

International Tax Issues in Structured Finance Transactions

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Synopsis

- Introduction**
- Financial Instruments**
- Securitization**
- Derivatives**

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Introduction

- Financial instruments play a vital role in any transaction
- Two broad category of financial instruments:
 - Basic instruments: Equity and debt instruments; and
 - Securitized products and derivatives
- Other classification based on functions performed also relevant, such as:
 - Price risk transferring;
 - Credit risk transferring;
 - Liquidity enhancing;
 - Credit generating instruments; or
 - Equity generating

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Types of Basic Instruments

Equity				
	Preference Shares	<ul style="list-style-type: none"> Compulsorily Convertible Optionally Convertible Non – Convertible 	<ul style="list-style-type: none"> - FDI - ECB* - ECB 	
	Debentures	<ul style="list-style-type: none"> Compulsorily Convertible Optionally Convertible Non – Convertible 	<ul style="list-style-type: none"> - FDI - ECB - ECB 	

*ECB – External Commercial Borrowings

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Taxation of Financial Instruments

- Taxability of basic instruments (equity and debt) provided under the Indian Income Tax Act
- Taxability of derivatives / hybrid instruments and income generated thereon is presently unclear

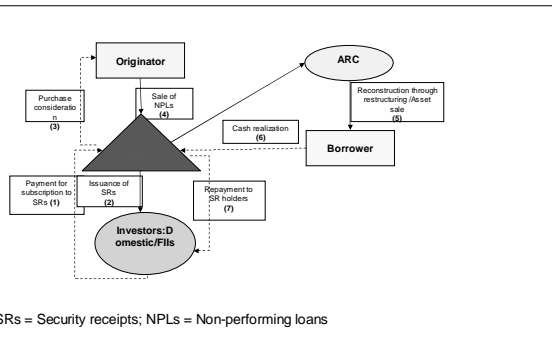
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What is Securitization?

- Pooling or aggregation of financial assets, typically debt obligations
- Debt obligations subsequently offered for sale in the form of new negotiable securities
- Forms of securitization
 - traditional or cash securitization: Placing of the financial assets under the control of an intermediary set up for this purpose (special purpose vehicle, or SPV) that issues the new securities.
 - Synthetic or unfunded securitization: Ownership of the underlying financial assets remains with the originator but the credit risk is transferred by means of credit derivatives.

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Securitization – a Typical Structure



Securitization – Tax Implications

- Tax implications to be examined for the following parties:
 - Taxability of the *originator*
 - Whether business profits or capital gains?
 - Taxability of the *SPV*
 - Trust taxation important
 - Taxability of the *investors*
 - Depending on the SPV taxation
 - Withholding taxes, as applicable
 - SPV making payment to originator
 - SPV collecting payment from debtors
 - SPV making payment to investors

Cross-border Securitization

- Cross-border securitization is a complex process :
 - Determination of jurisdictional framework
 - Determination of law applicable to cross-border securitization
- Tax issues in cross border securitization:
 - Whether transfer of receivables from originator to the SPV will be treated as loan or sale?
 - Taxation of the SPV
 - Minimize withholding tax and avoid mainstream tax
 - Taxation of investors
 - Respective jurisdictions; however, income characterization important
 - Withholding tax in the jurisdiction of the payer
 - Structuring through different jurisdictions to minimize tax implications?

Derivatives

- A 'derivative' derives its value from the underlying asset
- SEBI recently approved introduction of several new derivative products to cater to different investment strategies:
 - Mini contracts on equity indices
 - Options with longer life / tenure
 - Volatility index
 - Options on Futures
 - Bond indices and F&O contracts
 - Exchange traded currency (foreign exchange) F&O

Types of Derivatives

- Forward contract
 - Simplest mode of derivative
- Futures contract
 - Could be Index futures or Stock futures
 - More common as compared to Forwards
- Options contract
 - Could be Index options or Stock options
 - American option (before expiry) and European option (on expiry)
- Swaps
 - Nothing but a barter / exchange
 - Play an important role in international finance

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Derivatives – Tax Implications

- Whether business income or capital gains?
 - Business profits: objective and intention of the investor, magnitude of the transactions [TCW/ICI ruling (250 ITR 194), Morgan Stanley & Co (272 ITR 416)]
 - Capital gains: Whether constitute property or right?
- Taxability under relevant tax treaties
 - Business profits taxable only if PE exists
- Whether derivative trading a speculative transaction under section 43(5)?

Interest Rate Swap

- Interest rate swap ('IRS') – a type of derivative frequently used
- Whether the payment streams exchanged in an IRS could be characterized as 'interest' under the domestic tax laws / tax treaties?
- Cross border IRS – 'synthetic underlying debt' may need to be created
 - May result in 'interest' income
 - Payment by the non-resident to residents could be structured to match the cross-payments
- In absence of in-principal indebtedness, non-residents income may be characterized as business profits

Zero Coupon Bonds

- Zero coupon bonds ('ZCB'):
 - a bond that bears a zero coupon rate and hence issued at a price below its face value;
 - At maturity the investors receive the face value
- Whether income taxable as 'capital gains' or 'interest income'?
- Finance Act 2005 brought about rationalization of taxation of income from ZCBs:
 - Issued by Infrastructure Capital Company, Infrastructure Capital Fund or Public sector company
 - Will be treated as 'capital gains'
 - Issuers (prescribed as above) allowed deduction of the discount on a pro-rata basis having regard to life of such bond

Anti Avoidance Measures

- Certain anti-avoidance measures included in the domestic tax laws to curb tax evasion:
 - Interest / income stripping [section 94(1) and 94(2)]
 - Interest / income from securities taxed in the hands of the transferor
 - Benefit of loss denied:
 - Section 94(7) – loss to the extent of dividend amount is ignored;
 - Section 94(8) – loss ignored considered as cost of acquisition in respect of bonus units
 - Income transferred to non-residents [Section 93]
 - Income deemed to be income of the transferor

Take Aways

- Structured finance transactions in India are still at a nascent stage
- Domestic tax laws need to be geared to provide suitable clarity

Thank you

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