


***TD 2012/D11 - Income tax: does subsection 820-39(3) of the Income Tax Assessment Act 1997 only apply to special purpose entities that have been established for the purpose of carrying on securitisation activity?***

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## Draft Taxation Determination

Income tax: does subsection 820-39(3) of the *Income Tax Assessment Act 1997* only apply to special purpose entities that have been established for the purpose of carrying on securitisation activity?

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### Ruling

1. Yes. Subsection 820-39(3) of the *Income Tax Assessment Act 1997* (ITAA 1997)<sup>1</sup> only applies to special purpose entities (SPEs) that have been established for the purpose of carrying on securitisation activity. If an SPE has been established for the purpose of carrying on activities that are not necessary for, or incidental to, securitisation activity, the SPE will not satisfy subsection 820-39(3).

***Example 1 – securitisation transaction where the SPE acquires an interest in assets and satisfies the conditions of subsection 820-39(3)***

2. Oz Bank, an ADI within the meaning of the *Banking Act 1959*, is seeking to raise funding at a lower cost and obtain regulatory capital relief by securitising a pool of residential mortgage loans. Under its existing program for securitisation transactions, Oz Bank establishes an SPE, the 'JP2 Trust', to enable the trustee of the JP2 Trust to acquire an interest in the mortgage loans that OZ Bank is seeking to securitise. The JP2 Trust is separate and distinct from any other trust established under Oz Bank's securitisation program.

<sup>1</sup> All legislative references in this Taxation Determination are to the ITAA 1997 unless specified otherwise.

3. To fund the acquisition of the interest in the mortgage loans, the trustee of the JP2 Trust issues Class A, Class B and Class C floating rate notes to various institutional investors in the Australian capital markets. The Class A Notes are rated AAA by an internationally recognised ratings agency ('the RA'), the Class B Notes are rated AA by the RA and the Class C Notes are unrated. In terms of the payment of the principal and interest on the notes, the Class C Notes are subordinated to the Class B Notes and the Class B Notes are subordinated to the Class A Notes. Thus, the Class A Notes, being the most senior notes issued, have the lowest risk in terms of payment of interest and repayment of principal while the Class C Notes, being the most junior notes issued, have the highest payment risk. The three different classes of notes are 'debt interests' within the meaning of Division 974.

4. Because the interest on the mortgage loans are a combination of variable and fixed rates of interest and the interest payable on the notes issued by the trustee of the JP2 Trust are floating rate, the trustee of the JP2 Trust has entered into interest rate swaps with Oz Bank to hedge the interest rate risk. Oz Bank has granted a liquidity facility to the trustee of the JP2 Trust to address any timing mismatches that may occur between the cash flows generated on the underlying mortgage pool and the payment of interest on the Class A and Class B Notes. The trustee of the JP2 Trust has granted a floating charge over its interest in the assets of the trust to a security trustee, which holds the benefit of the interest on trust for the noteholders and other transaction creditors.

5. Payments of interest and principal on the notes are made solely from the cash flows on the mortgage loans that have been securitised by Oz Bank and the related liquidity facility entered into by the trustee of the JP2 Trust.

6. Oz Bank has obtained a legal opinion from its legal counsel that the JP2 Trust is an insolvency-remote SPE according to the RA's criteria for assessing the insolvency-remoteness of SPEs in securitisation transactions. This opinion was relied upon by the RA in assigning the credit rating on the notes issued by the trustee of the JP2 Trust.

7. In these circumstances, the JP2 Trust satisfies the requirements of subsection 820-39(3) as it has been established for the purpose of carrying on securitisation activity. All of the activities performed by the trustee of the JP2 Trust form part of, or are incidental to, the securitisation activity. The JP2 Trust is entirely debt funded and is an insolvency-remote SPE according to the relevant securitisation criteria of an internationally recognised rating agency.

8. **Annexure A** contains an illustration of a typical securitisation transaction involving the acquisition of an interest in residential mortgages.

***Example 2 – 'securitised' licence/lease structure where the SPE does not satisfy the conditions in subsection 820-39(3)***

9. As a result of a competitive tendering process undertaken by a State Government, 'BoldCo' was selected as the preferred bidder to undertake the finance, design, construction, operation and maintenance of a new prison. These activities are to be undertaken by BoldCo as part of a public-private partnership (PPP) project financing arrangement.<sup>2</sup>

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<sup>2</sup> A PPP is an arrangement between the public and private sector where the private sector is contracted to design, construct, operate and finance a public infrastructure asset.

10. The structure employed by BoldCo to carry out the project is described as a 'securitised licence/lease' structure. Under this structure:

- BoldCo establishes an SPE 'ConstructCo' (the project vehicle) to carry out the design, construction, operation and maintenance of the prison;
- BoldCo establishes a separate SPE 'SecureCo' to obtain the debt financing for the project;
- the Government grants a licence to ConstructCo to allow ConstructCo to access the designated area of land to construct the prison during the construction phase of the project. Under the terms of the licence, ConstructCo is also permitted to occupy and use the facility in order for ConstructCo to perform maintenance services during the operations phase of the project;
- ConstructCo is obliged to pay a quarterly licence fee to the Government in respect of the licence;
- to enable ConstructCo to fund the construction cost of the prison, ConstructCo borrows funds from SecureCo. In order to provide the loan to ConstructCo, SecureCo has obtained funding from a consortium of Australian banks under a syndicated loan facility;
- SecureCo also enters into a 'securitisation' agreement with the Government under which the Government assigns its right, title to and interest in the licence receivables to SecureCo at the end of the construction phase of the project;
- as consideration for the acquisition of the licence receivables, SecureCo is required to make a lump sum payment – a 'securitisation' payment – to the Government. The amount of the payment is equal to the construction cost of the prison;
- pursuant to a Payment Directions Deed, the Government directs SecureCo to pay the 'securitisation' payment to ConstructCo. This payment direction satisfies the Government's construction payment obligation to ConstructCo;
- SecureCo funds the 'securitisation' payment with funds obtained under the syndicated lending facility; and
- SecureCo also provides ConstructCo with a loan facility to meet the risk associated with the reduction of the 'quarterly service payments' payable by the Government to ConstructCo during the operations phase of the project where maintenance services do not meet agreed performance standards.

11. In these circumstances, SecureCo does not satisfy the requirements of subsection 820-39(3). In particular, SecureCo does not satisfy paragraph 820-39(3)(c) which requires SecureCo to be an insolvency-remote SPE according to the criteria of an internationally recognised rating agency that are applicable to its circumstances. To satisfy the relevant criteria, SecureCo must be established to only perform those activities that are necessary for, or incidental to, the type of activity contemplated by the criteria, that being securitisation activity. SecureCo has been established to carry out activities that are **not** necessary for, or incidental to, securitisation such as sourcing the project debt, the entering into of the payment directions deed and the provision of a loan facility to meet an abatement risk.

12. Additionally, a typical securitisation transaction will involve the issuance by the SPE of debt securities such as bonds, notes or commercial paper to investors to effect the securitisation of assets. In the case of SecureCo, it is not issuing debt securities to raise the funding to carry out the purported securitisation of the licence receivables, rather it is obtaining the funding via a syndicated loan.<sup>3</sup>

13. SecureCo does not also satisfy the conditions to be a 'securitisation vehicle' as defined in subsection 820-942(2).

14. **Annexure B** contains an example of the 'securitised licence/lease' structure commonly used in PPP arrangements.

***Example 3 – synthetic securitisation where the SPE satisfies the conditions in subsection 820-39(3)***

15. In addition to securitising a pool of residential mortgages, Oz Bank (the bank in Example 1) enters into a 'synthetic' securitisation to transfer credit risk associated with a portfolio of corporate loans. To carry out the securitisation, Oz Bank establishes an SPE, the 'B16 Trust' under its existing program for securitisation transactions.

16. The trustee of the B16 Trust issues three classes of credit-linked floating rate notes, YA, YB and YC Notes, to various institutional investors in the Australian capital markets. The Class YA Notes are rated AA by the RA, the Class YB Notes are rated A by the RA and the YC Notes are rated BBB by the RA. The notes constitute 'debt interests' within the meaning of Division 974.

17. The trustee of the B16 Trust utilises the proceeds from the issuance of the notes to invest in AAA rated Australian Government bonds and other highly rated debt securities. The trustee's interest in the assets is charged by the trustee in favour of a security trustee to secure its payment obligations under the notes and obligations to Oz Bank under the credit default swap (see next paragraph).

18. The trustee of the B16 Trust also enters into a credit default swap with Oz Bank linked to the portfolio of credit exposures (the reference assets). Oz Bank makes premium payments to the trustee of the B16 Trust during the term of the swap as consideration for the B16 Trust assuming the credit risk associated with the reference assets (that risk being ultimately assumed by the investors in the notes who expect to derive an enhanced return on their investment from the premium payments and the assets invested in by the trustee of the B16 Trust). If no 'credit events' occur during the term of the swap with respect to the reference assets, the amount payable by the trustee of the B16 Trust to the noteholders on maturity of the notes is the initial principal amount subscribed by the noteholders. Conversely, if credit events do occur, the principal amount due on the notes is to be reduced.

19. Oz Bank has obtained a legal opinion from its legal counsel that the B16 Trust is an insolvency-remote SPE according to the RA's criteria for assessing the insolvency-remoteness of SPEs in securitisation transactions. This opinion was relied upon by the RA in assigning the credit rating on the notes issued by the trustee of the JP2 Trust.

<sup>3</sup> Syndicated lending is a form of 'intermediated' debt as the borrower obtains funding through the intermediation of financial institutions. In contrast, securitisation is an example of 'disintermediated' debt where the borrower obtains funding directly from investors via the issuance of debt securities without the intermediation of any financial institution – see Everett and McCracken 2009, *Banking and Financial Institutions Law*, Lawbook Co, p.596. See also Schwarcz SL, Markell B and Broome LL 2004, *Securitization, Structured Finance and Capital Markets*, LexisNexis, p.206.

20. In these circumstances, the B16 Trust satisfies the requirements of subsection 820-39(3) as it has been established for the purpose of carrying on securitisation activity. All of the activities performed by the trustee of the B16 Trust form part of, or are incidental to, the securitisation activity. The B16 Trust is entirely debt funded and is an insolvency-remote SPE according to the relevant securitisation criteria of an internationally recognised rating agency.<sup>4</sup>

**Date of effect**

21. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

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**Commissioner of Taxation**19 December 2012

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<sup>4</sup> If the B16 Trust did not satisfy subsection 820-39(3) on the basis of, for example, a failure to satisfy paragraph 820-39(3)(b) or (c) but is otherwise a bona fide securitisation vehicle, it would not be able to satisfy the definition of 'securitisation vehicle' in subsection 820-942(2).

## Appendix 1 – Explanation

**❶** *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

22. Section 820-39 exempts *certain* SPEs from the application of the thin capitalisation rules in Division 820. Specifically, subsection 820-39(1) provides that the thin capitalisation rules do not apply to disallow any debt deductions of the entity if the entity meets the conditions in subsection 820-39(3) throughout the income year.

23. The conditions in subsection 820-39(3) are:

- (a) the entity is one established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself);
- (b) the total value of debt interests in the entity is at least 50% of the total value of the entity’s assets; and
- (c) the entity is an insolvency-remote special purpose entity according to the criteria of an internationally recognised rating agency that are applicable to the entity’s circumstances.

24. By virtue of subsection 820-39(4), the condition in paragraph 820-39(3)(c) can be met without the rating agency determining that the entity meets those criteria.

25. Subsection 820-39(3) is to be construed by reference to the language of the text adopted by Parliament, its context (interpreted in the widest sense) and the underlying purpose or policy of the provision (as found in the text or relevant extrinsic material).<sup>5</sup>

### Background to the introduction of subsection 820-39(3)

26. Subsection 820-39(3) was inserted into the ITAA 1997 by the *Taxation Laws Amendment Act (No.5) 2003*. The purpose for its introduction was to address the narrow or restrictive scope and operation of the definitions of ‘securitisation vehicle’ and ‘securitised asset’ in section 820-942. The extrinsic material which accompanied the introduction of subsection 820-39(3)<sup>6</sup> explains that the definitions of ‘securitisation vehicle’ and ‘securitised asset’ meant that a variety of bona fide securitisation vehicles and structures would not be able to take advantage of the benefits of the zero capital treatment provided under section 820-942.<sup>7</sup>

<sup>5</sup> *K & S Lake City Freighters Pty Ltd v. Gordon & Gotch Ltd* (1985) 157 CLR 309; (1985) 60 ALR 509; *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384; (1997) 141 ALR 618; *HP Mercantile Pty Ltd v. Commissioner of Taxation* (2005) 143 FCR 553; 2005 ATC 4571; (2005) 60 ATR 106; *Alcan (NT) Alumina Pty Ltd v. Commissioner of Territory Revenue* [2009] HCA 41; (2009) 239 CLR 27; *FC of T v. BHP Billiton Ltd & Ors* [2011] HCA 17; 2011 ATC 20-264; (2011) 79 ATR 1; *Consolidated Media Holdings Ltd v. Commissioner of Taxation* [2012] FCAFC 36 and section 15AA of the *Acts Interpretation Act 1901*.

<sup>6</sup> Explanatory Memorandum (EM) to the Taxation Laws Amendment Bill (No 5) 2003.

<sup>7</sup> The zero capital amount provides a carve out of certain assets from the thin capitalisation regime and as a consequence allows full debt funding of those qualifying assets. Assets held by a securitisation vehicle are included in the zero capital amount provided that the definitions of ‘securitised asset’ and ‘securitisation vehicle’ as set out in section 820-942 are satisfied.

27. Relevantly, paragraphs 1.6 and paragraph 1.7 of the EM make the following statements in relation to the reasons for the introduction and intended operation of subsection 820-39(3):

1.6 The securitisation industry is complex and dynamic. **Many securitisation programs** are not able to avail themselves of the benefits of the zero capital treatment provided under the thin capitalisation legislation. **In particular**, the current definitions do not contemplate origination, warehousing, two-tiered securitisation or synthetic securitisation. Nor do the current rules allow any residual equity holding in a securitisation vehicle. As a consequence, many **bona fide securitisation vehicles** will inappropriately have a proportion of their interest deductions denied under the thin capitalisation rules.

1.7 **To address this**, amendments will exclude special purpose entities from the thin capitalisation rules for all or part of the income year provided that the following conditions are met:

- 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 assumes the risk from another entity or creates the risk itself);
- at least 50% of the entity's assets are funded by debt interests; and
- 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. (emphasis added)

28. In relation to the intended scope and operation of subsection 820-39(3), paragraph 1.14 of the EM further states:

The three conditions in subsection 820-39(3) seek to cover a broad and ever expanding range of securitisation activity and structures. For example, the conditions seek to include a warehousing type entity where securitised assets are temporarily placed pending their transfer to another entity. The conditions also seek to cover a two tiered securitisation structure where one entity holds the securitised assets and the other entity issues the debt interests.

29. The Senate Economics Legislation Committee report into the Provisions of the Taxation Laws Amendment Bill (No.5) 2003 (the SELC report) echoes the statements made in the EM regarding the intended scope and operation of subsection 820-39(3). For example, paragraphs 2.16 and 2.21 of the SELC report relevantly states:

2.16 This Bill, will, if passed, exempt certain special purpose entities, in particular, '*securitisation vehicles*' from the operation of the thin capitalisation regime.

...

2.21 As explained in the explanatory memorandum, this condition seeks to ensure that the entity (i.e. the **securitisation vehicle**) meets or would meet an internationally recognised rating agency's requirements for an insolvency remote special purpose entity (that is, that the possibility of the entity becoming insolvent is remote). [emphasis added]

### **Paragraph 820-39(3)(c)**

30. Paragraph 820-39(3)(c) is of critical importance to the interpretation of subsection 820-39(3). It gives specific effect to the policy intention that only those SPEs that have been established for the purpose of carrying out securitisation activity will satisfy subsection 820-39(3).



31. To satisfy paragraph 820-39(3)(c), the entity must be an insolvency-remote SPE according to criteria of an internationally recognised rating agency that are applicable to the entity's circumstances. Significantly, the three major internationally recognised rating agencies<sup>8</sup> have published specific criteria for assessing or determining the insolvency-remoteness of SPEs only in relation to a particular type of activity – securitisation activity. It therefore follows that if an SPE has not been established to carry out securitisation activity, the criteria to which paragraph 820-39(3)(c) is referring will **not** be applicable.

*The concept of 'insolvency-remoteness'*

32. The concept of 'insolvency-remoteness'<sup>9</sup> is a fundamental tenet or cornerstone of almost all securitisation transactions and structures.<sup>10</sup> The basis for this principle relates to the essence of a securitisation transaction, which is the structural and legal isolation or 'de-linking' of an underlying pool of assets from the insolvency risk of the originator of those assets (whether actually or synthetically), so that the holders of the securitised debt (the investors) may continue to benefit from the cash generated by such assets, notwithstanding the insolvency of the originator.<sup>11</sup> In their criteria for assessing the insolvency-remoteness of SPEs in securitisation transactions, the three previously mentioned rating agencies emphasise the importance of the transaction being structured to ensure that the SPE is 'insolvency-remote'.

33. For example, in their report or criteria for analysing insolvency-remote SPEs in securitisation transactions, Fitch state that:

Structured finance transactions rely on the concept of a bankruptcy-remote SPV to enhance the likelihood of separation of the SPV from its parent and other affiliates, and the separation of the assets from the originator and any related party, in the event of the insolvency of any such entities.<sup>12</sup>

34. Fitch further state that:

The aim of structured finance transactions is to enable noteholders to benefit from the assets in a specific pool by de-linking those assets and their associated rights from the credit risk of the originator, the SPV's parent, or any other affiliates.

Isolation of the financial assets serves to identify the assets supporting the noteholders' claims, to protect them from the claims of others and to improve control of the cash flows.<sup>13</sup>

<sup>8</sup> Fitch Ratings (Fitch), Standard & Poor's (S&P) and Moody's.

<sup>9</sup> Or 'bankruptcy-remoteness'.

<sup>10</sup> de Vries Robbé, JJ 2008, *Securitization Law and Practice – In the Face of the Credit Crunch*, Wolters Kluwer, p.15. See also Schwarcz SL, Markell B and Broome LL 2004, *Securitization, Structured Finance and Capital Markets*, LexisNexis, p.5.

<sup>11</sup> Standard & Poor's, 'Structured Finance Guide to Legal Issues in Rating Australian Securitization' (March 2005) p.2; Fitch Ratings, 'Criteria for Special-Purpose Vehicles in Structured Finance Transactions' (30 May 2012) p.1; Bank for International Settlements, 'The role of ratings in structured finance: issues and implications' (Report submitted by a Working Group established by the Committee on the Global Financial System, January 2005) p.1.

<sup>12</sup> Fitch Ratings, p.2. While 'securitisation' is a form or subset of 'structured finance', the two concepts are often equated with each other or used interchangeably. In Fitch's criteria for analysing bankruptcy-remote SPVs in structured finance transactions, the reference to a structured finance transaction is a reference to a securitisation transaction. See, for example, page 2 of the criteria where it is stated that 'The successful establishment and operation of an SPV is fundamental to any securitisation transaction' and page 3 where it stated that 'A newly formed SPV created for a specific securitisation transaction will, by definition, not be encumbered by any previous operating history.'

<sup>13</sup> Page 7.

35. Likewise, in their criteria for rating securitisation structures involving asset-backed commercial paper (ABCP), Fitch state that:

An ABCP program consists of a bankruptcy-remote, special purpose vehicle (SPV), or conduit ...<sup>14</sup>

36. In the equivalent S&P guide which sets out what S&P consider to be the key legal issues in rating securitisation transactions in Australia (one of those legal issues being the 'concept of insolvency-remoteness of special-purpose securitization vehicles'),<sup>15</sup> S&P state that:

To achieve 'insolvency-remoteness' of underlying assets from their originator, and for the issued instruments to have the potential to be rated higher than the originator, the benefit of the underlying assets must be transferred to a securitization entity – a special purpose entity (SPE) – in a manner that creates complete legal independence from the originator. Insolvency remoteness then allows credit analysis to focus on the credit quality of the underlying assets independent of the commercial viability of the originating transferor or the potential claims of any of its creditors.<sup>16</sup>

...

The SPE criteria emphasise minimization of the risk of voluntary or involuntary insolvency or bankruptcy of the SPE – the state that is referred to as being insolvency remote or bankruptcy remote.<sup>17</sup>

37. And further:

Transferring underlying assets into a securitization structure in a way that establishes complete legal independence from the originating transferor and that will survive the liquidation, winding-up, or other demise of the transferor is fundamental to securitization.<sup>18</sup>

38. In Moody's guide to rating securitisation structures involving ABCP, Moody's states that:

In its ratings process, Moody's reviews the corporate structure of the conduit SPV in order to determine that it is organized to promote 'bankruptcy remoteness'.<sup>19</sup>

*The SPE must only be established for the purpose of performing activities that are necessary for, or incidental to, securitisation*

39. In assessing the insolvency-remoteness of SPEs in securitisation transactions, the aforementioned rating agencies place significant emphasis on the SPE being established to only carry out those activities that are necessary for, or incidental to, the SPE's role in the transaction.

40. For example, in their criteria, Fitch state the following under the heading 'Limitation on Activities':

Fitch expects restrictions to be in place in the transaction that will preserve the future independence of the SPV. It is also expected that these restrictions will limit the business

<sup>14</sup> Fitch Ratings, 'Global Rating Criteria for Asset-Backed Commercial Paper', (10 November 2011) p.1.

<sup>15</sup> Page 1. On page 3 of the criteria, S&P state that the 'impact of the applicable insolvency regime(s) on a securitization structure is the central legal concern for any rating analysis'.

<sup>16</sup> S&P, p.7.

<sup>17</sup> Ibid.

<sup>18</sup> Page 15.

<sup>19</sup> Moody's, 'Moody's Approach to Rating Asset-Backed Commercial Paper', (3 February 2003), p.27.

the SPV may engage in to only what is necessary for it to perform its obligations under the transaction documents.<sup>20</sup>

41. In the context of stating that they do not assign credit ratings to SPEs in securitisation transactions, Fitch further states that:

Fitch does not assign credit ratings to SPVs in structured finance. This is because the SPV has no economic substance of its own; its assets are segregated, **it conducts no business other than its participation in the structured finance transaction and it is restricted from assuming liabilities other than the issuance of the notes that form part of the structured finance transaction.** The SPV therefore has no senior unsecured liabilities of its own that any rating could address ... [emphasis added]

42. Likewise, S&P in their equivalent criteria state the following under the heading 'Contractual restrictions':

The fundamental characteristic of a special purpose-entity is that it is restricted as much as possible to only the activities necessary to perform the transaction [i.e. the securitisation transaction]. Activity restrictions are designed to reduce the risk that an SPE may become insolvent from claims unrelated to the securitized assets or the issuance of the rated securities. In other words, the SPE should not, and should not be permitted to, engage in business activities that do not relate to the underlying assets unless the parties to the transaction are willing to allow the rating on the issued instruments to reflect the potential effect of those unrelated activities on the entity's ability to meet its rated obligations. Consequently, an SPE should not engage in any business or activity other than what is necessary for, or incidental to, its role in the transaction.<sup>21</sup>

43. Moody's in their criteria for ABCP state that:

... and the SPV's purpose should be limited to issuing commercial paper and using the proceeds to purchase or make loans against assets. Only those activities related to and necessary for that purpose should be permitted.<sup>22</sup>

44. In terms of paragraph 820-39(3)(c), it therefore follows that if an SPE has been established to perform activities other than those activities that are necessary for, or incidental to, securitisation activity, the SPE will not satisfy the requirements to be an insolvency-remote SPE according to the relevant rating agency criteria.

### **Paragraph 820-39(3)(a)**

45. Having regard to the policy intent underlying subsection 820-39(3) and the wording of paragraph 820-39(3)(c), paragraph 820-39(3)(a) supports the view that only those SPEs that have been established for the purpose of carrying on securitisation activity will satisfy the requirements of subsection 820-39(3). Paragraph 820-39(3)(a) requires that the entity is one established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself).

46. Specifically, the bracketed wording in paragraph 820-39(3)(a) '**whether the entity assumes the risk from another entity or creates the risk itself**' articulates the breadth of potential securitisation arrangements that the legislature is intending to cover. Whilst there are many different ways in which securitisation transactions can be structured, a securitisation transaction often involves an SPE being established to either **assume** (then

<sup>20</sup> Page 6.

<sup>21</sup> Page 8.

<sup>22</sup> Page 27.

manage) the economic risk associated with assets, liabilities or investments of another entity or the SPE being established to **create** (then manage) the risk itself.

*Securitisation structures where the SPE **assumes** the risk from another entity*

47. Two commonly recognised categories of securitisation structures where the SPE is established for the purpose of assuming the risk associated with assets, liabilities or investments from another entity then managing that risk include ‘true sale’ and ‘synthetic’ securitisations.<sup>23</sup>

48. In a typical ‘true sale’ or ‘funded’ securitisation, the SPE issues debt securities (bonds, notes, commercial paper) to investors. The proceeds from the issuance of the securities are then used by the SPE to acquire an interest in assets (such as residential mortgages) from the ‘originator’ of those assets. Along with the interest in the assets, the risk associated with the assets (typically credit risk) passes to the SPE. That risk, in turn, is assumed by the investors as the SPE’s ability to meet its principal and interest obligations in respect of the securities depends upon the acquired assets generating sufficient cash-flows.<sup>24</sup>

49. Under a ‘synthetic’ securitisation, credit risk is transferred, typically, by the originator of certain assets to the SPE independent of the assets to which the risk relates.<sup>25</sup> Unlike a ‘true sale’ securitisation where the SPE acquires both an interest in the assets and risk associated with the assets, the SPE in a synthetic securitisation only acquires or assumes the credit risk associated with the assets. To fund its assumption of the risk, the SPE issues debt securities to investors.<sup>26</sup> The proceeds from the issuance of the securities are used by the SPE to invest in high quality assets to enable the SPE to meet its payment obligations to the investors,<sup>27</sup> as well as to the originator in the case of an event to which the transferred risk occurs. The credit risk assumed by the SPE is passed on to investors by making, typically, the payment of the principal amount of the securities dependent upon that risk not eventuating.<sup>28</sup>

*Securitisation structures where the SPE **creates** the risk itself*

50. There are securitisation structures where the SPE is established to create, and then manage, the economic risk associated with assets, liabilities or investments rather than assuming the risk from another entity. This will be the case where the SPE ‘originates’ the

<sup>23</sup> In this Taxation Determination, the use of expressions such as ‘true sale’ securitisation or ‘synthetic’ securitisation are not intended to have or convey any specific legal, regulatory or accounting meaning. They are shorthand expressions which are intended to describe what is commercially occurring under the particular securitisation structure and to differentiate the structure from other types of securitisation structures.

<sup>24</sup> The SPE’s other liabilities in a ‘true sale’ securitisation will also include those relating to any interest rate, basis and/or cross-currency swaps entered into by the SPE.

<sup>25</sup> de Vries Robbé, JJ 2008, *Securitization Law and Practice – In the Face of the Credit Crunch*, Wolters Kluwer, p.333. In a synthetic securitisation, the transfer of risk from the originator to the SPE is generally achieved by a credit default swap. The originator pays the SPE a fee or premium for entering into the swap. Apart from a credit default swap, the transfer of risk from the originator to the SPE in a synthetic securitisation may be effected by a total return swap.

<sup>26</sup> Credit-linked notes are the debt securities issued to the investors in a synthetic securitisation.

<sup>27</sup> The fee paid by the originator to the SPE for the latter’s assumption of the risk associated with the reference assets is also used by the SPE to meet its payment obligations to the investors.

<sup>28</sup> de Vries Robbé, JJ 2008, *Securitization Law and Practice – In the Face of the Credit Crunch*, Wolters Kluwer, p.334.

assets to be securitised.<sup>29</sup> For example, an SPE will often originate assets into a 'warehouse' facility or portfolio for an interim period pending the securitisation of those assets.<sup>30</sup> In order to raise the funding necessary to originate the assets, the SPE issues debt securities to investors.

### Notes following subsection 820-39(4) and subsection 820-942(2)

51. A contextual aspect that supports the view that subsection 820-39(3) only applies to SPEs that have been established to carry on securitisation activity is Note 2 that follows subsection 820-39(4) and the Note following the definition of 'securitisation vehicle' in subsection 820-942(2).<sup>31</sup> By virtue of subsection 950-100(1), notes following provisions form part of the ITAA 1997.

52. Note 2, which follows subsection 820-39(4), states:

Note 2: An entity that does not qualify for the exemption in this section may still be a securitisation vehicle under subsection 820-942(2), in which case the value of its securitised assets will count towards its zero-capital amount under Subdivision 820-K.

53. The Note following the definition of 'securitisation vehicle' in subsection 820-942(2) states:

Note: An entity that does not qualify as a securitisation vehicle may be exempt from the thin capitalisation rules under section 820-39.

54. Thus in the situation where an SPE has been established to carry on securitisation activity but does not satisfy the conditions in subsection 820-39(3), it may be a securitisation vehicle within the meaning of subsection 820-942(2) (if the relevant conditions are satisfied) with the consequence that its securitised assets<sup>32</sup> will count towards its zero-capital amount.<sup>33</sup> Conversely, if the SPE has been established to carry on securitisation activity but does not satisfy the conditions to be a securitisation vehicle within the meaning of subsection 820-942(2), it may nevertheless be exempt from the operation of the thin capitalisation rules if the entity satisfies the conditions in subsection 820-39(3).

<sup>29</sup> de Vries Robbé, JJ 2008, *Securitization Law and Practice – In the Face of the Credit Crunch*, Wolters Kluwer, p.28. See also submission by the Australian Securitisation Forum dated 13 April 2006 in relation to the Anti-Money Laundering and Counter-Terrorism Financing Bill 2005.

<sup>30</sup> ASF submission, p.6.

<sup>31</sup> An entity is a 'securitisation vehicle' within the meaning of subsection 820-942(2) if all of the following conditions are satisfied:

- (a) it is an entity established for the purposes of acquiring, funding and holding securitised assets; and
- (b) it has acquired the assets from another entity (the **originator**); and
- (c) the acquisition of the securitised assets is wholly funded by the issuing of debt interests by the entity; and
- (d) in issuing the debt interests, the entity does not receive any guarantee, security or other form of credit support from any of its associate entities, the originator or any associate entity of the originator; and
- (e) the entity has not issued the debt interests for any purpose other than for the purpose of funding the acquisition of the securitised assets; and
- (f) there are no debt interests issued to the entity by any of the entities associate entities, the originator or any associate entity of the originator; and
- (g) any arrangements the entity has with any of its associate entities, the originator or any associate entity of the originator are those that would reasonably be expected to have been entered into by parties dealing at arm's length with each other.

<sup>32</sup> As defined in subsection 820-942(3).

<sup>33</sup> An SPE that does not conduct securitisation activity will not have 'securitised assets'.

## Securitisation

55. The concept of securitisation has been defined in various ways. For example, de Vries Robbé defines securitisation as:

...a financing technique in which the cash flow from an underlying pool of exposures is used to service at least two tranches of notes reflecting different degrees of risk. A key aspect of securitization is that the creditworthiness of the notes is de-linked from the credit risk of the originator.<sup>34</sup>

56. APRA in their Prudential Standard on securitisation (APS 120) define the concept as:

[a] structure where the cash flow from a pool is used to service obligations to at least two different tranches or classes of creditors (typically holders of debt securities), with each class or tranche reflecting a different degree of credit risk (i.e. one class of creditors is entitled to receive payments from the pool before another class of creditors) ...

57. The RBA has defined securitisation as:

Asset securitisation – the process of converting a pool of illiquid assets, such as residential mortgages, into tradeable securities ...<sup>35</sup>

58. In *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.*,<sup>36</sup> the Court of Appeal of Ontario made the following observations regarding the nature and process of securitisation involving ABCP:

... the securitization process is a hybrid phenomenon: it is a part sale (the originating company transfers its assets to the SPV) and part borrowing (the SPV borrows money from the public through commercial paper issued on the security of the transferred assets).

...

... it is important to be alert to the nature of the securitization process as a whole. A securitization transaction is more than any one of its constituent components. ... securitization may be viewed as, in essence, a capital market financing device whereby moneys are raised by a company through borrowings from the public, albeit against the security of assets sold by the company to an intermediary party. The sale of the transferred assets – which may well be a ‘true sale’ in the legal sense – is merely one element of the securitization transaction, part of the mechanics of effecting the overall purpose.

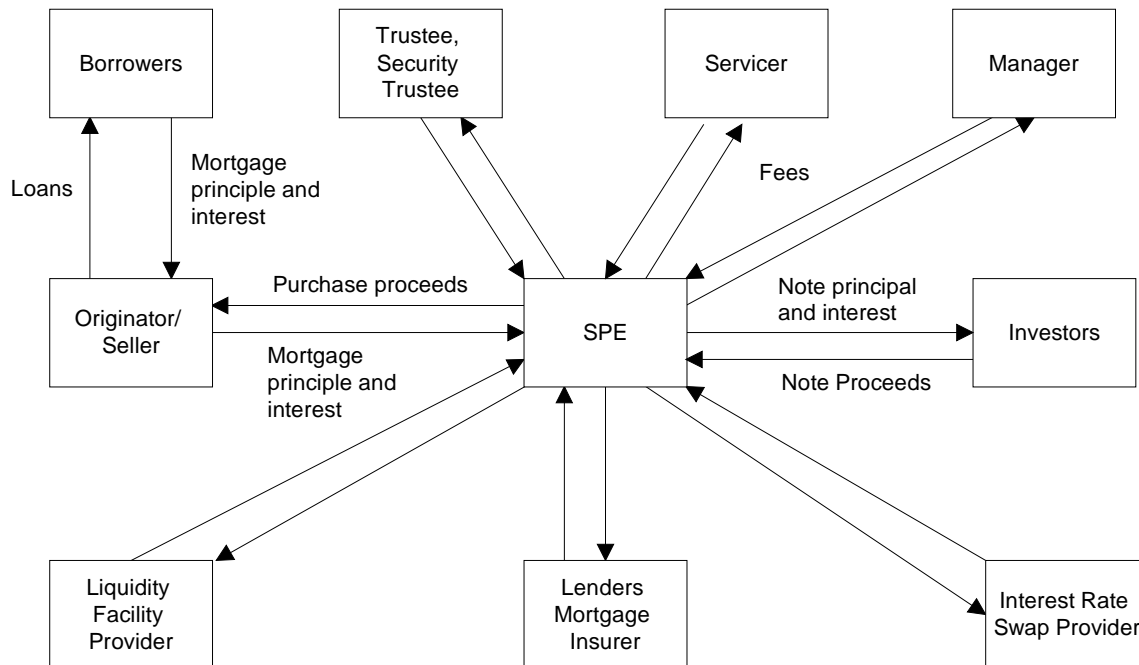
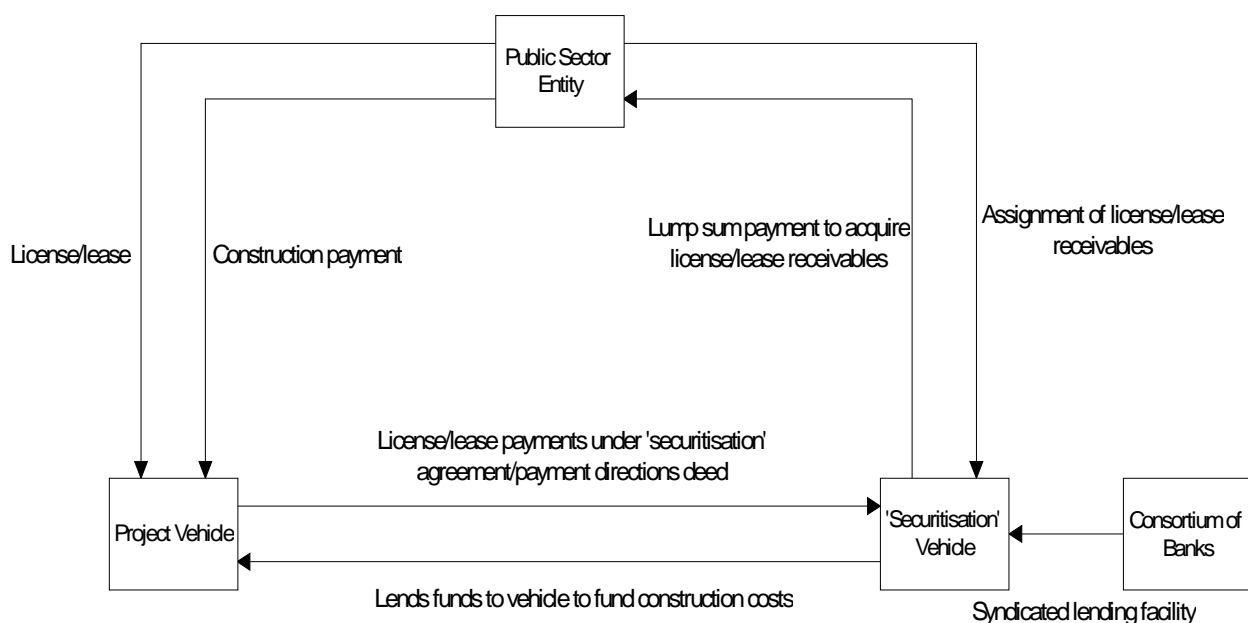
...

What makes a securitization effective for its purposes is the constellation of any number of features, only one of which is the sale by the originating company [of the assets to be securitized] to the SPV ... **The assets do not become ‘securitized’ until they have in effect been transformed by the SPV into negotiable securities issued to the public in the financial markets.** The transaction is not completed until the funds borrowed from the public are transferred to the originating company in payment for the purchase price for the assets. (emphasis added)

<sup>34</sup> de Vries Robbé, JJ 2008, *Securitization Law and Practice – In the Face of the Credit Crunch*, Wolters Kluwer, p.3.

<sup>35</sup> Bailey, K, Davies, M, Dixon Smith, L ‘Asset Securitisation in Australia’, *Financial Stability Review*, September 2004, pp. 48-56, at p. 48.

<sup>36</sup> [2005] 75 O.R. (3d) 784.

**Annexure A****Securitisation structure involving acquisition of residential mortgages****Annexure B****'Securitised' License/Lease Structure**

### **Appendix 3 – Your comments**

59. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

60. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at [www.ato.gov.au](http://www.ato.gov.au)

61. Please advise if you do not want your comments included in the edited version of the compendium.

**Due date:** 13 February 2013  
**Contact officer:** Peter Bou-Samra  
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Sydney NSW 2000



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### *Previous draft:*

Not previously issued as a draft

### *Related Rulings/Determinations:*

TR 2006/10

### *Subject references:*

- debt deductions
- insolvency-remote special purpose entities
- securitisation vehicles
- thin capitalisation
- zero-capital amount

### *Legislative references:*

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- ITAA 1997 Div 820
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