

LEGAL IMPLICATIONS OF TAX SECURITIZATION TRANSACTIONS IN INDIA

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Abstract

One of the most recent tactics to hit the financial markets in India is debt or asset securitization. Under asset securitization, a financial institution pools and packages individual loans and receivables creates securities against them, gets them rated, and sells them to the investors in the market, while the transactions involved during securitization attract taxation. Taxation issues surrounding securitization transactions have not been clearly clarified in the relevant tax laws in so far as regulations of securitizations are concerned (i.e., securitization transactions governed by RBI regulations or regulations of the Securities and Exchange Board of India (SEBI), the capital markets regulator). For instance, a lack of clarity in taxation provisions with respect to investment in the Security receipt (SRs) issued by the Asset Reconstruction Company (ARCs) is among the challenges. Moreover, Under the income-tax law, no specific tax rate is mentioned for the taxability of interest income or upside received by FPIs from their investment in the SRs. Thus, this study is a normative legal study that employs normative methods and looks for the provisions regarding the taxation of securitization transactions and its legal implications under Indian taxation regimes. Whereas provisions of tax statutes like the Income Tax Act and Stamp Duty Act are examined and analyzed in relation to other laws that govern securitization in India.

Keywords: *Taxation of Securitization transactions, Asset Reconstruction Company, securitization trust, Income tax, Special-purpose Vehicle, investors, financial institutions.*

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1.0 INTRODUCTION

“Securitisation” in its widest sense implies every such process that converts a financial relation into a transaction, more specifically, into a capital market instrument or security². Debt or asset reconstruction is one of the latest techniques that financial markets have been witnessing. Under asset securitization, a financial institution pools and packages individual loans and receivables creates securities against them, gets them rated, and sells them to investors in the market. Thus, asset securitization is nothing but a process of simulating assets into securities and securities into liquidity on an ongoing basis, increasing thereby turnover of business and profits, while also providing for flexibility in yield, pricing, pattern, risk, size, and marketability of instruments. In India income of Securitization trusts are exempted under the Income statute while it is taxable in the hands of investors. The tax laws that govern the taxation of private trusts, the most commonly used securitization vehicle in India, provide pass-through tax treatment to such vehicles, so long as the faith is not seen to be doing business. Taxation issues surrounding securitization transactions have not been clearly clarified in the relevant tax laws in so far as regulations of securitizations are concerned (i.e., securitization transactions governed by RBI regulations or regulations of the Securities and Exchange Board of India (SEBI), the capital markets regulator).

Methodology

This study is a normative legal study; it reviews some of the pieces of literature to gather the necessary information concerning the concept of the “taxation of securitization” by utilizing normative methods. Secondary data consisting of primary such as case laws, and legal instruments are gathered and utilized in this study.

1.2 Briefly development of securitization

The first structured asset securitization occurred in 1970 in the United States when the newly created Government National Mortgage Association began publicly trading in securities backed by a pool of mortgage loans. These securities, known as “mortgage pass-through securities”, facilitated the investors to purchase a fractional undivided interest in a pool of mortgage loans by providing for a share in the interest income and in the principal payments generated by the underlying mortgage. In creating a pool of mortgages, the lenders were very careful to put together those assets with similar characteristics in regard to quality, term, and

² Vinod Kothari: Securitization, Asset Reconstruction and Enforcement of Security Interests, 5th ed

interest rate. The pool of mortgages placed with trust was actually sold in the form of certificates to investors, either directly or through private placement.

Securitization has existed in India since the early 1990s. Citibank earned Rs.16 crores from GIC Mutual Fund by securitizing part of its auto loans in 1991, making it the first securitization transaction. Since then, a number of transactions have taken place. During this time there was no specific law pertaining to securitization. Until 2002, The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act (SARFAESI) was passed. The goal of its passage was to encourage banks and financial institutions to sell or securitize non-performing loans (NPLs) in favor of Assets Reconstruction Companies (ARCs) established with the Reserve Bank of India (RBI) under SARFAESI. However, a huge development of securitization in India was made in the case of **Mardia Chemicals Ltd v. Union of India**³ where the validity of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act (SARFAESI) was challenged. The constitutional validity of SARFAESI was assailed, in particular Sections 13, 15, 17, 34 on the basis that these sections are unreasonable and arbitrary. However, the court held that the SARFAESI Act is valid.

Up to now, several amendments have been made as well as many guidelines have been issued to regulate securitization in India. The amendments and guidelines are intended to have a wide-ranging influence on a variety of concerns, facilitating the establishment of a dynamic and healthy securitization market in India.

1.1 Challenges

One of the most recent tactics to hit the financial markets is debt or asset securitization. Under asset securitization, a financial institution pools and packages individual loans and receivables; creates securities against them, gets them rated, and sells them to the investors in the market, while the transactions involved during securitization attract taxation. In India income of Securitization trusts are exempted under the Income statute while it is taxable in the hands of investors. The tax laws that govern the taxation of private trusts, the most commonly used securitization vehicle in India, provide pass-through tax treatment to such vehicles, so long as the trust is not seen to be doing business. Taxation issues surrounding securitization transactions have not been clearly clarified in the relevant tax laws in so far as

³ (2004) 4 SCC 311; (2004) 2 SLT 991; (2004) 2 BC 397; (2004) 110 DLT 665; AIR 2004 SC2371

regulations of securitizations are concerned (i.e., securitization transactions governed by RBI regulations or regulations of the Securities and Exchange Board of India (SEBI), the capital markets regulator). For instance, a lack of clarity in taxation provisions with respect to investment in the Security receipt (SRs) issued by the Asset Reconstruction Company (ARCs) is among the challenges. Also, one of the issues is the pass-through regime for Alternative Investment Fund (AIF) income from SR investments. AIFs, in their capacity as Qualified Buyers (QBs), invest in security receipts issued by ARC trusts. Under the income-tax law, the ARC trusts enjoy a complete pass-through status, and the income is taxable in the hands of the investors based on the characterization that is determined by the ARC trust. The income is typically classified as 'business income by the ARC trust. The AIF loses its tax transparent status if it earns a business income, and such income is taxed at the AIF level at the maximum marginal rate, which is a deterrent for the investment to flow into ARC trusts. Moreover, Under the income-tax law, no specific tax rate is mentioned for the taxability of interest income or upside received by FPIs from their investment in the SRs. Thus, this study looks for the provisions regarding taxation of securitization transactions and its legal implications under Indian taxation regimes. Whereas, provisions of tax statutes like the Income Tax Act and Stamp Duty Act are examined and analyzed in relation to other laws that govern securitization in India.

1.3 Major Parties involved in Securitization

1.3.1 Originator

The originator may be a financial institution or bank which decides to its select pool of securitized loans and receivables with a view to creating liquidity. It identifies the loans and receivables from its portfolios to form a basket or pool of homogeneous assets for securitization. In India, this is typically a bank, an NBFC, or a housing finance company⁴.

1.3.2 The Borrower (alternatively called the Obligor)

is the individual (or an enterprise) that has taken a loan from the originator and entered into a contractual agreement with the originator to repay the interest and the principal. In the case of secured loans, the Borrower also provides collateral (a physical asset) as a security for the

⁴ Jennifer Romero Torres and others, *Securitization in India: Managing Capital Constraints and Creating Liquidity to Fund Infrastructure Assets*, Asian Department ,2017

loan. In the case of housing loans, the house that is bought with the loan is typically the collateral⁵.

1.3.3 Investor

It is an entity that wants to purchase the assets or receivables of the Originator. The investor makes his profit by receiving fixed or floating payments from the SPV or the trustee created in the process. In India, investors are typically banks, insurance funds, and mutual funds.

1.3.4 Trustees (of the SPV Trust) oversee the performance of all the parties and supervise the distribution of cash to the investor⁶.

1.3.5 Special Purpose vehicles

This is the intermediary who holds the assets transferred by the Originator on behalf of the end investor and it is the function of this entity to issue marketable securities to the investor in place of the assets taken up by it. The SPV is normally an organization distinct from the originator. Its main task is structuring. These agencies assess the risks connected with each transaction, impose credit enhancements corresponding with the PTCs' ratings, monitor transaction performance until maturity, and take necessary rating measures.

2.0 BRIEF MODUS OPERANDI OF SECURITIZATION

Securitization of assets involves a lending institution, termed as the originator, whose loans and receivables will be converted into securities, and a trust or a Special Purpose Vehicle (SPV), through which the former will qualify its assets. The originator, in fact, picks up a pool of assets of homogeneous nature, lifts them from its balance sheet, and passes them on to the SPV through a "pass-through transaction". The latter in turn converts them into the appropriate form of marketable securities for investment. The resultant of cash flow SPV to the originator would enable the latter to create further assets, while the periodical cash flows from the underlying collaterals by way of repayment of loans and interest payment will enable the SPV to pay off its obligations of principal and interest to its debtors⁷.

3.0 TAXATION OF SECURITIZATION AND LEGAL IMPLICATIONS

In this part, crucial and important provisions governing the taxation of securitization in India are examined by looking at the provisions of the Income Tax Act, as well as the legal implications that have been pointed out and analyzed.

⁵ Report of the Committee on the development of Housing Finance Securitization Market System 2019 pg 20

⁶ Ibid

⁷ OECD publication titled Trends and Developments in Securitisation, Financial Market Trends, No. 74, October 1999. Refer to, <http://www.oecd.org/finance/financial-markets/2752197.pdf> (last accessed in 28th February 2022)

3.1 Incomes not included in total income

Section 10(23DA)

The section provides an exemption of the income of securitization trust from the activity of securitization. Furthermore, the section provides the meaning of securitizations for tax purposes and securitization trust where the section⁸ provides that;

(23DA) any income of a securitization trust from the activity of securitization.

Explanation. —For the purposes of this clause, —

(a) “securitization” shall have the same meaning as assigned to it,—

(i) in clause (r) of sub-regulation (1) of regulation 2 of the Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 made under the Securities and Exchange Board of India Act, 1992 and the Securities Contracts (Regulation) Act, 1956; or

(ia) in clause (z) of sub-section (1) of section 2 of the Securitisation and Reconstruction of Financial Assets

(ii) under the guidelines on securitisation of standard assets issued by the Reserve Bank of India; and Enforcement of Security Interest Act, 2002; or

(b) “securitization trust” shall have the meaning assigned to it in the Explanation below section 115TC;

3.2 Meaning of securitization for the tax purpose

Under Section 10 (23DA) the meaning of securitization has been defined in the explanation where it encompasses the definitions in Regulation 2(1)(r) of Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 (hereinafter referred as “the Regulations”), or under the Guidelines on Securitisation of Standard Assets, issued by the RBI (hereinafter referred as “RBI Guidelines”). And the definition in clause (z) of sub-section (1) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002) (hereinafter referred to as “SARFAESI Act”).

3.2.1 The Regulations

Regulation 2(1)(r) of the Regulations defines “securitization” to mean the acquisition of debt or receivables by any special purpose distinct entity from any originator or originators for the

⁸ As Ins. by The Finance Act, 2016 in the Explanation to clause 10(23DA), effective from 1-4-2017

purpose of issuance of securitized debt instruments to investors based on such debt or receivables and such issuance. The Regulations provide qualifications to be met for the securitization transaction in the definition. The regulations provide the meaning of “issue” to mean an offer of *securitized debt instruments* by a *special purpose distinct entity* or under any scheme of such entity to the public or to any person(s), which is *proposed to be listed on a recognized stock exchange*; or offer of *security receipts* by a *trust set up by an asset reconstruction company* or under any scheme of such trust to the qualified buyers, which are *proposed to be listed on a recognized stock exchange*. Thus, only the securitization transactions, where the securitized debt instruments or security receipts are proposed to be listed on a recognized stock exchange by the special distinct entity or trust set up by asset reconstruction company respectively will qualify under Explanation (a)(i) to clause (23DA) of the Income Tax.

3.2.2 The RBI Guidelines (Directions)

The Master Direction – Reserve Bank of India (Securitisations of Standard Assets) Directions, 2021⁹ defined securitization as follows;

Securitization” means a structure where a pool of assets are transferred by an originator to a SPE and the cash flow from this pool of assets is used to service securitization exposures of at least two different tranches reflecting different degrees of credit risk, where payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the originator;

Provided that the pool containing a single asset eligible to be securitized is also permitted.

Provided further that a securitization structure may have tranches with different maturities

Hence, a securitization transaction has to fulfill the conditions as given in the Master Direction – Reserve Bank of India (Securitisations of Standard Assets) Directions, 2021 whereby a pool of assets is used only to service securitization exposure. The directions define the term securitization exposure to include but are not restricted to exposures to

⁹ Final guideline available at <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/85MDSTANDARDASSETSBE149B86CD3A4B368A5D24471DAD2300.PDF> (last accessed in March 2022)

securitization notes issued by the special purpose entity including asset-backed securities and mortgage-backed securities, credit enhancements, underwriting commitments, liquidity facilities, interest rate or currency swaps, credit derivatives, and tranching cover, as well as Reserve accounts, such as cash collateral accounts, which is earmarked to absorb credit losses arising from the securitization and is recorded as an asset by the originator.

3.2.3 SARFAESI Act

Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 defines securitization to mean the acquisition of financial assets by any [asset reconstruction company] from any originator, whether by raising of funds by such [asset reconstruction company] from [qualified buyers] by the issue of security receipts representing undivided interest in such financial assets or otherwise.

Therefore, when interpreting the meaning of securitization for the tax purpose, it should be noted that the meaning of “originator” is assigned a different meaning in the Regulations compared to the meaning of “originator” under the SARFAESI Act as well as in the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021. Furthermore, the meaning of securitization provided under the Regulations, RBI Guidelines and SARFAESI Act tries to distinguish a Specific Purpose District Entity (trust), company, and trust set up by an asset construction company. However, any securitization transactions that fall under the definitions of the Regulations, RBI Guidelines, and SARFAESI Act are covered under Section 10(23DA) of the Income Tax Act.

3.3 Special Provisions Relating to Tax on Distributed Income by Securitisation Trusts

3.3.1 The exemption of income under section 10 (35A)

Section 10(35A)

Section 10(35A) of the Income Tax Act provides for the exemption of tax of any income by way of distributed income referred to in section 115TA received from a securitization trust by any person being an investor of the said trust. The section provides as follows;

(35A) any income by way of distributed income referred to in section 115TA received from a securitisation trust by any person being an investor of the said trust.

Provided that nothing contained in this clause shall apply to any income by way of distributed income referred to in the said section, received on or after the 1st day of June, 2016.

Explanation. —For the purposes of this clause, the expressions —investor¹¹ and —securitisation trust shall have the meanings respectively assigned to them in the Explanation below [section 115TCA].

The aforementioned exemption intended that income received in the hands of the investors (other than the exempt category investors such as mutual funds) from the securitization trusts would be exempt income. This is due to the fact that the income was subject to distribution tax by the securitization trusts, the income in the hands of the investors was exempt. Exemption under section 10(35A) also means that the expenditure pertaining to the exempt income would be disallowed under section 14A of the Income Tax Act. Though, in 2016 the Finance Act¹⁰, brought in amendments to the aforesaid clause as securitization trusts had moved from the applicability of distribution tax to being pass-through vehicles. Therefore, the exemption of income under section 10 (35A) was withdrawn.

3.3.2 Definition of key terms under current tax regime

In India income of Securitization trusts are exempted under the Income statute while it is taxable in the hands of investors where taxation is governed under Chapter XII EA of the Income Tax Act. The Chapter provides for the meaning of key terms in the explanation for the purposes of taxation of securitization transactions. The definition of key terms can be defined and explained as follows;

Explanation. —*For the purposes of this Chapter,—*

(a) " investor " means a person who is holder of any securitised debt instrument or securities [or security receipt] issued by the securitisation trust;

The definition of "investor" is dependent on the definition of "securitized debt instrument", "securities", security receipt, and "securitization trust". Hence, a person will qualify as an investor only if the defined conditions of the given terms are satisfied.

a. " securities " means debt securities issued by a Special Purpose Vehicle as referred to in the guidelines on securitisation of standard assets issued by the Reserve Bank of India;

¹⁰ The Finance Act, 2016 (28 of 2016)

For the tax purpose, this definition refers to the meaning of securities to mean debt securities issued by an SPV as referred in the guidelines on the securitization of standard assets issued by the Reserve Bank of India. However, the term “Debt securities” has not been defined in the current Master Direction – Reserve Bank of India (Securitisatio n of Standard Assets) Directions, 2021. As a result, this cause the rise of ambiguous of the term “securities” for tax purposes as far taxation of securitization transactions is concerned. Though, under SARFAESI Act the term “Debt securities” is defined and referred to the meaning debt securities listed in accordance with the regulations made by the Board under the Securities and Exchange Board of India Act.

*c) “**securitized debt instrument**” shall have the same meaning as assigned to it in clause (s) of sub-regulation (1) of regulation 2 of the Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 made under the Securities and Exchange Board of India Act, 1992 (15 of 1992) and the Securities Contracts (Regulation) Act, 1956 (42 of 1956);*

The meaning of “securitized debt instrument” has to be derived from Regulation 2(1)(s) of the Regulations. Regulation 2(1)(s) makes reference to Regulation 2(1)(h) which provides that with respect to “securities debt instrument” means any person holding any securitized debt instrument which acknowledges the interest of such person in the debt or receivables assigned to the special purpose distinct entity.

*(d) “**securitisation trust**” means a trust, being a—*

*(i) “**special purpose distinct entity**” as defined in clause (u) of sub-regulation (1) of regulation 2 of the Securities and Exchange Board of India (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 made under the Securities and Exchange Board of India Act, 1992 (15 of 1992) and the Securities Contracts (Regulation) Act, 1956 (42 of 1956), and regulated under the said regulations; or*

*(ii) “**Special Purpose Vehicle**” as defined in, and regulated by, the guidelines on securitisation of standard assets issued by the Reserve Bank of India; [or]*

*(iii) **trust set-up by a securitisation company or a reconstruction company** formed, for the purposes of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002), or in pursuance of any guidelines or directions issued for the said purposes by the Reserve Bank of India which fulfills such conditions, as may be prescribed.*

The key elements of this definition are constitutional. Special purpose distinct entity is a trust, and it raises funds by issue of securitized debt instruments and acquires debt or receivables with such funds. SPDE also includes any trust set up by the National Housing Bank under the National Housing Bank Act, 1987 (53 of 1987) or by the National Bank for Agriculture and Rural Development under the National Bank for Agriculture and Rural Development Act, 1981 (61 of 1981).

The income Tax Act refers to the definition of SPV as defined and regulated by the guidelines on the securitization of standard assets issued by the Reserve Bank of India. However, it should be noted that the current Master Direction – Reserve Bank of India (Securitisations of Standard Assets) Directions, 2021 does not provide specifically the meaning of Special Purpose Vehicle but it contains the definition of Special Purpose Distinct Entity. Hence, there is an inconsistency between the Income Tax Act and the Master Direction – Reserve Bank of India (Securitisations of Standard Assets) Directions, 2021 as to the definition of SPV.

(e) “security receipt” shall have the same meaning as assigned to it in clause (zg) of sub-section (1) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002).

The meaning of security receipt has been referred to SARFAESI Act, security receipts are used in the acquisition of non-performing assets by asset reconstruction companies, which usually acquire them on the books of a trust, by issuing security receipts to the investors.

3.4.1 Tax on distributed income to investors

Chapter XII-EA (containing sections 115TA, 115TB, and 115TC) was inserted by the Finance Act, 2013 (17 of 2013), s. 33 (w. e. f. 1-6-2013) but the provisions of these sections currently are not operative when the Finance Act of 2016¹¹ was implemented. The most fascinating thing is that the provisions were not repealed but were excluded from the application.

115TA. Tax on distributed income to investors. — (1) Notwithstanding anything contained in any other provisions of the Act, any amount of income distributed by the securitisation trust to its investors shall be chargeable to tax and such

¹¹ The Finance Act, 2016 (28 of 2016)

securitisation trust shall be liable to pay additional income-tax on such distributed income at the rate of—

(i) twenty-five percent. on income distributed to any person being an individual or a Hindu undivided family;

(ii) thirty percent. on income distributed to any other person:

Provided that nothing contained in this sub-section shall apply in respect of any income distributed by the securitisation trust to any person in whose case income, irrespective of its nature and source, is not chargeable to tax under the Act.

All incomes received by investors from securitization is taxable in the hand of the investor. However, in order to apply section 115TA (1), there are two prerequisites that must be fulfilled. Firstly, the amount has to be “income”, Secondly, the amount has to be “distributed. This means that there is no tax if what is delivered is not income, the same there is no tax if revenue is not distributed. The tax is on distribution, which is comparable to dividends. For instance, any distribution of principal will not be liable to tax under section 115TA since the principal is not income. Furthermore, the Section imposes tax liability to the securitization trust whereby securitization trust shall be liable to pay additional income tax on such distributed income at the rate of twenty-five percent on income distributed to any person being an individual or a Hindu undivided family, and thirty percent. on income distributed to any other person.

(2) The person responsible for making payment of the income distributed by the securitization trust shall be liable to pay tax to the credit of the Central Government within fourteen days from the date of distribution or payment of such income, whichever is earlier.

Section 115TA (2) covers the circumstances where the duty of making payments of the income distributed by the securitization trust is made by another person, is required to pay tax to the credit of the central government. The provision is applicable where the securitization trusts were required to pay distribution tax and the responsibility was upon the “person responsible for distribution by the trust”, ie, the trustee. This means that a servicer doing distributions on behalf of the SPV is required to pay tax to the credit of the central government.

(3) omitted by Act 25 of 2014, s. 43 (w.e.f. 1-4-2015)

(4) No deduction under any other provisions of this Act shall be allowed to the securitization trust in respect of the income which has been charged to tax under sub-section (1)

Section 115TA (4) provides for the prohibition of any deduction to the securitization trust in respect of the income which has been charged to tax under sub-section (1). This means that expenses such as servicing fees, legal costs, and trustee fees are prohibited from the deduction hence, tax is imposed on gross income. In fact, this Sub-clause is superfluous because trust only distributes the “income” that leftovers henceforth, there is no disallowance of expenses.

(5) Nothing contained in this section shall apply in respect of any income distributed by a securitization trust to its investors on or after the 1st day of June 2016.]

Section 115TA (5) states that the provisions of distribution tax as provided for in section 115TA shall not be applicable for income distributed by the trust to its investors on or after 1 June 2016. For that reason, moving to the pass-through regime for securitization trusts.

3.4.2 Interest payable for non-payment of tax

115TB. *Interest payable for non-payment of tax. —Where the person responsible for making payment of the income distributed by the securitisation trust and the securitisation trust fails to pay the whole or any part of the tax referred to in sub-section (1) of section 115TA, within the time allowed under sub-section (2) of that section, he or it shall be liable to pay simple interest at the rate of one percent. every month or part thereof on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.*

Section 115TB provides that if tax is not paid within 14 days, the person responsible is obliged to pay interest at 1% per month or portion thereof on the amount of tax. Given that the liability to deduct distribution tax is no longer applicable as of 1 June 2016, the penalties for late payment of taxes also lose significance.

3.4.3 Securitisation trust to be an assessee in default

115TC. *Securitisation trust to be assessee in default. —If any person responsible for making payment of the income distributed by the securitisation trust and the securitisation trust does not pay tax, as referred to in sub-section (1) of section 115TA, then, he or it shall be deemed to be an assessee in default in respect of the*

amount of tax payable by him or it and all the provisions of this Act for the collection and recovery of income-tax shall apply.

Section 115TC discusses two types of default which are; first, default in making payment of income distributed by the securitisation trust¹². This means that the person responsible for making the payment is a trustee as provided under Section 115TA, hence, the trustee is deemed to be an “assessee in default”. Second, default in payment of tax by the securitisation. Thus, the securitisation trust is deemed to be the assessee in default. Similarly, the section has become inoperative.

3.5 TAX ON INCOME FROM SECURITISATION TRUSTS

With the implementation of Section 115TCA, securitisation transactions gained comprehensive tax transparency. The newly introduced provisions provide that the investors have obligation to pay tax on the income obtained, furthermore the securitization trust or the SPV has exempted in paying tax¹³.

3.5.1 Taxability of income from securitization trust in the hand of the investor

115TCA. *Tax on income from securitization trusts. — (1) Notwithstanding anything contained in this Act, any income accruing or arising to, or received by, a person, being an investor of a securitization trust, out of investments made in the securitization trust, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person had the investments by the securitization trust been made directly by him.*

Thus, Section 115TCA (1) clearly grants complete pass-through status to the securitization trusts and imposes taxation of any income accruing, arising or received by investors. Sub-section 1 overrides any other provision in the Act contrary to the provisions specified in the section.

3.5.2 Nature of income paid or credited by securitization trust in the hand of investor

(2) The income paid or credited by the securitization trust shall be deemed to be of the same nature and in the same proportion in the hands of the person referred to in subsection (1), as if it had been received by, or had accrued or arisen to, the securitization trust during the previous year.

¹² Kanga & Palkhivala: The Law and Practice of Income Tax, 11th ed, 2 Vols

¹³ Chaturvedi & Pithisaria's: Income Tax Law, 7th ed, Vol 5

This sub-section provides for the nature of income or credit by securitization in the hand of investors. This means that the nature of income, for example, business profits or capital gains, in the hands of the investors is deemed to be the same as the nature of income in the hands of the SPV.

3.5.3 Deemed Credit to investor

(3) The income accruing or arising to, or received by, the securitization trust, during a previous year, if not paid or credited to the person referred to in sub-section (1), shall be deemed to have been credited to the account of the said person on the last day of the previous year in the same proportion in which such person would have been entitled to receive the income had it been paid in the previous year.

The income is taxed at the moment it is distributed, or, if the income is accumulated (not distributed), then, at the time of crediting the income to the credit of the investor. Further, income remaining undistributed is deemed credited to the investors in accordance with the respective investors' entitlement. That is to say, there is no leeway of using the securitization SPV as a tax shelter.

3.5.4 A statement specifying the details of the nature of income to be furnished to investors and prescribed income-tax authority.

(4) The person responsible for crediting or making payment of the income on behalf of securitisation trust and the securitisation trust shall furnish, within such period, as may be prescribed, to the person who is liable to tax in respect of such income and to the prescribed income-tax authority, a statement in such form and verified in such manner, giving details of the nature of the income paid or credited during the previous year and such other relevant details, as may be prescribed.

This Sub-section 4 requires that the person who is responsible for distributing the income, i.e., the trustee on behalf of the securitisation trusts are required to furnish a statement¹⁴ to the income tax authority with respect to the income accrued, credited, or arisen during the previous year to validate the income falling due in the hands of the investors¹⁵. The procedures are provided under Rule 12CC of the Income Tax Rules.

¹⁴ Form 64E, Statement of income paid or credited by a securitisation trust to be furnished under section 115TCA of the Income-tax Act, 1961

¹⁵ Form 64F, Statement of income distributed by a securitisation trust to be provided to the investor under section 115TCA of the Income-tax Act, 1961

3.5.5 Income taxed in the year of accrued not taxable again in the year of payment

(5) Any income which has been included in the total income of the person referred to in sub-section (1), in a previous year, on account of it having accrued or arisen in the said previous year, shall not be included in the total income of such person in the previous year in which such income is actually paid to him by the securitisation trust.

The sub-clause 5 states that income is taxed whether or not it is distributed, even if it is credited or accrued in the investor's favor. This sub-clause ensures that the income is not double-counted in the total income of the investor in the sense that once income is credited but not paid has been included in the total income of the investor in a particular year, it shall not be again included in the total income of the investor in the year the income is actually paid/ distributed to the investor.

3.6 INCOME IN RESPECT OF INVESTMENT IN SECURITIZATION TRUST

194LBC.*Income in respect of investment in securitization trust.—(1) Where any income is payable to an investor, being a resident, in respect of an investment in a securitisation trust specified in clause (d) of the Explanation occurring after section 115TCA, the person responsible for making the payment shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon, at the rate of—*

- (i) twenty-five per cent., if the payee is an individual or a Hindu undivided family;*
- (ii) (ii) thirty per cent., if the payee is any other person.*

(2) Where any income is payable to an investor, being a non-resident (not being a company) or a foreign company, in respect of an investment in securitization trust specified in clause (d) of the Explanation occurring after section 115TCA, the person responsible for making the payment shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon, at the rates in force.

Explanation.—For the purposes of this section,—

- (a) —investor^l shall have the meaning assigned to it in clause (a) of the Explanation occurring after section 115TCA
- (b) where any income as aforesaid is credited to any account, whether called —suspense account or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be the credit of such income to the account of the payee, and the provisions of this section shall apply accordingly.

The aforementioned provision states that the income payable to Resident investors by a securitization trust is subject to TDS at the rate of 25% for individuals or HUFs, and 30% for any other person. Moreover, in the case of a non-resident investor or a foreign company, the rates in force shall apply. While the income is subject to TDS, the investor can be able to get full credit for tax paid. In the case of tax-exempt, investors such as mutual funds¹⁶, or other investors not likely to have as much tax liability, the investors can apply to the assessing officer of relevant jurisdiction for certification at NIL rate of deduction of tax at source or deduction of income tax at a lower rate under section 197¹⁷. When compared to tax withholding on interest payments on corporate bonds or other debt, the rate of withholding is quite high. Interest on debt is generally subject to a 10% withholding tax; however, no tax withholding duties apply to interest payments on listed corporate bonds made to resident taxpayers. Hence, The high rate of tax withholding¹⁸ makes PTC investment unappealing¹⁸.

4.0 TAXATION UNDER THE INDIAN STAMP DUTY ACT 1899

Agreement or document for transfer or assignment of rights or interest in financial assets is exempt from the stamp duty tax. Section 8F of the Indian Stamp Duty Act of 1899 provides that

notwithstanding anything contained in this Act or any other law for the time being in force, any agreement or other document for transfer or assignment of rights or interest in financial assets of banks or financial institutions under section 5 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, in favor of any asset reconstruction company, as defined in clause

¹⁶ Section 196 of Income Tax Act provides that “no TDS on income distributed to the Mutual funds specified under clause (23D) of section 10.

¹⁷ Chaturvedi & Pithisaria's: Income Tax Law, 7th ed, Vol 7(Sections 182 to 194LD)

¹⁸ Report of the Committee on the Development of Housing Finance Securitization Market System 2019, pg 62

(ba) of sub-section (1) of section 2 of that Act, shall not be liable to duty under this Act.

The Act provides for exemption of tax to asset reconstruction companies as defined in clause (ba) of sub-section (1) of Section 2 of the SARFAESI Act as well as makes reference to section 5 (1A). The SARFAESI Act provides the same where it states that any document executed by any bank or a financial institution under sub-section (1) in favor of the asset reconstruction company acquiring financial assets for the purposes of asset reconstruction or securitization shall be exempted from stamp duty in accordance with the provisions of section 8F of the Indian Stamp Act, 1899 (2 of 1899).

Furthermore, the Section under the proviso provides that the provisions of the sub-section 5(1A) shall not apply where the acquisition of the financial assets by the asset reconstruction company is for purposes other than asset reconstruction or securitization. The Indian Stamp Duty Act does not provide clarity for tax purposes as to the agreements and documents executed by the securitization trust as defined under Explanation (d) under Chapter XIIEA of the Income Tax Act. It should be noted that only Assets reconstruction companies can act as SPV in India as provided by the SARFAESI Act.

5.0 TAX IMPLICATIONS ANALYZED BY COMMITTEE TO REVIEW THE WORKING OF ARCS OF 2021

Given the issues affecting the ARC Sector's performance, the Committee to Review the Working of Asset Reconstruction Companies was formed to conduct a comprehensive review of ARC operations and it came with its reports on September 2021. The following are the tax implications noted by the committee¹⁹;

5.1 The pass-through regime for AIF income from investment in SRs

AIFs, in their capacity as QBs, invest in security receipts issued by ARC trusts. The ARC trusts have complete pass-through status under income-tax legislation, and the income is taxable in the hands of the investors depending on the classification set by the ARC trust. The revenue is often classified as 'business income' by the ARC trust. If the AIF produces a business income and that revenue is taxed at the AIF level at the maximum marginal rate, the AIF loses its otherwise tax transparent status, resulting in an effective tax rate of 42.74 percent. The Committee proposes that all income from investment in SRs issued by ARC

¹⁹ Chapter F.5 of the Report of the Committee to Review the Working of Asset Reconstruction Companies, 2021

trusts earned by an AIF should also be considered as pass-through and taxable in the hands of the investors of the AIF. The likelihood of a 42.74 percent tax at the AIF level discourages this investment from flowing into ARC trusts. As a result, a pass-through regime for AIF revenue from SRs issued by an ARC Trust is crucial to the viability of a competitive market for these NPAs and the maximizing of recovery for the ARC.

5.2 Clarity on the tax rate applicable to FPIs when they invest in the SRs issued by ARC trusts

There is no precise tax rate specified in the income-tax legislation for the taxability of interest income or upside obtained by FPIs from their investment in SRs. Presently, a concessional tax regime of 5% exists for taxability of income arising to FPIs and other non-residents (on Government securities, corporate bonds, ECB, etc.), subject to satisfaction of certain conditions. Interest income received by FPIs from investments in SRs may be subject to similar tax treatment. Furthermore, any upside resulting as business income may be taxed at a rate of 20% (since it is in the nature of income in relation to securities under Section 115AD of the Income Tax Act). The suggested modifications will encourage FPI investment in SRs and aid in the settlement of bad loans.

6.0 CONCLUSION

To summarize, securitization is an intriguing financial mechanism that has become an indelible worldwide phenomenon, especially in India. However, there is little doubt that this growth has created significant hurdles for all parties involved, including investors, regulators, and banks such as taxation of securitization transactions. To aid the securitization process in India, a special taxation system has been established in respect of the taxation of income derived from the activity of securitization by securitization entities set up as trusts. Due to the enactment of The Finance Act, 2016 (28 of 2016) and The Finance Act, 2013 (17 of 2013), Section 10 of the Income-tax Act has been altered, and a new Chapter XII-EA has been added to provide a specific tax system. This is because entities set up in the form of trust to undertake securitization activities were facing problems due to lack of special dispensation in respect of taxation under the Income-tax Act. However, the new tax regime still is facing some legal challenges as discussed and indicated when analyzing the provisions of the Income Tax Act. For instance, Securitization trusts have a pass-through. Any income credited to the investor by the securitisation trusts, on the other hand, is subject to tax deduction at

source under section 194LBC of the Income Tax Act. Though the income is subject to tax deduction at source, the investor will be able to get full credit for tax paid. In the event of tax-exempt investors, such as mutual funds, or other investors who are unlikely to have a large tax obligation, the investors may apply to the tax officer of the relevant jurisdiction for certification at the NIL rate of tax deduction at source. Thus, there is a need to reform the tax statutes and provide more clarity on the provisions of tax statutes dealing with the taxation of securitization transactions as was recommended by the Committee to Review the Working of Asset Reconstruction Companies, 2021.

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