



M&A Academy

Tax aspects of debt restructuring

28 May 2009

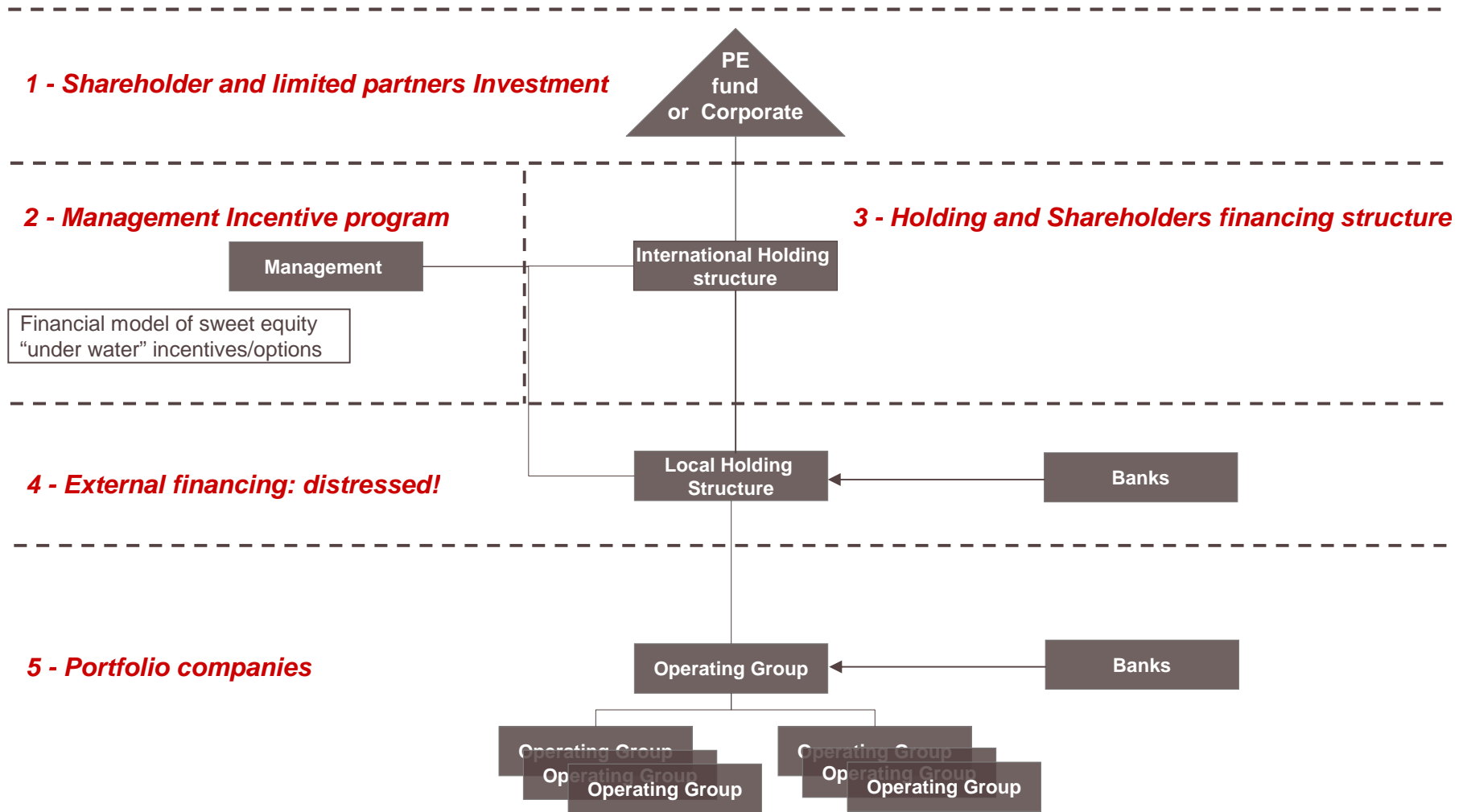
Agenda

- What's driving debt structuring transactions?
- The tax basics
 - Write-down or capital loss on receivable
 - Interest withholding tax
- Tax aspects of overall debt structuring
 - Waiver of debt
 - Deferral of interest payments or extension of maturity
 - Adjustment of interest rate
 - Alterations of warranties, collateral or seniority
 - Addition of warrants or equity kickers
 - Debt / equity swap
 - Change in equity ownership
 - Transfer of shareholder loans
 - Debt acquired at a discount
- Continuity Law
- Case study

What's driving debt structuring transactions?

- Drivers:
 - Underperforming businesses
 - Over-leveraged buy-outs
 - Enforced refinancing/repayment deadlines
 - Distressed lenders
- Involved parties:
 - Borrowing company (in distress)
 - Lenders
 - Shareholders (PE/Corporates)
 - Management teams

What's driving debt structuring transactions?



The tax basics

Capital loss on receivable

- Only tax deductible in the year the loss becomes real and definitive
- PQ:
 - Closure of bankruptcy
 - Certificate of receiver
- New Continuity Law (see infra)
- Case law by Brussels Court of Appeal
IF, reasonable and sufficient certainty

The tax basics

Write-down on receivable

- Write-down of receivable of which reimbursement is uncertain, is only tax deductible

1°) Loss is clearly identified and likely

2°) Conditions of sec 22-23 RD/ITC

- Deductible expenses
- Probable and clearly defined
- Recorded in B/S in separate account
- Form 204.3 – tax return

The tax basics

Interest withholding tax (WHT)

- WHT only becomes due when interest is either « attributed » or « made payable »
- Available for immediate collection (even if not actually paid)
- Could the renegotiation of a loan agreement trigger WHT?
- If the renegotiation leads to « material fundamental adjustments » this may entail **novation** in which case WHT will be due

The tax basics

Interest withholding tax (WHT)

- However novation can not be presumed:

Case law	Novation/WHT
Additional warranties	No
Alteration of maturity date	No
Deferral of payment terms	No
Alteration of interest rate	No
Alteration of currency	No
Transformation of a debt with interest into a debt in capital	Yes
A partial waiver of debt with return to a sound financial position clause	Yes

The tax basics

Interest withholding tax (WHT)

- Numerous WHT exemptions
 - Interest to Belgian banks
 - Interest to EU related (25% holding) Companies as defined under EU Interest & Royalties Directive
 - Interest to foreign banks located in the European Economic area (e.g. Iceland), or with whom Belgian has double tax treaty (e.g. USA)
 - Nominative registered bonds
 - Quid: shareholder loans by PE Fund?

Tax aspects of overall debt structuring

Waiver of debt

- All or part of debt can be waived
- Principal and/or interest can be waived
- Taxable profit for borrower
- Tax deductible for lender
- If between related parties, considered by Tax Authorities as « abnormal »
 - Waiver granted in favor of foreign companies: no tax deduction (sec 26 ITC)
 - Waiver received: no offsetting of losses, investment deduction, NID, dividend received deduction (sec 79,207 ITC)
 - Cross-border: adjustment of taxable basis (sec 185 ITC)

Tax aspects of overall debt structuring

Waiver of debt

- Conditional waiver of debt, there is revival of debt in case of return to a sound financial position
- Same treatment as plain vanilla debt waiver
- Required by Belgian Tax Ruling Commission between related parties to rebut the « abnormal character adjustments » (specific definition of sound financial position)
- Upon revival, the debt becomes deductible / taxable for the borrower / lender

Tax aspects of overall debt structuring

Waiver of debt

- In case of a partial waiver it sometimes occurs that the interest rate is increased on the remaining debt
- Interest rate should be market rate, based on risk profile of the borrower and the characteristics of the loan

Tax aspects of overall debt structuring

Deferral of interest payment or extension of maturity

- Alternative to reduce the installment without debt waiver
- Positive cash effect for borrower, but no improvement of the financial situation
- Deferral of interest payment will most likely give rise to compounding
- Deferral, but still accrual and thus tax base of both borrower and lender is not affected
- Conversely, extension of the debt maturity will quite often result in an increase of interest rate and possibly a premium at new maturity date
- No WHT issue since no novation

Tax aspects of overall debt structuring

Adjustment of interest rate

- Adjustment of the yield to reduce the installment
 - Increase of tax base of the borrower
 - Decrease of tax base of the lender
- Improves the long-term financial position of the debtor
- Mostly between related parties
- Arm's length, to be substantiated by financial distressed situation of the borrower
- No WHT issue since no novation

Tax aspects of overall debt structuring

Alterations of warranties, collateral or seniority

- If given by the borrower itself to secure its own debt, no upfront tax consequences for either the borrower or lender
- Upon exercise of warranties or collateral, any capital gain realized on the disposal of the collateralized asset will mostly be taxable (unless exemption; e.g. if collateral are shares)
- The borrower will offset repayment of its debt against the net proceeds of the disposal of the assets

Tax aspects of overall debt structuring

Alterations of warranties, collateral or seniority

- If given by related party (e.g. parent of the borrower), no tax consequences for guarantor, unless warranty is exercised
- Should a guarantee fee be paid by borrower to guarantor in consideration for the security
- OECD guidelines: intra-group service
- Therefore, some type of consideration should be appropriate since borrower improves its credit rating
- Careful, a subsidiary may not be the guarantor of its parent which e.g. has indebted itself for the acquisition of the shares of its subsidiary
- Probably there is no novation, thus no WHT

Tax aspects of overall debt structuring

Addition of warrants or equity kickers

- In exchange for a lower interest rate or reduction in principal, the borrower may issue a warrant with the debt which allows the lender to participate in the borrower equity
- This could be achieved through:
 - No alteration of original debt but only reduction of interest rate or principal and issuance of bare warrants, or
 - Transformation of original debt into convertible debt

Tax aspects of overall debt structuring

Addition of warrants or equity kickers

- Bare warrant:
 - In distressed situation, mostly received free of charge and is not « abnormal »
 - No novation: no WHT
 - When the warrant is exercised, the exercise price will form the acquisition value of the equity received
 - Subsequent realization of the shares will generate a tax free capital gain loss on shares
- Convertible debt:
 - The warrant may not be traded separately
 - Novation of debt: WHT
 - Upon conversion of convertible debt into equity, any capital gains or losses are taxable or tax deductible
 - Tax treatment criticized by tax scholars

Tax aspects of overall debt structuring

Debt / equity swap

- From an accounting point of view, it could be defended to convert the debt into equity of the borrower at a nominal value and record the shares at an economic value in the hands of the lender i.e. at a loss
- From a tax perspective, the Belgian Ruling Commission has recently ruled that a debt / equity swap at nominal value in the hands of the borrower does not constitute an abnormal or benevolent advantage granted to the lender
- However these rulings did not address whether the lender recorded a write- down which would be tax deductible
- Nevertheless, some old doctrine and case law confirms that such loss should be tax deductible

Tax aspects of overall debt structuring

Change in equity ownership

- Change in equity ownership may have an impact on participation exemption (10%) and withholding tax exemption on dividends (10%) and interest and royalty payments (25%)
- Change in equity ownership may restrict tax loss (carry-forward)
- If no change of control, no problem
- If change of control, tax losses are forfeited, unless the change in ownership is motivated by sound economic or financial reasons

Tax aspects of overall debt structuring

Transfer of shareholder loans

- Typically, shareholder loans exist in case of leverage buy-outs by private equity (PE), but could also be granted by a corporate parent
- In a distressed situation, a.o. exits may occur by which e.g. the shareholder loans granted by the PE fund are transferred
- Such transfer will trigger interest withholding tax on rolled up interest, unless exemption is available
- Quite often such PE funds are either located in tax haven countries or have no legal personality so that the classic exemptions are not available
- The question also arises, what happens if the debt is transferred at a discount.

Tax aspects of overall debt structuring

Debt acquired at a discount

- For the initial lender (transferor) the discount should be tax deductible, if at arm's length (distressed situation)
- The discount is not taxable in the hands of the borrower, since the debt keeps its nominal value, and there is upon the transfer of debt no waiver of debt
- For the acquiring company, the discount will become taxable if the borrower is able to fully repay the loan at maturity

Continuity Act of 9 February 2009

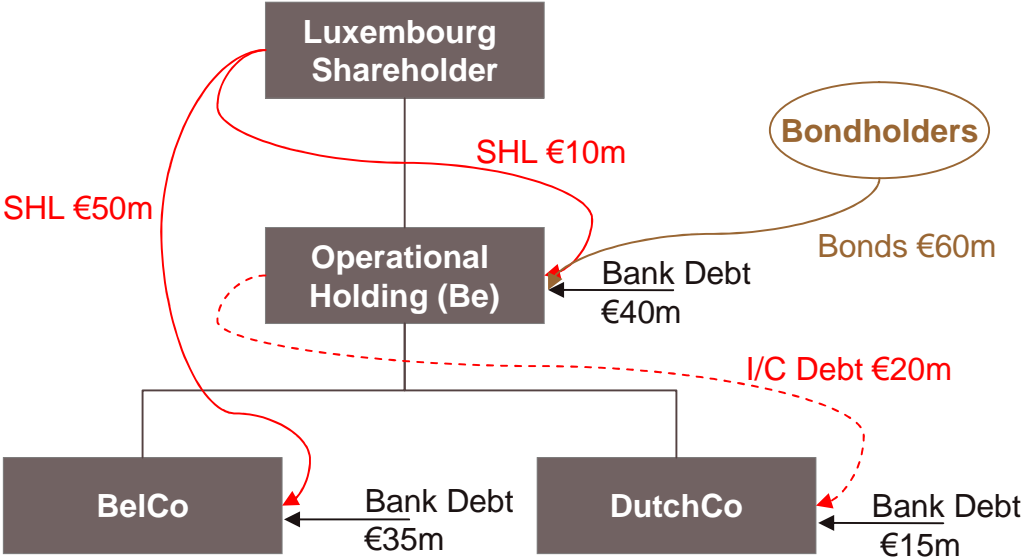
- Replacement of Judicial Composition Act of 17 July 1997
- If Judicial restructuring through Amicable or Collective agreement:
 - In hands of debtor, taxable profit resulting from waiver of debt is tax exempt
 - In hands of creditor, waiver of debt is tax-deductible also if not conditional and if on related parties
 - VAT refund in the event of waiver of commercial debt

Case Study

Debt restructuring - Group in financial distress

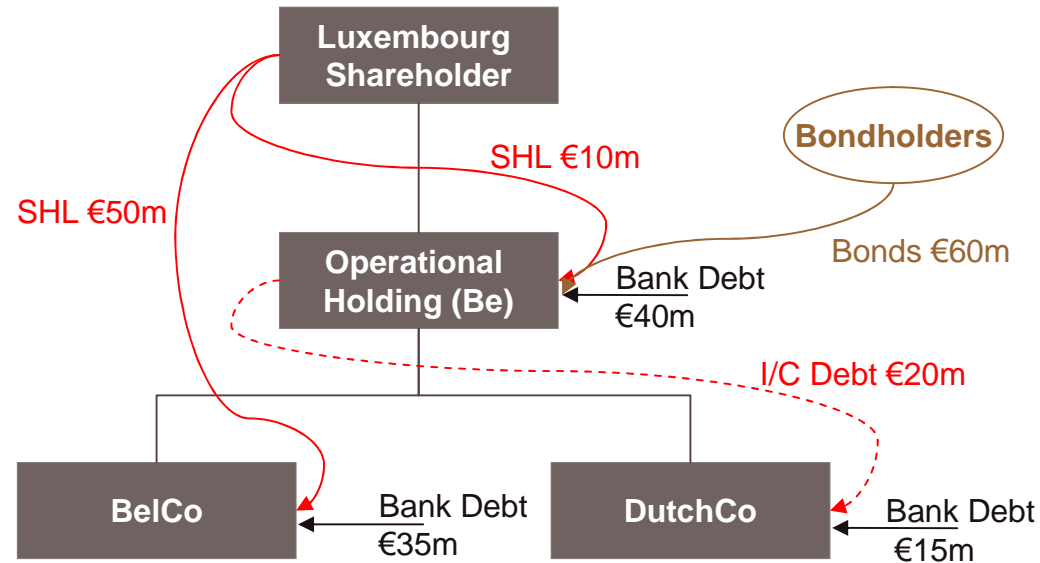
Current group structure before debt restructuring

	Total
→ Bank Debt	€90m
→ Bonds	€60m
- - → I/C Debt	€20m
→ SHL	€60m



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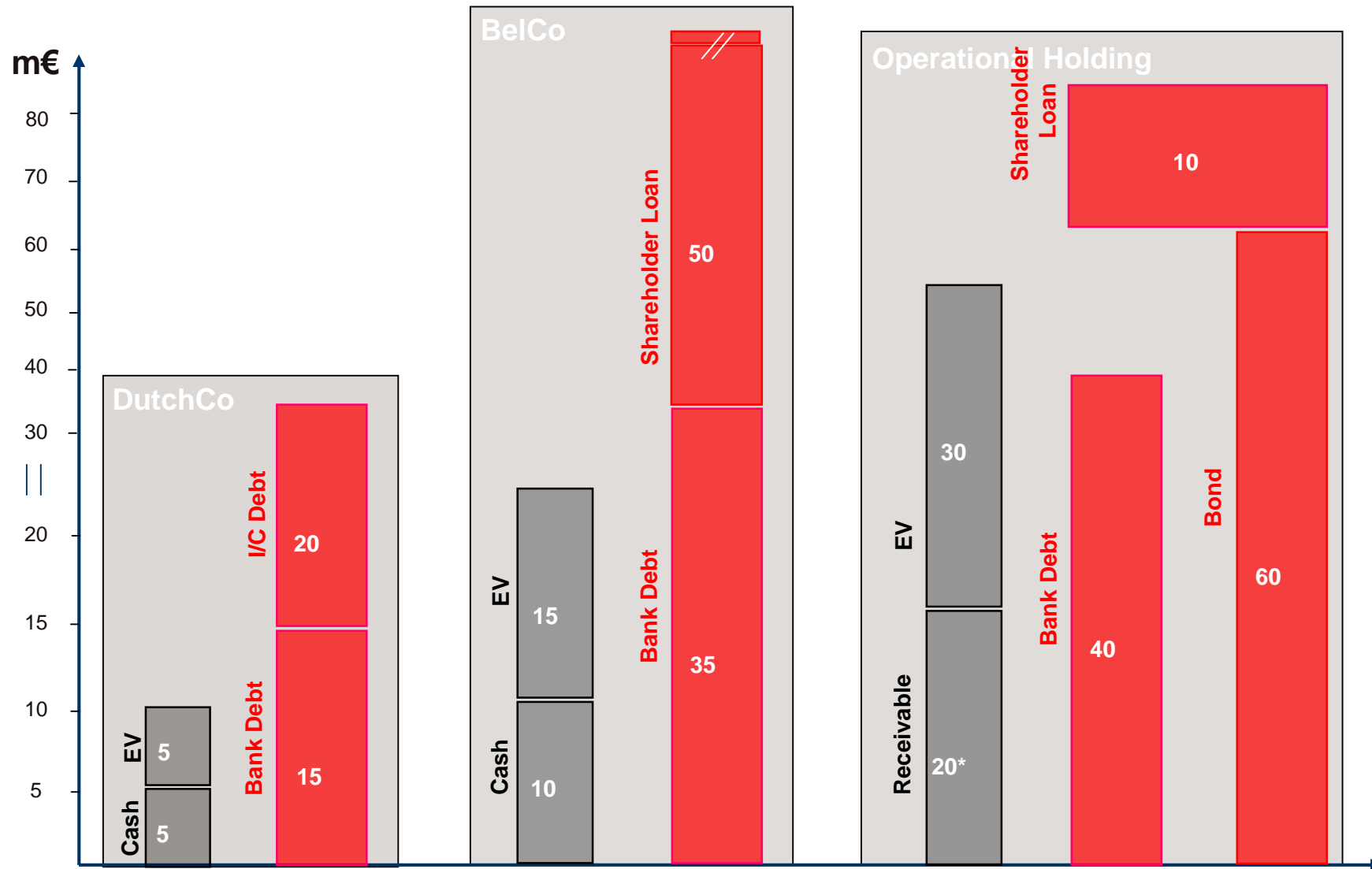


Name	Enterprise Value	Receivables & Cash	Bank debt	Bond	I/C Debt	Shareholder loan	Total debt	Net Debt	Equity value without participations
Operational Holding	30	20*	(40)	(60)	-	(10)	(110)	(110)	(80)
BelCo	15	10	(35)	-	-	(50)	(85)	(75)	(60)
DutchCo	5	5	(15)	-	(20)	-	(35)	(30)	(25)
TOTAL	50	15	(90)	(60)	(20)	(60)	(230)	(215)	(165)

* I/C receivable has no value

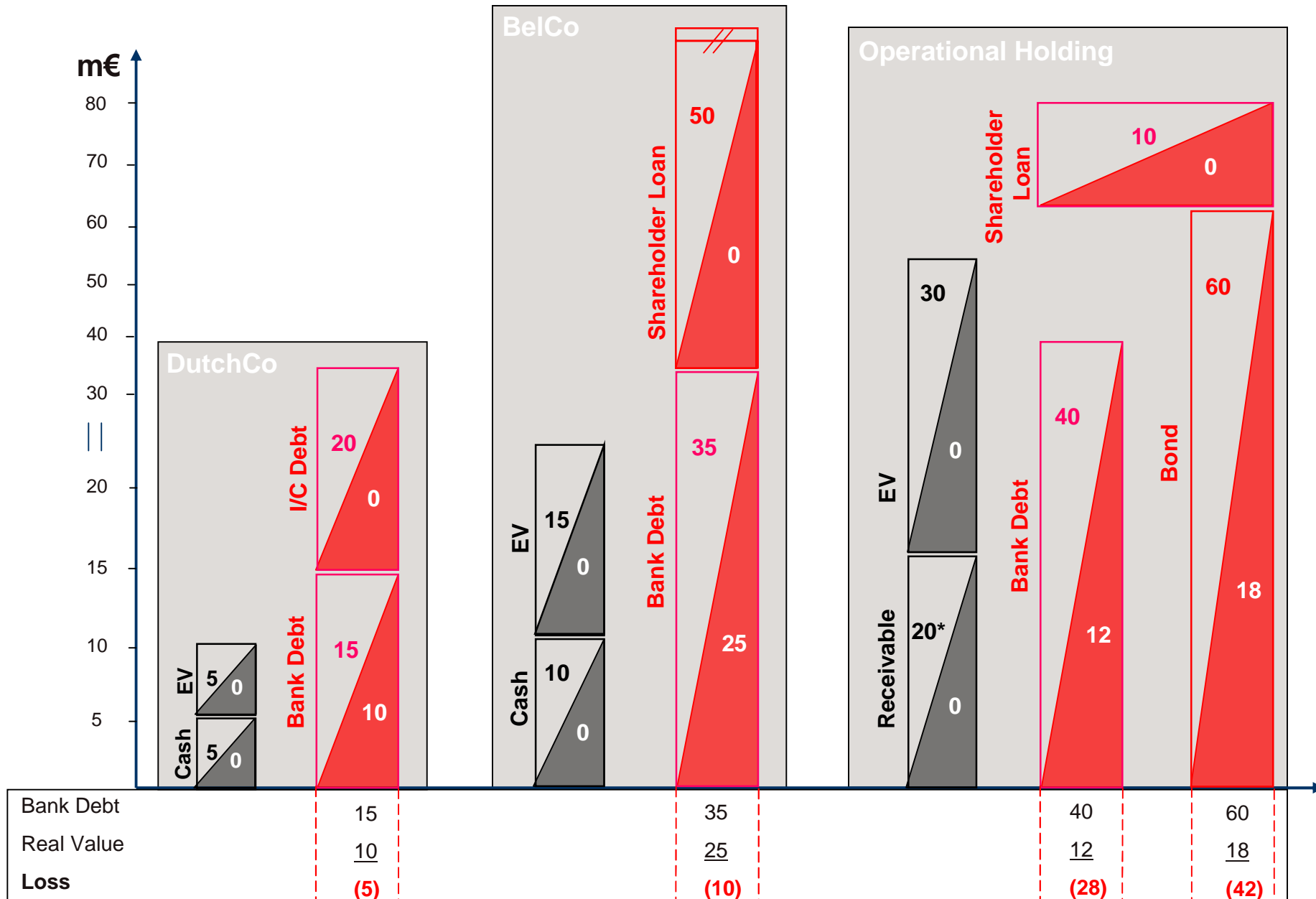
Assumption: no cross-guarantees

Current group before debt restructuring



* I/C receivable has no value

Current group before debt restructuring



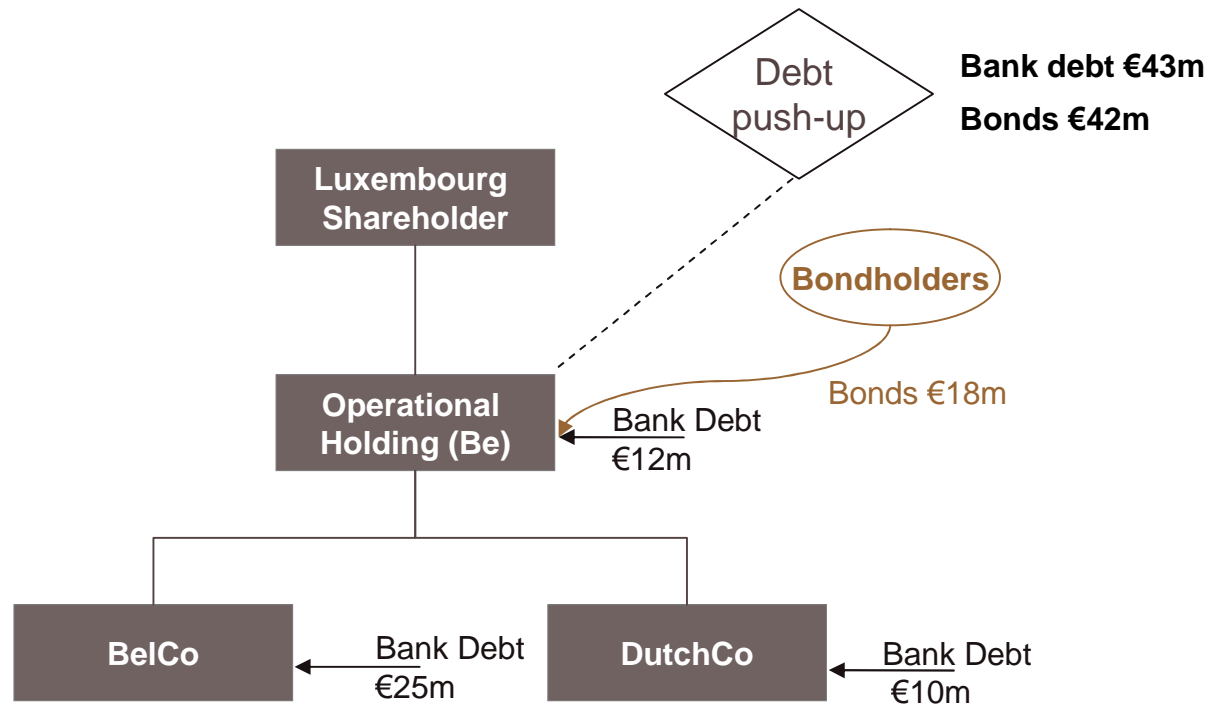
Key terms of debt restructuring

The group can only bear financial debt of **€65m** which means:

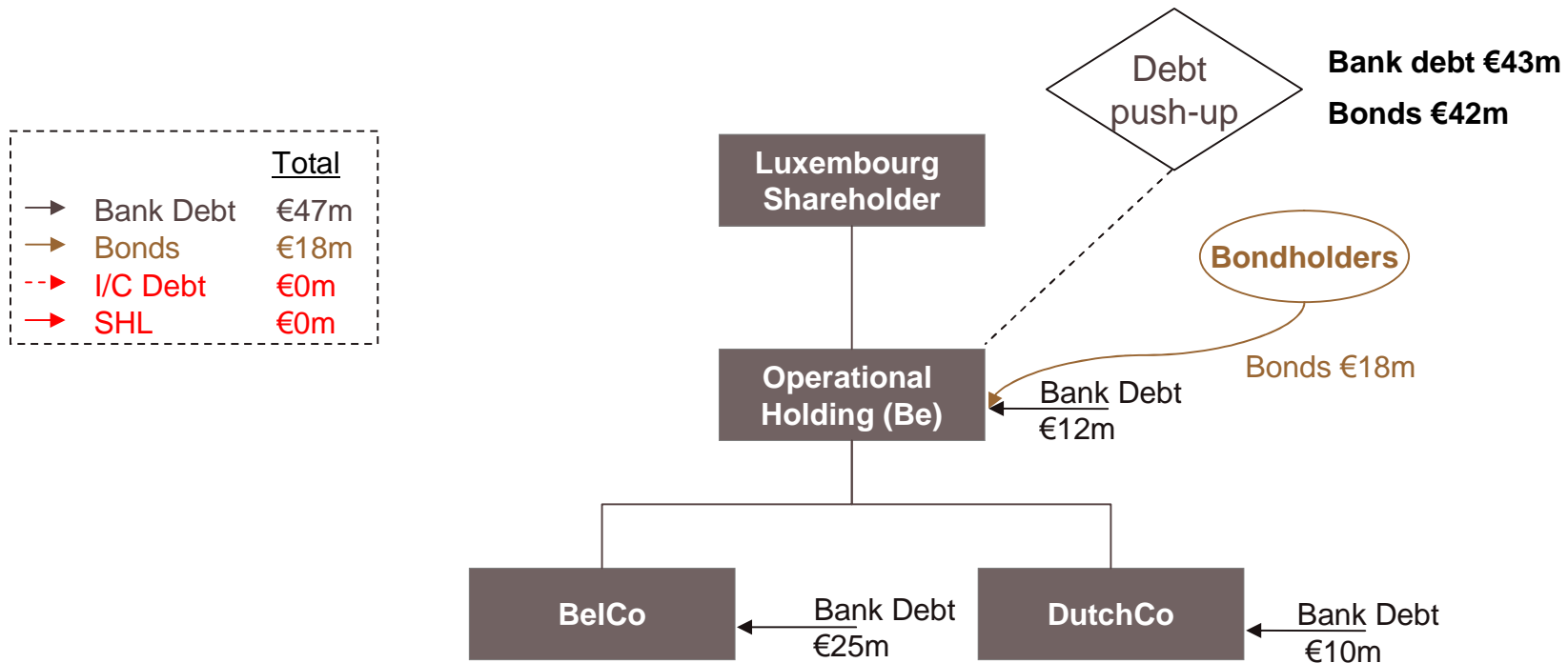
- **Elimination of shareholder loans (SHL)** from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m
- **Elimination of inter-company debt** of DutchCo to Operational Holding of €20m
- **Partial Debt-push-up** of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

New structure after debt restructuring

	Total
→ Bank Debt	€47m
→ Bonds	€18m
--> I/C Debt	€0m
→ SHL	€0m



New structure after debt restructuring



Name	Enterprise Value	Receivables & Cash	Bank debt	Bond	I/C Debt	Shareholder loan	Total debt	Net Debt	Equity value without participations
Operational Holding	30	-	(12)	(18)	-	-	(30)	(30)	0
BelCo	15	10	(25)	-	-	-	(25)	(15)	0
DutchCo	5	5	(10)	-	-	-	(10)	(5)	0
TOTAL	50	15	(47)	(18)	-	-	(65)	(50)	0

Assumption: no cross-guarantees

Key terms of debt restructuring

- The group can only bear financial debt of **€65m** which means:
 - **Elimination of shareholder loans (SHL)** from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m
 - **Elimination of inter-company debt** of DutchCo to Operational Holding of €20m
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Elimination of shareholder loans (SHL) from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m

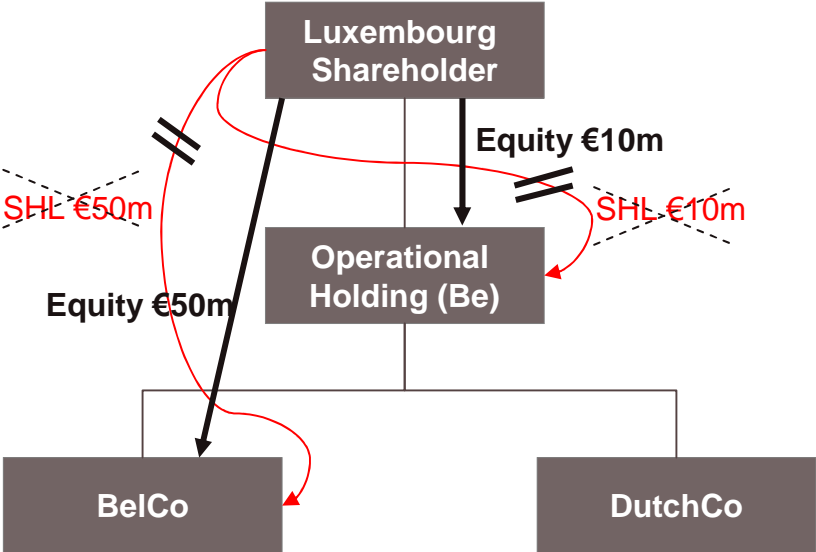
- Waiver of debt: not a good solution:
 - Taxable in the hands of Operational Holding and BelCo, and no sufficient tax losses to off-set
- Technique:
 - **Debt/equity swap** whereby Luxembourg shareholder contributes its shareholder loans on Operational Holding and BelCo with a face value of respectively €10m and €50m into resp. Operational Holding and BelCo at fair market value of €1 against issuance of new shares by Operational Holding and BelCo, the share capital of which will be increased by €10m and €50m.
 - **Subsequent sale** (or contribution) by Luxembourg shareholder of its shares in BelCo at fair market value of €1 to Operational HoldCo

Elimination of shareholder loans (SHL) from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m

- Tax aspects:
 - **Debt/equity swap:**
 - The losses realised by Luxembourg Shareholder on the Debt/equity swap in total amount of €60m are fully tax deductible
 - For the Operational holding and Belco the Debt/equity swap is a mere B/S operation (no waiver of debt) which should be tax neutral
 - The conversion of the accrued interest due by Operational Holding and BelCo into equity will be considered as a payment of interest (novation) which in principle is subject to withholding tax but will in most cases be exempt

Elimination of shareholder loans (SHL) from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m

- Debt/equity swap

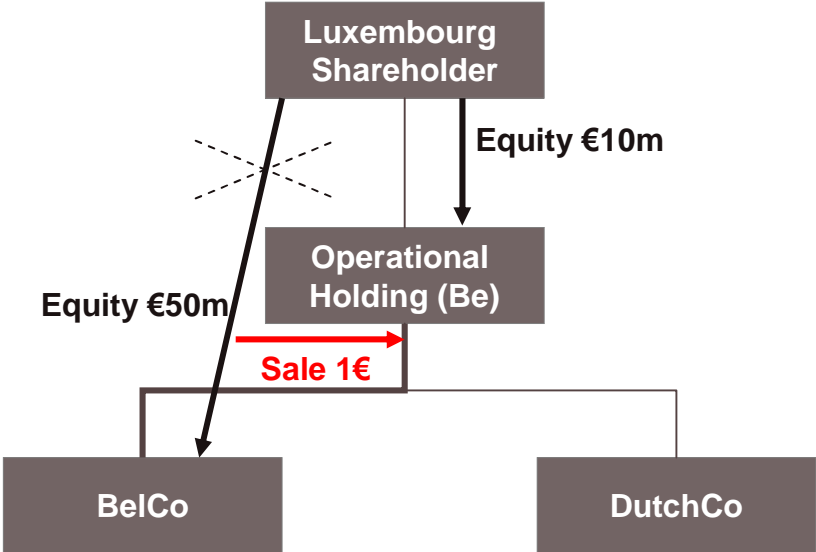


Elimination of shareholder loans (SHL) from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m

- Tax aspects:
 - **Subsequent sale** of the shares in BelCo to Operational Holding
 - In principle the Luxembourg shareholder should not realise any gain or loss on this transaction (loss already taken at moment of debt/equity swap) and therefore no tax consequences
 - The shares in BelCo so received by Operational Holding from Luxembourg shareholder will be recorded in its accounts at its acquisition value which is 1€

Elimination of shareholder loans (SHL) from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m

- Subsequent sale



Key terms of debt restructuring

- The group can only bear financial debt of **€65m** which means:
 - **Elimination of shareholder loans (SHL)** from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m
 - **Elimination of inter-company debt** of DutchCo to Operational Holding of €20m
 - **Partial Debt-push-up** of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

Elimination of inter-company debt of DutchCo to Operational Holding of €20m

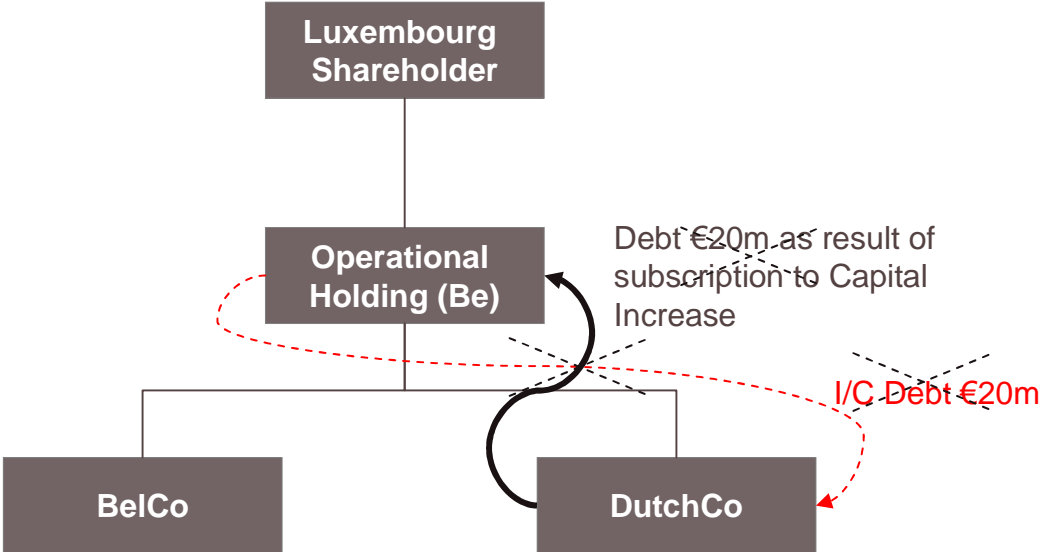
- Waiver of debt: not a good solution:
 - Tax deductibility in hands of Operational Holding is refused by Belgian Tax Authorities unless 'return to good fortune'-clause, which the bondholders and banks would not agree to
 - Possibly taxable in hands of DutchCo
- Debt/equity swap in DutchCo (through plain contribution of I/C receivable) is as such not possible under Dutch law
- Technique in the Netherlands:
 - **Set-off for full value (“verrekening”)** whereby Operational Holding subscribes to a capital increase of DutchCo (without effective cash payment) followed by a set-off between subscription obligation and I/C receivable

Elimination of inter-company debt of DutchCo to Operational Holding of €20m

- Tax aspects:
 - **Set-off for full value:**
 - Should not give rise to profit recognition in the hands of DutchCo
 - For the Operational holding the set-off between the subscription obligation and I/C receivable should be tax-neutral
 - The question arises at which value the shares which the Operational Holding has in DutchCo should be recorded
 - There is no withholding tax on interest under Dutch tax law

Elimination of inter-company debt of DutchCo to Operational Holding of €20m

- Set-off for full value



Key terms of debt restructuring

- The group can only bear financial debt of **€65m** which means:
 - **Elimination of shareholder loans (SHL)** from Luxembourg Shareholder on Operational Holding and BelCo of respectively €10m and €50m
 - **Elimination of inter-company debt** of DutchCo to Operational Holding of €20m
 - **Partial Debt-push-up** of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

Partial Debt-push-up of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

- Bond on Operational Holding of €60m is reduced to **€18m** (debt-push-up of €42m)
- Bank debt of €90m is reduced to **€47m** (debt-push-up of €43m):
 - On DutchCo level: from €15m to €10m
 - On BelCo level: from €35m to €25m
 - On Operational Holding level: from €40m to €12m

Partial Debt-push-up of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

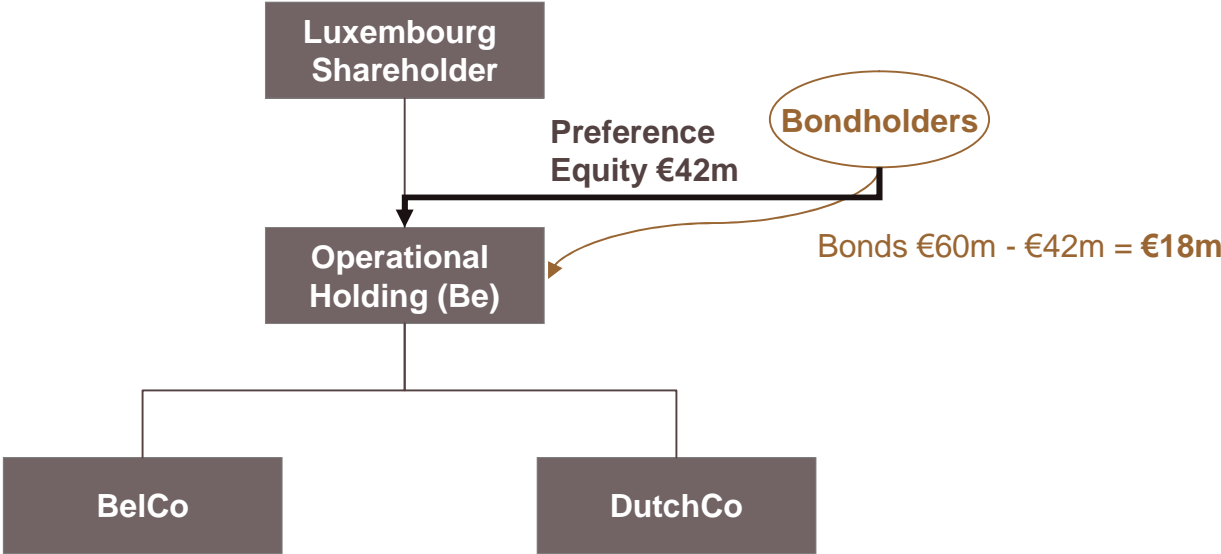
- Various techniques may be envisaged:
 - Plain vanilla partial Debt/equity swap
 - Replacement of current bonds and bank debt by new debt instruments issued by same borrowers followed by a partial Debt/equity swap
 - Partial conditional sale of bonds and bank debt to a new LuxCo
 - Partial sale of bonds and bank debt to a new LuxCo in exchange for an interest-free bond with options

Plain vanilla partial Debt/equity swap

- Bond debt is reduced from €60m to €18m and the €42m debt balance is contributed into share capital of Operational Holding in exchange for equity.
 - No tax impact in the hands of Operational Holding, since no waiver, only B/S operations
 - Since fair market value of bond is only €18mio, the loss for the bondholders of €42mio should be tax deductible
 - The preference shares in the accounts of the banks are recorded for €1
 - The conversion of the accrued interest due by Operational Holding into equity will be considered as a payment of interest (novation) which in principle is subject to withholding tax but will in most cases be exempt
 - Equity could be preference shares or separate class of shares in order to deal with issues such as dilution, voting rights, redemption rights in order to allow future recuperations of losses incurred by bondholders

Plain vanilla partial Debt/equity swap

- Debt/equity swap

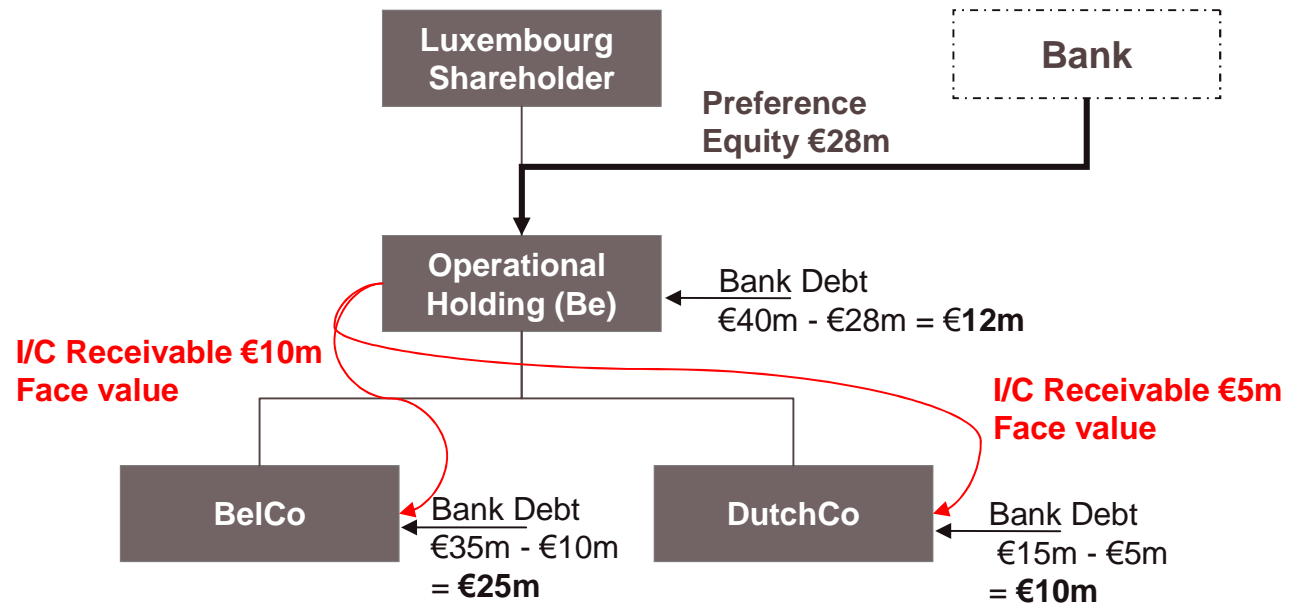


Plain vanilla partial Debt/equity swap

- Bank debt is reduced from €90m to €47m and the €43m debt balance (i.e. €28m on Operational Holding, €10m on BelCo and €5m on DutchCo) is contributed into the share capital of Operational Holding in exchange for equity of €28m
 - No tax impact in the hands of Operational Holding
 - Share capital of Operational Holding is increased with €28m since fair market value of receivable on BelCo and on DutchCo is 0
 - The receivable on BelCo with face value of €10m and on DutchCo with face value of €5m are recorded in the B/S of Operational Holding at €1
 - Since fair market value of bank debt is only €47mio, the loss for the banks of €43mio should be tax deductible
 - The preference shares in the accounts of the banks are recorded for €1
 - The conversion of the accrued interest due by Operational Holding into equity will be considered as a payment of interest (novation) which in principle is subject to withholding tax but will in most cases be exempt

Plain vanilla partial Debt/equity swap

- Debt/equity swap

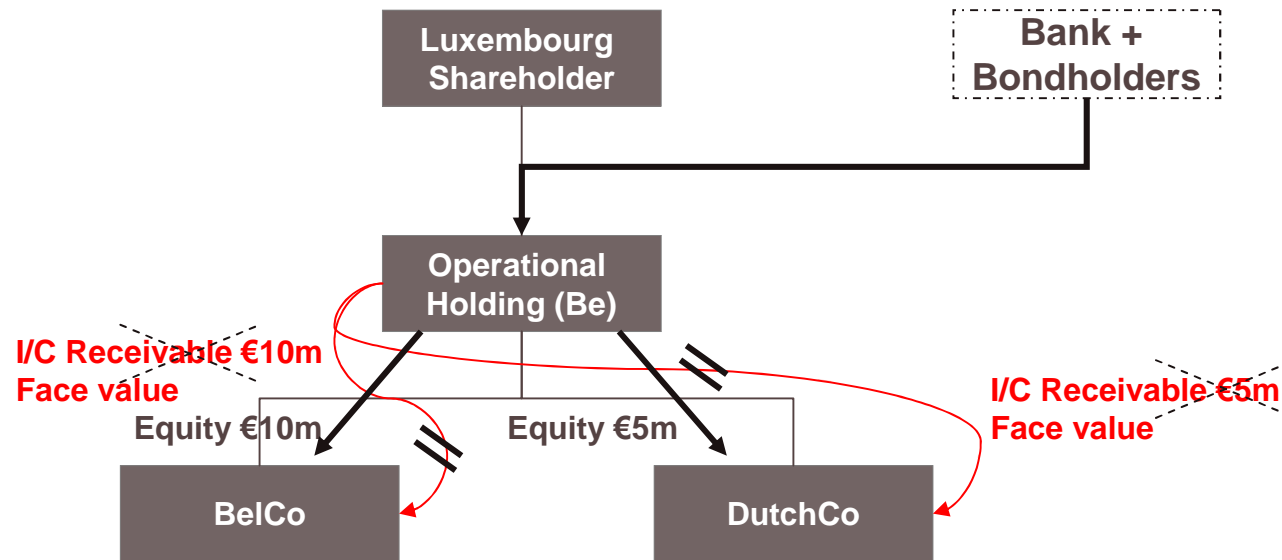


Plain vanilla partial Debt/equity swap

- Operational Holding contributes its inter-company receivable with a face value of €10m into the share capital of BelCo at fair market value of €1 against issuance of new shares, the share capital of BelCo will be increased by €10m
 - No tax gains or losses realised by Operational Holding upon its contribution
 - The conversion of the accrued interest due by BelCo into equity will be considered as a payment of interest (novation) which in principle is subject to withholding tax but will in most cases be exempt
- **Set-off for full value (“verrekening”)** whereby Operational Holding subscribes to a capital increase of DutchCo, followed by a set-off between subscription obligation and I/C receivable of €5m
 - Tax consequences see slide 38

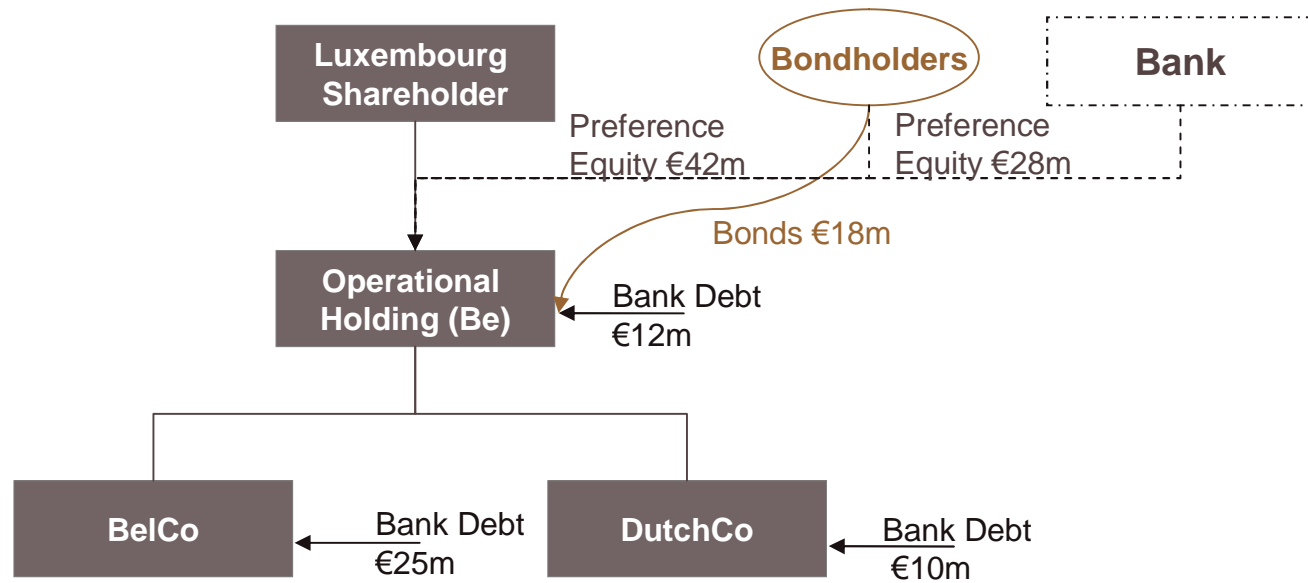
Plain vanilla partial Debt/equity swap

- Debt/equity swap



Plain vanilla partial Debt/equity swap

- Final structure



Partial Debt-push-up of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

- Various techniques may be envisaged:
 - Plain vanilla partial Debt/equity swap
 - **Replacement of current bonds and bank debt by new debt instruments issued by same borrowers followed by a partial Debt/equity swap**
 - Partial conditional sale of bonds and bank debt to a new LuxCo
 - Partial sale of bonds and bank debt to a new LuxCo in exchange for an interest-free bond with options

Replacement of current bonds and bank debt by new debt instruments issued by same borrowers followed by a partial Debt/equity swap

- Same tax treatment as plain vanilla partial Debt/equity swap
- However, in this scenario the existing bonds and bank debt conditions are first replaced by other conditions (maturity, interest rate, bullet, etc.)
- In addition, bondholders and banks may consider to place the equity in the market in order to extract cash and also because of the Basel II rules

Partial Debt-push-up of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

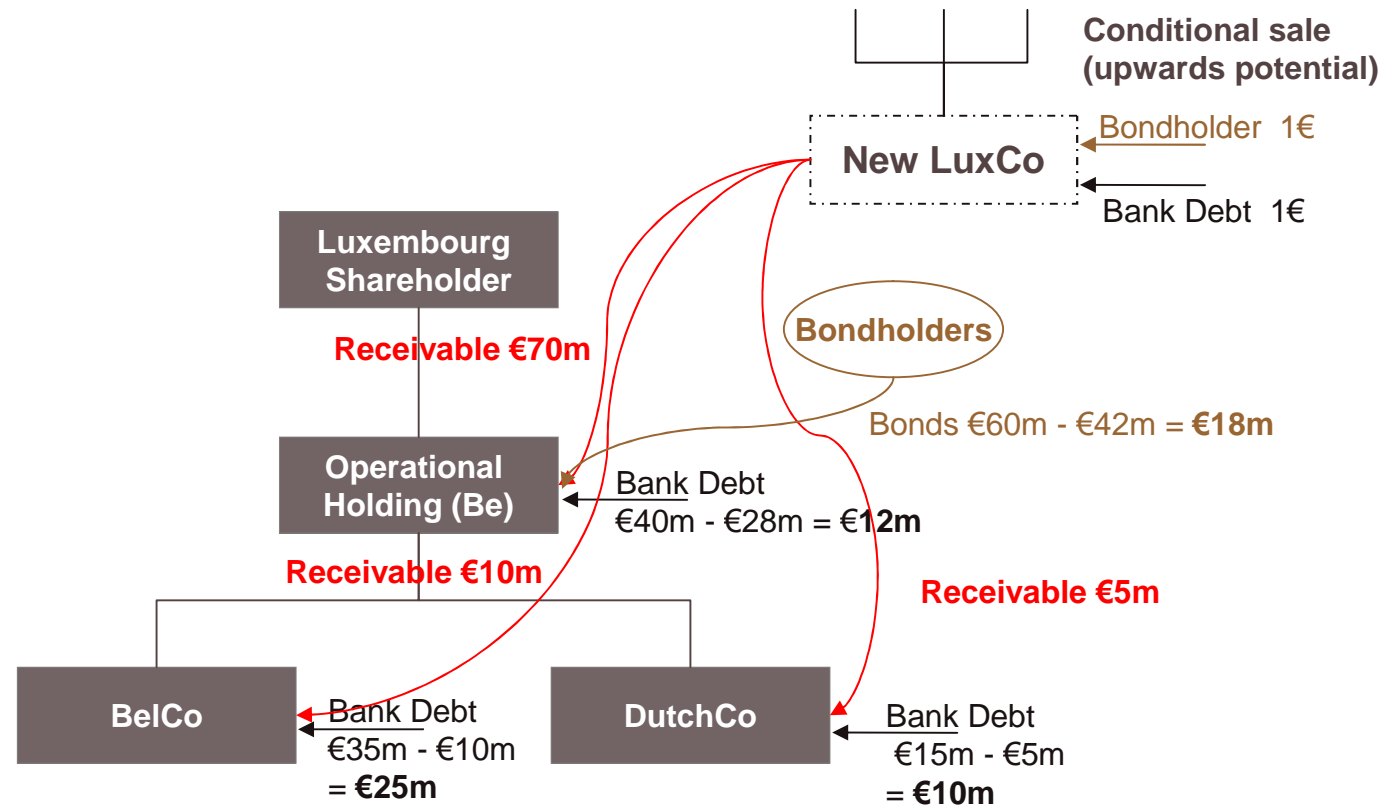
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Partial conditional sale of bonds and bank debt to a new LuxCo

- Bondholders and banks sell respectively part of their debt with a face value of €42m and €43m (i.e. €28m + €10m + €5m) to a new LuxCo (conditional sale) for 1€
 - In the hands of the banks the loss should be fully tax deductible
 - Banks tend prefer this scenario because they do not own shares (Basel II)
 - Banks have upward potential to recover their losses because the conditional sale foresees an additional payment when the financial situation of the group improves (off-balance sheet contingent debt of new LuxCo)

Partial conditional sale of bonds and bank debt to a new LuxCo

- Conditional sale of debt to new LuxCo

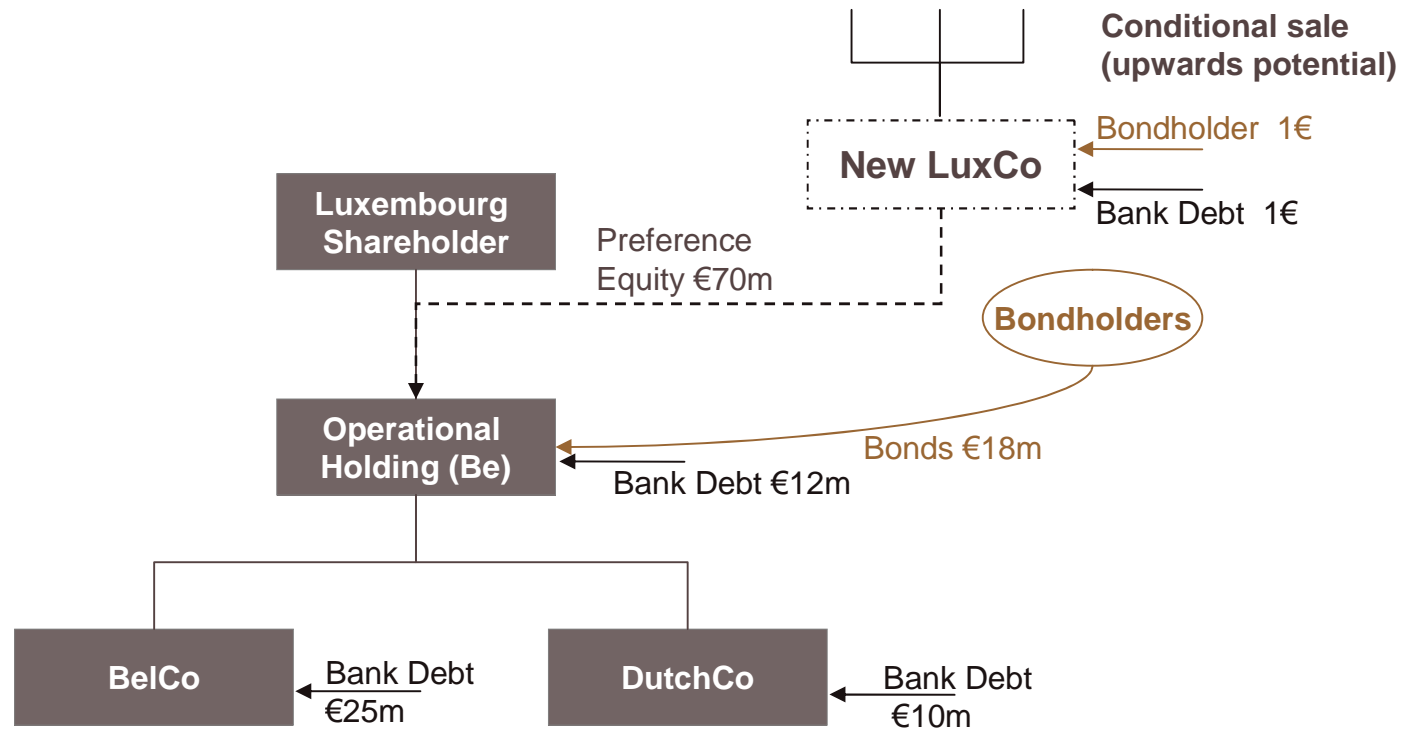


Partial conditional sale of bonds and bank debt to a new LuxCo

- Subsequently, new LuxCo performs Debt/equity swap on Operational HoldCo through issue of preference shares, followed by Debt/equity swap with BelCo and set-off for full value with DutchCo
 - Same analysis as described above mutatis mutandis applies
- If the performance of the group increases, Operational Holding redeems the preference shares and the proceeds are used by new LuxCo to fulfill the obligations towards the banks under the conditional sale

Partial conditional sale of bonds and bank debt to a new LuxCo

- Final structure



Partial Debt-push-up of bonds for €42mio (total €60m) and of bank debt for €43m (total €90m)

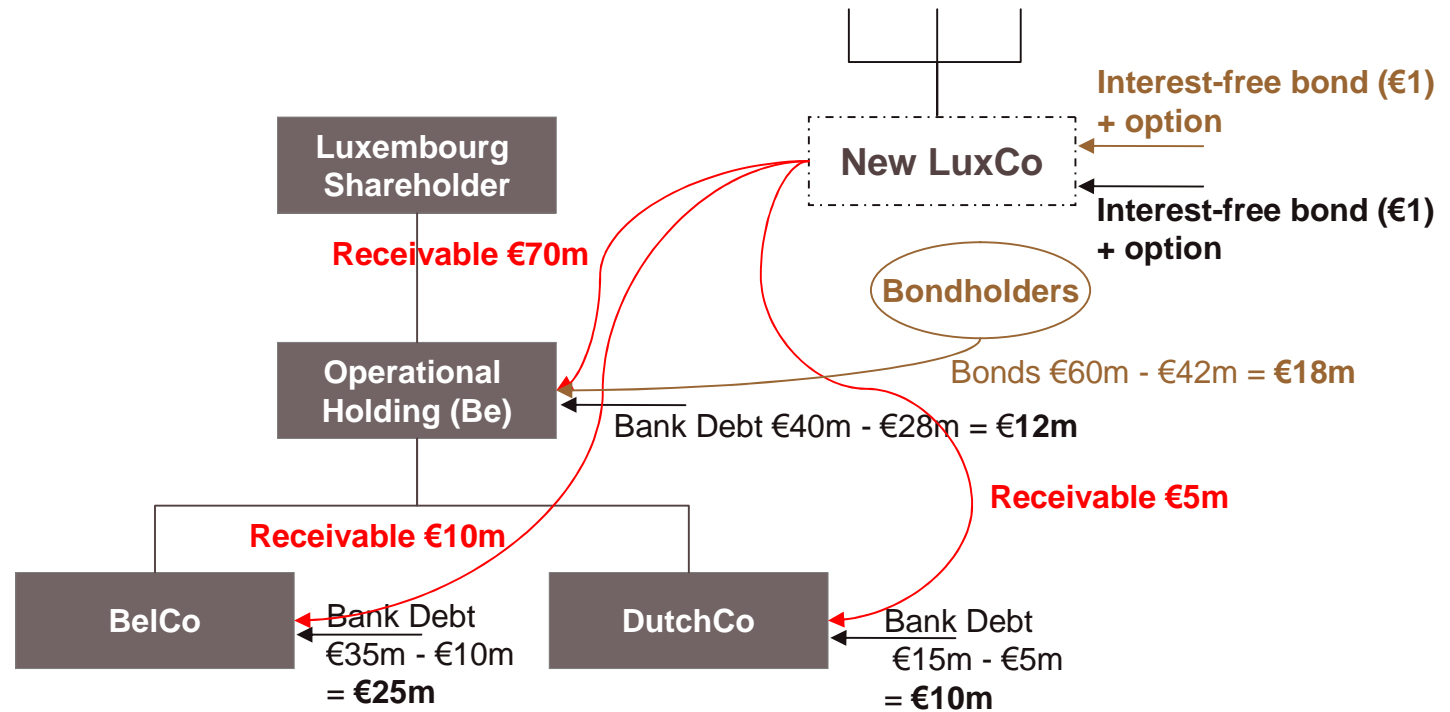
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 - **Partial sale of bonds and bank debt to a new LuxCo in exchange for an interest-free bond with options**

Partial sale of bonds and bank debt to a new LuxCo in exchange for an interest-free bond with options

- Under this scenario the conditional sale as explained above is replaced by an interest-free bond with options which permit to achieve the same result
- Bondholders and banks sell respectively part of their debt with a face value of €42m and €43m (i.e. €28m + €10m + €5m) to a new LuxCo in exchange for an interest-free bond with options/warrants on Operational Holding shares (combined with put-option)
 - Option should correspond to fair market interest rate
 - Upon the exercise of the options by Bondholders and banks, no profit should be recognised and subsequent capital gains (put-option towards e.g. Luxembourg shareholder) should be tax exempt
- For the rest the same steps are taken as explained above

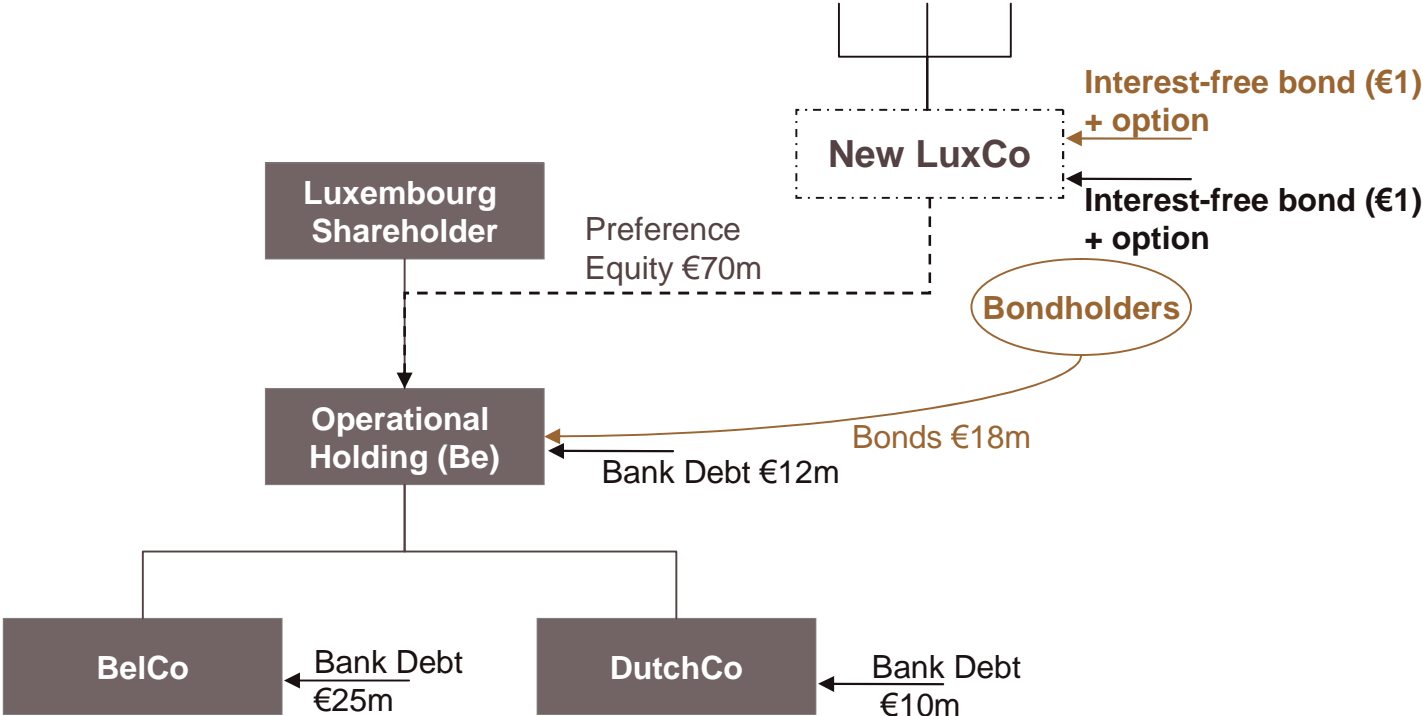
Partial sale of bonds and bank debt to a new LuxCo in exchange for an interest-free bond with options

- Sale of debt to new LuxCo



Partial sale of bonds and bank debt to a new LuxCo in exchange for an interest-free bond with options

- Final structure



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Jan Muyldermans

Lead Transactions Partner

jan.muyldermans@pwc.be

Office: 02/710.74.23

Cell: 0475/42.27.65