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New Portuguese Tax Regime Fills Gaps in Securitization Framework

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Portugal recently adopted a tax regime for securitization funds and companies. Decree Law 219/2001 of 4 August 2001 implements the authorization granted by last year's budget bill,[1] creating a tax regime that complements the securitization regime that was introduced by Decree Law 453/99 of 5 November 1999.

The securitization regime essentially follows the legislative trend in Southern Europe. Securitization may be used as a way of relieving the weight of credit risks on corporate balance sheets, particularly for credit institutions. Decree Law 453/99 envisaged the regulation of both the assignment of credits for securitization purposes and the incorporation and activity of securitization vehicles (that is, securitization funds and securitization companies).

Until now, the usual procedure for carrying out securitization operations in Portugal was to incorporate a special-purpose vehicle (SPV), which would issue securitized notes to be sold to institutional investors. The new regulation has opened the possibility of securitized bonds and securitized units to be available to noninstitutional investors.

However, Decree Law 453/99 establishes the regulation of only traditional securitization schemes (such as pass-through securities or collateralized securities). It does not provide rules applicable to more recent securitization models, such as those that do not require the transfer of the securitized credits from the originator to the securitization vehicle. Moreover, the regime establishes restrictions concerning the type of credits that may be assigned for securitization purposes, and the entities that may be involved in securitization operations.

The new tax rules fill the gap that has existed since the end of 1999 and finally make it possible to use Portuguese securitization vehicles.

Considering Portugal's economic outlook, securitization operations are expected to focus on the creation of securities (bonds or participation units). Those securities are backed by credit rights emerging from bank loans (including mortgages), personal credit, and trading receivables, among other assets. The main goals of the new tax provisions are to create a tax-neutral regime and to increase the international competitiveness of those financial instruments.

The Portuguese government received authorization from Parliament to create that new tax regime for achieving neutrality. Surprisingly, Decree Law 219/2001 does not completely respect that objective, merely mentioning that tax neutrality is achieved by granting the same tax treatment for the two types of securitization vehicles (securitization funds and securitization companies).

The initial objective was to ensure that the total tax burden of the securitization vehicle, and of the investor, was not greater than that applicable to a direct investment. However, neutrality now is granted at a horizontal, but not at a vertical, level. In fact, investors may be taxed more heavily than they would be if the investment were direct.

Nevertheless, competitiveness has been enhanced through the creation of a special exemption regime

[1]Article 9 of Law 30-G/2000 of 29 December 2000.

for nonresidents (without a Portuguese permanent establishment (PE) to which income can be attributed), individuals, and corporate bodies that receive income from units of participation in securitization funds, or securitized bonds of securitization companies.

To get a clear picture of the Portuguese tax regime applicable to those instruments, it is necessary to understand the essential legal and economic background of those two securitization vehicles and the way they interact with contributions and payments made by and to investors.

I. The Securitization Regime

A. Securitized Credits and Guarantees

Decree Law 453/99 requires that credits that may be purchased for securitization purposes (present or future pecuniary credits arising from existing legal relations whose value is known or can be estimated) must be free of any legal or contractual restrictions or conditions on their transfer; may not have been given in guarantee, detained, or seized; and may not yet be mature.

The law allows the credits to be guaranteed by entities other than the assignor, and by any other entity that is in a group or domain relation with the assignor, thus allowing, for example, the risk of credit default to be transferred to an insurance company.

To enhance the use of securitization, the formal requirements for the assignment of credits for securitization purposes were reduced. That was done in two ways. First, by waiving the rule requiring notification of the debtors of the assigned credits in several situations, specifically when the assignor is a financial institution, an insurance company, a pension fund, or a pension fund management company. Second, by abolishing the rule requiring a public deed to assign mortgage credits.

Decree Law 453/99 provides special rules for the securitization of credits held by financial institutions, as confirmed by the easing of formal requirements and the relationship those entities must maintain with the debtors after the transfer of the credits to a securitization fund or a securitization company. Thus, whenever the assignor is a credit institution, a financial company, or an insurance company, it must maintain management of the assigned credits. It must also provide for the collection and administrative services related to the credits and the debtors by entering into a "management of credits" agreement with the assignee.

In other situations, the functions of a credit manager may be performed by a third party or the assignee. The credit manager assumes an important role in the securitization process by serving as a liaison with the debtors for the collateralized credits during the life of the credits. The legislature even granted the credit manager a special power by requiring its express and individual approval for the charge or transfer of securitized credits, except in cases where the manager is the assignee.

Although Decree Law 453/99 establishes a favorable system for the development of securitization operations, there are also limitations, mainly regarding the entities involved. For example, the purchase of credits for securitization purposes under that system can be undertaken only by securitization companies or securitization funds, and the credits may be assigned only to the following entities:

- the Portuguese state or Portuguese state entities;
- credit institutions;
- financial companies;
- insurance companies;
- retirement funds;
- retirement fund management companies;
- other companies or entities that have their accounts legally certified by an auditor registered with the Portuguese Securities Market Commission (Comissao do Mercado de Valores Mobiliarios); and
- foreign companies or entities that have their accounts certified by an internationally recognized auditor, as long as the investors' interests are duly protected and the company's situation has been adequately analyzed.

B. Securitization Funds

Creating a securitization fund is one way to securitize credits under the existing framework. Securitization funds are autonomous funds, the property of which is attributed to the holders of securitization units. The funds may be of either variable or fixed value, depending on whether their assets or liabilities may be altered, which should be determined by the fund regulation, but at least 75 percent of their value must be composed of credits for securitization.

The incorporation of the fund is subject to the Portuguese Securities Market Commission's prior authorization, which must be requested by the fund management company. The favorable opinion of the Bank of Portugal or the Portuguese Insurance Institute may also be necessary if the assignor is a financial institution (pension funds and their management companies included) or an insurance company, respectively.

The funds may only issue securitization units that give their holders the right to periodic payments, the reimbursement of the units' nominal value, or a proportional part of the remaining value of the securitization fund at the time of its liquidation and division. As with securities, securitization units may be issued through public offers and may be listed on the Lisbon and Oporto Stock Exchange.

The management of the fund may be performed only by securitization fund management companies, which are financial companies with the exclusive purpose of managing one or more securitization funds. Those management companies may not assign the powers of administration of the securitization fund to third parties, but may use third parties to provide necessary services to the fund's management.

It should be stressed that, in the course of business, securitization fund management companies are prohibited from:

- obtaining loans for their activity or providing credit to other entities;
- creating charges, encumbrances, or any liens over the credits of the fund;
- purchasing for themselves any Portuguese or foreign securities of private entities; and
- purchasing real estate properties, other than those necessary to install their facilities.

Securitization fund management companies must have a minimum share capital of EUR 750,000 and must own assets equivalent to at least 1 percent of the net value of the managed funds when such value is not greater than EUR 75 million, and equivalent to 0.1 percent if the net value of the managed funds is greater than EUR 75 million.

Furthermore, there are two major legal requirements with which a securitization fund management company must comply. First, the company's head office and effective administration must be in Portugal (consequently, the fund itself will be considered to be located in Portugal). Second, an assignor is not allowed to have a direct or indirect interest of more than 20 percent in the securitization fund management company's share capital following the transfer by the assignor of more than 20 percent of the total net value of the securitization funds or of each fund managed by the company.

Finally, securitization funds and their management companies are subject, respectively, to the regulatory supervision of the Portuguese Securities Market Commission and the Portuguese Central Bank (Banco de Portugal).

C. Securitization Companies

Securitization companies, like fund management companies, are considered financial companies. However, the sole purpose of securitization companies is the execution of securitization operations through the purchase, management, and transfer of credit pools, and the issue of securitized bonds to fulfill payment of the purchased credit pools. In addition, securitization companies can render services to credit assignee entities concerned with the study of the credits' risks and management.

Those companies' activities can be financed only with their own capital resources (the minimum share capital is EUR 2.5 million) and through the issue of bonds, as long as they do not acquire their own bonds and do not issue short-term bonds. As with any other company, a securitization company can issue bonds within the limits set forth in the Portuguese Companies Code. However, securitized bonds issued in accordance with Decree Law 453/99 are under a special regime and therefore are not subject to such limits if they have an "A" rating or the equivalent. Like securitization fund management companies, securitization companies are subject to prudential ratios. In accordance with a rule issued by the Portuguese Central Bank, securitization companies' assets cannot comprise less than:

- 5 percent of the total amount of the issued securitized bonds, provided the company has formally issued securitized bonds with private placement and with a minimum value of PTE 100 million (approximately EUR 498,798);
- 10 percent of the total amount of the issued securitized bonds in all other cases; and
- 10 percent of the total amount of the issued securitized bonds if the company has issued securitized bonds with a nominal value of less than PTE 100 million.

Under Decree Law 453/99, securitized bonds are bonds whose reimbursement is guaranteed by collateralized credits. With each issue of securitized bonds, it is necessary to identify the characteristics of the collateralized credits in the issuance documentation (for example, the public offer prospectus). This may be done through a code that may be revealed only at the request of holders representing a minimum of 10 percent of the securitized bonds issued, and only if there is a breach of the bond loan conditions or of any of the interest or capital installment payments.

Each pool of collateralized credits is separated as an autonomous patrimony, a ring-fenced set of assets akin to a fund, that cannot be executed for other debts of the securitization company. Furthermore, the holder of the securitized bonds is given a special creditor privilege over the collateralized credits, without the need to register such privilege.

Securitization companies can execute the necessary exchange operations and derivative agreements for the coverage of risks inherent to their activity. Furthermore, those companies can purchase rated securities or short-term treasury or company bonds.

II. The Tax Regime

This section explains in further detail the tax consequences of securitization schemes. There is also a brief reference to the old form of securitization involving the International Center of Madeira.

A. Introduction

Although there are some commercial limitations as described above, securitization structures may become fashionable because of the tax exemptions granted to foreign originators and to individual or company holders of units or bonds issued by securitization vehicles. For nonresidents, the initial objective of achieving tax neutrality is overtaken because income taxes, as well as indirect taxes such as VAT and stamp duties, may be avoided altogether. As a rule, the central tax issues are the tax treatment of the originator's sale proceeds, the taxation of the issuer, and the taxation of investors. Although some clarifications should still be presented, the main framework has already been drawn up.

B. Tax Treatment of the Originator's Sale Proceeds

The Portuguese securitization structure is based on the sale by the originator of credit pools (for example, loans and receivables). The main corporate income tax rule applying to that transaction depends on the value of the transactions; namely, whether the credit's price is higher or lower than its book value.[2] In the former case, a positive result is recognized as income in the tax period when the assignment occurred. In the latter case, the negative result is recognized as a tax cost (meaning it is tax-deductible) in the tax period when the assignment occurred, unless the originator acquires some interest in the issuer proceeds.

In that case, the cost should be split, in identical fractions, among the tax periods between the date of assignment and the date income is paid by the issuer. As such, the cost is accepted as an allowable deduction because it is considered a necessary expense. The assignment value is not defined by law, and because it could be considered merely as the credit's purchase price (the discounted purchase price), it is reasonable to expect that in most cases, no recognition of income is expected.

The goals of that provision are slightly obscure, since the credit's price is, by nature, lower than its book value (its worth being reduced by at least interest value). It is also important to stress that discounted prices of credits cannot be deemed as a loan agreement. Therefore, no payment of interest by the originators is expected, and no withholding tax should apply.

However, income derived from those assignments is exempt from corporate income tax, provided that the recipients are either the Portuguese state and other public entities[3] or nonresident entities without a PE to which the income may be attributed. That applies unless at least 25 percent of their share capital is owned, directly or indirectly, by Portuguese residents, or they are resident in a low-tax jurisdiction as identified by a ruling of the Ministry of Finance. Management fees obtained by the originator, including any part of the interest attributed to the credits, qualify as income and are taxed on the date they are due.

Assuming that income derived from the assignment of credits should be characterized as commercial income and not as investment income, there is no withholding tax obligation when payments are made to the originators.

C. Taxation of the Issuer

As a rule, securitization companies and securitization funds are subject to corporate income tax at the rate of 32 percent.[4] The positive difference between the credit's price and the nominal value of the credit is qualified as a tax cost by the issuer. Generally, the result recognized by the originator as income, and paid by the issuer, is considered a tax cost by the issuer in the tax periods between the date of assignment (that is, acquisition of the credit) or first interest accrual (being a future credit), and the last date of refund, in proportion to the interest that arose or would arise in each of those tax periods.

To determine the taxable income of the securitization funds, the amounts due to the holders of securitized units[5] are considered a tax cost in the same tax period. Interest paid to securitized bondholders is tax-deductible by securitization companies. Income derived from the credits assigned is not subject to withholding tax when it is received by the issuer.

D. Investor Taxation

Investors may be resident or nonresident individuals or corporate bodies that acquire securitized bonds or units issued by both types of vehicles mentioned above. As a rule, the general tax regime for bonds is applicable to those two types of investment instruments. Thus, in principle, securitized bonds are taxed as follows:

- if held by resident individuals, interest is generally subject to a final withholding tax of 20 percent, unless the bondholder chooses another regime;

[2] Decree Law 219/2001, article 2/1.

[3] Article 9, Internal Revenue Code.

[4] Decree Law 219/2001, article 3.

[5] Article 32a and c of Decree Law 453/99.

- if held by resident companies, interest is generally subject to a withholding tax of 20 percent, and then is taxed at the general corporate income tax rate of 32 percent, plus the eventual applicable municipal surcharge.

Income obtained by nonresidents in Portuguese territory without a PE in Portuguese territory to which such income may be attributed is exempt from individual or corporate income tax. That exemption includes any interest or capital gain, but is not applicable if a Portuguese resident holds, directly or indirectly, a controlling interest of more than 25 percent in the nonresident entity, or if it is in a low-tax jurisdiction, as identified by the Ministry of Finance.

E. VAT

In accordance with article 5 of Decree Law 219/2001, the following operations related to securitization activities are exempt from VAT:

- management operations, and the management of the funds of securitized credits; and
- management services included in article 5 of Decree Law 453/99 (all services necessary to assure the good management of the credits and of their guarantees — namely, collecting services, administrative services related to the credits, and services related to the debtors and to the conservation of the credits' guarantees), and depository operations.

In addition, the assignment of credits between the originator and the issuer should be considered an exempt operation in accordance with article 9 (28/a) of the VAT Code.

Nowadays, despite the assignment of credits, article 5/2 of Decree Law 219/2001 establishes that the issuer may regularize the VAT on assigned credits, provided that the assigned credits are definitively considered bad debt in a foreclosure file, in a special file to establish recovery measures for the company, or in a bankruptcy file.

F. Stamp Duties

Although subject to stamp duties as a rule, the assignment of credits — including the reassignment to the originator — is exempt from stamp duties for the purposes of securitization. Until now, neither the vendor nor the issuer could recover VAT paid on bad debts. Portuguese law recognized that right only for the owner of the receivable, provided that the owner was named in the invoice as the creditor.

Loans and interest collected by credit institutions and financial authorities on behalf of the securitization funds and companies also are exempt from stamp duties. Commission fees and other payments paid by the issuer connected with the operations foreseen by article 5 of Decree Law 493/99, and with the depository operations, are also exempt from stamp duties.

G. Other Tax Obligations

Securitization funds and companies are subject to several tax compliance obligations regarding the funds they are managing and the identification of investors. While nonresident investors may be exempt from individual and corporate income tax, securitization funds and companies still must maintain the following data on nonresident investors:

- Tax identification, if the nonresident investors are central banks, public institutions, or international organizations; or are credit institutional financial entities, investment (movable or immovable) funds, pensions funds, or insurance companies domiciled in any OECD member state or in any state that signed a double tax treaty with Portugal, and subject to a special supervisory regime or administrative registration.
- A certificate of residence or equivalent documentation issued by tax authorities or by any other public body in the nonresident's state of residency, or by the Portuguese Consulate, if the nonresident investors are entities not indicated in the previous item, issued no more than three years before or three months after the date of the operations and the perception of income, unless the validity of such document is shorter. In that case, the relevant date is the one mentioned in such document.

H. Tax Liability

Securitization funds and companies are tax substitutes and are primarily liable for the tax withheld (under the individual or corporate income tax, depending on the investor's status as an individual or corporate body) or the tax that should have been withheld in accordance with the applicable tax law provisions.

As a rule, investors have secondary liability for the tax that should have been withheld by the securitization vehicle and delivered to the state, but their liability is limited to the difference between the tax that should have been withheld and the tax that was effectively withheld.

III. The Traditional Approach

The old form of securitization was not subject to a specific tax regime. Therefore, the tax burden was often significant, unless a careful plan was structured or the operations benefited from specific exemptions, because both the SPV and the investors were subject to taxes without a neutral tax framework. The SPV was subject to corporate income tax on all income obtained in Portugal or abroad, loans could attract stamp duties, and investors might again be subject to income tax on interest received.

Investors tried to obtain neutrality by structuring their operations so that interest was deducted from the SPV's taxable income, thus limiting taxation at the bondholder level. However, at a certain stage, the International Center of Madeira, with its special tax regimes, attracted several securitization operations. Provided that certain conditions were met, both the SPV and the investors could be exempted from income taxes, and stamp duties were not imposed.

For the time being, that route can still be used, but special care should be taken in view of the different regimes in existence. Companies should not perform operations that qualify as securitization transactions but do not completely comply with the requirements of the regulation set out above. The so-called "traditional" approach to securitization has to be characterized as a different operation rather than a securitization. Otherwise, the commercial and financial limitations mentioned above must be observed. Finally, companies should pay special attention to the instructions dictated by the European Commission to the Portuguese Republic in terms of compliance with the EU state aid regime.

IV. Conclusion

There is now a defined legal and tax basis applicable to the execution of securitization schemes in Portugal that allows companies, financial institutions, and investors to seek alternative — and probably more advantageous — financing forms and instruments.

On the one hand, the existence of a legal regime that allows companies and financial institutions to transfer credit pools from their balance sheets, and to issue — through a specific vehicle — asset-backed securities, may constitute a new path to relaunch the Portuguese securities market. On the other hand, the tax regime laid down by Decree Law 219/2001 grants several tax exemptions and benefits that may stimulate the incorporation of securitization vehicles that issue securities destined for subscription — mainly or exclusively — by foreign investors.

In any case, securitization may constitute a privileged instrument to attract foreign investment to the Portuguese securities market as a competitive investment structure, at least at the European level. ◆