

Transferring a Distressed Loan Portfolio to a Non-resident SPV: Key Taxation Considerations

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

Normally, there would be a wide range of opportunities for investors to contribute to and benefit from various restructuring options, custom-tailored transactions, rehabilitation techniques and solutions for such distressed assets.

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

In the current environment, problems in the finance sector and the growing stock of non-performing loans do not affect individual banks only. All market players can pay a heavy price. If left unresolved, these troubles can cut off the corporate sector from financial capital, thereby hampering 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 for banks to revitalize their portfolios through economically viable projects are slim.

In light of the above considerations, many Ukrainian banks are now considering proposals to transfer their distressed loan portfolios to non-resident special purpose companies (SPVs). Doing this could potentially allow for achieving the following goals:

- As a rule, such an SPV will be established by the group (in most cases by a foreign parent of the Ukrainian bank). At the group level, transferring a loan portfolio from one entity (the Ukrainian bank) to another entity (the SPV) should have no substantial effect on the group's financial position. But disposing of the non-performing loan portfolio could significantly improve the Ukrainian bank's financial performance and financial statements on a stand-alone basis.

- The loans can be transferred at nominal value or at a discount. By regulating the level of the discount, the group can inject additional capital into the Ukrainian bank and do it quicker than is possible under the standard procedure for increasing its charter capital.



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- As long as the group controls the SPV, it retains control over the assets and receives additional benefits if the quality of the loan portfolio improves and collections increase.

- Selling the loans at a discount potentially allows the Ukrainian bank to receive taxation benefits at local level.

Nonetheless, unfortunately gray areas and irregularities that deserve careful consideration remain.

First of all, the choice of jurisdiction is important, as it is driven by tax considerations (i.e., the withholding tax rate on the payments the Ukrainian borrowers are to remit to the new creditor, the possibility of benefitting from double tax treaty exemptions, taxation of inbound and outbound financing flows in the hands of the SPV, etc). Another issue that will inevitably arise, in terms of assigning a loan portfolio to an off-shore SPV, is the registration of each separate loan agreement with the National Bank of Ukraine. This requirement may potentially create problems for a bank with *mala fide* borrowers. At this stage, therefore, appropriate legal protection is required.

Moreover, when a bank opts for a foreign SPV, selecting what loans will 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) is crucial to the deal's viability.

Another issue is the tax treatment of the sale of a loan portfolio. Recent changes enacted by the *On Introduction of Changes into Certain Laws of Ukraine to Overcome the Negative Consequences of the Financial Crisis Act of Ukraine of 23 June 2009, No.1533 (the Act No. 1533)* shed some light on this tax treatment. Before the law, there were no rules for taxing such transactions. Importantly, the banks can now claim a deduction on the discount (i.e., the difference between the nominal value of the sold debt – except for the value of charges previously not recognized as income – and the proceeds from the sale).

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In reference to the above, the bank should consider the tax implications of releasing provision for non-performing loans, which means that the bank must operate additional loss provisions (accumulated loss) in order not to pay excessive corporate profit tax. (This is to some extent facilitated by the fact that the above-mentioned Act No. 1533 increases allowable bad loan provisions.)

For Ukrainian law-enforcement practice, the sale of overdue debt receivables is still rather unconventional, and there may be other potential areas for dispute with the tax authorities. They may, for example, disagree with the price of the deal based on the arm's length approach or try to challenge the substance of the deal for tax purposes.

From the SPV's point of view, there are plenty of international tax issues to consider while structuring the assignment deal. Inter alia, the parties involved must consider which person will be liable for paying withholding tax. When structuring the remittance of interest from the borrowers to an offshore SPV through a specialized Ukrainian company, the parties must ensure that the scheme will not trigger permanent establishment exposure in Ukraine. If the offshore company is created solely for the purpose of operating a bad loan portfolio, it should also have enough economic substance to use double taxation treaty protection, as well as meet other requirements to qualify for such protection.

The scope of issues that could arise in the structuring of this kind of deal is far wider than we were able to discuss above. The issues include specific legal ones (banking secrecy requirements, risks connected with litigation and enforcement that is in progress, dealing with collateral, operating foreclosed assets, etc.) as well as issues related to practical implementation, commercial benefits, etc.

Overall, the introduction of Act No. 1533 may give the green light to the process of rehabilitating and restructuring distressed assets, which could potentially revitalize Ukraine's ailing banking system. Law-enforcement practice and development of subordinate legislation will, however, demonstrate the extent to which the Government will support these incentives.

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- tax and legal structuring for inbound and outbound investments, including structuring to raise capital/financing in international financial markets;
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- real estate advice including acquisition, development, and disposal/operation;
- corporate structuring and restructuring, company incorporation, and advice on corporate and commercial law issues;
- non-performing loans portfolio: tax, legal, and financial structuring;
- corporate and personal tax planning and structuring, including international tax structuring, cross-border transactions, and transfer pricing;
- customs and indirect taxation;
- administrative litigation, including tax disputes;
- drafting and reviewing legal and tax aspects of commercial transactions and agreements;
- assistance with regulatory and currency control issues;
- labour and immigration law; and
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