Tax impediments to the sale of non-performing loans ('NPLs') in Central and South Eastern Europe ('CESEE')

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Tax impediments can be significant barriers to effective resolutions (including transfers) of NPLs. Consequently, a number of jurisdictions have taken steps, with varying degrees of success, to encourage NPL resolution. Other CESEE countries are looking to learn from successful jurisdictions and implement future changes. In particular, two key impediments have been identified, namely the ability to take tax deductions for write-offs and provisions, and the ability to utilise losses in the future. These areas, along with withholding taxes, VAT and transfer taxes are examined in detail as part of this note. The note also considers a case study involving Serbia which illustrates efforts made by the Serbian government to encourage NPL resolution.

1. OVERVIEW OF NPL TAXATION IN CESEE

In addition to legal and regulatory barriers, tax impediments often present themselves as challenging hurdles to be overcome in the pursuit of effective NPL resolution. As a result, tailored local tax measures are key to supporting banks' write-offs of NPLs and attracting investors to acquire distressed debt from banks.

In recent years, tax authorities across Europe have brought in changes to tax rules impacting the sale of non-performing loans and enabling banks to divest NPL portfolios from their balance sheet.

However, outside of areas such as VAT, which is harmonised at the EU level, differences in tax treatment across jurisdictions still remain. In certain jurisdictions, for instance in CESEE, NPL levels overall remain high and governments are looking to implement changes to their internal tax regimes to create a more dynamic NPL market and remove hurdles to banks' abilities to write-off or sell their NPL portfolios. For example, Serbia has issued amendments to its tax system in an attempt to remove tax impediments in the NPL market. Similarly, the National Reform Programme in Croatia has confirmed that there should be a change in tax legislation to incentivise NPL resolution. In late 2013, the Croatian tax legislation introduced a series of amendments to help facilitate NPL resolution, although these provisions have presented some uncertainty and the overall benefit for banks is mixed. Nevertheless, it appears that various jurisdictions are moving towards more favourable tax regimes for NPLs.

To provide recommendations on prospective tax legislative changes, the taxation of NPLs should be considered more holistically in the context of the local tax, legal and regulatory systems of each jurisdiction. However, as a starting point, it is helpful to outline the key drivers and impediments to the sale of NPLs from a tax perspective.

Tax impediments broadly fall within two categories:

- Those which discourage banks from writing-off and provisioning against non-performing loans appropriately (e.g. tax treatment of provisions and write-offs; utilisation of tax losses); and
- Impediments impacting the transfer of NPLs from banks to other entities, such as private equity groups or securitisation vehicles (e.g. withholding tax on interest payments, transfer taxes which increase the cost of buying NPLs for investors).

These tax impediments are discussed in turn.

2. TAX DEDUCTIONS FOR PROVISIONS AND WRITE-OFFS

Whether banks receive tax deductions for provisions or write-offs on loans can have a bearing on the overall effect of the recording of NPLs in their accounts (particularly where there is a timing element to the deductions involved). Although most jurisdictions now allow deductions for tax purposes for provisions and write-offs, the conditions that need to be met for the deductions to be allowed can sometimes introduce added complexities for banks when booking provisions or writing-off loans. As a result, banks keep large volumes of NPLs with little or no recovery value on their balance sheets. For instance, where a bank holds a large number of NPLs with smaller debtors, it may need to demonstrate that they have filed a lawsuit against each debtor before being allowed to take a tax deduction. Procedural steps like this can be discouraging from both an economic and commercial/practical perspective[3].

The table below provides a high-level summary of the tax treatment of provisions and write-offs in Romania, Serbia, Hungary, Croatia and Montenegro.

	Romania	Croatia	Hungary	Montenegro	Serbia
Corporation tax deductions					
Tax deduction allowed for write-off of NPLs	✓(4)	✓ (5)	✓ (6)	✓ (7)	✓ (8)
Tax deduction allowed for provisions booked in respect of NPLs	✓(9)	✓	X (10)	✓ (11)	✓ (12)

Consequently, it is clear that, whilst most CESEE jurisdictions permit tax deductions for write-offs and provisions booked in respect of NPLs, the ease with which a deduction is taken, varies from country to country.

3. UTILISATION OF TAX LOSSES CARRY FORWARD

Once banks have been allowed to take tax deductions for provisions and write-offs of NPLs, one of the key points to consider is whether they can derive value from those losses (i.e. can they offset these losses against current or future taxable income). To the extent that there are restrictions on the utilisation of tax losses carried forward, this may provide additional difficulties, as banks will not be able to derive value from tax losses through either:

- A decrease in their current year and future cash tax bill; or
- The recognition of a deferred tax asset on their balance sheet.

Restrictions on the future utilisation of tax losses carried forward generally come from:

- Time limits (i.e. the fact that after a certain number of years, tax losses have to be forfeited). This can be problematic for banks where they sustain high level of losses for a longer period of time which could lead to some of those losses having to be forfeited.
- Change of ownership restrictions whereby tax losses carried forward need to be forfeited upon a change of ownership.

In the last few years, there has also been a move in a number of Western Europe jurisdictions towards ensuring entities are tax paying in each tax year, by limiting the amount of tax losses which can be offset against taxable profits in any given year. However, in those jurisdictions, tax losses carried forward generally do not lapse.

For instance, in the UK, from 1 April 2016, new rules were introduced which restrict the utilisation of tax losses for banks to 25% of profits above £5 million. This measure will further reduce the amount of a banking company's annual taxable profit that can be offset by pre-April 2015 carried-forward losses from 50% to 25%, following the initial restriction introduced in April 2015. At the time, it was announced that new rules would apply to tax losses, whereby it will be possible for losses arising from 1 April 2017 onwards to be carried forward and set against future profits arising from different activities within the company and against future profits made by other members of the same group. The French tax system allows the first €1 million of taxable profits to be offset, and 50% thereafter, as long as there is no major change in business activity. Similarly, in Germany, there are no time limits on the utilisation of net operating losses. However, loss relief claimable in any one year is limited to €1 million plus 60% of current income exceeding that amount in order to ensure 'minimum taxation'.

The table below provides a high-level overview of current restrictions on the utilisation of tax losses carried forward in Romania, Serbia, Hungary, Croatia and Montenegro.

	Romania	Serbia	Croatia	Hungary	Montenegro
Tax losses					
Time limitation of tax losses carried forward	7 years	5 years (10 for losses incurred pre-2010)	5 years (13)	5 years	5 years
Restrictions on carry-forward of losses upon a change of ownership	No restrictions	No restrictions	Certain restrictions apply (14)	Certain restrictions apply (15)	No restrictions

4. WITHHOLDING TAX

Withholding tax on interest is usually a key consideration for foreign investors. To the extent that loans are expected to generate interest income, the quantum of potential withholding tax leakage on interest income can be a determinative factor for foreign investors acquiring NPLs. Under the EU Interest and Royalty Directive, or the relevant double tax treaty, withholding tax may, however, be reduced for foreign investors. Typically, the application of the EU Interest and Royalty Directive, or a relevant double tax treaty, requires consideration of the specific facts and circumstances of the proposed transaction. In particular, careful consideration needs to be given to the concept of beneficial ownership and any anti-avoidance provisions in the double tax treaty. Under the EU Interest and Royalty Directive and most double tax treaties, the recipient of the income will generally need to be regarded as the "beneficial owner" of the income in order to benefit from the provisions of the Directive or treaty. Some tax authorities have provided further guidance on what may or may not constitute beneficial ownership; however, depending on the chosen acquisition structure, this remains an area of potential uncertainty for foreign investors.

5. VALUE ADDED TAX (“VAT“)

Another key tax consideration for investors is whether the transfer will be subject to VAT or not. The European Court of Justice (“ECJ“) has ruled that the acquisition of non-performing loans should not be subject to VAT (European Court of Justice dated 27 October 2011 in Case C-93/10). Based on this case, the acquisition of NPLs should be VAT-free “when the difference between the face value of those debts and their purchase price reflects the actual economic value of the debts at the time of their assignment”. As such, where structured appropriately, the acquisition of NPLs within the European Union should not generally be subject to VAT. Given that NPLs are typically acquired using an EU resident investment holding vehicle, VAT should generally not be a key consideration for NPL resolution.

6. OTHER TRANSFER TAXES

Other transfer taxes, such as stamp duty or real estate taxes, may also be of relevance depending on the jurisdiction, type of NPLs being acquired and the proposed transaction structure. Depending on how the portfolio is acquired, i.e. whether it is via a share acquisition or an asset purchase, various transfer taxes may come into consideration. Typically, the transfer of shares in a company owning real estate may be subject to transfer taxes whilst with an asset deal, real estate transfer taxes are generally due upon the transfer of titles to real estate.

	Romania	Croatia	Hungary	Montenegro	Serbia
Other transfer taxes					
Stamp duty	No stamp duties are levied.	No stamp duties are levied.	Stamp duties are due for procedures requested from public authorities and courts.	No stamp duties are levied.	A number of administrative and judicial fees are levied in certain situations at national and local levels.
Transfer taxes on real estate	No general transfer tax on the sale of immovable property for companies, but certain charges of approximately 1% apply.[16]	Acquisitions (by sale, exchange or other means) of immovable property are liable to a 5% real estate transfer tax provided that these are not subject to VAT.[17]	Transfer tax is levied on the transfer of ownership (for consideration) of immovable property (4% up to HUF 1bn, 2% above, capped at HUF 200 million). Other transfer taxes may apply.[18]	A 3% transfer tax is levied on the transfer of immovable property.	A 2.5% transfer tax is levied on the transfer of immovable property (that is not subject to VAT).

7. CASE STUDY: THE EXAMPLE OF SERBIA[19]

A number of amendments have been made to the treatment of NPLs in Serbia, in a bid to kick-start economic growth following its fourth recession since 2009 and prompts from the IMF to reduce its NPLs. In particular, key tax impediments to the sale of NPLs in Serbia have had to be addressed.

These impediments include:

- Ambiguity in relation to rules for tax deductibility of bad debt provisions and write-off;
- Strict requirements which need to be met for write-off of receivables;
- Misinterpretation that write-off equals debt release; and
- Receivables arising from write-off being taxed at the individual's level as their private income.

In particular, the impediments relating to tax deductibility are of interest for taxation purposes. In practice, the Serbian rules governing tax deductibility of bad debt provisions and write-offs can be ambiguous. In jurisdictions where the government is looking to encourage the divestment of NPLs, this ambiguity of interpretation can create disincentives for banks. Serbia's tax legislation tends towards being rather general in nature and does not provide a comprehensive framework of rules that regulate the sale of NPLs.

Nevertheless, strict conditions for the write-off of receivables for tax purposes does exist in Serbia. In order for a write-off to be treated as deductible, the following conditions need to be met:

1. Receivables must have been previously included in the taxpayer's revenues;
2. Receivables are written-off in the accounts as uncollectable; and
3. The taxpayer must provide evidence that it has filed a lawsuit regarding the collection of the relevant receivables, or that an enforced collection procedure has been initiated.

As of 1 January 2016 an additional rule has been applicable for banks. Namely, expenses from the write-off of individual loan receivables from unrelated parties will be considered tax deductible provided more than two years from the loan maturity has elapsed and the bank provides evidence of debtor insolvency.

It should be noted that to the extent the bank does not meet these conditions, write-offs of receivables from natural persons are treated as, and taxed as, other income for individuals.

Whilst tax legislation does not provide us with a comprehensive set of rules in relation to the sale of NPLs, from a Corporate Income Tax ("CIT") perspective, the sale of receivables is, on the whole, adequately regulated. Please note that if receivables sold were previously impaired in part, and that impairment was treated non-tax deductible, the sale of receivables would result in these impairment expenses being permanently non-tax deductible. In addition, recent changes to VAT law in Serbia have introduced reverse charges in the case of enforced sales to a VAT registered buyer, which is of specific importance during NPL work-outs (conducted by banks or buyers of NPLs).

I. Newly adopted amendments

The Serbian Ministry of Finance has issued amendments to CIT law in an attempt to remove tax impediments in the NPL market. The amendments, which came into force on 1 January 2016, have been viewed in some quarters as somewhat insubstantial and are not considered to have addressed many of the previous issues relating to tax impediments in the NPL market.

These amendments have not altered the strict conditions governing the tax recognition of expenses relating to the write-off of receivables. Yet, provisions that were not previously treated as tax deductible will be treated as deductible (once general conditions for deductibility of expenses in relation to write-off are fulfilled). Furthermore, previously unregulated situations, for example the deductibility of claims in restructuring procedures, have been addressed. Consequently, it appears that whilst some progress has been made, the removal of tax impediments is still a work in progress.

Furthermore, it is not clear how far these provisions are applicable to banks. For instance, the amendments introduce detailed rules for the recognition of write-off of expenses for banks. Specifically, expenses from the write-off of individual loan receivables from unrelated parties will be considered tax deductible provided more than two years from the loan maturity has elapsed and the bank provides evidence of debtor insolvency. However, at this point, it is not clear whether a bank can apply the general rules for recognition of write-offs of receivables as tax deductible if this produces a more favourable outcome than the two-year rule does. In addition, the requirement that banks provides evidence of debtor insolvency is rather general and unclear, and therefore subject to varied interpretations in practice.

II. Tax related aspects of a NPL sales transaction

For the bank, the transfer of receivables should generally be exempt from VAT without the right to recover input VAT. In addition, losses generated on the sale of receivables (i.e. the difference between sale price and net book value) are deductible.

8. Conclusion

In recent years, jurisdictions in CESEE have brought in a number of welcome changes to their tax legislation with an aim of helping banks to divest NPL portfolios from their balance sheet. In some instances, however, the local tax rules can be ambiguous and lead to uncertainty for banks wishing to dispose of their NPLs. Additionally, in some jurisdictions, the rules do not provide a comprehensive framework for the regulation of the sale of NPLs. Nevertheless, many jurisdictions in CESEE are moving towards more favourable tax regimes which aim to encourage the disposal of NPLs and which should help to create a more fluid market for NPL portfolios.

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[2] The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

[3] Write-offs of receivables (where the receivable is derecognised from the balance sheet) in Croatia are generally deductible for tax purposes only if these are performed on the basis of a bankruptcy or settlement procedure. Exceptionally, write-offs of certain bank loan receivables are tax deductible for the banks if specific requirements are met. Provisions for doubtful receivables (where the receivable remains in the balance sheet, but is adjusted to a lower value or zero) are tax deductible if income was recognised on the basis of the receivable, if the receivable is more than 60 days overdue at year end and if the receivable was not collected until 15 days prior to submission of the annual Corporate Profit Tax return). However, if the receivables on the basis of which a provision was made are not sued or enforced within 3 years, the related provision becomes tax non-deductible.

[4] Tax deductions for write-offs is allowed for the part of the receivable which was covered by a deductible provision or if the bankruptcy procedure was finalised with a court decision.

[5] Write-offs of NPLs by financial institutions are deductible, provided that specific conditions are met, as prescribed in the Croatian Corporate Profit Tax Law.

[6] Actual bad debts are deductible.
[7] Receivables may be written off if they were included in taxable income and a procedure to collect them has failed.
[8] Generally, in order for a write-off to be treated as deductible, the following conditions need to be met:

i. Receivables must have been previously included in the taxpayer's revenues;
ii. Receivables are written-off in the accounts as uncollectable;
iii. The taxpayer must provide evidence that it has filed a lawsuit regarding the collection of the relevant receivables, or that an enforced collection procedure has been initiated; and
iv. For banks, write-offs with respect to loans granted to unrelated parties are deductible if two years have elapsed from the due date and the bank has provided evidence of debtor insolvency.

[9] Provisions set up by banks for principal and interest are entirely deductible. Provisions set up for other receivables may be deductible up to 30% only after 270 days only and up to 100% if a bankruptcy procedure has been started.
[10] No provision can be set up for doubtful debts. Where the value of a debt has decreased permanently and substantially, a deduction for tax purposes is not available.
[11] Allocations to provisions for doubtful debts from debtors who are also creditors are non-deductible.
[12] The general rule is that provisions (corrections) for bad and doubtful debts are tax deductible if at least 60 days have expired from the due date. Provision has to be made individually for each debt. For banks, provisions for bad debts are recognised as tax deductible if made in accordance with the National Bank of Serbia's regulations.
[13] Earlier tax losses are set off before later ones.
[14] In the case of a statutory change or a change in the ownership structure during the tax period for more than 50% compared to the ownership structure at the beginning of the tax period, the taxpayer does not assume the right to carry forward the tax losses if:

- the taxpayer (company) did not perform any business activity during two tax periods preceding the change in the ownership structure; or
- the taxpayer (company) changes the type of the business activity within two tax periods following the statutory change or change in the structure of the ownership (except if the business activity has been changed with the purpose of preserving working places or to recover the business).

[15] Tax losses cannot be carried forward if the legal predecessor did not perform any business activity during two taxation periods preceding the change of ownership; or the legal successor significantly changes the type of business activity.
[16] These are due for notarisation of sale agreements and recordings in the Real Estate book.
[17] It may be possible to opt to apply VAT (which is recoverable) on the transfer instead of real estate transfer tax (which is irrecoverable), provided certain conditions are met.
[18] A 4% transfer tax applies in the case of the following asset types: amongst others the exercise of beneficial interest in respect of real estate property and shareholdings in real estate companies (4% up to HUF 1bn, 2% above, capped at HUF 200), rights in immovable assets, and any financial gain obtained through the termination of such rights.
[19] KPMG Serbia, *Draft of Analysis of the existing impediments to the sale of NPLs in Serbia*, December 2015.