

# Distressed debt and non performing loans

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An overview of the main tax considerations when investing in distressed debt and non-performing loans (“NPLs”)

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In the last 6 to 9 months we have seen a huge increase in private equity funds, hedge funds and other investors investing in distressed debt and NPLs. When structuring these investments, tax plays a significant role.

The main tax considerations are:

- a) withholding tax;
- b) taxation of the asset owning vehicle;
- c) VAT; and
- d) carry planning.

Depending on location and character of the debt portfolio, there may be withholding tax on interest payments and on the collection proceeds where the proceeds consist of accrued interest. Setting up an investment company in a favourable treaty jurisdiction may avoid this withholding tax. However, careful structuring is required to avoid local authorities denying treaty access on the basis that the investment

company is in their view not the beneficial owner of the interest (a requirement under most double taxation treaties).

In order to avoid taxation on the debt collection profits and the interest, the investment company needs to be located in a low tax jurisdiction or, where treaty access is required to mitigate withholding tax, in a treaty jurisdiction with a favourable regime for distressed debt and NPL investments. Suitable offshore locations include Jersey, Barbados and Cayman. Suitable treaty jurisdictions include Luxembourg, the Netherlands, Ireland and Singapore.

Careful structuring is required to avoid irrecoverable VAT on the debt collection services provided to the investment company, especially where the investment company is in the EU.

Given the nature of these investments, proper tax planning may result in little or no taxation for the carry holder. However, the UK anti-avoidance provisions need to be considered carefully.

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