Securitisation – what are the current issues and trends in Australia and New Zealand?

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OVERVIEW

1. In Australian securitisations the decision as to the type of issuing vehicle, trust or company, will depend on the nature of the instrument to be issued. Commercial paper is almost exclusively issued by a corporation while the issuing vehicle for medium or longer term paper will, with almost equal certainty, be a trust.

2. This paper looks at recent and proposed amendments in income tax and goods and services tax ("GST") law in Australia that may impact significantly when a trust is used as the issuing vehicle in a securitisation.

INCOME TAX ISSUES

INTRODUCTION

3. It is an essential requirement of any securitisation transaction that the securitisation trust be "tax neutral" so that the trustee will not be liable to tax on any net (taxable) income of the trust estate. Historically, this has been achieved by ensuring that:

   - The beneficiaries are presently entitled to the income of the trust estate.
   - The beneficiaries are not non residents.
   - The trust is not taxed as a company under Divisions 6B or 6C of Part III of the *Income Tax Assessment Act* 1936 ("1936 Act").

4. While these issues are well settled, the ability to ensure the tax neutrality of a securitisation trust has been complicated by recent developments in relation to the Australian income tax legislation, starting with the final report of the Ralph Review of Business Taxation which was published on 21 September 1999.

5. Some of the key amendments and proposals of importance to a securitisation trust include:
   - the introduction of the consolidation regime
   - the new thin capitalisation rules
   - amendments to the interest withholding tax exemption for publicly issued debentures, and
   - the withdrawal of the Federal Government's proposal to tax non-fixed trusts in a similar manner to companies.

6. Each of these issues are discussed below in relation to their impact on a securitisation trust. A brief overview on how trusts are taxed in Australia is set out below.

OVERVIEW OF THE TAXATION OF TRUSTS IN AUSTRALIA

7. In Australia the income of a trust is usually taxed in the hands of the beneficiaries according to their respective share of the trust income. This is subject to the proviso that the trust has income in a particular year and that the beneficiaries are presently entitled to the income. However, a trust is required under Australian tax law to calculate its taxable income and lodge a tax return. The income derived by a trust for tax purposes will retain the character it possessed in the trust in the hands of the beneficiaries in determining their own tax positions for an income year. For example, if a trust derives a capital gain, it will be taxed in the hands of the beneficiary as a capital gain. Accordingly, a trust is essentially a flow-through entity for taxation purposes.

8. However it should be noted that:
   - The trustee of a trust may be liable for tax in certain situations, such as where there are non-resident beneficiaries or where no beneficiary is presently entitled to the income of a trust; and
   - Some unit trusts are taxed as if they are companies.

9. Neither of the above exceptions should be relevant in a properly structured securitisation program.

IMPACT OF THE NEW CONSOLIDATION REGIME

10. With effect from 1 July 2002 a new tax consolidation regime was introduced in Australia. The regime operates to treat wholly owned corporate groups which make the necessary elections as a single entity for income tax purposes[1]. The effect of this is that transactions between members of the consolidated group are ignored for income tax purposes. The decision to be treated as a consolidated group is optional. However, from 1 July 2003 (subject to some transitional provisions) loss transfers and asset rollovers between members of the same wholly owned group were removed thus making consolidation essentially a compulsory regime for most corporate groups.

11. A company is required to be the head entity in a consolidated group and to consolidate with all of its wholly owned entities[2]. A wholly owned entity is one in which all the membership interests (ie. shares or units) are owned by the head company or other members of the consolidated group. If a group elects to be taxed as a consolidated group, all wholly owned entities of the group must be included, ie it is not possible to cherry pick and include or exclude particular group members. A securitisation trust will be required to be included in a consolidated group where its unitholders are members of the same consolidated group.

12. Being a member of a consolidated group will not generally alter the income tax treatment of a securitisation trust, with one exception. Under the regime, the head entity is primarily liable for the combined tax liability of the consolidated group[3]. However, all members of the consolidated group are jointly and severally liable for the tax liabilities of the group, for the period in which they are a member, in the event that the head entity defaults in making a payment of tax[4]. This is a major concern to securitisation trusts as the potential for the trust and the trustee to be liable for the tax liabilities of other

[1] Section 701-1 of the *Income Tax Assessment Act* 1997 ("**1997 Act**')
[2] Section 703-10 of the 1997 Act
[3] Section 701-1 of the 1997 Act

group members will impact on the tax neutrality of the trust. At the very least, this is likely to lead to a downgrading of the trust by rating agencies or even a refusal to rate the trust. It will also be a significant discentive to independent corporate trustees from accepting a role in securitisations. The Australian Securitisation Forum is currently lobbying the Federal Government to provide a carve-out for securitisation vehicles from the consolidation regime, and in the meantime is working with the rating agencies to try and ensure a smooth transition to the new regime.

Inclusion of a securitisation trust in a consolidated group

13. As set out above, a securitisation trust is automatically included in a consolidated group where its unitholders are members of the same consolidated group. In practice, where members of a consolidated group would hold both the income and capital units in the trust, it is common to issue the capital unit (or create a second class of capital unit) which is issued to an entity that is not a member of that consolidated group. Due to the fact that not all of the units in the trust are held by a member (or members) of the same consolidated group, the trust will not be included in that consolidated group. This is discussed further below in the context of the anti-avoidance provisions.

Tax Sharing Agreements

14. There is an exception to the principle of joint and several liability where the group tax liability is covered by a valid "tax sharing agreement" between the head entity and the members. Where there is a valid tax sharing agreement each member's liability for the group's tax liability is limited to the amount specified in the tax sharing agreement.

15. A valid tax sharing agreement is one which:
- Exists immediately prior to the time when the head entity's liability is due and payable;
- Provides a mechanism for determining that part of the amount of the group tax liability that is to be allocated to the group members;

[4] Section 721-15 of the 1997 Act

- Allocates a particular amount of the potential group tax liability between group members on a reasonable basis;
- Has not been entered into as part of an arrangement, a purpose of which was to prejudice the Commissioner's ability to recover some or all of the unpaid amount of the group liability from group members; and
- Complies with any other requirements set out in regulations.[5]

16. Where a valid tax sharing agreement exists the Taxation Commissioner is essentially bound by its terms. Accordingly, it provides a higher level of comfort to the parties to it (including a trustee of a securitisation trust) than, for example, a tax indemnity would given that the tax indemnity would normally be given by the head entity which would also be the defaulting party.

17. It is therefore critical to ensure that any tax sharing agreement is "valid", and how such validity can be determined when the agreement is entered into. Validity in this regard is not something which is determined at the time of entering into the tax sharing agreement, but will likely be determined at a point where there has been default in the payment of group tax.

18. There is no guidance in the legislation as to what constitutes a "reasonable amount". The Explanatory Memorandum to the Consolidation legislation states that the Taxation Commissioner would publish guidelines as to what would be considered to be a "reasonable allocation" of liability, such that the tax sharing agreement could be treated as being valid. One would expect that a reasonable allocation of the group's tax liability should be reflective of the tax position of the group member on a non-consolidated basis. For securitisation trusts, where the transactions entered into are always intended to result in a tax neutral position for the trust, that reasonable allocation should be nil. Whether the guidelines will allow such an approach remains to be seen. The long awaited guidelines have not been released to date.

19. A valid tax sharing agreement must allocate a particular amount to each contributing group member. In practice this will ordinarily be a formula in the tax sharing agreement allocating the group tax liability among the contributing

[5] Section 721-25(1) of the 1997 Act

members. Provided that the method of allocation between the Group members is consistent, such as using the income tax that would be payable but for consolidation, there should be no difficulty in the allocation of a zero amount to securitisation trusts.

20. There are two integrity measures in the consolidation legislation which may impact on the validity of a tax sharing agreement. Firstly, a tax sharing agreement may be ignored where there is an arrangement that has a purpose of prejudicing recovering by the Commissioner of the group tax liability.[6] In this regard, the allocation of a zero amount to a securitisation trust will not impact in any way on the recovery by the Commissioner of the group's tax liabilities due to the fact that such trusts are by design tax neutral and will not contribute to any group tax liability.

21. Secondly, a tax sharing agreement will not be upheld where the Commissioner gives the head company a written notice to produce the agreement in the "approved form" and the head company does not produce the agreement within 14 days of the notice being received.[7] This measure is of concern to securitisation trusts as such a circumstance cannot be adequately mitigated against in the transaction documents.

Anti-avoidance provisions

22. For ratings purposes securitisation trusts are required to be tax neutral and in this regard it is imperative that such a trust does not become jointly and severally liable for the group tax liabilities of a consolidated group. In the absence of any guidelines from the Commissioner, there is a strong case to be made for the proposition that securitisation trusts should not be members of a consolidated group so as to avoid any potential liability for the trustee of the trust. This can be achieved simply by ensuring that the income unit and the capital unit are held by parties who are not members of a consolidated group. It is also becoming common to require the trustee and unitholders to ensure that the trust ceases to be part of a consolidated group if it becomes

[6] Section 721-25(2) of the 1997 Act
[7] Section 721-25(3) of the 1997 Act

part of a group and a valid tax sharing agreement is not in place. There is a live issue as to whether the Australian Taxation Office might seek to apply the general anti-avoidance rules contained in Part IVA of the 1936 Act to this structuring.

23. The following conditions must be satisfied for the Commissioner of Taxation to be entitled to apply Part IVA to an arrangement:

(a) There must be a scheme that was entered into after 27 April 1981;

(b) A taxpayer must obtain a "tax benefit" in connection with the scheme; and

(c) Having regard to the following factors it could be concluded that the scheme was entered into for the purpose of enabling the taxpayer (either alone or in association with others) to obtain a tax benefit in connection with the scheme:

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act would be achieved by the scheme (ignoring the application of Part IVA);

(v) any change in the financial position of the taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

(vii) any other consequence for the taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi).[8]

24. Ignoring the other factors that are required to be satisfied before the Commissioner may apply Part IVA to an arrangement, the arrangement must produce a tax benefit for a taxpayer. A tax benefit is defined as:

(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

(b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out; or

(c) a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out; or

(c) a foreign tax credit being allowable to the taxpayer where the whole or a part of that foreign tax credit would not have been allowable, or

[8] Section 177D of the 1936 Act

might reasonably be expected not to have been allowable, to the taxpayer if the scheme had not been entered into or carried out.[9]

25. A securitisation trust by its design is tax neutral. The effect of deconsolidating a trust or ensuring that a trust is not consolidated is to ensure that the trust will not be jointly and severally liability for the tax liabilities of the consolidated group. Where a transaction is structured so that the trust is not consolidatable no tax benefit will arise. The trust was and continues to be tax neutral. Where a trust is deconsolidated after forming part of a consolidated group, the only tax consequence is that the trust will no longer be jointly and severally liable for any unpaid group tax liabilities. This does not give rise to a reduction in the assessable income or an increase in tax deductions for a taxpayer (in this case the relevant taxpayer being the trust). Further, even if it did, a particular "amount" is not identifiable.

26. Accordingly, while the issue is currently live, the better view is that one of the main requirements that must be satisfied for the general anti-avoidance provisions to be applied to the consolidation or deconsolidation of a securitisation trust is not satisfied in this instance. Further, when the objective of Part IVA as stated by the Treasurer in the Explanatory Memorandum to Part IVA is considered, this being to "strike down blatant, artificial or contrived arrangements" but is not intended to "cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs", it is irrational and without a legal basis that the Commissioner would seek to apply Part IVA in this instance.

THIN CAPITALISATION

27. The thin capitalisation provisions,[10] which have applied from 1 July 2001, deny interest (and other debt deductions) to certain entities for income tax purposes where specified debt to equity ratios are breached.

[9] Section 177C of the 1936 Act
[10] Division 820 of the 1997 Act.

28. These rules apply to entities which are classified as either "inward investing entities" or "outward investing entities". An outward investing entity includes an Australian trust which is an Australian controller of an Australian controlled foreign entity and, in certain circumstances, associated entities.[11] The associate entity rules are very wide and often have the capacity to include securitisation trusts within their scope.

29. An inward investing entity is a foreign entity or a foreign controlled Australian entity.[12] The relevant tests for determining control of an Australian entity such as a securitisation trust are, very broadly, whether 5 or fewer foreign entities hold a total control interest (which includes direct and indirect interests) of at least 50% interest in the trust, or a foreign entity holds a control interest of 40% in the trust and no other entity controls the trust.[13]

30. Where the securitisation trust meets the tests for either an inward or outward investing entity then usually the thin capitalisation provisions will apply because the securitisation trust will be 100% geared. A securitisation vehicle is treated as a financial entity for the purposes of these rules and is subject to a debt to equity ratio of 20:1, subject to the concession for "securitisation vehicles" set out below which allows some assets to be fully debt funded. However, due to the restrictive nature of the definition of "securitisation vehicle" the concession does not apply to many securitisation trusts in practice.[14] Where a securitisation trust does not satisfy this concession it must either rely on satisfying the arm's length test (which is difficult to satisfy and would lead to increased compliance costs) or suffer the loss of interest deductions.

31. The Australian Securitisation Forum has been lobbying Federal Government to provide a more practical exemption for securitisation vehicles from the thin capitalisation regime. The Government responded positively to this and has introduced an exemption for bona fide securitisation vehicles from the thin

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[11] Subdivision 820-B of the 1997 Act
[12] Subdivision 820-C of the 1997 Act
[13] Subdivision 820-H of the 1997 Act
[14] Subdivision 820-K of the 1997 Act

capitalisation regime.[15] The current concession and the proposed exemption are discussed below.

32. The impact of a denial of interest and other debt deductions to a securitisation trust will increase the amount of net (taxable) income of the trust. While the tax neutrality of a securitisation trust will not be affected on the basis that the income unitholder will be taxed on the net income of the trust (and not the trustee), the application of these rules to securitisation trusts leads to increased compliance costs and impacts on the potential ratings of the trust.

Securitisation vehicle

33. This concession is meant to provide a carve out for the securitised assets of a securitisation vehicle from the thin capitalisation regime and allow a securitisation to be fully debt funded in respect of those assets. A securitisation vehicle is required to satisfy all of the following requirements to obtain this concession:

(a) It must be an entity established for the purposes of acquiring, funding and holding securitised assets.

(b) It has acquired the securitised assets from another entity.

(c) The acquisition of the securitised assets is wholly funded by the issuing of debt interests by the trust.

(d) In issuing the debt interests the trust does not receive any guarantee, security or other form of credit support from any of its associate entities, the originator of the assets or any associate entity of the originator.

(e) The trust has not issued debt interests for any purpose other than the purpose of funding the acquisition of the securitised assets.

[15] This amendment is contained in Taxation Laws Amendment bill (No.5) 2003 ("**TLAB (No.5)**").

(f) There are no debt interests issued to the trust by any of the entity's associate entities, the originator or any associate entity of the originator.

(g) Any arrangements the trust has with any of its associate entities, the originator or any associate entity of the originator are those which would reasonably be expected to have been entered into by parties dealing at arm's length with each other.[16]

34. However, in most securitisation transactions, the securitisation vehicle is unlikely to satisfy all of these requirements. In particular, the requirement that the securitisation trust not receive any credit support from specific entities is often not satisfied. Further, variants on a traditional securitisation structure such as warehousing, two-tiered and synthetic securitisations do not fit within this definition. As a consequence, many bona fide securitisation vehicles have not been able to utilise this concession and are subject to the thin capitalisation rules.

TLAB (NO. 5)

35. Following intensive lobbying by the Australian Securitisation Forum, the Minister for Revenue announced on 2 December 2002 that the Federal Government was proposing to amend the thin capitalisation rules for securitisation vehicles. On the 27 March 2003 TLAB (No.5) was introduced into the House of Representatives. The Bill was been referred to the Senate Economics Legislation Committee on 18 June 2003 for inquiry by 11 August 2003 (the first day of the Spring Parliamentary sittings) into the proposed amendments. However, it is expected that the Government will pass the Bill in the next sitting of Parliament.

[16] Subdivision 820-K of the 1997 Act

36. If enacted in its current form, TLAB (No. 5) will provide a complete exemption from the thin capitalisation rules for bona fide securitisation vehicles that meet certain conditions, and will apply for income years commencing on or after 1 July 2001 (the commencement date of the current thin capitalisation rules).

37. Under the rules, an entity will be exempt from the thin capitalisation rules where the following conditions are met:

(i) The entity is established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumed the risk from another entity or creates the risk itself);

(ii) At least 50% of the entity's assets are funded by debt interests; and

(iii) The entity is an insolvency remote special purpose entity according to the criteria of an internationally recognised rating agency applicable to the entity's circumstances.

38. In relation to condition (iii), the Explanatory Memorandum makes it clear that the securitsation vehicle must be able to show that it satisfies the criteria of an internationally recognised ratings agency most applicable to its circumstances, however, the entity is not actually required to be rated. The Explanatory Memorandum also states that a ratings agency may be satisfied that this criteria has been met where the entity can demonstrate that the entity:

- is restricted to activities necessary to its role in the transaction;
- is restricted from incurring additional indebtedness;
- cannot be subject to reorganisation, merger or change of ownership; and
- holds itself out to the world as a separate entity.

39. The amendments also allow several legal entities to demonstrate that they meet this criteria where they are taken together to be one single notional entity.

40. These amendments have been drafted broadly to reflect the fact that securitisations may take many different forms and should provide a complete exemption for most bona fide securitisation vehicles from the thin capitalisation rules. The current concession (as set out above) for securitisation vehicles will remain in the legislation. However, it is unlikely to be of any practical use once the new exemption contained in TLAB (No. 5) has been enacted.

INTEREST WITHHOLDING TAX

41. The payment of interest withholding tax is an issue of importance to a trustee of a securitisation trust. Where an Australian resident trust makes a payment of interest to a non-resident (not carrying on business in Australia through a permanent establishment), the trustee on behalf of the trust is required to withhold interest withholding tax (unless an exemption applies). While the tax liability is that of the non-resident entity that is earning the interest, the trustee is obligated to withhold the tax from interest payments made to the non-resident and remit the tax to the Australian Taxation Office.

42. Where an Australian securitisation vehicle issues securities to a non resident entity, the transaction is normally structured so that the exemption available for publicly offered debentures from interest withholding tax[17] is applicable. To obtain this exemption the debenture must satisfy a public offer test. The public offer test will be satisfied if the issue of a debenture by a trustee company results from the debenture being offered for issue:[18]

a) to at least 10 persons each of whom:

[17] Section 128F of the 1936 Act
[18] Section 128F(3) of the 1936 Act

i) was carrying on a business of providing finance, or investing or dealing in securities, in the course of operating in financial markets; and

ii) was not known, or suspected, by the company to be an associate of any of the other persons covered by this paragraph; or

b) to at least 100 persons whom it was reasonable for the company to have regarded as having acquired debentures in the past or being likely to be interested in acquiring debentures; or

c) as a result of being accepted for listing on a stock exchange, where the company had previously entered into an agreement with a dealer, manager or underwriter, in relation to the placement of debentures, requiring the company to seek such listing; or

d) as a result of negotiations being initiated publicly in electronic form, or in another form, that was used by financial markets for dealing in debentures; or

e) to a dealer, manager or underwriter, in relation to the placement of debentures, who, under an agreement with the company, offered the debenture for sale within 30 days in a way covered by any of paragraphs (a) to (d).

43. The issue of a debenture by a trustee company will also satisfy the public offer test if the debenture is a global bond as defined in section 128F of the 1936 Act.

Issuing of debentures to associates

44. The issue of a debenture by a company will not satisfy the public offer test if (at the time of the issue) the issuing company knew, or had reasonable grounds to suspect, that the debenture was being acquired directly or indirectly by an associate of the company and either:

- the associate is a non-resident and the debenture was not being acquired by the associate in carrying on a business in Australia at or through a permanent establishment of the associate in Australia; or

- the associate is a resident of Australia and the debenture or interest was being acquired by the associate in carrying on a business in a country outside Australia at or through a permanent establishment of the associate in that country; and

- the debenture was not being acquired by the associate in the capacity of a dealer, manager or underwriter in relation to the placement of the debenture, or a clearing house, custodian, funds manager or responsible entity of a registered scheme.[19]

45. Amendments were recently made to section 128F to exclude certain associates from the ambit of this rule to make it easier for Australian debt issuers to issue notes onshore and to certain non-resident associates. These amendments received royal assent on 2 April 2003 and apply from 29 August 2001 (they are contained in the provision set out above). Previously an issue of debentures would fail the public offer test where an issuer with actual knowledge or a reasonable suspicion issued notes to any associate, unless that associate was acting in the capacity of a dealer, manager or underwriter in relation to the placement of the notes. Due to the extremely broad definition of associates in the legislation, the inclusion of all associates of the issuer in this test was very restrictive and lead to high compliance costs for the securitisation trust.

46. The amendments now allow an issuer to issue debenture to on-shore associates (in any capacity) and to offshore associates acquiring the notes in the capacity of a dealer, manager or underwriter in relation to the placement of the notes, or a clearing house, custodian, funds manager or responsible entity of a registered scheme.

[19] Section 128F(5) of the 1936 Act

Payment of interest to associates

47. The exemption from interest withholding tax in section 128F will also not apply where interest is paid to an entity that the issuer knows, or has reasonable grounds to suspect, is an associate of the issuer and either:

- the associate is a non-resident and the payment is not received by the associate in respect of a debenture that the associate acquired in carrying on a business in Australia at or through a permanent establishment of the associate in Australia; or

- the associate is a resident of Australia and the payment is received by the associate in respect of a debenture that the associate acquired in carrying on a business in a country outside Australia at or through a permanent establishment of the associate in that country; and

- the associate does not receive the payment in the capacity of a clearing house, paying agent, custodian, funds manager or responsible entity of a registered scheme.[20]

48. This provision will cause the requirements of section 128F to fail even where the notes were initially issued in accordance with the requirements of the section. Previously this provision also applied to all associates of the issuer.

49. The amendments to the associate provisions in section 128F have been beneficial for securitisation vehicles and have decreased compliance costs associated with ensuring the trustee complies with the requirements of section 128F.

STATUS OF THE TRUST

50. In October 2000 an exposure draft of legislation was released by the Federal Government which proposed to tax non-fixed trusts in the same manner as companies. In response to the numerous critical submissions received in relation to the exposure draft, the Treasurer announced on 27 February 2001 that the exposure draft was to be withdrawn and a new consultation process would be entered into which would be based on principles that would protect some "legitimate" uses of trusts whilst addressing the perceived tax abuse in the trusts area generally.

51. In November 2002 the Board of Taxation ("Board") released its Report on the Taxation of Discretionary trusts to the Federal Government. In the Report the Board recommended that the current tax treatment of trust should be retained. The Board also recommended that certain integrity measures be introduced in relation to discretionary trusts to reduce perceived tax abuse in this area. In press releases issued on 12 December 2002 and 25 June 2003, the Federal Government announced its intention to amend taxation laws to adopt the Board's recommendations.

52. While the Federal Government has not expressly confirmed that it will not introduce legislation in the future that will tax non-fixed trusts in a manner similar to companies, given the Board's recommendations and the Government's response, this is considered unlikely.

GST ISSUES

OVERVIEW

53. The goods and services tax ("GST") is a form of value added tax which applies to all "taxable supplies" at the rate of 10%. An entity will only make a taxable supply if each of the following criteria set out within section 9-5 of the GST Act[21] are satisfied:

- the entity makes the supply for consideration; and

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[20] Section 128F(6) of the 1936 Act
[21] *A New Tax System (Goods and Services Tax) Act 1999*

- the supply is made in the course or furtherance of an enterprise that the entity carries on; and
- the supply is connected with Australia; and
- the entity is GST registered, or is required to be GST registered.

54. For the purposes of the GST Act the expression "supply" is very broadly defined in section 9-10(a) as "any form of supply whatsoever". Without limiting the generality of this provision, section 9-10(2) further defines the term supply to include *inter alia* a "financial supply" and supplies of rights.

55. GST does not apply to a supply which:

- falls outside the scope of the GST regime (for example, supplies made by entities that are not GST registered or required to be GST registered);
- is "input taxed" (such as a "financial supply"); or
- is "GST-free" (for example, supplies made to non-residents who are not present in Australia may be GST-free) .

56. Where a supply may be classified as both input taxed and GST-free, the supply will be treated as being GST-free[22].

Input tax credits

57. A GST registered entity may be entitled to recover the GST which is included within the price of the entity's acquisitions as "input tax credits". The GST Act provides that an entity is entitled to recover input tax credits on "creditable acquisitions" which it makes[23]. Pursuant to section 11-5(a), an acquisition will be a creditable acquisition if the acquisition is made solely or partly for a "creditable purpose".

[22] Section 9-30(3)(a) of the GST Act.
[23] Section 11-20 of the GST Act.

58. An acquisition will be made for a "creditable purpose" to the extent that the acquisition is made in the carrying on of the entity's enterprise[24]. However, an acquisition will not be made for a creditable purpose to the extent that the acquisition relates to making supplies that would be "input taxed"[25]. Under the GST Act "financial supplies" are input taxed[26]. Therefore an entity is not entitled to input tax credits for acquisitions that relate to any financial supplies made by the entity.

59. There are however exceptions to this rule and in some circumstances an entity may be entitled to input tax credits on acquisitions even though they relate to financial supplies made by the entity. Specifically this is where:

- the supplier does not exceed the financial acquisitions threshold ("FAT")[27];

- the acquisition relates to a "borrowing" made by the entity and the borrowing itself does not relate to the making of another input taxed supply such as the on-lending of the monies[28];

- the entity is entitled to recover "reduced input tax credits" ("RITCs") in respect of certain prescribed "reduced credit acquisitions"[29];

- the financial supply is made to a non-resident who is not present within Australia, or it is supplied to entities (including Australian residents) who use the thing supplied outside of Australia, and as such the financial supply is GST-free[30]; and

- the financial supply is made between entities that are a part of the same GST group[31].

[24] Section 11-15(1) of the GST Act.
[25] Section 11-15(2)(a) of the GST Act.
[26] Section 40-5 of the GST Act.
[27] Section 11-15(4) of the GST Act.
[28] Section 11-15(5) of the GST Act.
[29] Section 70-5(1) of the GST Act.
[30] Items 2, 3 and 4 of the table within section 38-190(1) of the GST Act.
[31] Section 48-45(2) of the GST Act.

ISSUES FOR THE VENDOR

60. Depending on the form and nature of the securitisation, the arrangement will often involve the vendor transferring an interest in an income producing asset. For example, a mortgage securitisation[32] may involve an ADI, such as a bank, assigning an equitable interest in certain of its mortgages to an issuing trust. Assuming the vendor is GST registered, the GST characterisation of this supply will depend upon the nature of the underlying income producing asset that is being securitised. If the supply is a "financial supply", it will be input taxed.

Financial Supplies

61. The definition of a "financial supply" is set out in the GST Regulations[33]. Essentially a financial supply includes the provision, acquisition or disposal of any of the eleven interests that are listed in the table in Regulation 40-5.09(3) of the GST Regulations. The listed interests include:

- Item 2: a debt, credit arrangement or a right to credit, including a letter of credit;
- Item 3: a charge or mortgage over real or personal property;
- Item 10: securities including a debenture; and
- Item 11: derivatives.

62. Regulation 40-5.02 provides that in relation to financial supplies, an "interest" includes "anything that is recognised at law or in equity as property in any form". The Regulation also contains a list of examples of various "interests" including "a right to future property".

63. In respect of mortgage securitisations, an assignment of a bank's equitable interest in the mortgages to an issuing trust vehicle will be a financial supply

[32] For GST purposes, it is not necessary to distinguish between "residential" and "commercial" mortgages.
[33] *A New Tax System (Goods and Services Tax) Regulations 1999*

as mortgages over real property are specifically listed in item 3 of the table in Regulation 40-5.09(3).

64. However, the issue is not so clear where the securitisation arrangement does not involve mortgages. Examples of other classes of assets include chattel leases and hire purchase arrangements. At issue is whether the securitisation of such assets involves the supply by the vendor of an interest in a "debt" for the purposes of item 2 of the table in Regulation 40-5.09(3). If the vendor is supplying an interest in a debt, the supply will be input taxed as a financial supply as opposed to being a taxable supply.

Supply of an interest in a debt

65. The GST Regulations contain schedules that provide examples of interests which are likely to be a financial supply. The examples for item 2 which are set out in Schedule 7 of the GST Regulations include a right "to an income stream under a securitisation arrangement". The inclusion of this example suggests that there was a legislative intention to treat assignments of "income streams" as financial supplies.

66. Despite this apparent legislative intent, it is not clear that the assignment of the right to receive income in the future involves an interest in a "debt". The word "debt" is not defined in either the GST Act of the GST Regulations. However, the ATO considers a "debt" to be[34]:

"*An amount due from one entity to another or <u>a presently existing obligation</u> to pay an <u>ascertainable</u> amount <u>at a future time</u>*". (emphasis added)

[34] As defined in the Glossary of Terms set out in Schedule 1 of GSTR 2002/2.

67. In contrast to the definition of the term "incurs a debt" which was determined to apply for the purposes of section 556 of the *Companies (New South Wales) Code*[35], the definition adopted by the ATO is quite narrow. In *Hawkins v Bank of China* (1992) 26 NSWLR 562, the Court held that the word "debt" includes a contingent liability, such as a guarantee[36]. However, the ATO definition of a "debt" does not extend to contingent liabilities.

68. In *Hawkins v Bank of China* it was noted by Kirby P that where there is a choice as to the precise meaning of the word "debt", and the meaning is dependant upon the context of the legislation, "it is a legitimate performance of the Court's task of statutory construction to accept the meaning which advances rather than frustrates the legislature's purpose"[37].

69. As noted above, it would appear that there is a legislative intention to treat assignments of income streams[38], including interests in "future property"[39], as financial supplies. Consequently, if the issue is ever considered by the Courts, it is arguable the Courts will adopt a meaning of the word "debt" which advances rather than frustrates this legislative intent.

70. The Court in *Hawkins v Bank of China* also defined the word "incurs" to include: "the undertaking of an engagement to pay a sum of money at a future time, <u>even if the engagement is conditional and the amount involved uncertain</u>"[40] (emphasis added). This definition, when read in conjunction with the definition of the word "debt", appears to go further than the definition of the word "debt" that has been adopted by the ATO. The ATO definition suggests the amount of the future payment should be "ascertainable".

71. The suggestion that the amount of a future payment must be "ascertainable" before it will be treated as a "debt" could be problematic. For example, a lessee may have an obligation on the first day of a newly granted lease to pay rent for the five year term of the lease. However, the rent for the final two years of the lease may not be readily "ascertainable" on this first day if the

[35] This section was the precursor to section 588G of the Corporations Act 2001.
[36] *Hawkins v Bank of China* (1992) 26 NSWLR 562 at 577 per Kirby P.
[37] *Hawkins v Bank of China* (1992) 26 NSWLR 562 at 577 per Kirby P.
[38] See the examples for Item 2 in Schedule 7 of the GST Regulations.
[39] See example 6 as listed in Regulation 40-5.02 of the GST Regulations.

lease provides for there to be a rent review after the first three years. Also the rent may not be payable for any period during which the rented chattels are unable to be used (ie: if there is an abatement of rent). Applying the ATO definition of the word "debt", the lessor would not be making a financial supply if it assigned its right to receive the rent because the amount payable by the lessee in the future will not be ascertainable.

72. It is noted that even if the supply of a right to receive future income does not involve the supply of an interest in a "debt", the supply may still be a financial supply pursuant to section 9-30(2)(b) of the GST Act. Under this section the supply of a right to "receive a supply that would be input taxed" is also input taxed. Therefore, if the assignment of an income stream involves a supply of right to receive a supply that would be input taxed, the assignment itself will be an input taxed supply.

Supply of an interest in income producing assets

73. To date the GST debate in a securitisation context has been focussed on whether the assignment of an "income stream" involves an assignment of an interest in a "debt" as suggested by the examples for Item 2 in Schedule 7 of the GST Regulations. However, it must be noted that most securitisations do not involve a supply of an "income stream". Rather, a securitisation involves a supply of an interest in an underlying income producing asset.

74. The better view is that when determining whether a securitisation involves a financial supply by the vendor, it is not necessary to determine whether the vendor is assigning an income stream that may be an interest in a debt. Instead it is necessary to analyse the nature of the interest in the underlying income producing asset which is to be assigned. The assignment of an interest in some income producing assets, such as mortgages, will involve a financial supply. However, the assignment of an interest in other assets, such as leased chattels, may be a taxable supply.

[40] *Hawkins v Bank of China* (1992) 26 NSWLR 562 at 572 per Gleeson CJ.

Acquisition-supplies

75. The GST Regulations provide that an entity which has acquired a financial supply is also deemed to make a financial supply[41]. The ATO refers to such supplies as "acquisition-supplies"[42]. While an entity will not be liable for GST on its acquisition-supplies because such supplies are input taxed, the entity may not be entitled to recover full input tax credits for costs which are associated with the making of the acquisition-supply.

76. For example, the assignment of an equitable interest in a mortgage as a part of a securitisation will be a financial supply by the vendor that assigns the interest. The issuing trust which acquires the equitable interest in the mortgages is deemed to also make a financial supply. Therefore the issuing trust has made an input taxed "acquisition-supply". While the issuing trust will not have a GST liability on this supply, the issuing trust may not be entitled to full input tax credits for costs, such as trustee and management fees, that relate to the acquisition of the interest in the mortgages.

Synthetic Securitisations

77. There are alternative securitisation arrangements, such as "synthetic securitisations", that do not involve the supply of an interest in the underlying income producing asset. Rather, the arrangement involves the issuing trust assuming the risk of default in respect of the underlying assets. The issuing trust is paid a fee for assuming this risk. The issuing trust does not acquire any interest in the underlying assets, and therefore does not acquire an interest in any of the items listed in the table for Regulation 40-5.09(3). However, depending upon the terms of the contract between the issuing trust and the entity which holds the income producing asset, it is likely that the issuing trust is making a financial supply by providing an indemnity or guarantee[43].

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[41] This is the effect of Regulation 40-5.06(2) of the GST Regulations which provides that an entity that acquires an interest in a financial supply is also the "financial supply provider" of the interest.
[42] Paragraph 26 of GSTR 2002/2.
[43] The provision of an indemnity or guarantee is a financial supply under Item 7 of the table in Regulation 40-5.09(3).

ISSUES FOR THE ISSUING ENTITY

78. In many securitisations the note issuing entity will be a trust, although in some instances the entity will be a company.

Trust entities

79. The term "entity" is defined in section 184-1 of the GST Act. Section 184-1(g) provides that an "entity" includes a "trust". However, as a trust is not a separate legal person, section 184-1(2) provides that it is the trustee of the trust (being a company or an individual) which is taken to be the GST entity. Pursuant to section 184-1(3), a legal person will be treated as a different GST entity for each of the different capacities in which the person acts.

80. For example, Trustee Company Ltd may be appointed as the trustee of the issuing trust for a particular securitisation arrangement. As the company is carrying on the business of providing trustee services, it will be able to register for GST in its own capacity. However, it is likely the company will also be able to register for GST in a separate capacity as the issuing trustee. Supplies and acquisitions which are made by the company in its capacity as issuing trustee will be treated as having been made by the issuing trust for GST purposes.

Carrying on an enterprise

81. In order to register for GST, the entity must be carrying on an "enterprise". The expression "enterprise" is defined[44] to include *inter alia* an activity or series of activities, done:

- in the form of a business; or

- in the form of an adventure or concern in the nature of trade.

[44] Section 9-20 of the GST Act.

82. The issue of whether an entity is carrying on enterprise such that it is able to register for GST is particularly relevant for issuing trusts. If the issuing trust is not carrying on an enterprise, it will not be able to register for GST and subsequently it will not be entitled to recover input tax credits or RITCs on any of its acquisitions.

83. The Commissioner has released a miscellaneous public ruling, MT 2000/1, which sets out the ATO's view on when an entity will be carrying on an enterprise for the purposes for the *Australian Business Number Act 1999* ("ABNA"). The definition of the term "enterprise" is the same within both the ABNA and the GST Act. The Commissioner has also issued a GST Determination, GSTD 2000/8, which confirms that the Commissioner's views as expressed within MT 2000/1 apply equally in a GST context.

84. If an issuing trust merely holds an interest in some incoming producing assets, it may be that the trust is not carrying on an enterprise[45]. However if, as is usually the case, the issuing trust is providing other services in addition to holding the interest in the assets, it is likely that the issuing trust will be carrying on an enterprise in the form of a business. Such business activities are usually conducted by a manager that is appointed by the trustee of the issuing trust. For example, the business activities of the trust may include collecting income and taking enforcement action in the event of default.

Issuing of notes

85. The issuing of notes by the issuing trust will be a financial supply as the issue of the notes will involve an interest in a "security"[46]. A security includes a "debenture" as that term is defined in section 9 of the *Corporations Act 2001*.

86. Although the issue of the notes will be a financial supply, the issue of the notes will not be an input taxed supply if the notes are issued to either:

- non-resident entities who are not present within Australia when the notes are issued[47]; or

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[45] See the discussion on holding companies which do not provide any services in example 9 from MT 2000/1.
[46] Item 10 of the table in Regulation 40-5.09(3).
[47] Item 2 of the table in section 38-190(1) of the GST Act.

- an entity (including an Australian resident) who is not in Australia when the notes are issued and the "effective use or enjoyment" of the notes takes place outside of Australia[48].

87. To date the ATO has not provided any public guidance on its interpretation of the expression "effective use or enjoyment". The ATO is currently preparing a draft public ruling which is scheduled for release in August 2003 which it is anticipated will address this issue. However, in relation to notes, an entity may be considered to have the "effective use or enjoyment" of those notes if the notes are issued to the entity at a place outside of Australia and the entity continues to receive the benefits of holding the note.

88. In either of the two situations listed above the issue of the notes will be a GST-free supply. Consequently the issuing trust will not have a GST liability on the issue of the notes, however, the issuing trust will remain entitled to recover input tax credits for GST paid on costs, such as trustee and management fees, that are associated with the issue of the notes.

89. If the notes are issued to entities within Australia, the issue of the notes will be an input taxed supply. As the supply will be input taxed, the issue of the notes will not give rise to a GST liability for the issuing trust. However, the issuing trust may not be entitled to recover full input tax credits for GST paid on costs associated with the issue of the notes.

Financial acquisitions threshold

90. If the issuing trust does make an input taxed supply by issuing the notes to an entity within Australia, the issuing trust will nevertheless be entitled to full input tax credits for GST paid on costs which are associated with the financial supply, such as trustee and management fees, (these costs are referred to as "financial acquisitions") if the issuing trust remains below the "financial acquisitions threshold" ("FAT"). To remain below the FAT an entity must not exceed either limb of the FAT test. If the FAT is exceeded, the entity will not be entitled to full input tax credits in relation to its financial supplies unless another exemption or concession (such as the "borrowing" concession) is available.

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[48] Item 3 of the table in section 38-190(1) of the GST Act.

91. The FAT will be exceeded if during any twelve month period:

a) more than $50,000 worth of input tax credits relate to financial acquisitions; or

b) more than 10% of all input tax credits which would otherwise be available relate to financial acquisitions.

92. The twelve month period must be considered on both a prospective and retrospective basis.

93. For example, an issuing trust makes financial acquisitions of $220,000 (including GST of $20,000) during a twelve month period. These financial acquisitions may include management and trustee fees as well as legal and accounting fees. As the input tax credits relating to these financial acquisitions (ie: $20,000) are less than $50,000, the issuing trust will not exceed the first limb of the FAT. However, if the $20,000 input tax credits represent more than 10% of all input tax credits that the issuing trust could claim, as is likely to be the case, the issuing trust will exceed the second limb of the test. Exceeding either limb of the test will mean that the issuing trust exceeds the FAT. It will then be necessary for the issuing trust to determine whether it is entitled to full input tax credits under another provision (such as the "borrowing" concession) or whether it can claim a portion of the input tax credits as reduced input tax credits ("RITCs").

Supplies consisting of a "borrowing"

94. The issuing trust may also be entitled to recover full input tax credits for its financial acquisitions if[49]:

(a) the acquisitions relate to a financial supply consisting of a "borrowing"; and

(b) the borrowing relates to supplies made by the issuing trust which are not input taxed.

[49] Section 11-15(5) of the GST Act.

95. The term "borrowing" is defined by reference to the definition of the word in section 995-1 of the *Income Tax Assessment Act 1997*. The definition provides that "borrowing" means:

"any form of borrowing, whether secured or unsecured, and includes the raising of funds by the issue of a bond, debenture, discounted security or other document evidencing indebtedness".

96. It is clear that the issue of notes by the issuing trust will constitute a borrowing. Therefore, it is necessary to consider the purpose for which the funds have been raised through the issue of the notes. Where the funds are used by the issuing trust to acquire an interest in an income producing asset, and the acquisition involves the issuing trust making an input taxed acquisition-supply, the issuing trust will not be entitled to recover full input tax credits. For example, if the issuing trust acquires an equitable interest in certain mortgages, the acquisition of the interest will be an input taxed "acquisition-supply" and the borrowing concession will not be available.

97. However, if the issuing trust uses the funds to acquire an interest in an income producing asset which does not involve an input taxed "acquisition-supply", the trust will be entitled to recover input tax credits for GST paid on its financial acquisitions that relate to the issuing of the notes.

98. In relation to a synthetic securitisation, it is unlikely that the issuing trust will be entitled to recover full input tax credits for GST paid on financial acquisitions which relate to the issuing of credit linked notes through the borrowing concession. While the issuing of the notes will be a financial supply that consists of a borrowing, the funds raised will usually be invested in an account with a bank with a suitable credit rating. The investment of the funds in this manner will involve the issuing trust making an input taxed "acquisition-supply" such that the borrowing concession will not be available.

Reduced input tax credits

99. Even though the issuing trust may not be entitled to full input tax credits for GST paid on its financial acquisitions, the issuing trust may be entitled to recover at least some percentage of the GST paid as "reduced input tax

credits" ("RITCs"). Where a RITC is available, the issuing trust can recover 75% of the amount of the full input tax credit which would have been otherwise available.

100. An entity is only entitled to RITCs for those financial acquisitions that are prescribed as "reduced credit acquisitions". A list of the prescribed reduced credit acquisitions is set out in the table in Regulation 70-5.02 of the GST Regulations. Relevantly for the issuing trust, such acquisitions include "trustee services" at Item 29 in the table.

101. The ATO has recently released a comprehensive draft public ruling, GSTR 2003/D3, which sets out the ATO's view on when an acquisition will qualify as a "reduced credit acquisition". For the purposes of Item 29 the ATO will accept that trustee services provided in compliance with the terms of the trust deed (if any) are a reduced credit acquisition[50]. However, the ATO has suggested that it will not accept that services provided by the trustee which are outside the scope of services required by the trust deed are a reduced credit acquisition, unless the services provided are separately listed as a reduced credit acquisition under another item within the table[51].

SECURITY TRUST

102. Securitisations also involve a security trust which holds a charge over the income producing assets that have been acquired by the issuing trust. The charge is held for the benefit of the note holders of the issuing trust, with the note holders all being a beneficiary of the security trust.

103. For GST purposes it is necessary to consider whether the security trust is carrying on an enterprise. As the security trust does nothing more than hold a charge over the assets of the issuing trust (unless the issuing trust is in default), it is likely that the security trust is not carrying on an enterprise and that it is unable to register for GST. As a result, the security trust may not be entitled to input tax credits, or RITCs, for GST paid on any acquisitions which are made by the trust. From the perspective of the security trustee this is

[50] Paragraph 667 of GSTR 2003/D3.
[51] Paragraph 668 of GSTR 2003/D3.

unlikely to be a significant issue as the costs of the security trust, including the trustee fee, are usually met by the issuing trust.

104. However, from the perspective of the issuing trust the payment of these costs may be a significant issue . Where the issuing trust meets the trustee fees of the security trustee, the issuing trust will not be entitled to recover the GST paid on the trustee fee as input tax credits or RITCs. This is because the issuing trust will not be the recipient of the security trustee's services, regardless of the fact it is the issuing trust which is paying the trustee fee[52].

NOTE HOLDERS

105. Note holders will not be required to pay GST on their acquisition of the notes because the supply of the notes will be either an input taxed or a GST-free supply. However, for note holders that are GST registered, the acquisition of the notes will be an input taxed "acquisition-supply".

106. While note holders will not have a GST liability on the acquisition-supply made when acquiring the notes, note holders may not be entitled to full input tax credits for GST paid on costs associated with the acquisition of the notes. Such costs may include, for example, legal fees or brokerage fees.

CREDIT RATING ENHANCEMENTS

107. Enhancement techniques are often used to increase the credit rating of the notes that are to be issued. Common techniques include:

- "credit wraps" which involve a third party with a sufficient credit rating providing a guarantee;

- liquidity facilities that provide the issuing trustee with sufficient funds to make any necessary payments;

- subordinated debt arrangements where a third party acquires "junior notes" with a higher risk than the risk attaching to the "senior notes"; and

[52] Section 11-5(b) of the GST Act.

- swap arrangements.

108. Each of these techniques involves the making of input taxed financial supplies. For example, the provision of the guarantee by the entity that is providing the credit wrap will be a financial supply as guarantees are listed in Item 7 of Regulation 40-5.09(3). Similarly, swap arrangements are likely to involve financial supplies on the basis that the arrangement involves the provision of an interest in a "derivate" for the purposes of Item 11 in Regulation 40-5.09(3). As a result these credit enhancements will not attract GST. However, the entities which are involved in these arrangements may not be entitled to full input tax credits for GST paid on costs, such as legal fees, that are associated with the making of the financial supplies or the corresponding acquisition-supplies.

CONCLUSION

109. The above discussion illustrates a number of the complexities which can arise when applying the GST financial supply rules to a securitisation arrangement. To date the ATO has provided little public guidance regarding its view on the application of GST to securitisations. However, it is anticipated that the ATO's position will become more clear following the release of its proposed draft ruling on GST and the assignment of income streams[53]

[53] The ATO has indicated that it is endeavouring to issue the draft version of this ruling by late October 2003 with the final ruling currently scheduled for release in April 2004.