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Dear Sir

## **NTLG IFRS Sub-committee**

### **Potential tax consequences for securitisation trusts from the introduction of International Accounting Standards**

I write on behalf of the Tax Committee of the Australian Securitisation Forum (*ASF*) to alert the NTLG IFRS Sub-committee to a potential difficulty that could confront securitisation trusts as a result of the adoption of IFRS.

#### **1. Background – Tax Neutrality**

It is an essential characteristic of securitisation transactions that the securitisation vehicle (Issuer) which issues debt interests to the capital markets is *tax neutral*. In the case of rated issues of debt interests, the rating agencies require that every issue be the subject of a comprehensive *tax neutrality opinion*. In the case of unrated issues, investors will have the same interest as the rating agencies in ensuring that the ability of the Issuer to pay principal and interest on the debt interests is not eroded by the payment of tax.

Since the aim of securitisation is to raise funds from the capital markets at a cost less than the income on the underlying mortgages or other investments acquired by the Issuer with the funds borrowed from the capital markets, there should normally be a margin between the cash collected by the Issuer and the cash required to be paid to investors in the debt interests. If the taxable income for each year of the transaction equates to the actual cashflows then it would be expected that the net margin, (ie. the profit of the Issuer) would be available to the owner of the Issuer and the only risk for investors is the strength of the underlying assets and the attached cashflows in which the Issuer has invested the funds raised from the capital markets which is precisely the risk that the investors expect to take. However, if, for example, timing differences cause the taxable income from the securitisation transaction to be derived differently over the life of the transaction from the way in which it is accounted for for statutory accounting purposes then those timing differences could result in tax liabilities arising in particular years which would not arise if the taxable income had been spread evenly over the life of the transaction.

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This is an issue which is of ongoing concern to the securitisation industry in the context of TOFA. The general issue of mismatches and the resultant timing differences is not the subject of this submission but is mentioned by way of background.

## 2. Potential Impact of IFRS on the Operation of Section 97

### (a) The potential for an accounting loss

The Tax Committee of the ASF understands that with the adoption of IFRS, there is a real possibility that some securitisation vehicles could record losses for accounting purposes in certain income years primarily as a consequence of the requirement to account for unrealised gains and losses on swap transactions which are frequently used as an integral part of securitisation transactions.

Where the Issuer is a trust then the adverse effect of a mismatch which produces a tax liability will be borne by the income beneficiary of the trust rather than having to be met by the trustee out of the assets of the trust. In this way, the tax neutrality of the trust is preserved (although the economics of the transaction from the point of view of the income beneficiary might become unpalatable). Accordingly, a high degree of comfort can be derived by the rating agencies and the investors in debt interests issued by the Issuer as to the tax neutrality of the Issuer where the Issuer is a trust, notwithstanding the differences which might occur between accounting profit and net income calculated in accordance with Division 6 of Part 3 (Division 6) of the *Income Tax Assessment Act 1936 (1936 Act)*.

If a trust (and a large number of Issuers in securitisation transactions are trusts) incurs a loss for statutory accounting purposes then the question arises as to whether the tax neutrality of the trust can be preserved.

It is well established by the relevant case law (see for example *Federal Commissioner of Taxation v Totledge* 82 ATC 4168 and *Davis v Federal Commissioner of Taxation* 89 ATC 4377) that present entitlement for the purposes of s97 of the 1936 Act attaches to the *trust law income* and not to the net income as calculated for the purposes of Division 6. Irrespective of whether the so called quantum approach or the proportionate approach is adopted in applying s97 of the 1936 Act, it will be the case that if there is no trust law income of the trust estate for a particular year of income then there is no amount to which present entitlement can attach and therefore the trustee will be subject to tax at what is effectively a penal rate under s99A of the 1936 Act.

Whilst it has been recognised that accounting profit calculated in accordance with generally accepted accounting principles may not, strictly, equate precisely with the calculation of *trust law income*, it has been widely accepted in the securitisation industry that provided the trust has an accounting profit in each income year according to generally accepted accounting principles then it should be regarded as having trust law income to which present entitlement can attach.

On the basis that the adoption of IFRS could mean that in a particular income year it can no longer be assumed that the trust will have a net profit when applying

generally accepted accounting principles, the whole issue of present entitlement must be reconsidered.

**(b) The concept of Trust Law Income**

The ATO has expressed a view in Taxation Ruling TR95/29 that present entitlement can attach to the gross income of a trust. This is said to be consistent with the authorities, including Totledge's case referred to above. With respect, we do not believe that the income of a trust which carries on a business and incurs expenses in earning the income can be equated with a classic testamentary trust under which the holder of a life interest is entitled to all of the income with the trustee being authorised to deduct certain (minor) expenses. The trust law income is the distributable income of the trust and in the case of a securitisation trust and other trusts carrying on a business, the only income that can ever be available for distribution is that which remains after the payment of interest and other expenses. Therefore, we do not believe that the authorities referred to in TR95/29 are directly relevant to securitisation trusts and certainly subsequent decisions of the courts would cast doubt upon the applicability of the views adopted in TR95/29. Accordingly, little comfort can be drawn from TR95/29.

There are views that by careful drafting of the Trust Deed, trust law income (ie. distributable income) can be defined in such a way as to effectively equate it to net income calculated in accordance with Division 6. Whilst this is not an unreasonable argument, it is not free from doubt and thus does not remove the uncertainty over the tax neutrality of securitisation trusts.

**3. Action Required**

The ASF requests that the ATO consider what measures can be adopted to provide certainty to securitisation trusts and their advisers that the trustee will not suffer tax in the event that the trust has no net accounting profit according to IFRS but does have net income for the purposes of Division 6.

Yours faithfully



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