# Covered BONDS – *a global taxation perspective*

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**The use of securitisation or 'covered bonds' has been a major factor in the development of the credit markets and has enabled issuers to greatly reduce the cost of financing. While the US has undoubtedly taken the lead, this phenomenon has taken place in many parts of the world. However, taxes and tax uncertainty reduce the efficiency of the securitisation structures in various jurisdictions. Each country's tax system deals with the issues in its own way. In this article, we explore the tax treatment in the US, France, Italy, and the UK.**

## UNITED STATES

There are many types of asset-backed securities (the US term for covered bonds) that are currently sold that represent interests in, or are collateralised by, debt obligations of US obligors. These include pass-through certificates, pay-through bonds, equity interests in the issuers of pay-through bonds, pass-through debt certificates, solely in the case of mortgage-backed securities, REMIC regular and residual interests, and CDOs and equity interests in the issuers of CDOs.

### Avoidance of issuer-level taxes

The principal tax motivation for using each of these types of asset-backed securities is to avoid subjecting the issuer of these securities to tax on the income from the underlying assets as it passes through its hands to investors. It would not be economical to issue an asset-backed security if the issuer incurred any material tax costs with respect to payments it collects on assets and pays over to investors. Thus, it is not feasible, for example, to issue such securities in the form of stock of a US corporation. The income from assets held by a US corporation would bear the full weight of the US federal corporate income tax because no offsetting deductions would be allowed in computing the corporation's taxable income for dividends paid on the stock.

Securitisation structures avoid material issuer-level taxes in one of three ways. First, to the extent an asset-backed security is considered debt for tax purposes, the issuer is allowed deductions for interest expense, and the taxable

income arising from the issuer's assets is, to that extent, effectively shifted away from the issuer of the security to the holder of the security (who may or may not itself be subject to US federal income taxation).

Second, for securities that are not treated as debt, tax can be avoided by ensuring that the issuer is considered to be transparent, which means that the issuer is not classified as a corporation for tax purposes, and its income is allocated to, and taxed only to, its owners. Achieving tax transparency is more involved than simply avoiding use of a local-law business corporation as the issuer, because trusts, limited liability companies, and partnerships may be classified for tax purposes as corporations in some circumstances.

The real estate mortgage investment conduit (or REMIC) rules, by statute, adopt both approaches in avoiding an issuer-level tax by treating the issuer as a transparent entity and by classifying REMIC regular interests as debt, for purposes of allowing an interest deduction to the issuer.

The third approach to avoiding issuer-level taxes is to use as an issuer a corporation organised in a tax haven outside of the US. Such a corporation generally can invest and reinvest in debt obligations of US obligors through an office or an agent in the US without becoming subject to net income taxation in the US (and, with limited exceptions, without becoming subject to the 30% withholding tax on US-source interest). Income of the corporation that is paid as interest to US taxpayers or that is allocable to equity owned by US taxpayers, would, of course, be taxable to them.

### Types of asset-backed securities

The first types of asset-backed securities to be developed in the US were, in order:

- pass-through certificates;
- pay-through bonds;
- equity interests in issuers of pay-through bonds; and
- REMIC interests.

These securities are used to securitise fixed or largely fixed pools of assets, which in the case of a REMIC, must consist of real property mortgages. Pay-through bonds can also be used to finance receivable pools with revolving features by reinvesting rather than passing through principal receipts to holders of the pay-through bonds.

In the case of a trust issuing pass-through certificates, an issuer-level tax traditionally has been avoided by ensuring that the trust qualifies to be taxed as a so-called 'grantor trust' or 'fixed investment trust.' This requires that the trust hold a fixed pool of assets and not issue sequential-pay classes. The adoption of the so-called 'check-the-box' entity classification rules in 1997 has made it easier for a trust that fails to qualify as a trust for tax purposes still to be transparent, by qualifying as a tax partnership. Nonetheless, meeting the tax requirements of being a fixed investment trust continues to be a significant goal of tax planning in this area to avoid the TMP rules (described below) in the case of issuers of mortgage-backed securities.

### Mortgage-backed securities

One of the key economic goals for the sponsors of mortgage-backed securities is to pass through to investors prepayment risk and other risks with respect to identified mortgage pools. Thus, the requirement for fixed investment trust classification of a fixed pool generally is not a commercial obstacle for those securities. On the other hand, the ban on sequential-pay classes limits the ability to tailor maturities to better meet the needs of different investor groups. Pay-through bonds (which are taxed as debt rather than equity in the trust) were devised to permit prepayment risk to be allocated between classes of investors through the creation of fast-pay and slow-pay structures, and more generally, to allow the issuance of shorter-term, lower-yielding classes.

The issuance of debt instruments, however, has a number of disadvantages. Traditionally, the two most significant disadvantages have been the need for a material amount of equity to avoid recharacterisation

of the debt as equity for tax purposes and the requirement that a controlling equity owner report the debt on its balance sheet.

In the context of mortgage-backed securities, pay-through bonds were employed largely in the period prior to the adoption in 1986 of the REMIC rules, which permit fast-pay and slow-pay securities to be issued in the form of equity interests in trusts without an entity-level tax. Similar to the rules for fixed investment trusts, the REMIC rules require a fixed asset pool with certain limited exceptions. The REMIC rules are elective, but they are generally perceived to be beneficial and are used in almost all cases where it is possible to do so.

Moreover, under current law, a pay-through bond structure has a significant tax disadvantage compared to a REMIC structure because an issuer of pay-through bonds must pay a corporate tax on the taxable income from the collateral remaining after deducting interest expense on the bonds. Before 1992, such a tax typically was avoided by organising the issuer as an unincorporated entity such as a trust. In 1992, the taxable mortgage pool (or TMP) rules came into effect. They force any issuer of mortgage-backed pay-through bonds to be classified as a corporation for tax purposes (and prohibit that corporation from offsetting its income with losses or credits by joining in a consolidated return with other corporations).

The TMP rules were enacted in 1986 as an adjunct to the REMIC legislation to ensure that, after a five-year transition period, REMICs (which are subject to certain tax avoidance rules) would be the exclusive means of issuing multiple-class mortgage-backed securities without an issuer-level tax. An entity is generally a TMP if it issues two or more classes of pay-through bonds that differ in the timing of principal payments and more than half of the collateral for the bonds consists of real property mortgages.

The pay-through bond structure continues to be used to securitise non-mortgage assets. Further, despite the TMP rules, the structure also is used for mortgages where the technical requirements of the REMIC rules cannot be met, the cost of corporate status is outweighed by the cost of making a REMIC election, or the TMP definition is not met (for example, because an entity issues only a single class of debt, or because the mortgages it holds are financially troubled – the TMP rules contain an exception for entities formed to liquidate distressed loans).

### Credit card receivables

Turning from fixed to revolving asset pools, pass-through debt certificates have been used most widely in securitisations of credit card receivables. Securitisations of credit card balances (or more generally any short-term receivables) need to accommodate reinvestments of cash-flows from receivables in new receivables. Because of the reinvestment feature, a trust holding the receivables would not qualify for tax purposes as a trust. Further, as an economic matter, the sponsor generally does not want to shift to investors prepayment or other economic risks inherent in short-term receivables. Rather, the goal of this kind of securitisation is to raise funds by issuing securities that resemble (and can be priced almost as cheaply as) conventional high-quality debt instruments, while at the same time removing a corresponding interest in the receivables from the sponsor's balance sheet for financial and regulatory accounting, and regulatory capital purposes.

Currently, in a typical transaction, a trust holds receivables and issues pay-through debt or debt with a certain (or mostly certain) fixed maturity. In the past, these securities were cast in the form of pass-through certificates to achieve favourable accounting treatment but were nonetheless expected to be taxed as debt instruments for US federal income tax purposes. In light of their hybrid characterisation, these securities are often referred to as pass-through debt certificates.

The certificates generally do not receive principal during an initial revolving period, but amortise quickly when that period is over. In some cases, a portion of the collections on the receivables is reserved periodically so that the certificates can have an essentially fixed maturity. The certificates are generally well protected against default risks. The ability to treat the certificates as debt under general tax principles depends on the mismatch between the terms of the certificates and the underlying receivables as well as the low risk of issuer default.

### CDOs

An offshore corporation can be used to securitise a fixed or revolving pool of almost any type of debt obligation, including mortgages. The securities issued are generally referred to as collateralised debt obligations (or CDOs). There are two main limitations:

- debt obligations of US obligors held by the CDO issuer must qualify as debt in registered form for tax purposes (which is typically the case with commercial loans and securities and typically not the case with mortgages and consumer receivables);[1] and
- the CDO issuer must not engage in a loan origination business or any other business other than investing and trading in securities (including, for this purpose, any debt instrument or derivative financial contract relating to debt instruments or interest rates).

A foreign issuer is generally used in circumstances where use of a corporation (rather than a tax transparent entity) is desirable or unavoidable, or to achieve some non-tax advantage. An issuer can be organised as a corporation while still avoiding the burden of an entity-level tax if it is located in a tax haven outside of the US. This structure has been used most often to finance portfolios of high-yield bonds or commercial loans.

### Synthetic CDOs

CDOs are sometimes created synthetically by having a CDO issuer use derivatives to sell credit risk to investors. Similarly, CDO issuers may acquire an investment portfolio with an appropriate level of risk by purchasing exposure to credit risk using derivatives. The term synthetic CDO (or SCDO) is used to refer to both synthetic liabilities of CDO issuers and synthetic assets of CDO issuers.

A synthetic CDO that is a synthetic liability can be created by combining a high-quality noncontingent debt instrument with a credit default swap (or CDS) entered into between the investor and a CDO issuer. A CDS is a contract, typically written using standardised documentation from the International Swaps and Derivatives Association (ISDA), wherein one party, the protection purchaser, makes periodic payments (based on a notional principal amount) in exchange for a payment from the protection seller solely upon the occurrence of a credit event (a default on a reference debt obligation or an insolvency event with respect to a reference obligor).

A similar approach can be used by a CDO issuer to create synthetic collateral. Thus, instead of acquiring loans or bonds, a CDO issuer may invest in a high-quality debt instrument and a CDS under which it sells credit protection and receives compensation. The CDS would relate to reference obligations or reference obligors to which the CDO issuer wants economic exposure in its investment portfolio. The entering into of positions in CDSs generally is not considered a US trade or business and, thus, entering into such CDSs in connection with the issuance of SCDOs does not cause a non-US corporation to be subject to tax in the US.

## FRANCE

Since the 1960s, French public authorities have consistently sought to establish a favourable refinancing

framework for mortgage-backed securities essentially through the following main stages of developments:

- the creation of the *marché hypothécaire* (mortgage market);
- the establishment of the *Caisse de refinancement de l'habitat* (the French equivalent of Fannie Mae)
- the introduction of a legal framework for securitisation (the law of December 23, 1988), which also established the *Fonds Communs de Créances* (or FCCs), and
- the establishment of *Obligations Foncières* and *Sociétés de Crédit Foncier* (or SCFs) by the law of June 25, 1999.

*Obligations Foncières* (the French term for covered bonds, but loosely translated as linked to real estate) are expressly designed by law to be bonds issued by SCFs and secured by means of a statutory preference right over a ring-fenced pool of assets that benefit from the highest ratings with very low refinancing costs and high liquidity.

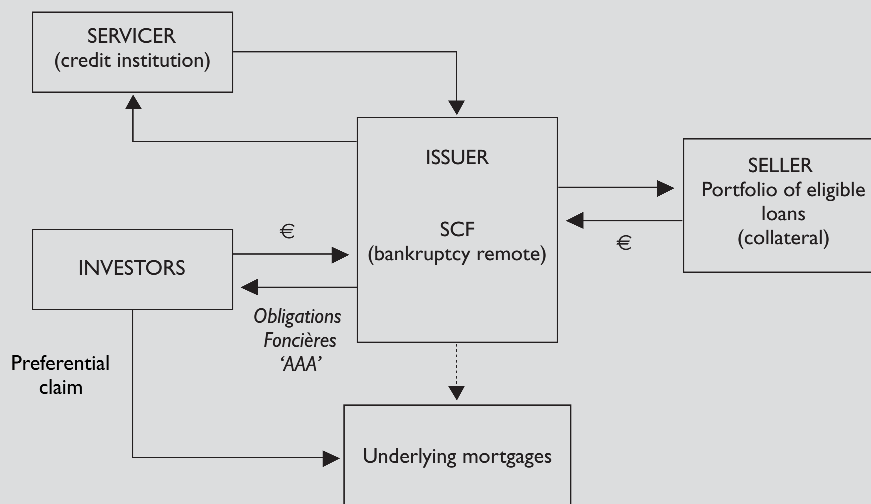
## General framework

The French framework is built around the following mechanism:

- a credit establishment transfers certain highly collateralised or publicly guaranteed debt obligations to a specialised refinancing entity (an SCF); and
- in return, the SCF issues on the debenture market bonds secured by a preferential right (*droit préférentiel/privilège*) on the underlying debt obligations, guaranteeing principal and interest payments due on the bonds.

*Obligations Foncières* issued by an SCF generally benefit from a very competitive rating from the rating agencies. Also, the amount of *Obligations Foncières* outstanding, as well as (in most cases) their standardised amortisation structure, ensures excellent liquidity. As a result, *Obligations Foncières* present substantially lower refinancing costs compared to rates generally applicable to senior AAA notes issued by

**Typical SCF structure** **Exhibit 1**




**Source: Orrick, Herrington & Sutcliffe LLP**

standard securitisation vehicles. For issuers, *Obligations Foncières* offer banks the opportunity for a quasi on-balance sheet securitisation of assets because the underlying assets are registered as collateral and remain on the balance sheet of the institution originating the assets and bonds respectively. In the event of the bankruptcy of the issuer, *Obligations Foncières* holders have a preferential right on the cash-flow generated by the registered assets.

An SCF's sole purpose is to acquire and grant eligible guaranteed loans and loans to public entities in order to finance the issuance of *Obligations Foncières* benefiting from a preferred right in case of a bankruptcy in accordance with the provisions of the French Code *monétaire et financier*. This increases investors protection and, thus, the ratings and acceptance of *Obligations Foncières* by international investors.

### Eligible assets

The receivables held by an SCF must meet certain eligibility criteria in order for the SCF to purchase them. Eligible receivables generally include the following:

- loans secured by a first mortgage or equivalent real estate security. Mortgaged assets must have a loan-to-value ratio of at least 60% (or in certain cases, 80% or even 100%);
- loans guaranteed by credit institutions or insurance undertakings having at least €12m of stockholders equity, up to a limit of 20% of the SCF's assets (subject to certain other conditions);
- loans granted to and guaranteed by the state, public institutions, local authorities, or their representatives in the European Economic Area, Switzerland, the US, Canada, or Japan;
- units or notes issued by FCCs or similar entities subject to the laws of an EEA State, Switzerland, the US, Canada, or Japan, provided that the assets of such FCC or similar entity are composed of not less than 90% of receivables with guarantees similar to those attached to the loans described above;
- other notes issued on regulated stock exchanges meeting requirements defined by the European Central Bank within the limit of 20% of the equity of the SCF; and
- ongoing contract receivables from public entities.

### Transfer of receivables

The transfer of loans giving rise to the issue of *Obligations Foncières* by an SCF is carried out by the mere delivery of an assignment form (bordereau). The transfer is enforceable between the parties and against third parties from the date of execution of the assignment form, notwithstanding any bankruptcy proceedings. The delivery of the assignment form entails the transfer of all ancillary rights attached to the transferred receivables. The debtor is informed, by a mere notification letter, only if the company in charge of collecting the receivables is no longer entitled to do so.

### Bankruptcy remoteness

One comparative advantage of *Obligations Foncières* issued by an SCF is their high degree of bankruptcy remoteness by express operation of law. Holders of *Obligations Foncières* are given preferential treatment: in case of default by the lending financial institution, the claim of the holders of *Obligations Foncières* will take precedence over any other creditor including customarily privileged claims (including the French tax administration's privilege).

### Coverage ratio

An SCF must ensure that any point in time its assets represent at least 100% of its guaranteed liabilities. For this purpose, the assets of the SCF are weighted depending on several criteria linked to the quality of the security attached to the eligible assets acquired or loans granted by the SCF. Like any other financial company (*société financière*), an SCF must have a share capital of €2m at least.

### Authorised transactions

In order to finance its activities, in addition to issuing *Obligations Foncières*, an SCF may issue other bonds, or otherwise raise other funds, that do not benefit from any legal privilege. An SCF is also authorised to own any real or movable properties requested to achieve its legal objectives. However, an SCF is not allowed to issue promissory notes.

### Tax treatment applicable to *Obligations Foncières*

As there is no specific provision dealing with the revenues and proceeds of *Obligations Foncières*, they generally follow the rules applicable to obligations ('bonds') pursuant to the French tax code.

Interest and any other revenue (such as discount or premium) are subject to tax on their full amount (income tax at the progressive rate for individual bond holders or corporate income tax at the standard rate for corporate bond holders). Individual bond holders may, however, elect to be subject to a 27% withholding tax rather than to include the related revenue or proceeds in their income subject to the progressive scale.

Interest and other proceeds paid to nonresident bond holders will, unless provided otherwise by any applicable tax treaty, be subject to a 16% withholding tax that must be levied by the paying agent. They may, nevertheless, be exempt from such withholding tax provided that they demonstrate (by all appropriate means) that they are resident outside of France for tax purposes. That justification must be provided to the paying agent on or before the payment is made.

### Tax treatment of SCFs

There is no specific tax regime applicable to SCFs. They are subject to corporate income tax at the standard rate (i.e., roughly 34%). Pursuant to private ruling letters they may, however, be exempted from tax (on a case-by-case basis) on capital gains from the sale of *Obligations Foncières* they own (e.g., covered bonds issued by other SCFs). Further, SCFs may deduct interest paid on *Obligations Foncières*. Generally speaking, there is no tax rule limiting the amount of debt the SCF may issue, but the SCF must comply with the appropriate capital adequacy guidelines.

## ITALY

### Covered bonds: a new opportunity in the Italian market

Even though the Italian securitisation law (the Law 30 April 1999, no. 130, hereinafter, 'Law 130') was enacted relatively late as compared to other European countries, the Italian securitisation market continues to be one of the most active in Europe. Securitisations have gained growing significance in the Italian market and, since Law 130 came into force, the Italian securitisation market has become the second largest European market by volume in relation to issuances.

Recent Law 14 May 2005, no. 80 (hereinafter, 'Law 80/2005') amended Law 30 by adding two new articles: Article 7-bis and Article 7-ter. These amendments finally introduced in Italy legislation concerning covered bonds.

### Article 7-bis: the structure

Under Article 7-bis, the structure of a covered bond transaction is as follows:

- a bank transfers:
  - (a) claims arising from mortgage loans or loans secured by voluntary mortgages;
  - (b) claims owed by public entities or guaranteed by a public entity; and/or
  - (c) notes issued under a securitisation transaction backed by the claims mentioned under clauses (a) and (b) above (collectively, the 'assets'), to an SPV, the sole corporate purposes of which are the purchase of such claims and the granting of a guarantee for the securities issued by the bank, which is not necessarily the bank transferring the assets;

- the SPV purchases the assets by means of a loan granted or guaranteed to it by a bank, which could also be the bank transferring the assets;
- the bank transferring the assets (or another bank) issues securities (the 'bonds'); and
- the SPV applies the assets it purchases to:
  (a) satisfy the rights attaching to the bonds;
  (b) satisfy rights of the counterparties to derivative agreements entered into for hedging the risks related to the assets and rights of counterparties in secondary finance transactions; and
  (c) pay the costs of the transaction.

### Main features

From a legal perspective, a covered bond transaction differs in several aspects from a traditional securitisation transaction that is structured as a true sale of receivables by way of assignment to a Law 130 SPV. The main features of a covered bond transaction include the following:

- The segregation principle applicable to securitisation transactions generally also applies to covered bond transactions. In addition, no creditors, other than the holders of the bonds, the counterparties to the derivative agreements, or counterparties to other agreements relating to the transaction can benefit from this segregation.
- As in a traditional securitisation transaction, the transfer is perfected by way of publication in the Official Gazette and registration in the register of companies where the SPV is enrolled and, consequently, the SPV may enforce the transfer against assigned debtors and other parties.
- The Ministry of Economy and Finance is to enact an implementing regulation of Article 7-bis, in relation to several key issues of the structure.
- In accordance with Article 53 of the Consolidated Banking Act, the Bank of Italy is to enact an implementing regulation concerning the requirements to be complied with by the bank issuing the bonds, the criteria to be adopted by the bank to evaluate the assets, and the relevant formalities to integrate the assets, as well as the formalities to confirm compliance with applicable requirements (including auditor functions).

### Claims owed by a public entity

Law 80/2005 allows the transfer to the SPV of claims owed to the bank issuing the bonds (or to another bank) by public entities, providing for a special regime concerning the effectiveness and validity of the transfer. Furthermore, the provisions of Articles 69 and 70 of the Royal Decree November 18, 1923, no. 2440 (requiring compliance with certain formalities when claims owed by Italian public entities are transferred, e.g., the transfer is to be notified through a court bailiff to the public entity, the deed of assignment of these claims must be a public deed, etc.) do not apply to covered bond transactions.

### The guarantee

As mentioned, under Law 80/2005 one corporate purpose of the SPV is to apply the assets it purchases to satisfy rights attaching to the bonds, to satisfy rights of the counterparties to derivative agreements entered into for hedging the risks involved in the assets, and to satisfy rights of counterparties in secondary finance transactions, as well as to pay the costs of the transaction. In addition to such purpose, the SPV is allowed to grant a guarantee of the bonds.

With regard to guarantees, Article 7-bis, paragraph 5, states that a further regulation by the Italian Ministry of Economics and Finance, upon a hearing of the Bank of Italy, is to be enacted in this respect specifying the characteristics of such a guarantee. Until such a regulation is enacted, it will not be possible to better qualify and further analyse the guarantee.

### Non-applicability of clawback action

Article 7-bis, paragraph 4, last sentence, provides that Article 67, paragraph 3, of Royal Decree March 16, 1942,

no. 267 (the so-called 'Bankruptcy Law') will apply to loans granted to the SPV and also to the guarantee granted by the SPV. Article 67, paragraph 3, provides for certain cases in which clawback provisions do not apply. Thus, the clawback action under the Bankruptcy Law will not be enforceable in respect of loans to the SPV.

### Tax issues

For income tax purposes, due to the requirement of a covered bonds issuer to be characterised as a fully licensed bank, all asset-backed securities of this kind will be subject to the ordinary regime applicable to bonds and other similar debentures issued by resident banks and listed companies, i.e., the substitute tax regime introduced by the so-called 'gross-coupon reform' of Legislative Decree April 1, 1996, no. 239, which, among others, grants a total exemption on interest income to several special categories of non-resident bondholders (such as institutional investors) and to foreign bondholders that are resident in a country whose tax administration allows an exchange of information that is deemed acceptable by the Italian tax authorities.

Further, the benefits set out in Article 15 of the Presidential Decree 601/1973 will continue to apply to the assignment of receivables arising from transactions indicated in Articles 15, 16, and 19 of such decree. Pursuant to Article 6, paragraph 2, of Law 130, the regime set forth in Article 15 of the decree will apply to the SPV if the transferred assets are receivables arising out of medium and long-term financing transactions entered into by credit institutions and their subsidiaries and branches that carry on, in accordance with applicable provisions of law, medium and long-term financing activities. Under Article 15 of the decree, such financing transactions, and any and all acts, agreements, contracts, guarantees, and activities related to them, including receivables transfer agreements entered into in relation to such financing transactions, are exempted from stamp duties, mortgage taxes, land taxes, and government license duties (whenever such transactions are entered into by the foregoing entities), and subject to a substitute tax equal to 0.25% of the amounts paid.

In relation to covered bonds, Law 80/2005 added to Law 130 other specific provisions (Article 7-bis, paragraph 7) implying that the assignment of the assets may be deemed as a non-taxable transaction for tax purposes when:

- the price paid for the assignment is equal to the value of the claims as reported in the asset and liability statement; and
- the loan to the SPV is granted or guaranteed by the assigning bank.

This aspect of covered bond transactions will, however, necessarily have to be further commented on and detailed by the Italian tax authorities in order to clarify the extent of its application.

### Article 7-ter

In accordance with Article 7-ter, Article 7-bis, paragraphs 5 and 6 shall apply to the establishment of segregated assets (which qualify as assets) and the segregation of the relevant cash-flows carried out in accordance with Article 2447-bis of the Italian Civil Code to guarantee the holders of the bonds to which Article 7-bis refers.

Article 2447-bis provides for two kinds of segregated business assets: the 'operational segregated business asset,' provided for by Article 2447-bis letter (a), and the 'financial segregated business asset,' provided for by Article 2447-bis letter (b).

According to Article 7-bis, it appears that the bank issuing the bonds could establish operational segregated business assets in relation to a specific business (the issuance of the bonds and the repayment of the holders of the bonds). The result should be that in case of default of the bank, only the holders of the bonds could look to the segregated assets.

For the obligations undertaken in relation to a specific business, the company's liability is limited to the operational segregated business assets, except where the company, by the resolution establishing the operational segregated business assets, has undertaken to partially guarantee the obligations undertaken.

The assets that are included in the pool of operational segregated business assets constitute assets segregated for all purposes from the general assets of the company, with the effect being that no creditors, other than the creditors of the specific business, are entitled to obtain satisfaction of their claims from the segregated assets. Furthermore, with respect to the assets that are included in the pool of operational segregated business assets, no actions from creditors different from the creditors of the specific business are allowed.

In case of bankruptcy, the assets that are included into the pool of operational segregated business assets do not constitute general bankruptcy liabilities, but are separately liquidated in favour of the creditors of the specific business.

## UNITED KINGDOM

Unlike the US, Ireland and some of the countries of continental Europe, the UK has not yet introduced any legislation specific to the tax or commercial treatment of covered bonds.

### Development of the covered bond market

In the absence of specific legislation, UK covered bonds are market-driven products that make use of traditional securitisation methods to replicate the commercial and risk profile of the European model. In the typical UK covered bond structure, the originating credit institution will isolate pools of assets on which the bond programme is indirectly secured in order, in effect, to augment the credit of the originator. While in traditional covered bond transactions the asset pool may consist of residential mortgages, commercial mortgages, or certain claims on governmental or quasi-governmental entities, UK covered bonds have so far focused exclusively on residential mortgages. HBOS plc (the company formed in the merger of Bank of Scotland and the Halifax Building Society) issued the first UK covered bonds in 2003 and since then, UK covered bonds have developed as a hybrid between corporate bonds and the sort of residential mortgage-backed securities that one would expect to see in a full securitisation.

Arguably, the lack of specific legislation has proven to be a benefit to the further development of the market because it allows greater flexibility in structuring offerings in the UK than elsewhere. So, for example, whereas the US REMIC rules require a more or less fixed mortgage pool, the asset pool for a UK covered bond may be relatively fluid, enabling non-performing mortgages to be withdrawn from the pool and replaced by new security.

The primary purpose of issuing covered bonds is to enable the originator to access cheaper funding than would otherwise be available. In addition to the security provided by the asset pool, the bondholders look to the unsecured credit of the bond issuer and, potentially, other members of the originator's group. The HBOS issue mentioned above achieved a AAA credit rating at a time when HBOS itself had a AA rating.

Even during a period of historically low interest rates, the major residential mortgage companies have been quick to recognise the benefits of a covered bond programme, which contemplates multiple issuances in large volumes that increases their cost-effectiveness. This prompted the Financial Services Authority to issue guidance on the acceptable ratio of covered bond issuances to total assets in a letter to the British Bankers' Association dated August 4, 2005.

## Tax issues

As might be expected, substantially the same tax issues arise in a covered bond programme as in a securitisation, with tax neutrality as the overriding objective. However, in structuring a covered bond programme, an originating institution would not typically be seeking off-balance sheet treatment or any tax advantage. Hence, the issuer can be supported by guarantees from its parent credit institution and other group companies. As a result, the transferee of the mortgages and, if different, the issuer, will both be members of the originator's group and this should make the resolution of most tax issues more straightforward.

The sale of mortgages by the originator is effectively a disposal of 'loan relationships' within the ambit of the Finance Act 1996 corporate debt rules and taxable as a 'related transaction.' In a securitisation, this will mean that, in general terms, the calculation and recognition of taxable profit of the originator will reflect its accountancy recognition and may trigger an acceleration of the charge to tax. In a covered bond transaction where, as is usually the case, the originator and the acquiring party are closely connected, the basic rule is subject to the connected party override in relation to permitted accountancy rules and a transfer pricing analysis will be required.

No taxable profit arises on a sale for par value, but if the market value exceeds par, as where the rate in relation to a portfolio of fixed-rate mortgages exceeds the current market rate, an immediate charge to tax would arise on the uplift. However, the purchasing entity should be entitled to a corresponding deduction that effectively mirrors the originator's position.

The avoidance of material issuer-level tax leakage can be achieved through use of one or more of the three generic structures noted in the section of this article relating to the US. Namely:

- the matching of income and deductible expenditure to minimise the issuer's taxable profit;
- the utilisation of a tax transparent entity as issuer; or
- by locating the issuer in a low tax jurisdiction (although this latter method is unlikely to be a viable option in a mortgage-backed covered bond structure.)

In a typical securitisation, the use of a newly established single purpose issuing vehicle can create initial uncertainty as to the basis of taxation of the vehicle. The question to be considered on the facts of each case is whether the issuer is merely an investment vehicle because it has simply acquired a single pool of assets with the proceeds of a single issuance, or whether it has commenced a financial trade.

When structuring a new covered bond programme, it should be possible to side-step this issue by separating the ownership of the asset pool from the issuance of the bonds. Subject to the requirements of the rating agencies, the bonds may then be issued by an existing bank or other financial trader in the originator's group. The proceeds of the issue are then used either directly or indirectly to fund the acquisition of the initial pool of mortgages.

Unlike in a securitisation, the bond payments are not necessarily funded by repayments under the mortgage pool, nor is the bondholders' recourse restricted to the mortgage pool. This should mean that concerns about restricted deductibility of interest pursuant to Section 209 of the Income and Corporation Taxes Act 1988 can also be avoided.

As it already carries on a financial trade, there should be little doubt that the transaction is on trading account for the issuer, and, hence, it would expect to be taxed only on the net margin from the transactions. The separation of asset holder and issuer also simplifies the withholding tax analysis.

Where covered bonds are issued by a UK special purpose vehicle, it will usually be necessary to have them listed on a recognised stock exchange in order to avoid having to deduct UK income tax on interest payments. However, if the UK issuer is a bank within the meaning of section 840A of the Income and Corporation

Taxes Act 1988 and interest on the bonds is paid within the ordinary course of its business, interest may be paid without any deduction for withholding tax, without the necessity to have the bonds listed.

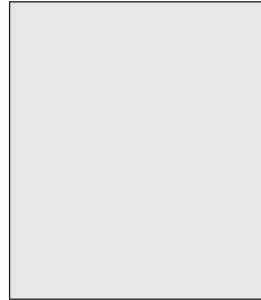
The entity that holds the asset pool is likely to be a limited liability partnership that has the corporate status required by the insolvency analysis, but which is transparent for tax purposes. The members will usually be existing companies in the originator's group – perhaps even including the originator itself.

As noted above, the use of a tax transparent entity is a classic securitisation technique for avoiding a material tax charge at the issuer level on the holding of a pool of income-producing assets. Interest payable on the loan from the issuer to fund the acquisition of the asset pool should be payable without deduction of income tax as the result of the bank status of the issuer or its UK tax residence.

In conclusion, although a UK covered bond programme raises the same generic tax questions as one would expect in any securitisation, the market has developed a structural model that delivers cost-effective solutions and a robust tax analysis.

**Note:**

1. Mortgages generally are first securitised in some manner offshore so as to create simple mortgage-backed securities in registered form and the registered form securities are then securitised offshore.



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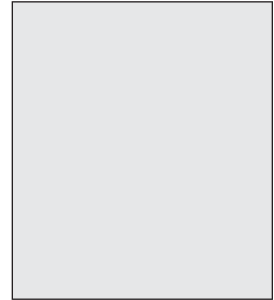

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