisfied

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<sup>3</sup> [http://www.irs.gov/pub/irs-regs/td\\_9184.pdf](http://www.irs.gov/pub/irs-regs/td_9184.pdf)

<sup>4</sup> <http://www.law.cornell.edu/uscode/text/26/subtitle-A/chapter-1/subchapter-M/part-IV>

- A REMIC selection is required to be made by an entity or pool of assets to qualify as a REMIC.
- A REMIC must buy only qualifying mortgages. Qualifying mortgages include obligations principally secured by an interest in real property, any qualified replacement mortgage, and includes pass through certificates and regular interest in other REMICs. Amendments made in 2004, effective January 1, 2005, allowed REMICs to buy interests in reverse mortgages as well.
- A REMIC can hold only permitted investments which include cash flow investments, qualified reserve assets, and foreclosure property.

If multiple classes of mortgage-backed debt are to be issued, use of a REMIC is generally the only way to avoid income tax at the SPV level. Mortgages are transferred to a REMIC in return for interests therein. Such a transfer does not result in gain or loss for tax purposes.

#### *Taxation of REMIC interest holders*

- The broad principles of taxation of REMICs are as follows; the REMIC itself is not taxed, but the interest holders are.
- The entire income of the REMIC is taken as the income of the residual interest holders, and the interest paid on the regular interests is taken as if it were deductible expense. In other words, the (total income of the REMIC – interest on regular interests) is allocated to the residual class holders as their income. As mentioned above, in view of any minimum amount of residual interest, this has the effect of treating almost the entire regular interest in the REMIC as a debt and achieving tax neutrality.

#### **Taxation of SPV in China**

In 2006, Ministry of Finance and State Administration of Taxation issued the “*Circular of Tax Policy Issues Relevant to the Securitization of Credit Assets*”<sup>5</sup> mainly relating to business tax, stamp duty and corporate income tax on the transferred assets, during the process of credit asset securitization under trust method.

The parties involved in the asset securitisation under the trust method could be listed as under:

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<sup>5</sup> <http://www.asianlii.org/cn/legis/cen/laws/cotmfatsaotortpictsoca1500/>



# INDIAN SECURITISATION FOUNDATION

- **Initiating institution**– the financial institution, acting as a originator transfers its credit assets to the trust.
- **Trustee institution** - the institution that takes charge of managing the trust properties and sells asset-backed securities on the basis of its covenant on trust. Trustee appoints a loan servicer and a fund custodian ("Servicer") to manage the credit assets
- **Loan service institution** - the institution accepts a fee from the trustee institution and takes charge of servicing the loans
- **Fund custody institution** - the institution that is entrusted by the trustee institution to take charge of custody of the funds with the SPV.
- **Securities registration and trusteeship institution** - China Government Securities Depository Trust & Clearing Co. Ltd.
- **Institutional Investors** – trust issues the asset backed securities (ABS) in the form of trust beneficiary certificates to institutional investors ("ABS Investors").

## Provisions relating to Income Tax

- The Originators gain or loss from transfer/ assignment of credit assets shall be subject to corporate income tax as taxable profits or deductible losses as per the provisions of Peoples' Republic of China (PRC) Corporate Income Tax Law.

In the process of assignment, redemption and replacement, originator and the SPV shall pay cost and fees as applicable in case of business transactions between independent enterprises; otherwise the taxation authority shall make adjustment according to the relevant provisions of the "Law on the Administration of Tax Collection".

- Taxation of the SPV depends on the distribution policy of the SPV. In respect of trust income that is distributed in the same year as it is received, to the ABS investors, the SPV is not subjected to tax. In respect of the trust income not distributed to the ABS investors in the same year, the trustee has to pay corporate income tax.
- Income earned by the institutions, involved in the process of securitization of credit assets, in respect of the services to securitization transactions, shall be subject to corporate income tax as per the provisions of PRC Corporate Income Tax Law. Some of the institutions have been listed below:-

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- i. loan service institutions that
  - ii. trustee institutions
  - iii. fund custody institutions
  - iv. securities registration and trusteeship institutions .
- The tax treatment of the ABS investors depends on the distribution policy of the SPV and the subsequent tax treatment of the SPV.

If the distributions are made in the current year and no income tax has been paid by the trustee, then the investor is required to recognise the income from the trust on an accrual basis, and pay corporate income tax accordingly.

However if the distributions are not made in the current year and income tax has been paid on it by the trustee at the trust level, then the subsequent distribution shall be treated as an after tax gain by the ABS investor.

Gains derived or losses suffered by the ABS investor from trading in ABS shall be taxable or deductible as per the provisions of the PRC Corporate Income Tax Law.

Gains or losses attributable to an ABS investor upon liquidation of trust shall be taxable or deductible as per the provisions of the PRC Corporate Income Tax Law.

### **Taxation of SPV in UK**

The Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296)<sup>6</sup> have been introduced which provide a permanent tax regime for securitisation companies in UK. These regulations apply with effect from accounting periods commencing on or after 1<sup>st</sup> January 2007.

Regulation 14(1) provides the basis for taxation of securitisation companies, which meet the definitions in regulations 4 to 9 and satisfying the payment and retained profit conditions.

### **Payment condition**

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<sup>6</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/cfm72320.htm>





Regulation 11<sup>7</sup> sets out the payment condition. According to the payment condition, the company must pay out during the accounting period or within 18 months thereafter, all amounts that it has received in an accounting period, except for amounts needed to be retained to provide for losses or expenses of the business, or to enhance creditworthiness, or the retained profit of the securitisation company for the period.

If a company fails to satisfy the payment condition at any point of time the company will be taxed on the basis of its profit as per books of accounts and will result in a company being permanently excluded from the regime.

### **Retained Profit**

A securitisation company is taxed on its “retained profit” rather than on the profit shown in its accounts if it satisfies the payment condition

Regulation 10<sup>8</sup> defines retained profit. Retained profit is the amount required by the securitisation company to be retained or designated as the profit of the securitisation company. In essence, this will be a very small amount required to be retained year by year in order to show corporate benefit, usually expressed as a percentage of asset value, funding or annual income or a specific amount.

As per regulation 14<sup>9</sup>, the taxable amount is the greater of  $[(RP-DS+D), 0]$ , plus the ‘specified amount’. These terms are defined in Regulation 14(2) and 14(3)

RP is the retained profit of the company in the accounting period as defined in regulation 10.

DS is any distribution received from another securitisation company that is party to the same CMA and which is made from the other company’s retained profit.

‘D’ is the ‘catch up charge’. ‘D’ brings into charge any amounts which have escaped being included in ‘RP’, when they are distributed.

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<sup>7</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM72510.htm>

<sup>8</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM72480.htm>

<sup>9</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM72580.htm>

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Specified amount as per Regulation 14(3)<sup>10</sup> ensures that any exit charge under CTA09/S344 - 346<sup>11</sup> or CTA09/S630- 632<sup>12</sup> is added to the taxable profits calculated under Regulation 14.

If a company is a securitisation company before the commencement date of the regulations, it must elect into the regime to be within its scope. Without this election, the company will continue to be taxed according to the profit as per books.

### **Taxation of SPV in Australia**

Income Tax in Australia is currently being levied under two Acts - Income Tax Assessment Act 1936 (the 1936 Tax Act) and The Income Tax Assessment Act 1997 (the 1997 Tax Act). The 1997 Tax Act is a rewrite of the 1936 Act but in a clearer style and is being progressively enacted.

An Australian based SPV can either be structured as a trust or a company or (in a two-tier structure) a combination of both.

Where the SPV is structured as a company, the company will pay tax on its net assessable income at the standard corporate tax rate. To claim deductions for prior and/or current year losses and bad debts an SPV has to pass through the continuity of the ownership test or continuity of business test. It means tracing of controlling interests in the corporation through interposed entities and the application of the test is complex if shares are held (directly or indirectly) in a corporation by discretionary or charitable trusts (which is often the case in securitisations).

Where the SPV is structured as a trust, the beneficiary of a trust, rather than the trust itself, will be liable to tax on the trust's income provided that the beneficiary is presently entitled to that income. In case of trusts, tax is levied on the trustee if an Australian resident beneficiary is not presently entitled to the net income of the trust for tax purposes or where the trustee is taxed as a company for the purposes of Division 6B<sup>13</sup> or 6C<sup>14</sup> of the 1936 Act. In such cases, the tax is levied on the trustee and not on the beneficiaries.

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<sup>10</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM72600.htm>

<sup>11</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM34110.htm>

<sup>12</sup> <http://www.hmrc.gov.uk/manuals/cfmmanual/CFM35320.htm>

<sup>13</sup> [http://www.austlii.edu.au/au/legis/cth/consol\\_act/itaa1936240/](http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/)

<sup>14</sup> [http://www.austlii.edu.au/au/legis/cth/consol\\_act/itaa1936240/](http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/)

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In case an SPT (Special Purpose Trust) incurs losses/bad debts and it desires to claim it as deduction, different tests have to be applied depending upon whether the trust is a fixed trust (where all income and capital of the trust are the subject of fixed entitlements) or a non-fixed trust (all trusts other than fixed trusts). The tests that must be passed by a non-fixed trust are generally difficult to pass than those applicable to fixed trusts.

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