Article Title: ARCHIVE | Legal Criteria: Tax Consolidation and the Implications for Australian Securitization Vehicles Data: Authors: Peter Gibson, associate general counsel, Melbourne (61) 3-9631-2055; Andrew Robinson, assistant general counsel, Melbourne (61) 3-9631-2171 As more corporate groups are looking at tax consolidation under the Income Tax Assessment Act, Standard & Poor's has received an increasing number of enquiries as to its position or requirements where a securitization vehicle forms part of a group consolidated for tax purposes. Standard & Poor's requires a securitization vehicle to be bankruptcy remote. That is, the securitization vehicle is remote from any risk of voluntary or involuntary insolvency proceedings. One of the essential components of Standard & Poor's analysis of bankruptcy remoteness is that the securitization vehicle either has no liability for tax or is assessed to be able to meet its tax liabilities from its own resources. In order to maintain the integrity of a securitization transaction, a securitization vehicle must not have exposure to unrelated claims, such as a liability for the tax owed by other group members. Under the consolidation regime, the head company of a group will be primarily liable for any tax liabilities of the consolidated group. If the head company fails to meet a tax liability on time, subsidiary members of the consolidated group may become liable for all or part of that tax. This potential liability for the taxes of other group members poses a significant risk to a securitization vehicle. The most obvious solution is to ensure a securitization vehicle is not a member of a consolidated group, either by establishment as an "orphan" entity or by the transfer of sufficient equity interests to an unrelated entity, to ensure the securitization vehicle is not wholly owned within the consolidated group. Where it is not possible or practical to deconsolidate the securitization vehicle, adequate protections must be in place to limit the tax risks. Tax Sharing Agreements and Reasonable Allocation The tax laws have made provision for one such limitation in the form of "valid tax sharing agreements" (TSAs). It is contemplated that under a TSA the subsidiary members of the group may limit their liability to a "reasonable allocation" of the total amount of the consolidated group's tax liability. Although the Australian Taxation Office (ATO) has not issued a definitive statement on what would constitute a reasonable allocation of the group's tax liability for a securitization vehicle, its Receivables Policy issued in April 2003 provides an indication that allocation on a stand-alone basis is reasonable. Standard & Poor's would accept that allocation of liability on a stand-alone basis would be reasonable for a special-purpose company (SPC). However, for a securitization trust where the residual income beneficiary is subject to tax on income derived by the trust and not the trustee, a reasonable allocation of liability should ideally be zero, reflecting the position that the trustee and the trust assets are separate from the beneficiary's group. Ultimately, if a securitization vehicle is, or will on election become, a part of a consolidated tax group, Standard & Poor's will require a firm tax opinion that concludes that the securitization vehicle will have no greater liability for tax, as a consequence of consolidation, than it would have on a stand-alone basis. Practical Compliance Beyond the question of what is a reasonable allocation of tax liability, there are also some practical issues that need to be adequately addressed. These include satisfactory procedures to ensure a TSA remains effective as the make-up of a group changes; a method to ensure that the securitization vehicle is in a position to provide a copy of the TSA to the ATO on request, or ensure it is provided by the head entity; and provision for the securitization vehicle to maintain access to sufficient funds to pay its reasonable allocation of tax, rather than pay it away to a head entity, which, Standard & Poor's may assume, becomes insolvent before it satisfies its tax obligations. Standard & Poor's recognizes that these issues are not peculiar to securitization vehicles and need to be resolved for the benefit of all consolidated groups that are seeking to rely on TSAs to limit the potential joint and several liability of group members. Exposure Periods In analyzing the potential exposure associated with an election to consolidate, Standard & Poor's will look at tax risk over two periods. The first period is from the date of consolidation until the date on which the TSA is signed. The legislation allows a decision to consolidate to be backdated to the beginning of the tax year—consequently, the date of consolidation may predate the TSA by a significant period. (A TSA cannot be effective prior to the date it is signed.) The second period is the period during which the subsidiary entity is subject to the TSA. This period will end with either the liquidation of the subsidiary entity or its deconsolidation. During the first period, the subsidiary entity has joint and several liability for certain elements of the group's tax liability without the benefit of the nil allocation in the TSA. During the second period, the subsidiary entity is exposed to the risk of the TSA remaining valid, enforceable, and appropriately maintained; and being presented to the ATO within 14 days of request. Standard & Poor's Approach Over the past six months, Standard & Poor's has considered each consolidation proposal on its own merits. Standard & Poor's approach, to date, has been largely driven by the rating on the head company, the rating on the debt issued by the SPC, the length of the two exposure periods, and the number and nature of the subsidiary entities involved. Therefore, Standard & Poor's has developed the following guidelines to assist in the analysis of the requirements for bankruptcy remoteness of a securitization vehicle issuing 'AAA' rated debt. Where the head company is rated below 'BBB' or is unrated, Standard & Poor's will seek assurances regarding: Provisioning for the amount of any potential liability for the first period—the analysis of this financial risk will need to be supported by appropriate tax advice; How the TSA will be administered, including changes to the group structure, meeting the ATO presentation requirement, and reserving and funding of the allocation of tax payable by the SPC (if any)—this administrative risk may be mitigated through the appropriate involvement of independent tax agents or independent trustees; The effectiveness of the TSA, including confirming that a nil or stand-alone allocation is reasonable—the analysis of this legal risk will need to be supported by appropriate legal opinion; and How long the SPCs will rely on the TSA to maintain their tax position. For head companies rated above 'BBB', Standard & Poor's assumes that the procedural aspects of a TSA will be managed, but will require appropriate assurances of: The amount of potential liability for the first period; The reserving and funding of the allocation of tax payable by the SPC (if any); The effectiveness of the TSA, including confirming that a nil or stand-alone allocation is reasonable; and How long the SPCs will rely on the TSA to maintain their tax position. For head companies rated above 'AA-/A-1+', Standard & Poor's will assume that tax will be properly managed and accounted for, however, may require assurance regarding the effectiveness of the TSA, including confirmation that a nil or stand-alone allocation is reasonable. These guidelines are by no means absolute, and different circumstances may indicate the need for additional assurances. The guidelines have been formulated by Standard & Poor's to deal with what are likely to be unintended implications of the consolidation regime. Because of the uncertainties that consolidation can interpose in a securitization structure, there would be a real advantage in the securitization industry seeking amendments to the law to allow for the ability to "carve out" securitization vehicles from consolidated groups. Such an approach would be consistent with the treatment of securitization vehicles under recent thin capitalization changes. This article updates the article "Structured Finance Rating Considerations With Tax Consolidation Under Australian Taxation Law", published by Standard & Poor's on June 11, 2003. A copy of this article is available on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com.