RESTRUCTURING AND REHABILITATION OF DISTRESSED ASSETS: TAX AND REGULATORY ASPECTS

By Ernst & Young LLC

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Introduction

The uncertainties in today's economic and financial environment pose complex challenges to businesses and financial institutions. The credit crunch, political instability and contradictory regulations create a difficult playing field that requires businesses to adjust their corporate strategies to rapidly changing circumstances.

Normally, investors would have a wide range of opportunities to contribute to and benefit from the various restructuring options, custom-tailored transactions, rehabilitation techniques and solutions for distressed assets that proliferate today.

In the Ukrainian legal and regulatory environment, however, business not only bears the burden of turnaround for its own sake, but also faces significant impediments caused by underdeveloped and constantly fluctuating legislation. Due to this, certain appropriate solutions become unreasonably distorted or difficult to achieve.

Still, there are some positive trends that the Government will, hopefully, exploit.

Restructuring and Rehabilitation Programs

In today's situation, the finance sector's problems and the problems associated with a growing stock of nonperforming loans do not affect only individual banks. All market players could potentially pay a dear price. If left unresolved, these troubles could cut the corporate sector off from capital and thus hamper economic recovery. And that's only the tip of the iceberg. Until overall corporate profitability and returns on investment recover from the downturn, the chances of banks revitalizing their portfolios through economically viable projects are scarce.

Whether Government intervention is required and, if so, to what extent it is required, are up for discussion. It is beyond doubt, however, that, as a critical minimum, there should exist a sound legislative framework setting out transparent principles and procedures for efficient asset resolution.

In Ukraine, collateral enforcement seems to be the tool banks most commonly use for distressed asset rehabilitation and restructuring.

It would be unfair to say that the government did not attempt to establish legislation to regulate the restructuring process. Such legislation exists, and deals mostly with individual borrowers. The lawmakers tried to provide banks with incentives for implementing restructuring programs and created guarantees for borrowers who agreed to restructure their liabilities. The corporate sector, however, was mostly left to care for itself.

Meanwhile, banks have been developing their own restructuring programs, relying little on assistance or guidance from the authorities. Many such programs exist. They depend on the financial positions of the borrower and the bank, the value of the collateral, the current status of the servicing of the loan, and other factors.

For many loans, the value of the collateral is lower than the outstanding amount of the loan and accrued interest. This is especially true for mortgage loans secured for residential and commercial real estate, the value of which fell considerably in the recent part. In such cases a bank may offer a borrower to hand over the collateral (the real estate) voluntarily. In exchange the bank will forgive the whole outstanding amount of the loan (including that part of the loan that exceeds the fair market value of the real estate). This makes sense for both parties: the bank receives assets that it can sell in the future to recover the debt and the borrower receives full clearance of all its debt.

From a tax perspective, however, this option may generate additional taxation costs for the borrowers. This is because the tax authorities will likely regard the amount of the loan the bank has forgiven as taxable income received by the borrower. Corporate borrowers

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will be required to include this amount into a general taxable base that is subject to a 25% corporate profits tax. For individual borrowers, banks will likely be required to act as tax agents who will have to charge and pay to the Ukrainian budget a personal income tax of 15%. Normally the personal income tax should be withheld from the amount of payment made to the individual. However in this case the bank is not making any payment to the borrower (the loan was issued long time ago), and therefore the bank will likely have to pay this tax at its own cost.

There are also cases in which the borrower would be able to service the loan if the interest rate were reduced substantially. Reducing the interest rate may also be advantageous for the bank – although it will accrue less income, the chances will be higher that it will actually receive that income and recover the principal amount of the loan. Yet in doing so, the bank could potentially violate taxation rules. They require the bank to recognize interest income at the fair market price level. The Ukrainian tax authorities will likely argue that the original interest rate that the loan agreement stipulated is an indicator of fair market level.

Apart from the tax considerations, there are many other practical, legal and financial considerations that complicate restructuring and rehabilitation processes.

As a result, selling loan portfolios is drawing more and more attention from financial institutions.

Why Sell the Loan Portfolio?

There are several reasons why a financial institution (the bank) would opt to assign the loan portfolio rather than deal directly with the defaulted loans.

First, finding ways to cooperate with problem debtors requires significant administrative resources, while outsourcing this function is rather tricky (largely because debt-collecting activity is poorly regulated). Further, if debt restructuring does not work, enforcing the collateral that secures the loan may appear to be the only viable choice for the bank. Unclear tax treatment, regulatory gaps and lengthy court/enforcement procedures, however, sometimes undermine the efficiency of this solution. Moreover, the deal must be carefully formalized, since imprudent wording not only increases tax risks but also creates the potential for miscellaneous legal claims.

Restructuring the distressed assets through loan portfolio assignment is becoming rather popular for those seeking to avoid tax costs and (sometimes) to get rid of their debt-collecting headache. Recent changes in the tax legislation fostered the demand for this solution. Unfortunately, though, there remain gray areas and irregularities that must be carefully considered.

A bank can transfer the loan portfolio from its balance sheet in two ways.

First, the bank may transfer the loans to a special purpose company (SPV) established by its group (in most cases by a foreign parent of the Ukrainian bank). The loans can be transferred at a nominal value or at a discount. In this structure the group retains control over the assets and receives additional benefits in the event the quality of the loan portfolio improves and collections increase.

Second, the bank may sell the loans to third party investors (they also usually set up an SPV to buy the loans). In this case the group transfers to these investors all risks and benefits related to the loan. Such investors usually offer a very low price for the loan portfolio. At the moment in Ukraine, unsecured loan portfolios are being sold at a discount varying from 90% to 98% of the outstanding amount of the loan and accrued interest.

Finally, these two options may be combined. That is, the group and the investors will jointly own the SPV that will purchase the loans from the Ukrainian bank. In this case the investors and the group will share all the risks and benefits that the loans bring.

Numerous questions should be critically addressed before loans are sold to the SPV. The crucial points are, inter alia, the SPV's legal status and residency, the type of the NPLs to be assigned, the structure of the financial flows, collection and servicing functions and the necessity for a feasibility study (treating practical aspects, the pricing mechanism and commercial benefits).
Below, we touch on some of the legal, regulatory and tax aspects of such a deal.

Banking Secrecy

Basically, Ukrainian civil law allows for assigning the creditor's rights to a third party. Banking law does not explicitly ban it either.

Banking secrecy rules, however, must not be disregarded. Thus, the Ukrainian Law On Banks and Banking Activity ("the Banking Law") prohibits banks from disclosing to anyone information about their clients and operations unless legislation specifically allows/

requires it. In a loan assignment transaction, the assigning bank would naturally disclose information about the borrower to the new creditor. Hence, the question is whether the assigning bank can be found in breach of the banking secrecy rules.

The recently adopted Ukrainian Law On Financial Recovery of Banks (“the Recovery Law”) introduced special rules for disclosing information subject to banking secrecy. In particular, a bank is allowed to disclose banking secrets to the assignee provided the assignment in question constitutes part of the bank’s financial recovery program.

Current practice indicates that the regulator is not interested in challenging banks’ assigning their loan portfolios to third parties in violation of banking secrecy rules. There is a chance, however, that borrowers and interested third parties (if any) could make legal claims.
To safeguard the bank’s interests, it is worth obtaining the client’s written consent for disclosure before the assignment. It could be a good idea to build the necessary safeguard clause into the banking service agreement.

Open Litigation

Another important issue to consider is the potential effect on open litigation with borrowers (if there is any). In particular, the procedural rules imply that after the loan assignment is executed, the court will likely terminate legal proceedings under the claim of the original creditor. This means that the new creditor may have to initiate new litigation.

Who Can Buy the Loan Portfolio?

There is room for uncertainty regarding the status of the legal entity that lends funds to individuals and corporations.

The Financial Services Commission opined that the lender should not necessarily be a financial institution unless the loan falls under the definition of financial credit and some other conditions are met. Since the bank’s loan portfolio logically qualifies for financial credit, the new creditor (a Ukrainian resident) is expected to be a financial institution.

As regards non-residents, one point of view is that they can perform certain financial services without registering as financial institutions in Ukraine. This is the case in such cross-border transactions as interest-bearing loan financing and financial leasing (these services qualify as financial services under Ukrainian law). We may reasonably assume that the same approach can be applied to acquisition of loan receivables by a non-resident entity. The National Bank of Ukraine (NBU) has also indirectly confirmed the legality of assignment of loans to foreign creditors. However, there are no clarifications from the Financial Services Commission, which is a regulatory authority for financial services that non-banking entities perform.

If a foreign SPV is opted for, the choice of jurisdiction is important, as it will carry tax implications (relating, for example, to the withholding tax rate on the payments the Ukrainian borrowers will remit to the new creditor, to the possibility of benefitting from double tax treaty exemptions, to taxation of inbound and outbound financing flows in the hands of the SPV, etc.).

Yet there are other questions that surround structures with foreign SPVs.

First, the assigned loan must be registered with the NBU according to the procedure established for registration of cross-border loans. The assignment of the loan agreement to the foreign creditor will not come into effect until its registration with the NBU.

Surprisingly, however, the obligation to register the assigned loan lies with the borrower. Neither the new creditor (the non-resident SPV) nor the assigning bank is entitled to file a registration application on behalf of the borrower, unless the borrower grants one of them power of attorney. This may create problems with mala fide borrowers that are unwilling to cooperate and assist with the loan’s registration. In a worst-case scenario, the non-resident SPV could be unable to extract foreign currency proceeds from Ukraine.

Second, interest rates under cross-border loans are subject to statutory limitations depending on the term of the loan (up to 11% per annum for loans with fixed interest rates; for loans with floating interest rates LIBOR for three-month USD deposits plus 750 points).

Assuming the assigned loan agreements provide for higher interest rates, it is not quite clear whether the assignment will smoothly pass through NBU registration.

Finally, when opting for a foreign SPV, selecting the loans to be included in the portfolio also becomes important. Thus, the currency in which the debt is denominated and the borrower’s status (individual vs. legal entity) are crucial to the deal’s viability.

Servicing the Loan

It is general practice to engage a Ukrainian bank to service the loans after they are assigned to a special purpose vehicle created in Ukraine or abroad. The agreement(s) between the bank and the SPV define the specific scope of the servicing functions.

The SPV may also consider the necessity of involving a Ukrainian agent to enforce the loans. Such an agent would, in any case, be required if the SPV is located abroad (as practice shows, the state execution service would most likely be unable to collect foreign currency from the borrowers and transfer it to the SPV).

Importantly, however, the enforcement agent's involvement may give rise to a permanent establishment risk, which should not be disregarded.

Tax Considerations

Discount Deductibility

Recent changes to the Ukrainian Law On Corporate Profit Tax ("the CPT Law") shed some light on the tax treatment of assignment of receivables under the loan agreements. Before those changes, rules governing the taxation of such transactions were lacking.

Importantly, banks can now claim deduction on the discount (i.e., the difference between the nominal value of the assigned debt and the proceeds from the assignment). The exception is the amounts of assigned penalties and other payments not recognized as taxable bank income in previous reporting periods.

To explain, upon the first assignment of receivables under a loan agreement, the initial creditor is allowed to recognize deductible expenses equal to the nominal value of the assigned principal loan amount. The nominal value of the assigned accrued interest and other receivables under the loan agreement should be deductible for the bank in the amount of taxable income the bank recognized for such interest and for other receivables in the previous reporting periods.

The purchase price the SPV paid for the acquired loans would increase the bank's taxable income, subject to 25% CPT.

Release of Loan Impairment Provisions

According to the tax laws the bank will be required to release all provisions created for the assigned NPLs into its taxable income, subject to 25% CPT. Release of the loan impairment provisions upon assignment of the NPLs will not have an adverse CPT effect on the bank if it is able to increase provisions for other loans or has a comparable amount of accumulated tax losses to set off against the increase in its taxable income.

Inherent Tax Risks

From a practical perspective, sale of the overdue debt receivables is still rather unconventional in terms of standard Ukrainian practice and may create potential areas for dispute with the tax authorities.

For example, transfer pricing rule issues may have to be considered if the SPV is a non-resident or if the SPV and the assigning bank are related parties for tax purposes.

For corporate profit tax purposes, transfer pricing rules cover transactions on sale of goods (works, services). The CPT Law's wording, however, is unclear as to whether assignment of receivables under a loan agreement could qualify as sale of goods (works, services). The applicability of transfer pricing rules to the discussed assignment of the NPLs, therefore, is questionable. In addition, none of the statutory methods for arm's length price calculation seem to be relevant to loan portfolio assignment.

Nevertheless, the tax authorities may opt for a less favorable approach and insist on applying the transfer pricing rules. It is therefore practical to devise arguments proving that the loan portfolio's sale price is at arm's length level.

Another modern trend is relevant to this discussion: it consists in the tax authorities' attempts to challenge the substance of deals for tax purposes.

There is no unified and consistent guideline for applying this doctrine except for the odd and awkward initiatives and documents the tax authorities issue. In summary, the key idea is that agreements lacking a business purpose are void. This tool was originally intended to combat evident tax evasion, but it is now finding application on a far wider scale and is reportedly being used against bona fide taxpayers.

As practice shows, therefore, the tax authorities might fail to see the business purpose in the bank's selling the loan portfolio at a price much lower than its nominal value. Though the risk is not immediate, the bank should still be able to offer sufficient business reasons for why it sold the NPLs to the SPV at the given price (apart from achieving the tax effect).

Withholding Tax Considerations

According to the Ukrainian CPT Law, certain types of income non-residents receive from Ukrainian sources are subject to the withholding tax. Whenever applicable, this tax should be withheld by a Ukrainian resident that pays income to a non-resident.

If the new creditor is a foreign SPV, therefore, there are plenty of withholding tax issues to consider while the assignment deal is being structured.

First, the question arises as to which person is deemed a withholding tax agent. Under the ordinary transaction set-up, if the borrower (corporate entity) directly remits interest and other payments to the non-resident creditor, it is liable for tax withholding.

However, if the Ukrainian bank is vested with loan administration functions (i.e., payment collection and transfer to a non-resident SPV), there may be grounds to regard that bank as the withholding tax agent. Notably, the CPT Law does not provide for a mechanism for administering the withholding tax in the event the payers of income are individuals.

Given this, it is necessary to take a critical look at the bank's servicing functions if a definitive conclusion is to be drawn.

Second, it is important to identify all the types of Ukrainian-sourced income that the foreign SPV is to receive and to and calculate the applicable withholding tax rates.

Thus, Ukrainian-sourced income that a non-resident derives is subject to 15% withholding tax. Under the conventional loan assignment structure, one can expect that the incomes of the following types of foreign SPVs would fall within the scope of the Ukrainian withholding tax:

- interest,
- penalties and fines
- discount, i.e., the margin between the amounts collected from the debtor and the purchase price of the debt, if earned by the SPV (although the law provides no definition of discount income, it is nevertheless listed as income subject to withholding tax).

The withholding tax burden may fall under the applicable double tax treaty (DTT) between Ukraine and the non-resident's country. When deciding on the best jurisdiction for the SPV, therefore, it is necessary to analyze Ukraine's double tax treaties with countries of strategic choice to select those that offer the best tax regimes for the incomes at stake.

Taxation of a Ukrainian Factoring Company

If debt is transferred to a Ukrainian financial company, it may encounter disadvantageous tax treatment.

According to the Ukrainian corporate profit tax law, a factoring company should calculate the taxable result for each individual loan purchased from a Ukrainian bank.

The taxable result is calculated as gross proceeds the factoring company received from debtors less the cost of purchasing the loan from the bank-originator. If the taxable result is positive (that is, profit is received), the factoring company should include it into gross taxable base, which is subject to 25% corporate profit tax. If the taxable result is negative (loss is incurred), the factoring company is not eligible to deduct this loss (i) against profits received on other loans or (ii) from a general taxable base.

Because of these restrictions, the factoring company's effective tax rate could significantly exceed the statutory profits tax rate of 25%.