

The Brief

September 2006

The Securitisation Group

New tax rules for UK securitisation SPVs

The UK Government is introducing a new tax regime for securitisation SPVs which will provide greater certainty and simplicity on the tax position of SPVs taxed in the UK and may avoid the need for offshore vehicles.

Following a lengthy and constructive consultation process, the UK Government has now published a second draft of regulations introducing a new tax regime for UK securitisation SPVs, to take effect for accounting periods beginning on or after 1 January 2007. It will apply to new and existing vehicles which fall within certain specific categories. This is a summary of the new regime as proposed at the date of writing - but please bear in mind that the rules may be amended before the legislation takes effect.

If you want further information on the new rules, please contact Anthony Davis, Tel. +44 (0)20 7826 9770 - E-mail: adavis@gide.com.

Executive summary

The new regime for UK securitisation vehicles will apply to many vehicles involved in securitisation structures which involve an issue of bonds on the capital markets and which are taxed in the UK. The effect will be that the company will be taxed on the actual profit it retains under the terms of the arrangement (normally a minimal amount) and not on its profit as determined for accounting purposes. Relief will be given for interest on non-recourse debt. The regime will apply to Issuers of bonds which hold financial assets such as loans, receivables and derivatives (but excluding shares) and to companies which act as intermediate companies between Issuers of bonds and companies holding other forms of assets. It may be extended, after further consultation, to companies which hold real estate or leased assets.

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Some history

Until now, the tax treatment of SPVs set up for securitisations in the UK has been determined by the usual rules for UK corporate taxpayers, as supplemented by some ambiguous guidance given by the Inland Revenue in the 1980s. While it has generally been possible to structure deals so that a clean opinion can be given on the tax consequences to the required rating agency level, in some cases the existence of certain features of the UK tax regime has made the use of vehicles in the UK problematic. An example is that the Revenue has for a number of years maintained that interest on non-recourse debt is not tax deductible so that many Issuers have had to be established in jurisdictions such as tax havens, Ireland or the Netherlands where the regime is more favourable, even if they hold UK assets.

Background

The temporary regime

The introduction of International Accounting Standards ('IAS'), and the modification of UK generally accepted accounting practice ('GAAP'), gave rise to concerns that securitisation companies might suffer unexpected tax charges as a result of the uncertain application of the new accounting rules. The effect of IAS 39 (which prescribes principles for recognising and measuring financial instruments) was to introduce a much greater level of volatility to the profits of securitisation companies and consequently the taxation of such companies. Under IFRS, debt, assets and liabilities which economically match one another over the life of a securitisation company do not necessarily have matching accounting treatment each year.

This uncertainty has the potential to impact negatively credit ratings and in some cases could have resulted in actual tax charges even though the overall profit of a vehicle might be negligible. This is because the UK tax treatment of many types of assets held by securitisation vehicles, including, in particular, loan assets, depends on the accounting treatment.

The potential impact of the changes to accounting practice led to the introduction of a temporary regime, in section 83 of the Finance Act 2005, under which securitisation companies are taxed under the 'loan relationship' rules in the Finance Act 1996 as if their accounts were prepared under 'old' UK GAAP as it stood on 31 December 2004. This was planned as a temporary measure while consultation and drafting work on a new regime was carried out.

Extension of the temporary regime

The temporary measures in the Finance Act 2005 were due to end on 31 December 2006. Delays in the drafting of the new legislation led to the Finance Bill 2006 containing measures to extend the temporary regime for a further year until the end of 2007. This will now be superseded by the new Regulations which will take effect for accounting periods beginning on or after 1 January 2007. Transitional treatment for existing vehicles is proposed in a limited number of cases, and details are still under discussion.

The new regime

What companies will benefit from the new regime?

The new regime will cover five categories of companies provided that they meet certain conditions, including a 'payment condition' (described below). They must also not, at any time, have an 'unallowable purpose' consisting of, broadly, being a party to a capital market arrangement for a tax avoidance purpose consisting of securing a tax advantage for any other person.

Of the categories of company eligible for the favourable treatment under the regime, the most important is the '**note-issuing company**' (referred to below for convenience as 'Issuer'). The requirements which apply to this category of company are:

- Issuer must be a party as a debtor to a 'capital market investment', where securities are issued and where this is part of a 'capital market arrangement.' These terms have the same meaning as under insolvency law (in relation to the power to appoint an administrative receiver) and will be satisfied in most cases likely to arise. The definition requires, among other things, that the 'capital market investment' must be:
 - Rated by an internationally recognised rating agency,
 - Listed on the official list,
 - Traded on a recognised investment exchange or a foreign market or,
 - Consist of a bond or commercial paper issued to one or more persons falling within the relevant regulatory rules (investment professionals, high net worth individuals and companies, persons in foreign states permitted under their own law to invest in bonds or commercial paper).

- The total value of the capital market investments in question must be at least £10 million.
- The securities must be issued wholly or mainly to 'independent persons' - that is, persons not 'connected with' Issuer for tax purposes.
- Issuer's only business must be: (a) being a debtor under the capital market investment; (b) acquiring, holding and managing 'financial assets' or acting as guarantor of certain liabilities and (c) incidental activities.
- Issuer must have a 'retained profit.'

The concepts of 'financial assets' and 'retained profit' are discussed further below.

Apart from an Issuer, the other categories of company within the regime are:

- An **'asset-holding company'** - one whose business consists of acquiring, holding and managing financial assets for the purposes of the capital market arrangement entered into by Issuer, and whose liabilities representing debts are owed either to Issuer or to a company in the next category. An example of a company in this category is a company set up in the UK which holds UK situated assets such as loans, trade debts or other receivables, which is funded by a multi-jurisdictional Issuer.
- An **'intermediate borrowing company'** - one whose business is to make loans to asset-holding companies as an intermediary between it and the Issuer. In this case the asset-holding company to which it makes loans does not have to hold financial assets, so an example of this category is an intermediate company in a whole business securitisation.
- A **'warehouse company'** - one whose business is acquiring financial assets to transfer to an asset-holding company or an Issuer, or will become an Issuer.
- A **'commercial paper funded company'** - one which was an asset-holding company or intermediate borrowing company but whose obligations have been transferred to or replaced by obligations to one or more banks.

What assets can they hold?

The regime will apply to companies which hold 'financial assets'. The Government has undertaken to consult on the possibility of extending the regime to companies which hold real estate or leased equipment.

The definition of financial assets has not been finalised; however, it is likely to rely on the accounting definitions and will therefore include debts and all forms of financial receivables and derivatives. It will not include shares or the proceeds of sale of non-financial assets.

What profit will be taxed?

Under the new regime, securitisation companies which satisfy the relevant conditions will be taxed on their 'retained profit'. This means the amount required by the capital market arrangement in question to be retained or designated as profit. Essentially, this means the profit actually made, as demonstrated by the documentation relating to the securitisation, unless the company does not make that profit in which case the taxable profit will be a lower amount, if any. The taxable profit will thus be the actual commercial profit - which will normally only be a minimal amount required to demonstrate corporate benefit - rather than any greater or lesser amount in a particular year derived from accounting principles.

This level of taxable profit compares favourably with the regimes in other jurisdictions, notably Ireland, Netherlands and Luxembourg. A table comparing the tax treatment of the different regimes is found at the end of this briefing note.

The 'payments condition'

The payments condition, like the concept of retained profit, is fundamental to the tax treatment under the new regime. The intention is that the company must pay out in any accounting period, or the following 18 months, all amounts which it has received in that accounting period except for amounts needed to provide for losses or expenses or for credit enhancement or the 'retained profit'. Payments which are not made because of a legal prohibition or where there is a reasonable excuse for the failure to make them are treated as paid out for the purpose of satisfying the condition. It is expected that compliance with this condition will be verified for the purposes of any tax opinion by reference to the transaction documents including the waterfall and any cash flow model.

Non-recourse loans

A problem with forming securitisation vehicles in the UK has been the risk that interest could be disallowed as a deduction for tax purposes because it depended on the results of the company's business which, as the Revenue has stated, may be the case with a non-recourse loan.

Under the new regime the relevant statutory provision (section 209(2)(e)(iii) of the Income and Corporation Taxes Act 1988) is disappplied to securitisation companies.

Effect of the new rules on groups

The detailed application of the new rules to securitisation companies which are part of a group has not been finally decided. It is, however, intended that the regime will apply to securitisation companies which are part of a group, and the rules therefore disapply the rules concerning group relief for losses. However, amendments to other provisions may also need to be included before the draft rules become final.

Insurance SPV's

Consultations are continuing on the application of the rules to insurance securitisation vehicles permitted by recent regulatory changes. These are vehicles which carry on business as pure reinsurers and which finance their obligations by the issue, indirectly or through other securitisation companies, of capital market investments.

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