



DAUDS ADVISORY

Securitisations ... and the Revenue : Tax

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Introduction

1. Corporates are almost always in need of cash – whether for growing and expanding the business, settling maturing debt obligations, or funding a take-over. Depending on its credit rating, a company may meet this need by issuing unsecured debt securities. However, raising capital this way may be a tad expensive. A less expensive alternative may be for the company to pledge its existing assets and borrow against them. Yet another way to raise cash is through factoring of the company's book debts. However, none of the three options may be suited to the company's needs. Issuing securities is an on-balance

sheet form of financing – the debt must be recorded on the company’s balance sheet as a liability. This may increase the company’s debt-to-equity ratio, leaving it more leveraged and thus increasing the perceived risk attached to the company. Factoring might involve some recourse to the company as seller of its book debts.

2. Enter structured finance in the form of securitization. The prime advantage of this funding tool lies in the fact that it is a less expensive off-balance sheet form of financing – it also does not add to the company’s leverage, and accordingly perceived risk.

Fundamentals of securitisation

3. Securitization involves the conversion of a bank’s, or company’s, loans/financial assets into ready cash, rather than relying on the smaller regular cash flows generated by the asset over a period. Just about any financial asset is securitizable – common asset classes include mortgage loans, corporate loans, credit card payments, motor vehicle loans, lease payments, insurance premiums, student fees, royalties, etc. Securitization is particularly useful for banks since the fewer the assets on their balance sheet, the less the regulatory capital and reserve funds they should be required to maintain.
4. A securitization transaction involves three important players – an originator, a special purpose vehicle (SPV) or special purpose entity (SPE), and investors. The originator (bank or company) is usually the capital raiser. As part of the securitization process, the bank will bundle

its loans together (pool the loans), and sell them to the SPV/SPE set up specifically for the purpose of the transaction. The SPV/SPE will package the loans into securities and sell them to investors. The cash raised from the sale of the securities is then used to pay the originator for the sale of its financial assets to the SPV/SPE.

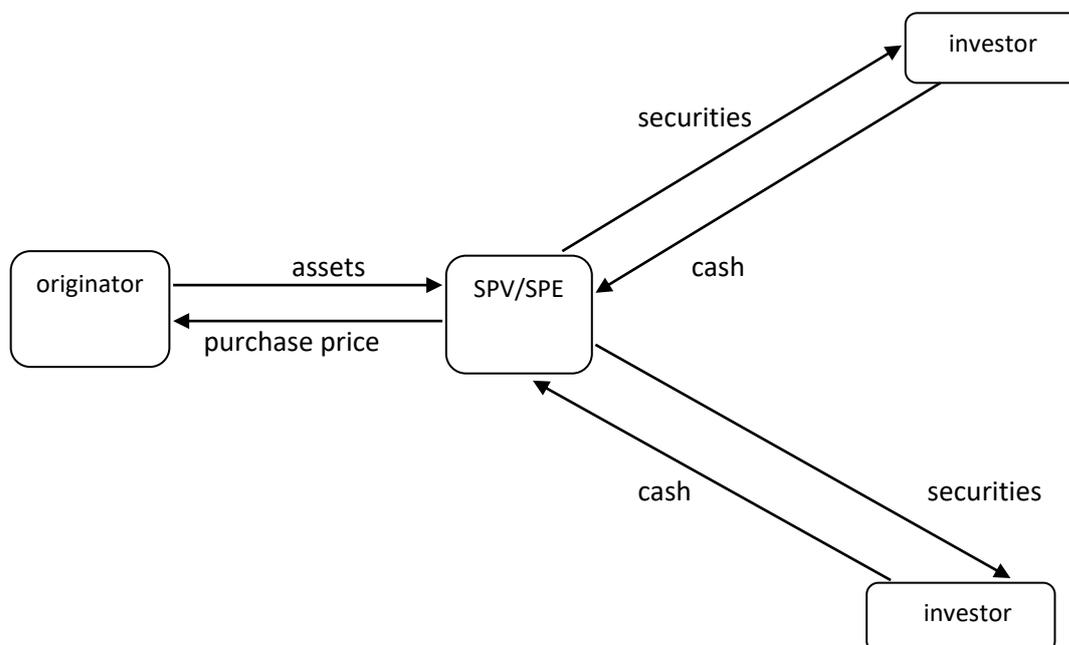
5. Once the assets are transferred to the SPV/SPE, the latter (and no longer the originator) becomes entitled to the cash flows (regular payments by, for instance, debtors on their loans) generated by those assets. These cash flows are used by the SPV/SPE to service the securities it had issued by making regular interest payments, and for the repayment of the principal amount to investors (purchasers of the securities). Since the securities are backed/supported by the underlying assets (the loans, credit card payments, insurance premiums, lease payments, student fees, royalties) which generate the cash flows, they are alternately referred to as-

- mortgage-backed securities (MBS), if the underlying assets constitute loans extended for the purchase of property;
- asset-backed securities (ABS), if the underlying assets constitute, for instance, credit card payments or loans extended for the purchase of motor vehicles;
- collateralised loan obligations (CLOs), if the underlying assets constitute corporate loans.

6. The securitization industry is replete with acronyms – in addition to the above, others include CMOs (collateralised mortgage obligations), CDOs

(collateralised debt obligations), CBOs (collateralised bond obligations).

7. No securitization transaction is complete without a credit enhancement facility – provided by either the originator itself or purchased as a form of risk cover from an insurance company, or bank. Where the facility is provided by the originator, it may take the form of either:
 - over-collateralisation – the originator transferring more assets than the value of the securities to be issued by the SPV/SPE; or
 - the originator subscribing for the junior (and accordingly more risky) securities of the SPV/SPE.
8. The purpose of the credit enhancement facility is to improve the rating of the securities, thus making them attractive to potential investors as well as to protect investors from losses that might occur if the underlying loans which generate the cash flows were to become bad.



Tax aspects

The originator

9. Receipt of the purchase price by the originator upon the sale of its financial assets (the loans, credit card payments, lease payments, insurance premiums, royalties, etc.) may be of a revenue or capital nature. The originator may argue that what had been sold to the SPV/SPE is, in fact, a part of its business (income-earning structure), and the receipt should accordingly be of a capital nature, so that any gain is taxed at the more favourable capital gains tax (CGT) rates. The tax agency, on the other hand, may argue that what the originator sold is income streams, and receipt of the purchase price is therefore of a revenue nature, which is includible in the originator's gross income and taxed at ordinary rates for companies (the corporate tax rate).
10. The originator may sell its financial assets at a discount, or premium. Loss from the discounting of the promissory notes may, like a factoring charge, be of a revenue nature and, therefore, deductible under normal tax provisions. It may thus be argued that the loss to the originator from the discounted purchase price paid for its assets is similarly deductible.

The SPV/SPE

11. Prior to the sale of its assets, the originator would under normal tax provisions have been entitled to a deduction in respect of interest payments by its debtors that had become bad. When the SPV/SPE steps

into the shoes of the originator, it (the SPV/SPE) should henceforth be entitled to the same deduction. The SPV/SPE should also be entitled to a deduction for doubtful debt under usual tax provisions.

12. Where the SPV/SPE obtains the assets at a discount, two scenarios present themselves:
 - should the SPV/SPE recognise the entire discount at the point of sale? or
 - may the SPV/SPE spread the gain (arising from the discount) over the term of the loans?
13. The proposition of spreading the gain arising from the discount over the terms of the loans may be supported by the argument that, while there is no interest-bearing arrangement between the originator and the SPV/SPE, once the latter steps into the former's (the originator's) shoes, an interest-bearing arrangement between the SPV/SPE and the originator's erstwhile debtors comes into being, thus rendering section 24J applicable.
14. That the purchase price of the assets may be capital or revenue in the originator's hands does not mean that payment by the SPV/SPE will necessarily follow the same characterisation. The tax agency may still apply the capital/revenue test to determine the nature of the payment. The SPV/SPE should not find it too difficult, though, to argue that the payment is of a revenue nature, and therefore deductible in full under normal tax provisions.

15. Once the SPV/SPE has issued the securities, the amount of interest payments on them should ordinarily be determinable.