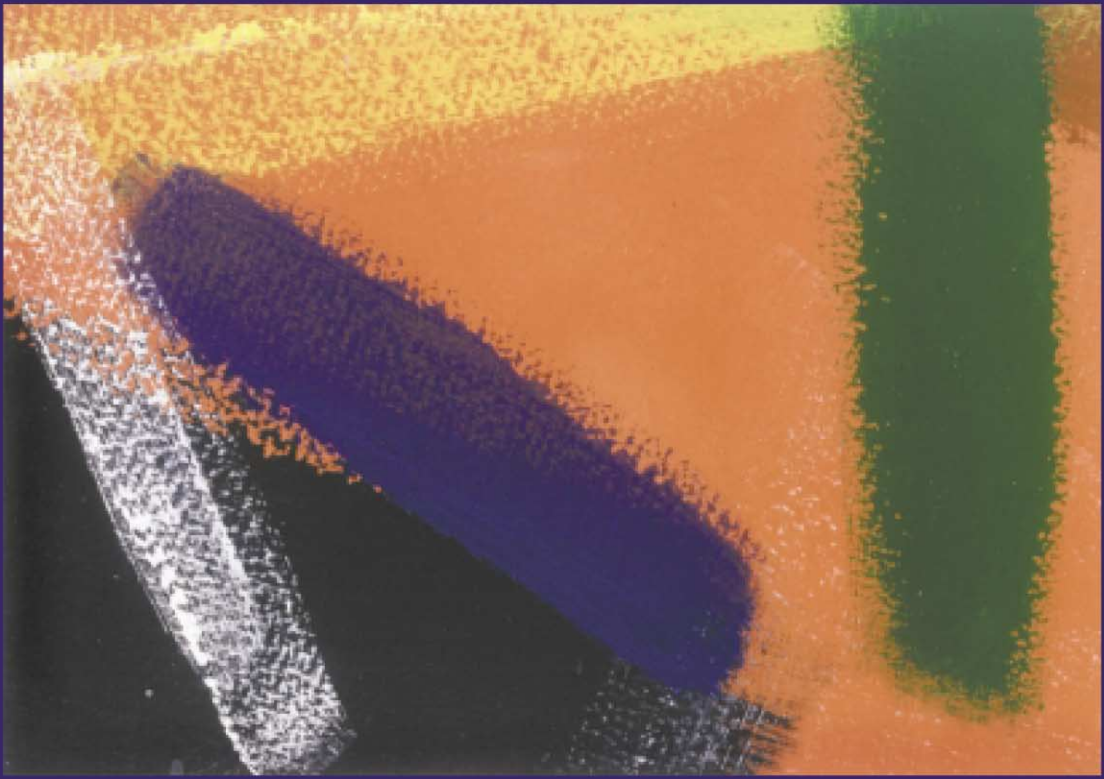
US tax-specific points for issuers and SPVs

Kaye Scholer LLP



This article first appeared in *Global Securitisation and Structured Finance 2004*, published by Globe White Page Ltd, www.globalsecuritisation.com.

US tax-specific points for issuers and SPVs

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Awareness of tax issues is critical in virtually every securitisation. US federal income tax considerations, in particular, can have a significant impact on the economics of a transaction. US state and local taxes must also be taken into account. This chapter focuses primarily on US federal income tax issues of concern to issuers and special purpose vehicles (SPVs). These issues can be divided into three areas:

(1) gain or loss to an issuer on a transfer of receivables or other securitised assets;
(2) avoidance of 'entity-level' tax on an SPV; and
(3) the tax treatment of investors.

In addition, under so-called 'tax shelter' regulations, taxpayers participating in certain securitisation transactions may be required to disclose such participation on their federal income tax returns. Although prompted by a concern to combat abusive tax shelters, these regulations, described briefly below, may impact issuers and investors in a broad range of securitisations.

Gain or loss to originator

A major tax issue is whether the originator will recognise gain or loss for US income tax purposes on a transfer of receivables into an SPV/issuer. If the transfer is viewed as a sale for tax purposes, gain or loss is generally triggered; alternatively the transfer may be viewed as a loan secured by the transferred assets. A loan will not trigger gain or loss. Whether tax sale treatment is desirable depends largely on the originator's tax basis in transferred assets. If, for example, income from receivables has previously been included in income, a tax loss can be claimed if, as is likely the case, the receivables are sold at a price reflecting a discount from face. In the absence of prior income inclusion, however (for example, if the securitised assets reflect rights to future revenues from film or music royalties not yet accrued for tax purposes) sale treatment can trigger a costly tax gain.

Distinguishing between sale and loss

The tax characterisation of a transfer may or may not comport with its treatment for accounting or other regulatory purposes. In general, tax treatment is governed by the economic substance of the transaction, regardless of nomenclature or form. It is helpful, however, for parties clearly to express their intent as to tax consequences because arguing against a chosen transaction form may be viewed unfavourably by the taxing authorities. Thus, it is not uncommon to see an agreement denominated as a "sale" of receivables that includes an express provision setting forth the parties' agreement and understanding that the transaction is a loan for tax purposes.

Characterisation of a transfer as either a sale or a secured loan depends on a number of factors, the most significant of which revolve around the degree to which potential upside (or benefits), on the one hand, and economic risk (or burdens), on the other, have been shifted. Relevant factors looked to in making this determination include: whether yield is based on a fixed purchase price reflecting a discount from face or is a floating yield; the extent of retention by the originator of residual power of disposition over the receivables and of benefit from their residual value; the degree of the SPV's risk for non-payment, taking into account overcollateralisation, any outside credit enhancement, historic loss levels and recourse to the originator; whether transferred receivables are specifically identified; whether legal title to receivables and/or of entitlement to interest or finance changes thereon is transferred; notification to obligors of the transfer of receivables; retention by originator of liability for intangibles, excise or similar taxes or of risk regarding collection activities; retention by originator of servicing functions (although loan-like, this generally is not deemed inconsistent with a sale); degree of mismatching between the terms of the underlying receivables and those of trust certificates, notes or other instruments held by investors; and, whether the originator has a right to repurchase a transferred pool of receivables, if at all, only when the remaining aggregate principal balance thereof is 10 per cent or less of the original principal balance.

Many transactions involve a two-step structure consisting of a tax sale into an SPV wholly-owned by the originator, followed by a transfer treated as a tax loan into a second SPV that issues interests to investors. This may facilitate accounting sale treatment while avoiding tax gain if the first SPV either is a wholly-owned corporate subsidiary of a corporate originator or if it is a limited liability company wholly-owned by the originator (in the latter case, regardless of how the originator is organised).

Transfers to REMICs and FASITs

If the securitisation involves either a 'real estate mortgage investment conduit' (REMIC) or 'financial asset securitisation investment trust' (FASIT) specific statutory rules, rather than the above-described factual inquiry, will govern the tax treatment of transfers from an originator to the SPV. REMICs are found exclusively in mortgage securitisations. 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, as discussed below. Transfers of mortgages to a REMIC in return for interests therein do not result in gain or loss for tax purposes. Transfers to FASITs, by contrast, are generally not tax-deferred and, depending upon valuation of the underlying receivables, can trigger significant tax gain. It is largely as a result of this fact that FASITs, introduced to facilitate securitisations of a wide range of assets, have not enjoyed much popularity since they appeared on the scene in 1997. In fact, pending proposed legislation would eliminate FASITs, although no such provision has been enacted to date.

Taxation of SPVs

A second set of tax issues revolves around minimising income tax on the SPV.

Corporate SPVs

Under US income tax principles, US incorporated entities are subject to an 'entity level' tax. If a corporate SPV issues debt securities to investors, however, deductions for interest paid on the indebtedness will likely reduce taxable income, and, therefore, income tax cost, to a relatively low level. If the corporate SPV is wholly-owned by a corporate originator then the SPV can be included in the originator's consolidated group for federal income tax purposes. This avoids any separate federal tax on the SPV (although, as noted below, this consolidation may not be available for state income tax purposes).

Unincorporated entities

If a US unincorporated business entity is used as the SPV, entity level tax is avoided under the 'check-the-box' regulations. Under these rules, unless an election to be treated as a corporation is made, a non-corporate SPV will be treated as a non-taxable partnership, if it is owned by two or more persons, or simply ignored for tax purposes, if it has a single owner (including, for example the originator). The advent of these 'check-the-box' rules, which generally became effective beginning in 1997, thus greatly eased concerns over taxability of SPV's. Accordingly, limited liability companies (LLCs) are increasingly being used in securitisation transactions to achieve bankruptcy remoteness with respect to receivables transferred thereto by an originator.

Trusts may be used in some securitisations. In a 'pass-through' transaction, in which a pool of receivables is deposited into a trust that issues certificates of beneficial ownership to investors, the trust may qualify as a 'grantor trust,' which, similar to a single member LLC, is ignored as an entity separate from its owners. If, however, the trustee is entitled to vary the trust's investments by acquiring new receivables (other than solely in substitution for defective assets during an initial period) or to reinvest moneys held by the trust, or if more than a single class of certificates is issued to investors (unless the sole distinction between classes is that payments with respect to one class are subordinate to payments with respect to another), grantor trust treatment will not be available. Under the check-the-box rules, failure to qualify as a grantor trust need not lead to a trust level tax. It does, however, trigger relatively burdensome tax reporting requirements. For this reason, issuers may seek to maintain grantor trust status.

If, as in many credit card transactions, a business trust is formed to hold receivables and issue certificates to investors that are treated as debt securities, the trust may properly be viewed as a mere security device on the theory that, except for principal and interest due certificate holders, all amounts are held therein for the originator's benefit. In such case, the trust arguably can be ignored for income tax purposes. Alternatively, the check-the-box rules may be relied on to avoid entity-level tax.

Publicly traded partnerships

An unincorporated entity (including an LLC or trust otherwise qualifying as a partnership under the check-the-box rules), can lose its non-taxable status under the 'publicly traded partnership' (PTP) rules if interests in it are traded on an established securities market or a secondary market "or substantial equivalent thereof." This issue is avoided in many privately-offered deals by imposing restrictions on transferability of equity interests in the SPV or limiting holders of such interests to no more than 100 in order to fall within a regulatory safe harbour.

Taxation of REMICs and FASITs

Finally, SPV's that qualify as REMICs and FASITs generally pay no entity-level tax, except, as to REMICs, in respect of income from certain "prohibited transactions" or on certain income from foreclosure property. In order to qualify as a REMIC or FASIT, specific statutory tests must be met, covering the types of assets that may be held; the type of interests that may be issued to investors, and investors. REMICs, like grantor trusts, must maintain a fixed pool of mortgages that generally cannot vary following an initial 90-day period. REMICs and FASITs are the exclusive non-taxable vehicles that can be used to offer multi-class mortgage-backed securities where classes of certificates vary other than in respect of their degree of subordination and, therefore, interest rate. An SPV that is not a REMIC or FASIT and issues, for example, 'slow/pay-fast/pay' mortgage-backed certificates, will be subject to entity-level tax.

Cross-border issues

In cross-border securitisations, the SPV may be a non-US entity. If the SPV holds US receivables or other US-based assets, it is important to ensure that the SPV will not be treated as doing business in the US so as to avoid imposition of US net income tax on it or its (non-US) investors. Under the check-the-box rules, a non-US SPV will be subject to corporate income tax on income from a US trade or business if it is organised as a legal entity included on an IRS list of 'per se' corporations (generally non-US equivalents of US stock corporations) or if none of its equity owners are, under the laws of the jurisdiction in which it is formed, liable for its obligations (unless, in the latter case, an election for non-corporate treatment is made). Alternatively, if the SPV is not subject to US income tax in its own right, non-US equity owners may be taxable if the SPV is treated as engaged in a US trade or business.

Whether a SPV will be treated as engaged in a US trade or business depends on the relevant facts and circumstances. The criteria hereb are not terribly clear-cut. Typically, therefore, structuring is undertaken to ensure that an off-shore SPV cannot be viewed as engaging in anything that could be perceived as a business, as opposed to passive investment. Thus, for example, if the SPV owns a fixed pool of US receivables, a primary concern will be to ensure that the US servicer has no discretion to take action on behalf of the non-US SPV other than in respect of performance of ministerial tasks. Under a regulatory safe harbour, an SPV will not be treated as engaged in a US trade or business provided all it can be said to be doing is investing for its own account. If, as in many CBO transactions, the non-US SPV is investing and reinvesting through a US collateral manager in a variety of debt obligations, practitioners typically will caution against any behaviour, including origination of loans and direct negotiation with originators, that might be viewed as the conduct of a financing business and, therefore, would not fall under this safe harbour. More complicated issues are raised if certain types of assets, including, for example, credit default swaps, which may be viewed as a form of guarantee or insurance, are held by the SPV. Insurance characterisation raises a potential US excise tax cost as well as susceptibility to a finding of taxable "business" activity. In this case, deals will be structured so that the SPV can be said to be acting solely off-shore. Generally this means having no US office and no US dependent agents, including collateral managers, with power to bind the SPV.

If a non-US SPV is formed in a jurisdiction with which the US has an income tax treaty, the SPV cannot be taxed on its business profits unless it acts through a 'permanent establishment' (PE) in the US. Although it is somewhat easier to avoid classification as a PE, than to avoid being treated as doing business generally, the tests are similar. The US has no tax treaties with tax havens, including, for example, the Channel Islands or the Cayman Islands, in which many SPV's are formed in an effort to avoid local tax.

A non-US SPV may also be subject to US withholding (as opposed to net income) tax if it holds interest-bearing receivables of US obligors. This issue is the same as that which arises in respect of non-US investors holding debt securities of US SPV's or, in a 'pass-through' transaction, where purchased certificates represent interests in receivables of US obligors. US withholding tax is discussed below.

Taxation of investors

A third set of tax issues found in securitisation transactions revolves around the income taxation of investors in notes, trust interests or other securities issued by an SPV. Typically, the securities will be treated either as indebtedness of the SPV (or the originator) or as an equity interest in the SPV or in the underlying receivables.

Taxation of debt securities

If securities are treated as debt, investors will be taxed, at ordinary income rates, on stated interest that is paid or accrued. Frequently, the debt will also carry 'original issue discount' (OID) either because it is issued at a discount from face and/or because the terms and rating of the indebtedness (including, for example, if the debt is subordinated and timely payment of periodic interest is not necessarily anticipated) is such that stated interest is not deemed unqualifiedly payable in all events at scheduled intervals. OID is taxable as ordinary income and accruable in income based on its economic yield over the life of the instrument, regardless of the investor's method of accounting for tax purposes. Similarly, if debt is acquired in the secondary market at a discount, the 'market discount'; or, in certain cases, the 'short-term acquisition discount,' rules treat the difference between principal amount and acquisition price as equivalent to interest and taxable as ordinary income, either during the investor's holding period or upon sale or other disposition of the obligation. Conversely, if debt is issued or acquired at a premium, deductions may be claimed in respect of such premium cost.

Principal repayments on securities treated as debt, except to the extent of OID, market discount or short-term acquisition discount, are tax-free to the extent of an investor's tax basis in the debt, generally its purchase price. If less than tax basis is recouped, a tax loss may be claimed.

Taxation of non-debt interests

If investor interests are not treated as debt but, rather, as ownership interests in underlying receivables or as equity of an SPV, the income tax consequences are somewhat different in a number of respects. Timing of income inclusion is a key difference. For example, if the SPV is a grantor trust issuing certificates of beneficial interest representing ownership interests in receivables, each investor will take into account its share of items of interest, OID, market discount and short-term acquisition discount with respect to the receivables themselves. Principal repayments on the underlying receivables are tax-free, with loss (or gain) resulting upon prepayment or final payment of each receivable to the extent proceeds are less than (or exceed) the SPV's allocable basis. The same happens if an investor is treated as holding equity interests in an SPV formed as a trust or other unincorporated entity that is treated as a partnership for income tax purposes. If, however, the SPV is a corporation (or a PTP taxable as such) then investors treated as equity owners thereof will generally be taxable only on returns on their investments when paid, as dividends. Corporate investors in such case may qualify for a "dividends-received" deduction that will exclude from income a portion of the return paid.

Special issues for certain investors

Characterisation of investor interests as debt, equity or ownership of underlying receivables can carry somewhat more dramatic consequences for certain classes of investors. Pension plans, for example, generally may want to be assured that the security they are purchasing qualifies as debt for tax purposes so as to avoid potential violations of ERISA and/or imposition of excise taxes. Pension plans, as well as other tax-exempt investors, who want to avoid income tax on 'unrelated business taxable income' (UBTI) may also prefer an investment characterised as debt for US tax purposes. Interest income (including OID, market and short-term acquisition discount) is generally not treated as UBTI to tax-exempt investors, provided they do not borrow to make their investment. If, however, such investors are viewed as partners in an SPV that is churning collateral and, as such, may be viewed as engaged in a financing business unrelated to a tax-exempt investor's exempt purposes, the investor's return will be taxable UBTI. Similarly, non-US investors, not otherwise engaged in business in the US, are likely to prefer holding an investment treated as debt (or an interest in receivables clearly qualifying as such) to an investment treated as equity in either a partnership or a corporation. This is because interest income, including OID and other discount, on debt securities is generally free of US net income or withholding tax to non-US investors not otherwise engaged in a US trade or business, so long as the investors are unrelated to the issuer and the debt is either targeted solely to non-US investors or is in registered form. (Interest on debt securities not fitting these requirements may still be tax-free to investors resident in jurisdictions with which the US has income tax treaties.) A non-US investor viewed as holding equity in an SPV treated for US tax purposes as a partnership, by contrast, risks being viewed as doing business in the US and, as such, subject to US net income tax and required to file US income tax returns. Moreover, non-US investors holding equity in a corporate SPV are subject to a 30 per cent withholding tax (subject to treaty reduction) on dividends received from the SPV (although they will not be subject to net US income tax).

Characterisation of investor interests as debt or equity

Whether or not securities held by investors in a securitisation transaction will be treated as debt for US tax purposes is not determined by the form of the instrument. The characterisation of investor interests turns primarily on the degree of economic risk, on the one hand, and potential upside, on the other, held by an investor. A fixed upside and protection against non-payment risk are the key indicators of indebtedness. Relevant factors looked to thus include: whether the obligation has a fixed maturity date, fixed interest and fixed interest payment dates; the degree of security insuring repayment, including level of overcollateralisation, outside credit enhancement and, if applicable, credit rating; the existence of creditors' rights, including, especially, the right to call a default for non-timely payment of principal or interest; level of subordination and the debt-to-equity ratio of the issuer (although generally, a relatively low level of equity will not jeopardise debt treatment for senior tranches); the form of the transaction and the parties' expressed intent regarding US income tax characterisation; the extent of matching between cash flows on underlying collateral and those on the securities in question (mismatching evidencing debt); and limitations on an SPV's rights to prepay and to substitute collateral.

REMIC and FASIT interests

The US income tax treatment of investors in REMICs and FASITs is prescribed by statute. 'Regular' interests in these vehicles, which must fit prescribed statutory criteria, including term and types of interest rates, are treated as indebtedness for all US tax purposes. Thus REMICs and FASITs may issue various classes of regular interests and even the most deeply subordinated classes will be treated as debt. FASIT 'ownership' interests and REMIC 'residual' interests are treated as equity and only one class is permissible. Holders of these interests are taxed on income of the FASIT or REMIC, calculated after taking into account income from assets held by the SPV, reduced by interest expense on the regular interests. This income can be very low, although there are certain rules (including required inclusion of 'excess inclusions' in the case of REMIC residual interests and limitation on use of other losses to offset income derived from FASIT ownership interests) that guarantee certain minimum levels of income inclusion. Further, tax-exempt and non-US holders of REMIC residual interests are disadvantaged, tax-wise, and FASIT ownership interests may be held only by certain taxable US corporations.

US investors in non-US SPVs

Where the SPV is a non-US entity with US investors distinct US tax issues are present. These relate to the potential application of sets of rules variously designed to avoid deferral of US tax on certain passive off-shore income earned for the benefit of US persons. Under the Subpart F rules, for example, 'Subpart F income,' including interest, of 'controlled foreign corporations' (CFCs) can be taxable even if no amounts are actually distributed. CFC's are non-US corporations, in which over 50 per cent of the vote or value is owned by five or fewer US persons. Under the 'passive foreign investment company' (PFIC) rules, any US shareholder of a PFIC (a non-US corporation with primarily passive income) will be subject to an interest charge on dividend distributions unless the investor elects to recognise its share of the PFIC earnings on a current basis or, if the PFIC's stock is regularly traded, to 'mark-to-market' built-in gain or loss attributable to the difference between the PFIC's value and the investor's tax basis in its stock. A foreign SPV whose income consists of interest on underlying receivables or similar assets is likely to qualify as a PFIC and, if it is a CFC, its income will constitute Subpart F income. Thus, both the CFC and PFIC rules can impact US investors where the SPV is a foreign entity taxed as a corporation for US income tax purposes and the US investor holds an interest denominated as equity in the SPV or subject to recharacterisation as such.

US state and local taxes

Most US states and some municipalities impose taxes that can impact securitisation transactions. State income taxes generally follow US federal rules. One area where state and federal rules differ is the treatment of consolidated returns. Thus, for example, transfers of receivables from a corporate originator to a wholly-owned corporate subsidiary may be ignored for federal, but not for state, income tax purposes, resulting in unexpected state tax cost if a tax gain is realised. A transfer to a wholly-owned unincorporated entity, such as an LLC, can generally be used to solve this problem, except with respect to activities in Texas, which still subjects LLCs to tax. Similarly, some states may not have adopted all current federal rules in respect of taxation of REMICs and FASITs and investors therein and it is, therefore, prudent to check the status of relevant state law in transactions using these entities. Non-income taxes, such as sales or other transfer taxes, excise taxes, or taxes on intangibles, may also be imposed by states or municipalities in which a transaction takes place.

Impact of 'tax shelter' regulations on securitisation transactions

Regulations issued last year and prompted by the IRS's concerns with the proliferation of abusive tax shelters, but containing a much broader reach, may impact US taxpayer participants (including foreign persons engaged in business in the US) in securitisations. These rules generally are effective for transactions entered into on or after January 1, 2003.Under the regulations, participants in any transaction falling into one of six categories of 'reportable transactions' must disclose this participation to the IRS on their US federal income tax returns.

Two of the six categories of reportable transactions could have an impact on a wide range of securitisations. These are: transactions where the federal tax treatment differs from accounting treatment and certain loss transactions. A third category, confidential transactions, may also come into play, although to a more limited extent than previously, in view of recent IRS guidance as described below.

Book/tax differences

This covers transactions where the treatment of any item for US federal income tax purposes differs (or is reasonably expected to differ), by more than $10 million from the treatment for book purposes, generally as determined by application of US GAAP. This category requires disclosure by business entity taxpayers (and affiliates) who either are reporting companies under US securities laws or have $250 million or more in gross assets. Although at first blush this category would appear to have a very wide impact on securitisations, the IRS has issued a list of exceptions that narrow the scope considerably. Transactions treated as a sale, purchase or lease for book purposes and as a financing for tax purposes are not covered. Nor is treatment of a transaction as a sale for book purposes and as a non-taxable contribution to a REMIC, although this exception does not cover differences resulting from the application of different valuation methodologies to determine the relative value of REMIC interests for purposes of allocating tax basis among those interests (if contributed mortgages are valued differently for book, as opposed to tax purposes, then disclosure would be required if the $10 million threshold is met).

Certain loss transactions

Transactions generating a business loss in excess of prescribed thresholds are disclosable under these rules. This could impact, for example, originators, with respect to sales of receivables, or investors, with respect to sales of asset-backed debt or other securities, in each case if the sale generates a significant enough loss. Here too, the IRS has issued a list of exceptions, including in respect of losses relating to REMIC residual interests and to certain 'qualifying basis' assets. Interestingly, however, the latter exception does not cover interests in pass-through entities (including grantor trusts, partnerships or LLC's) nor does the definition of 'qualifying basis' cover tax basis in assets attributable to income accrual eg debt interests attributable to accrued interest, OID or market discount).

Confidential transactions

In the original version of the regulations, confidential transactions were defined, with certain exceptions, as those in which the taxpayer's disclosure of the claimed federal income tax treatment or tax structure of a transaction was limited in any way by or for the benefit of any person who makes or provides a statement as to potential tax consequences. This definition potentially subjected many routine securitisation transactions to disclosure requirements. Late in 2003, the IRS issued additional guidance on this issue, clarifying that confidential transactions would only include situations in which an advisor is paid a minimum fee for tax advice and that advisor imposes a limitation on the taxpayer's disclosure of tax strategies. Thus, confidentiality provisions in a routine loan or receivables purchase agreement entered into between principals to a transaction should not trigger disclosure. Nor should restrictions on disclosure in private placements, where the issuer is not being paid for tax advice. If, however, a party to a transaction can also be said to be acting as an advisor, carve-outs or confidentiality waivers may still be appropriate so as to avoid disclosure, even in routine transactions. The new rules apply to transactions entered into on or after December 29, 2003 but may be relied upon for transactions entered into on or after January 1, 2003.

Required disclosure

Disclosure required under these regulations is quite broad, including a description of the transaction and the tax benefits (defined to include deductions or exclusions from income and basis adjustments derived therefrom). Taxpayers may submit requests for IRS rulings, or may make 'protective' disclosure, if they are uncertain as to whether the disclosure requirements apply.

Taxpayers failing to disclose reportable transactions as described above will be precluded from taking advantage of a "reasonable cause" exception to penalties for tax understatements. Pending legislation contains more specific penalties for failure to comply with the regulations.

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Published by Globe White Page in association with Deutsche Bank