

# Tips for investing in distressed loans in Ukraine

Now is a popular time to buy distressed loans cheaply in Ukraine. However, there are many tax issues to consider, such as where to locate the corporate entities used to make the purchases, explains [Igor Chufarov](#) of Ernst & Young

**T**he global economic crisis gave new meaning to the concept of the “distressed investor.” This kind of investor is willing to risk their capital by acquiring assets that are at a low price because of the crisis and hopes to sell them for a profit when business normalises.

The Ukrainian banking and financial sectors, hit hard by the crisis, naturally offer a lot of opportunities for distressed investing. The rapid fall in the quality of loan portfolios and growing provisions created incentives for Ukrainian banks to get rid of their distressed assets. Recent changes in the tax legislation facilitated this course of action. In particular, Laws of Ukraine dated June 23 2009 No 1533 and dated July 24 2009 No 1617 specifically allowed Ukrainian banks to deduct (discount) losses incurred when selling a loan portfolio. This cleared the way for banks to sell distressed loans to third-party investors.

Now many banks are tendering for sale their retail unsecured consumer loan portfolios and their auto loan and mortgage portfolios in foreign or local currencies. Low asking prices should be attractive for potential investors. But apart from purely business considerations (the pricing of the assets and the expected profitability) the interested investor should think about designing a robust legal and tax structure with which to make the investment and repatriate the expected profits from Ukraine.

Underdeveloped and fluctuating legislation means that investors can expect to face significant impediments because of Ukraine’s legal and regulatory environment. Certain civilised structuring solutions will become unreasonably distorted or be difficult to achieve.

There are several basic structures that an interested investor can consider for structuring acquisitions of distressed loan portfolios from Ukrainian banks:

- a foreign special purchase company (non-resident SPV);
- a Ukrainian financial company that can provide factoring services (factoring company);
- a Ukrainian venture fund.

Each of these structures implies that an investor establishes a vehicle (a company or a non-corporate entity such as a venture fund) in a chosen jurisdiction and enters into an agreement with a bank in Ukraine to purchase the loans. On the basis of this agreement the investor’s vehicle becomes a new creditor under the loan agreements and receives all rights to collect outstanding loan principal, accrued interest and commission fees and other payments from the borrowers in Ukraine.

## **Non-resident SPV**

The non-resident SPV is the most obvious choice for a foreign investor. It creates an opportunity to repatriate all distressed loan proceeds from Ukraine to a jurisdiction with low or no taxation.

Selecting the foreign jurisdiction for the location of the SPV is important, as it is driven by tax considerations (for example, the withholding tax rate on payments the Ukrainian borrowers will remit to the new creditor, the possibility of benefiting from double tax treaty exemptions and taxation of inbound and outbound financing flows in the hands of the SPV). Some jurisdictions may, under certain conditions, consider profit that the SPV realises to be of a capital nature for tax purposes and thus exempt it from corporate profit tax. Cyprus is often ranked first among the jurisdictions usually shortlisted by investors.

Unfortunately, the tax benefits that a non-resident SPV structure could potentially provide are overshadowed by regulatory impediments. In particular, under National Bank of Ukraine (NBU) regulations, each loan assigned to a foreign company must be registered with the NBU. The registration is handled by regional NBU departments and is generally not burdensome. However, it is important to note that the obligation to register the assigned loan lies with the borrower (an individual or a corporation). The new creditor (the non-resident SPV) is not entitled to file a registration application on behalf of the borrower, unless the borrower issues power of attorney to the new creditor.

An impediment to the transfer of loan proceeds from Ukraine could arise if the borrower is unwilling to cooperate and assist with the registration of the loan. The NBU's regulations prohibit banks from servicing payments abroad on loan agreements (including assigned loan agreements) that are not duly registered with the NBU. Therefore, if the borrower refuses to register the loan, the non-resident SPV will most likely be unable to extract foreign currency proceeds from Ukraine.

Currency control regulations may also hinder transferring loans denominated in Ukrainian currency to the non-resident SPV. Ukrainian currency (UAH) is not freely convertible, and the non-resident company is restricted in terms of repatriating its proceeds from Ukraine.

The combination of these regulatory impediments effectively means that the non-resident SPV structure may work if the investor is contemplating purchasing a limited number of large corporate loans in a foreign currency. In that case completing the currency control procedures (registering the loans with the NBU) should not be too burdensome. For loan portfolios consisting of a large number of individual loans other structures may need to be used, because arranging for the registration of each individual loan may be unfeasible in practice.

## **Ukrainian factoring company**

The Ukrainian company that the investor establishes in Ukraine to purchase loan portfolios will probably be required to obtain financial institution status because:

The Civil Code of Ukraine qualifies factoring as financing provided in exchange for assignment of a monetary obligation

and for a fee (the definition has recently been clarified by the State Commission of Ukraine for Regulation of the Financial Services Markets (the Financial Services Commission). In particular, it qualifies a discount to the debt value as a factor's fee. Factoring is mentioned among those financial services that require the service provider's registration as a financial institution. Financial institutions should provide financial services on an exclusive basis.

To obtain financial institution status, the Ukrainian company should be included in the State Register of Financial Institutions of Ukraine. The Financial Services Commission maintains this register.

To conduct factoring operations, the SPV may be recorded in the register as a "financial company," which is a separate type of financial institution according to the Commission's regulations. To be included in the register, the company must comply with a number of Financial Services Commission requirements.

Overall, it is not that difficult to create and register a financial company, which is evidenced by the fact that there are dozens of such companies in Ukraine. The disadvantages of the factoring company structure, however, lie in the taxation treatment of its operations.

A factoring company is subject to all applicable Ukrainian taxes, including the corporate profit tax. For tax purposes the factoring company should define a taxable result for each loan purchased as a difference between proceeds collected on the loan and the cost of purchasing the loan. Importantly, the tax law imposes restrictions on netting losses and gains between different loans. If it incurs losses on one loan, the company is unable to deduct the losses against gains realised on other loans or against taxable profit from other operations. This could significantly increase the effective tax rate of the company.

There are also grey areas and uncertainties in a Ukrainian factoring company's tax regime. It is not clear if the factoring company should continue accruing interest income in its tax books on the loans purchased. If the loans are denominated in foreign currencies, the factoring company may be required to revalue the loan principal and overdue interest in its books and recognise foreign exchange gains (or losses) in the tax return. It is important to understand that the likelihood of actually collecting such accrued (unrealised) income in full is doubtful in circumstances when the loan is long overdue and is purchased at a big discount. Recognising such accrued income in the company's tax books may therefore increase its effective tax rate even further.

For these reasons, from a tax perspective an alternative structure deserves consideration. According to that structure, the loan portfolio is assigned to a Ukrainian venture fund operated by an asset management company. A venture fund is not subject to corporate profit tax on any proceeds

## Biography



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Chufarov has more than 10 years of professional experience in rendering tax and legal consulting services. He advises clients on a broad variety of matters, specialising primarily in financial markets and financial services and corporate restructuring.

His client portfolio includes leading Ukrainian and international banks, securities traders and investment firms, insurance companies and also companies operating in the telecommunications, oil and gas, retail and IT sectors. He has extensive experience in tax and legal due diligence, M&A tax advisory services, distressed assets advisory and structuring. During 2007-2008 he worked in Ernst & Young's Moscow office in the financial services group.

from its assets. Tax-free repatriation of profits from the venture fund can also be arranged.

Another complication with the Ukrainian factoring company's structure arises in the area of currency control operations. As a factoring company is a financial institution under Ukrainian law, it is required to have a general licence from the National Bank of Ukraine to perform currency transactions if it is going to collect proceeds on loans in foreign currencies.

To side-step this requirement, the factoring company may engage a Ukrainian bank to act as servicer on the purchased loan portfolio. That bank will convert foreign currency proceeds on the non-performing loans (NPLs) into UAH and will credit UAH proceeds to the factoring company's bank account. The factoring company will thus receive only UAH proceeds.

Based on this, you could argue that the asset management company is not required to receive a general licence from the NBU because it will not receive any foreign currency in its bank account.

At the same time, the law defines a currency transaction as, among other things, any "assignment of debt receivable denominated in a foreign currency". On this basis, the proposed assignment of the foreign currency loans to the factor-

ing company may be regarded as a stand-alone currency transaction. Following the literal interpretation of the law, the factoring company is required to obtain a general licence from the NBU to perform this currency transaction. Interested investors should obtain a clarification from the NBU about this issue before entering into the proposed transaction.

### Ukrainian venture fund structure

A venture fund has no legal entity status and represents a contractual mutual investment vehicle (assembly of assets) jointly owned by the fund's investors and managed by the asset management company (AMC). All transactions with the venture fund's assets are carried out by the AMC, which is a legal entity acting under a licence issued by the Ukrainian Commission on Securities and the Stock Market (SEC).

Upon obtaining a licence from the SEC to manage mutual investment funds, the AMC should register as a financial institution and should comply with financial services regulations.

An obvious advantage of the venture fund is its tax efficiency. According to Ukrainian law, only corporate entities and individuals are recognised as taxpayers. The venture fund itself does not qualify as a taxpayer.

All transactions with venture fund assets are carried out by the AMC, which has the status of a corporate profit taxpayer on a general basis. The AMC manages the venture fund's assets not on its own behalf but on behalf of and for the benefit of third parties – the investors. The AMC should therefore not account for transactions with the venture fund's assets in its own tax returns.

As a result, all gains and losses that the venture fund realises on its assets (purchased loans) are not taxable (deductible). For this reason the venture fund should not suffer from restrictions on netting gains and losses on the loans purchased – restrictions that apply to a factoring company.

Taxation may also be avoided at the stage when profits are repatriated from the venture fund. Dividends paid by Ukrainian companies are normally subject to advance corporate profit tax of 25%. However, for venture funds (and other mutual investments funds) an exemption applies. If the venture fund's investors are non-resident persons, they can, on the basis of applicable double tax treaties, obtain an exemption from Ukrainian withholding tax on dividends and capital gains received from investment into the fund. Finally, many foreign jurisdictions would treat income from investments into the venture fund as income of a capital nature and not subject it to profit tax.

Is that too good to be true, the potential investor may ask? Are there any hidden pitfalls? Of course there are.

Acquiring a debt portfolio for cash consideration at a discount should qualify as a factoring service that the AMC has provided to the originator of the loans. There is a list of financial services that financial institutions may not combine.

According to it, asset management services (that is, the AMC's managing of the venture fund) may not be combined with any other financial service (for example, factoring), unless otherwise is established by the law. The law does not provide an exemption for factoring services. On this basis, one may argue that the AMC may not provide factoring services and that, therefore, the venture fund's acquisition of the loan portfolios does not comply with the law. The issue may be clarified with the Financial Services Commission.

The venture fund structure is unfortunately affected by the same currency control issues that are relevant for the Ukrainian factoring company. The AMC, as a financial institution, may need to receive a general currency licence from the NBU to purchase loans in foreign currencies.

## **Structural merits**

As this indicates, if compared against each other none of these options appears to be a clear winner. One option offers great tax benefits and advantages to the investor but is troublesome from a regulatory perspective. Another option is simple and straightforward, but results in higher taxation costs. As a result, the investor must perform a feasibility study to identify the option that best suits present interests in each particular case.

The range of issues that could arise when structuring this kind of deal is far wider than everything mentioned here. These include specific legal issues (such as banking secrecy requirements, risks connected with litigation and enforcement in progress, dealing with collateral and operating foreclosed assets), practical implementations aspects and commercial benefits.

Interested investors should also remember that for all structures discussed here, there are plenty of international tax issues to consider. The investor should choose a proper jurisdiction for the holding company that will own shares in the SPV – a jurisdiction that will allow it to avoid Ukrainian withholding taxes on dividends and capital gains. A careful choice of the financing structure for the SPV is also important.

# Know where to go?

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