

**SPECIAL PURPOSE ENTITIES: USES AND ABUSES**  
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**I. Introduction**

Special Purpose Entity (SPE) is a global term, and is used interchangeably with the term Special Purpose Vehicle (SPV). An SPE is either a Trust or a Company. SPEs can be either on shore or offshore. Special purpose corporations are used for a variety of legitimate purposes, including structured risk management solutions. In securitizations, the SPE houses the asset risk either through the purchase of the assets or in synthetic form. The assets are then used as collateral for notes issued by the SPE.

SPEs are powerful structured finance tools. Both the banking community and the investment community have benefited as SPEs facilitated bank balance sheet management and facilitated the creation of new investment asset classes. Because of their normally off-balance sheet, bankruptcy remote, and private nature SPEs can be used for both legitimate and illegitimate uses. Even when used legitimately, the way the issuance of SPEs is represented is sometimes ethically marginal.

Reaction to recent financial scandals in which special purpose entities were allegedly abused, including Banco Ambrosiano, BCCI, Enron, AIG, and Parmalat – to name only a few - threaten to cripple some of the legitimate and beneficial uses of SPEs, while failing to address the underlying causes of the problem.

FASB responded with proposed accounting changes for SPEs. Some proposed changes, such as recognizing certain upfront derivative contract payments as a financing instead of as revenue, are appropriate. Other proposed changes, such as some aspects of FIN 46, are counterproductive attempts to answer the wrong question. New rules proposed to give the appearance of doing a good accounting job fail to address the issue. Even worse, they provide potential unnecessary complications for collateralized debt obligations (CDOs). In fact, the new rules may exclude some beneficial structures by throwing into question whether reserve accounts built up from residual cash flows in synthetic deals will cause the CDO to be treated as a variable interest entity (VIE).

SPEs have been used to legitimately move assets off of a balance sheet and monetize them through repackaging combined with sales to investors. SPEs have also been used for embezzlement, money laundering, to mischaracterize revenues and losses, to perpetrate fraud on unwitting fund investors, to move money offshore for tax evasion, to channel funds to terrorist operations, and to disguise the source of money for illegal arms sales.

The Sarbanes-Oxley Act is a step in the right direction, but lacks effective deterrents. While the Sarbanes-Oxley Act may make it harder for U.S. entities to abuse SPEs, the larger problem for the international community is the prevention of illegal cross border money flows. The question that requires an answer is how do we competently manage structured finance activity and deter abuse?

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**I. Legitimate Uses of Structured Finance and Special Purpose Entities**

All of the following are examples of SPEs: Special Purpose Corporations (SPCs) which may or may not be Special Purpose Subsidiaries or *captives*; Master Trusts; Owners Trusts; Grantor Trusts; Real Estate Mortgage Investment Conduits (REMICs); Financial Asset Securitization Investment Trust (FASIT); Multiseller Conduits; Single Seller Conduits; and certain Domestically Domiciled Corporations.

Special purpose entities are often classified as either *passthrough* or *paythrough* structures. Passthrough structures pass through all of the principal and interest payments of assets to the investors. Passthrough structures are therefore generally passive tax vehicles and do not attract tax at the entity level. Paythrough structures allow for reinvestment of cash flows, restructuring of cash flows, and purchase of additional assets. For example, credit card receivable transactions use paythrough structures to allow reinvestment in new receivables so bonds of a longer average life can be issued.

For securitization of cash assets, the key focus is on non-recourse (non-recourse to the originator/seller) financing. The structures are bankruptcy remote so that the possible bankruptcy or insolvency of an originator does not affect the investors' right to the cash flows of the vehicle's assets. The originator is concerned about accounting issues, especially that the structure meets requirements for off-balance sheet treatment of the assets, and that the assets will not be consolidated on the originator/seller's balance sheet for accounting purposes. For bankruptcy and accounting purposes, the structure should be considered a sale. This is represented in the documentation as a *true sale at law* opinion. The sale is also known as a *conveyance*.

The structure should be a debt financing for tax purposes also known as a debt-for-tax structure. Tax treatment is independent of the accounting treatment and bankruptcy treatment. An originator selling assets to an SPE will want to ensure that the sale of assets does not constitute a taxable event for the originator. The securitization should be treated as a financing for tax purposes i.e., treated as debt of the originator for tax purposes. This is represented in the documentation in the form of a tax opinion.

The structured solution to the bankruptcy, true sale, and debt-for-tax issues varies by venue. For example, if a U.S. bank wants to securitize receivables, the structure requires two SPEs to avoid a federally taxable asset sale and to achieve off-balance-sheet financing and a bankruptcy remote structure. In the U.S. SPEs are usually organized as trusts (for tax reasons) under the laws of the state of Delaware or of New York. The first SPE is a wholly owned, bankruptcy remote subsidiary of the originator/seller, and the SPE buys the assets in a true sale. The assets are now beyond the reach both of the creditors of the originator/seller and the originator/seller. Wholly owned subsidiaries are consolidated with the originator/seller for U.S. federal tax purposes, so this achieves the debt-for-tax objective. The second SPE is the issuer of the debt (or ABS) and is entirely independent of the originator/seller. It is a bankruptcy remote entity. The second SPE buys the assets of the first SPE as a true sale for accounting purposes and a financing for tax purposes. Figure 1. in the appendix shows a schematic of this structure.

Other venues are more problematic, and the regulations with respect to the local equivalent of the U.S. Bankruptcy Court's automatic stay procedures, accounting rules, and tax laws must be verified with experts who have local expertise.

For example, two entities are required for Italian securitizations. The first entity can be onshore and purchases the assets. The onshore entity cannot issue bonds, or it will attract heavy Italian taxes. The second entity is offshore and the second vehicle issues the bonds.

France is in the process of changing their securitization rules, and future securitizations will be easier in that venue. Business should grow exponentially in 2005.

Synthetic securitizations do not get true sale treatment for accounting purposes, since no asset has been sold. This is true whether the vehicle is an SPE or a credit-linked note. The motive behind these structures is to reduce regulatory capital according to regulatory accounting principles. Funding is a non-consideration or a minor consideration. These are usually balance sheet deals for bank regulatory capital relief. Partial funding is feasible with a hybrid structure. A corollary motive is to get credit risk relief. These structures are especially popular with European banks that have cheap and abundant funding relative to U.S. banks.

Repackaging is another legitimate use of SPEs. U.S. banks often set up multi-issuance vehicles (MIEs) in the Cayman's or other tax friendly venues. These are Qualifying Special Purpose Entities (QSPEs) for Financial Accounting Standards Board (FASB) purposes. By definition, they are off balance sheet, bankruptcy remote entities. The assets are put presumptively beyond the reach of the bank transferor's creditors through a true sale. Furthermore, the bank is not obligated to repurchase the transferred assets. Setting up the SPE in this way insulates the customers from the bank's credit risk, and ensures the assets don't re-emerge on the bank's balance sheet, even though the SPE may often purchase assets from the bank sponsor's books.

Accounting rules are always subject to change. FASB continually reviews the conditions to be imposed on active SPE assets through equity ownership, management agreements, or other means. They have regular meetings on SPEs, sale criteria, transfers of financial instruments, and modification of the definition of a QSPE.

The MIE issues notes that reference only the underlying collateral specific to each note (unlike the structure in which the collateral for all the EMTNs is a reference pool of assets). The noteholders do not have a claim to any other asset owned by the SPE. Each set of assets is funded separately with its own EMTN tranche combining the risk characteristics of the underlying assets and/or derivatives. The derivatives may be hedges or may actually be an underlying asset, such as a credit derivative.

Figure 2. in the appendix shows a typical vanilla repackaging. The SPE purchases assets. The assets are pre-funded from proceeds of an EMTN issued by the SPE and underwritten or sold by the bank arranger's (bank sponsor's) capital markets group. The SPE pays the asset cash flows to the bank arrangers swap desk as one leg of a swap payment. The bank arranger provides the structured coupons due to the investors under the EMTN issue.

A diverse group of investors purchases EMTNs issued by an MIE: insurance company funds, independent funds, bank sponsored funds, corporations, insurance companies, commercial banks, merchant banks, investment banks, savings banks, regional banks, and US investors eligible to purchase 144A assets.

The MIE offers more competitive note issuance, because it can take advantage of a more advantageous funding cost relative to the bank's funding cost. From the investor's point of view, the SPE issued note is different from a credit-linked note issued

by the bank sponsor, since the investor has no exposure to the bank sponsor (assuming that bank sponsor collateral is not used for synthetic repackagings). The note is securitized by collateral purchased by the SPE and frequently – but not always – selected by the investor.

### **III. Venue of the Special Purpose Entity**

There is no easy answer to the question: “Where is the best place to set up an SPE?” It depends on the structured finance application among other considerations. SPEs are currently set up in a variety of tax friendly venues including Delaware (in the United States), New York, Luxembourg, the Netherlands, the Caymans, Ireland, Jersey, Guernsey, and Gibraltar.

While SPEs in the United States are often, but not always, set up as trusts for tax reasons, in non-U.S. venues, the special purpose corporation is a common structure. Venues can be chosen wherever an SPE structure is allowable, but as a rule, only tax friendly venues for the specific structured finance application are chosen.

While choice of venue usually revolves around tax issues, other considerations can be important. For example, many investors in Germany will buy notes issued by SPEs, but often require an OECD issuer. Therefore, the SPE must be set up in an OECD country. Among the OECD countries, the Netherlands, Luxembourg, and Ireland are currently the most commonly used tax-friendly venues.

In tax terms, we want the SPE to pay zero tax on payments flowing in and flowing out. We want to avoid corporate income tax at the venue of the SPE and the bank sponsor. There are two withholding tax issues: 1) withholding tax at the source, the venue of the incorporation of the SPE, on EMTNs issued by the SPEs; and 2) withholding tax imposed on the underlying assets purchased by the SPEs by the country in which the assets were originated. The goal is that neither interest nor dividends paid by the SPEs is subject to withholding tax, so an ideal venue does not impose this tax.

If we choose a venue such as the Cayman Islands that does not have tax treaties in place with most jurisdictions, there is no mechanism for reclaiming tax withheld (if any) on the underlying asset income from the country of origination. The SPE will purchase assets that are not subject to withholding at the country of the assets’ origination so that investors will not suffer a reduced return.

If instead we choose a venue with tax treaties in place, assets that suffer withholding tax may specifically be chosen so the withholding tax can be reclaimed. This is a legitimate use of an SPE. Tax evasion is illegal; tax avoidance is legal.

We do not want to suffer tax on the SPEs income. In Europe, we also want to avoid value added tax (VAT) and stamp duties. The goal is to have zero tax leakage, if possible. Venues such as the Caymans, Jersey, and Guernsey offer this advantage, but may not enjoy ready investor acceptability.

Other venues such as the Netherlands, Luxembourg, and Ireland, also offer several tax advantages. There is no withholding tax on note interest. There is no stamp duty. There may be a very small value added tax (VAT) on servicing and administration for the SPE. There is no withholding tax on deposits. Among these three venues, there are other considerations that may affect the final choice, however. The Netherlands

seems to take several weeks longer to provide tax rulings for SPEs compared to Ireland and Luxembourg. In the Netherlands, there seems to be a turf war between Amsterdam versus Rotterdam, and most SPEs are set up in Amsterdam. For speed, one might choose Ireland or Luxembourg. In Ireland, the SPE must fit within the Irish tax securitization code. This may drive up the cost slightly relative to Luxembourg. U.K. based deal arrangers might find it more convenient to deal with Ireland, since Ireland uses an English law based system. Lately, Ireland has been the fastest of the three venues in actual set-up time; usually two to three weeks once the paperwork is in order.

#### **IV. Flexibility and Regulation**

The flexibility and privacy of offshore SPEs in particular makes them very powerful financial tools for legitimate securitizations, but also makes them attractive tools for illegal financial dealings. The key issue seems to be disclosure of the true ownership of the SPE. Legitimate businesses voluntarily disclose minority ownership interests in offshore SPEs as equity on their balance sheet. Offshore subsidiaries are also disclosed.

While SPEs are ideal for securitizing assets, they are also ideal for hiding assets. Many offshore venues do not divulge ownership of SPEs, and to complicate matters, the owner may be one or more SPEs in different venues. There is no easy answer to this dilemma, since any legitimate means can be exploited for illegitimate gain.

The overall issue, however, is how do regulators wish to react to any illegal financial activity, including the abuse of SPEs. What is the best course of action for entities such as the International Monetary Fund that are in a position to distribute funds? One could suggest that each country must introduce rule of law and financial accountability before debt is forgiven or before new funds are lent. Even in strong financial venues like the United States, it is difficult to curtail abuse. In disadvantaged countries, especially venues in which corruption is suspected, it may be even more difficult to curtail financial abuse, and the issues are more difficult. There are broader humanitarian issues such as the effect of withholding funds on the general population and whether funds provided aren't diverted to special interests instead of employed as intended.

#### **References**

Tavakoli, Janet M. *Collateralized Debt Obligations & Structured Finance: New Developments in Cash and Synthetic Securitization*, John Wiley & Sons, August, 2003. Adapted and condensed from Chapters 3 and 8.

Figure 1.

## Double SPE Structure for U.S. Accounting and Tax Regulations

