Deloitte.

Dbriefs

# Asset Reconstruction Companies (ARCs): Tax and regulatory framework

The Dbriefs M&A Tax series

Vishal Agarwal / Rajesh Agarwal / Shashikant Shenoy
29 August 2019

# Agenda

- Introduction
- Asset Reconstruction Companies (ARCs)
- Deconstructing a resolution plan
- Resolution plan – regulatory, accounting and tax considerations
- Concluding remarks
- Questions and answers

# Introduction

# Introduction

## Evolution of resolution framework in India

### 1985 to 2019

**1985**
Sick industrial companies (Special provisions) Act (BIFR)

**1993**
Recovery of debt dues to Bank and Financial Institutes Act (RDBFI)

**2001**
Corporate Debt Restructuring Cell (CDR)

**2002**
SARFAESI Act (ARCs)

**2014**
Announced asset classification forbearance on Restructuring ended from March 2015

**Jan 2014**
Revitalising distressed assets in the economy (SMA and JLF)

**Dec 2014**
Flexible structuring of long term loans (5:25)

**Jun 2015**
Strategic Debt Restructuring (SDR)

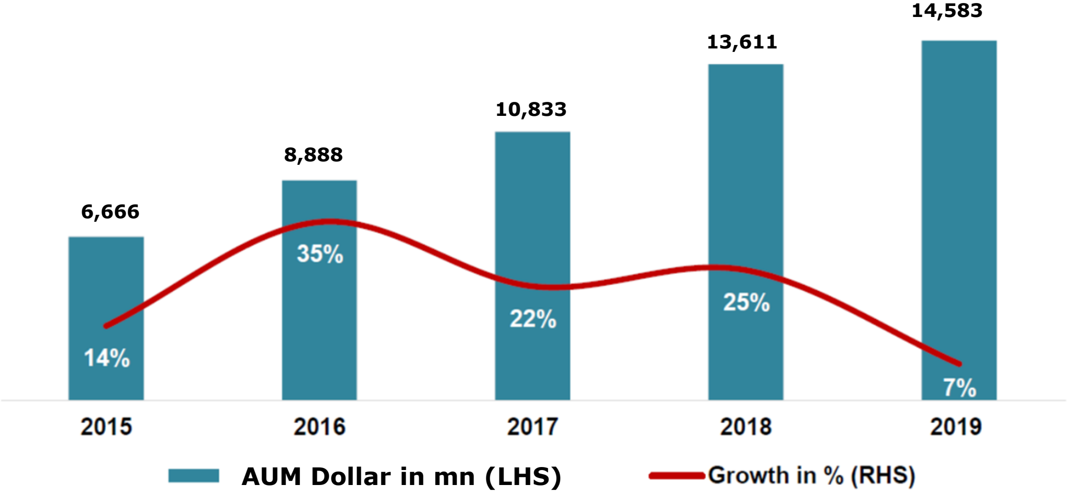
**Jun 2016**
Scheme of Sustainable Structuring of Stressed Assets (S4A)

**Sep 2016**
Guidelines on sale of stressed asset by banks

**Dec 2016**
Insolvency and Bankruptcy Code (IBC)

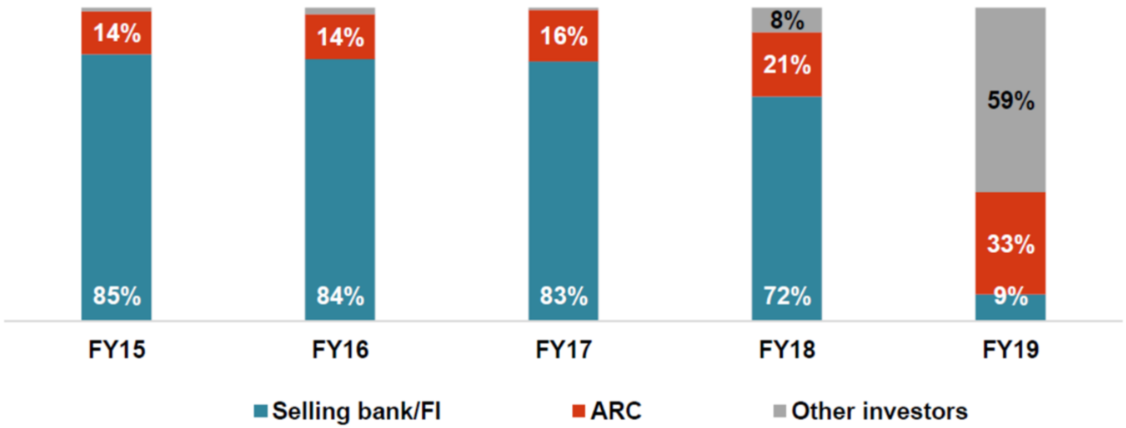
**Feb 2018/ June 2019**
Prudential framework

## Introduction
# Asset Reconstruction Companies in India – growth trend




- **Trend of AUM growth of ARCs***
  - AUM increased by 7%
  - AUM growth slowed on higher discount rate and increase in SR redemptions
  - Structural shift – substantial increase in cash share of acquisition cost

- **Trend of investment proportion by different subscribers***
  - Investment by investors increased as against selling institutions
  - Foreign banks, stressed assets funds and global pension funds, subscribed to ~60% of total SRs issued



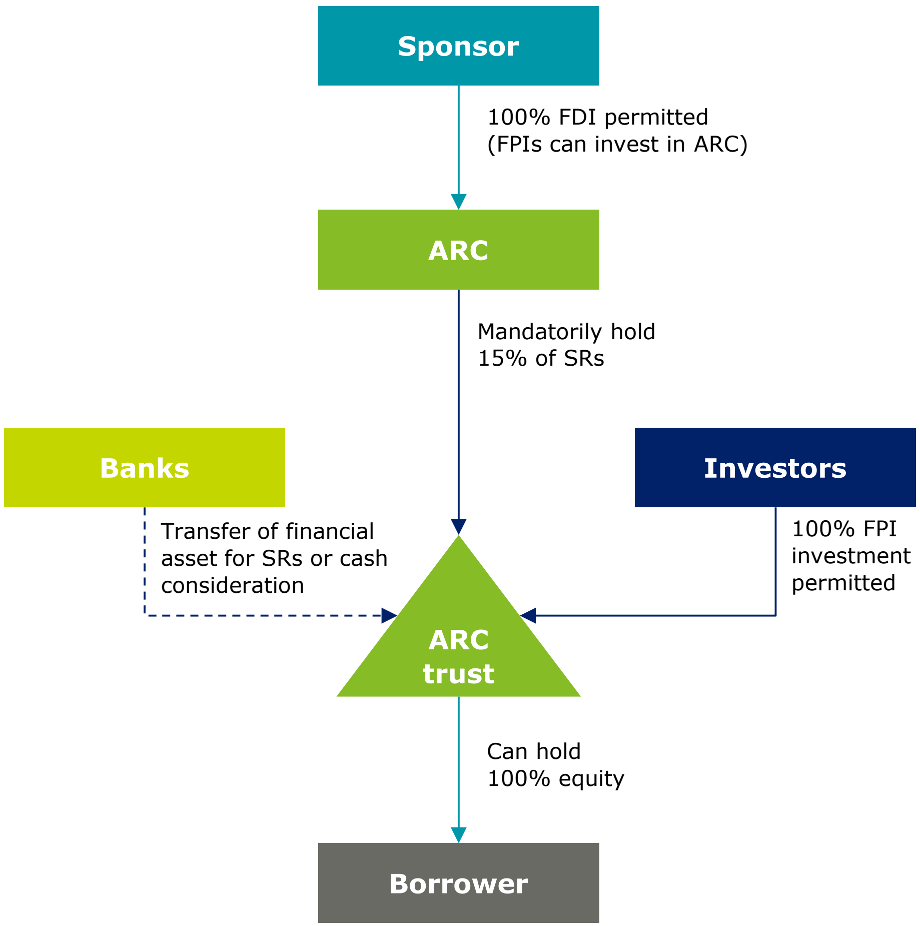

*Source: CRISIL

*Note: The above analysis is based on CRISIL-rated ARCs, which account for ~75% of the overall industry AUM*

# Asset Reconstruction Companies (ARCs)

# Asset Reconstruction Companies
## Structure and regulatory framework

### Typical ARC structure

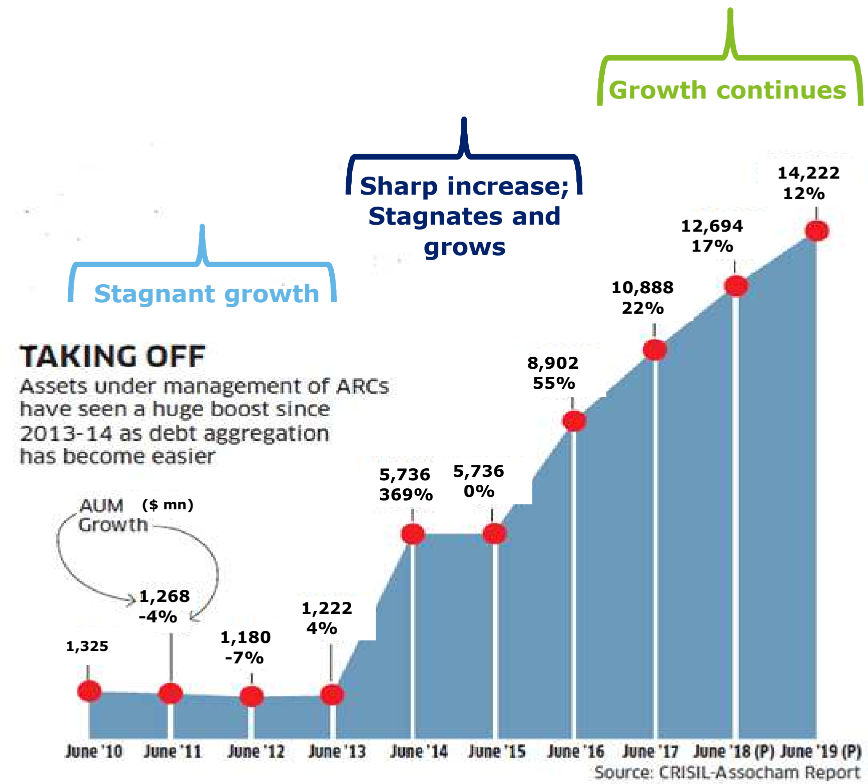



- ARC can form multiple such structure and sale different type of assets to different class of investors

- **Key attributes of ARCs**
  - RBI approval required for setting up ARC
  - 100% FDI permitted
  - Net Owned Fund (NOF) of at least INR 100 crore (USD 13.89 million) – (CCDs not considered towards NOF)
  - Permitted to undertake securitization and reconstruction activities only; lending not permitted
  - Can acquire “financial asset” from financial institution; to be realized within 8 years of acquisition
  - Financial assets to be held through trusts
  - Can be a sponsor or investor in another ARC or Acquire debt from another ARC
  - Permitted to convert debt into 100% equity shares of borrower company subject to provisions of loan documentation; does not trigger open offer under takeover code

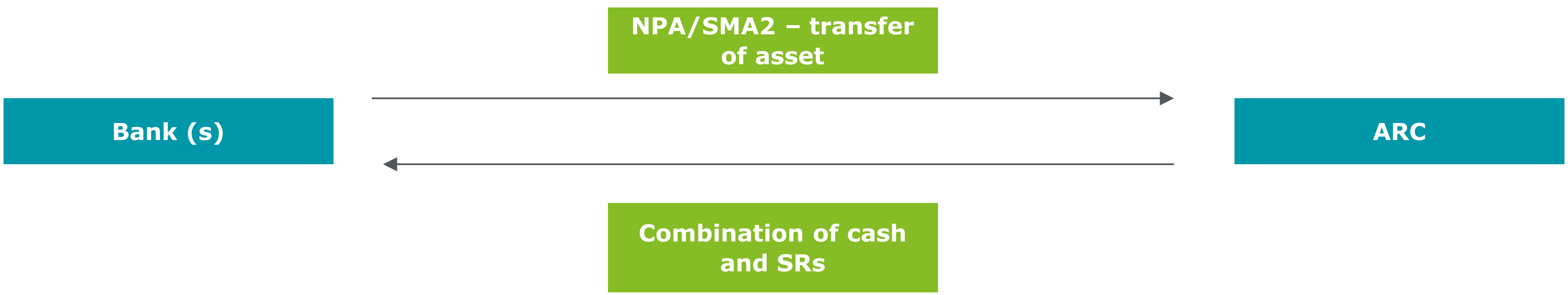
# Asset Reconstruction Companies
## Role of ARCs in resolution process

- In last two decades, ARCs have played a major role in debt resolution
  - It may be seen that from FY 2010 to FY 2013 the AUMs under ARCS had stagnated
  - However post, various restructuring scheme issued by RBI like JLF and SDRs and issuance of Insolvency and Bankruptcy Code, the ARCs participation has been doubled
- In current environment, ARCs operate with multiple structures along with banks, promoters (existing and new) and investors/fund houses. ARCs has moved from conventional structure to Pre-pack NCLT structure over the years
  - Structure I: conventional approach
  - Structure II: portfolio approach
  - Structure III: ARCs working with existing promoters
  - Structure IV: arbitrage approach
  - Structure V: pre-pack NCLT
  - Structure VI: complex situations



# Asset Reconstruction Companies
## Structure I: conventional model

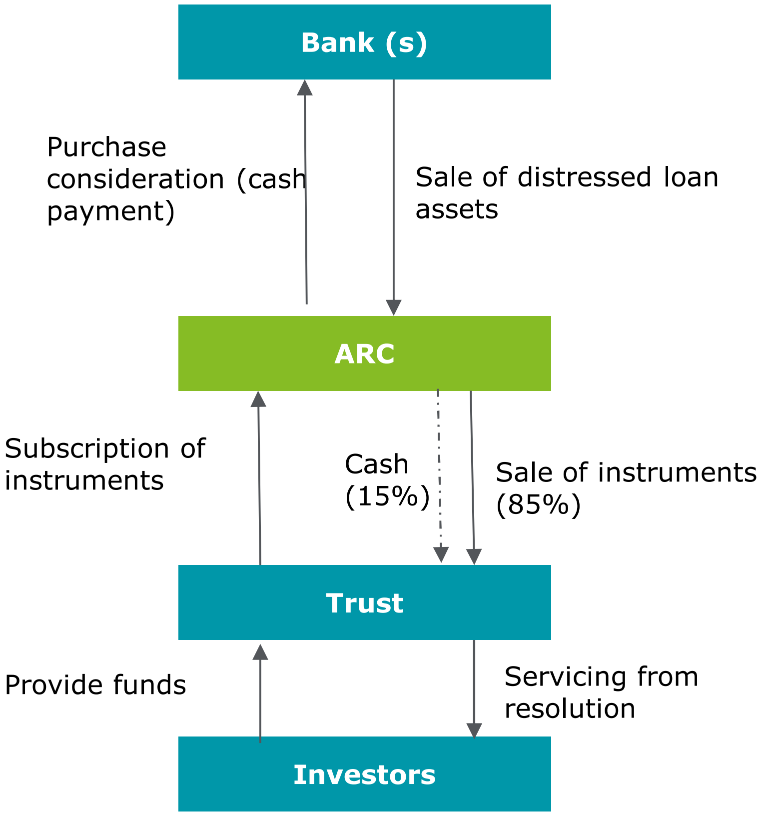
- In conventional structures the ARCs aggregate and buys the distressed asset from banks at combination of cash and Security Receipts (SRs) and ARCs resolve the asset in time period of 5 to 8 years




- **Key features**
  - Poor track record of ARCs to recover the dues
  - Change of RBI provisioning norms over the time making conventional model less attractive
  - NCLT provides strong forum to Banks for resolution

# Asset Reconstruction Companies
## Structure II: portfolio approach

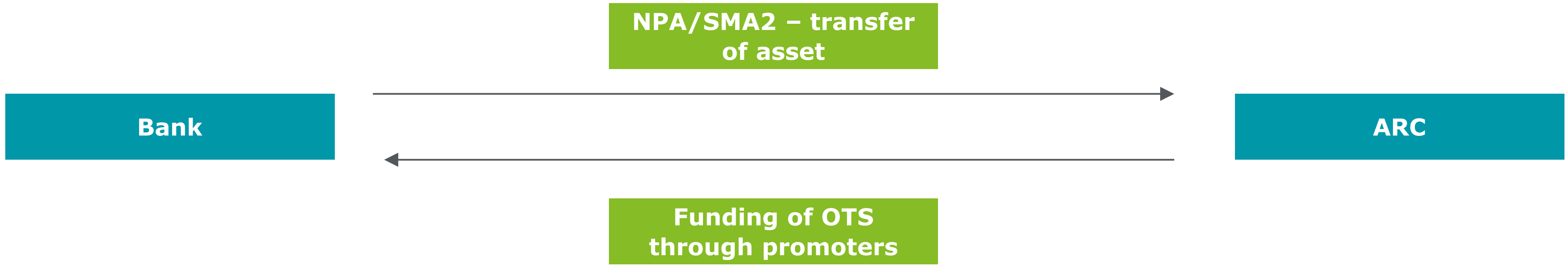
- In this approach mainly the ARCs funded by distressed funds work with banks. ARC works for investor by aggregating the asset and pay in cash to lenders and also undertake resolution of the asset
  - **Key features**
    - ARCs are required to consolidate the majority of debt from multiple lenders for being successful
    - Multiple large distressed funds entering India using ARCs for this purpose (Blackrock/Deutsche/Varde Partners/SSG/KKR/Bank of America, etc.)
  - **Transactions**
    - Banks are in process of selling its loans to ARCs through sale of loan process



# Asset Reconstruction Companies

## Structure III: ARCs work with existing promoters

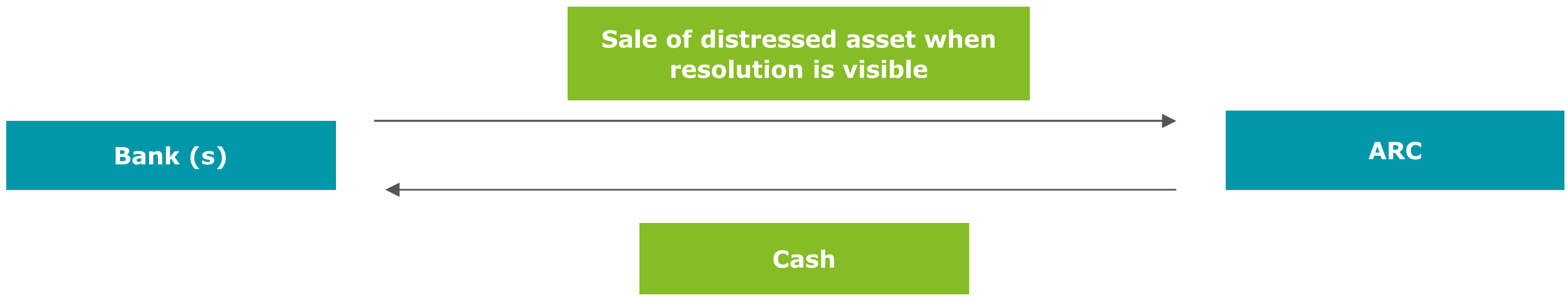
- In such structures the ARCs fund the One Time Settlement (OTS) of the promoters by buying out the loan from the banks




- **Key features**
  - Banks run a swiss-challenge method for fair price discovery
  - ARCs arrange financing from funds/investors for funding the OTS
  - ARCs work with existing promoters and restructure the loan with the promoters
  - After certain period of time promoters refinance the loan to provide exit to ARCs
  - This is an appropriate structure where banks does not want to work with existing promoters because of Section 29A restrictions. Promoters offer OTS to settle the loan
- **Transactions**
  - Multiple transactions are being worked out and are in final stages in various sectors mainly like power, metals, etc.
  - ARCs funding OTS provided by BMM Ispat Pvt. Ltd

# Asset Reconstruction Companies
## Structure IV: arbitrage approach

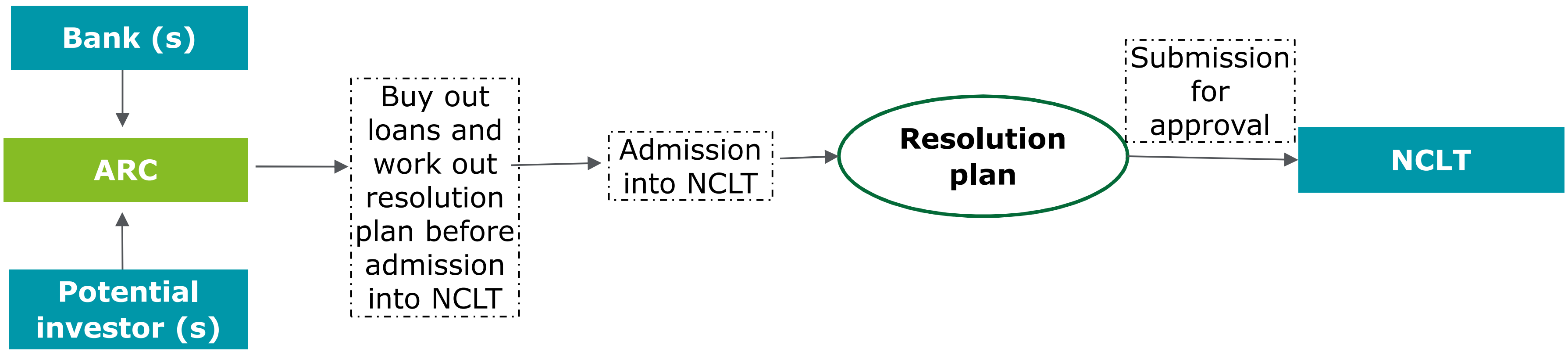
- Under arbitrage approach, the resolution plan is visible but there is uncertainty as to the timing of the resolution and Banks need to undertake resolution on priority




- **Key features**
  - ARCs come in with a resolution proposal and hold the assets until resolution
  - ARCs resolve the asset and provides the asset to the investor
- **Transactions**
  - Essar Steel Limited and Binani Cement Limited – banks are in the process of selling their loans to ARCs/investors when the resolution plan has/had been approved

# Asset Reconstruction Companies
## Structure V: pre-pack NCLT

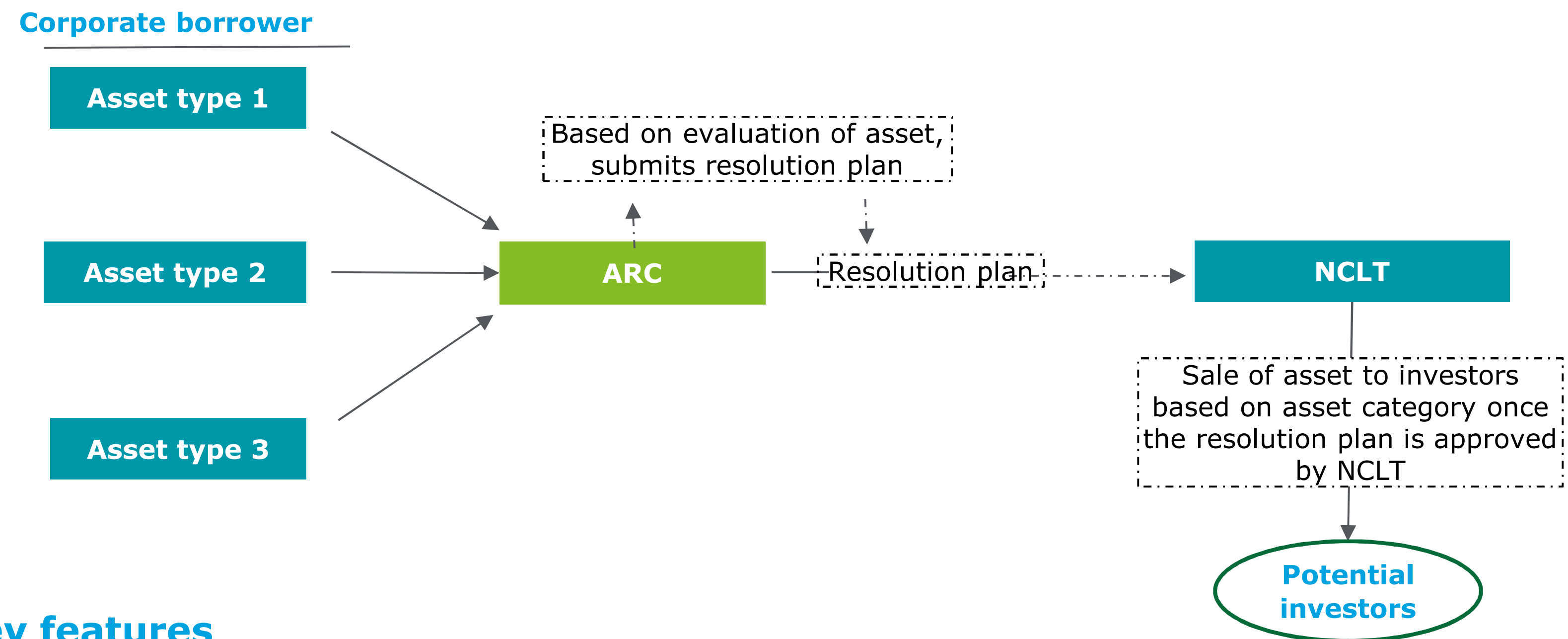
- In such structures, ARCs work with potential investors/lenders before admission into NCLT




- **Key features**
  - Resolution plan is worked out between banks and investors
  - ARCs have two options
    - ARCs buy the loan and take the company into NCLT
    - The investors backing the ARCs participate as resolution applicant

# Asset Reconstruction Companies
## Structure VI: complex situations

- This is used where the borrower has multiple assets and resolution is through a piece-meal sale of assets. IBC does not permit sale of assets in piece-meal




- **Key features**
  - ARCs participate as resolution applicant and based on investor requirement, work out resolution plan
- **Major transaction**
  - Resolution plan for Aircel Ltd

# Asset Reconstruction Companies

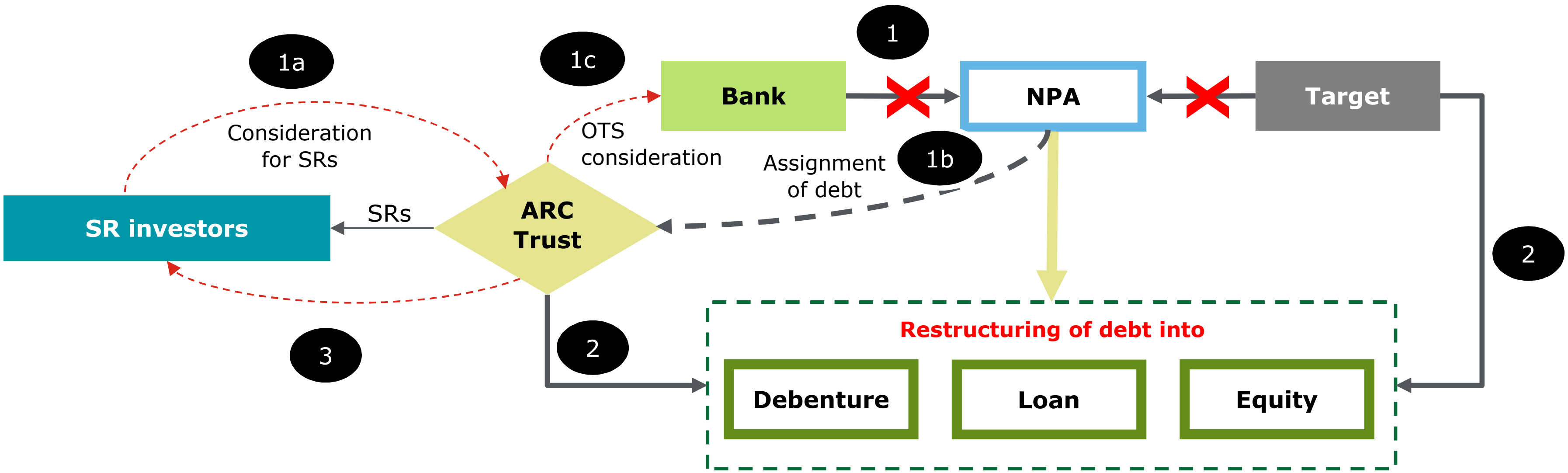
## Change in RBI guidelines

| Description | Conventional structures | Present regulations |
|---|---|---|
| **Provisioning** | • If the sale to SC/RC is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year<br>• When banks/FIs invest in the security receipts/pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognized in books of the banks/FIs at the lower of<br>a) The redemption value of the security receipts/pass-through certificates, and<br>b) The NBV of the financial asset | • If the sale to SC/RC is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year<br>• Incase the investment by a bank in SRs is more than 10 percent of its sold assets, the provisions held in respect of these SRs shall be higher of<br>a) The provisioning rate required in terms of net asset value declared by the SCs/RCs<br>b) And progressive provisioning as per extant asset classification and provisioning norms |

# Deconstructing a resolution plan

# Deconstructing a resolution plan

## Mechanics and stakeholders




- **Structure mechanics**

1. Target (borrower) company fails to repay the its bank borrowings. Bank classifies the borrowing as an NPA. Target approaches the ARC for funding the OTS
    a. ARC trust raises funds from investors and issues SRs
    b. ARC trust acquires NPA of target from banks
    c. ARC trust pays consideration to the bank in the form of OTS for acquiring the loans of the target
2. ARC trust may restructure the debt of target into debenture, loan with change in terms, equity, etc.
3. Borrower to pay returns to ARC trust, which the SR trust will up stream to the SR investors

# Resolution plan from the lens of various stakeholders

## Points for consideration

**SR investors**

- Maximizing returns
- Return of invested capital
- Taxability

**SR trust**

Maximizing returns

- Return of invested capital
- Adequate security
- Sustainable vs unsustainable loan

**Banks**

- Clean up of books
- Minimizing hair-cut
- OTS vs IBC

**Target**

- Revival and continuity of business
- Retaining promoter ownership
- Restructuring – impact on books
- Tax outflow

# Resolution plan – regulatory, accounting, and tax considerations

# Resolution plan – regulatory, accounting and tax considerations
## Implications for banks

### Illustrative treatment of NPA in bank's books

- Bank advances loan of $100, this turns bad on account of non-payment

**Bank**

**Loan = $100**

**Borrower**

| Impact in books on loan turning bad | | |
|---|---|---|
| • Provision recognized in books ($75) | | • Provision not fully tax deductible<br>• Impacts Capital adequacy |
| • Carrying value in books $25 | | |
| • Sold for $40; Provision reversed $15 | | • No tax implications<br>• Improves Capital adequacy |

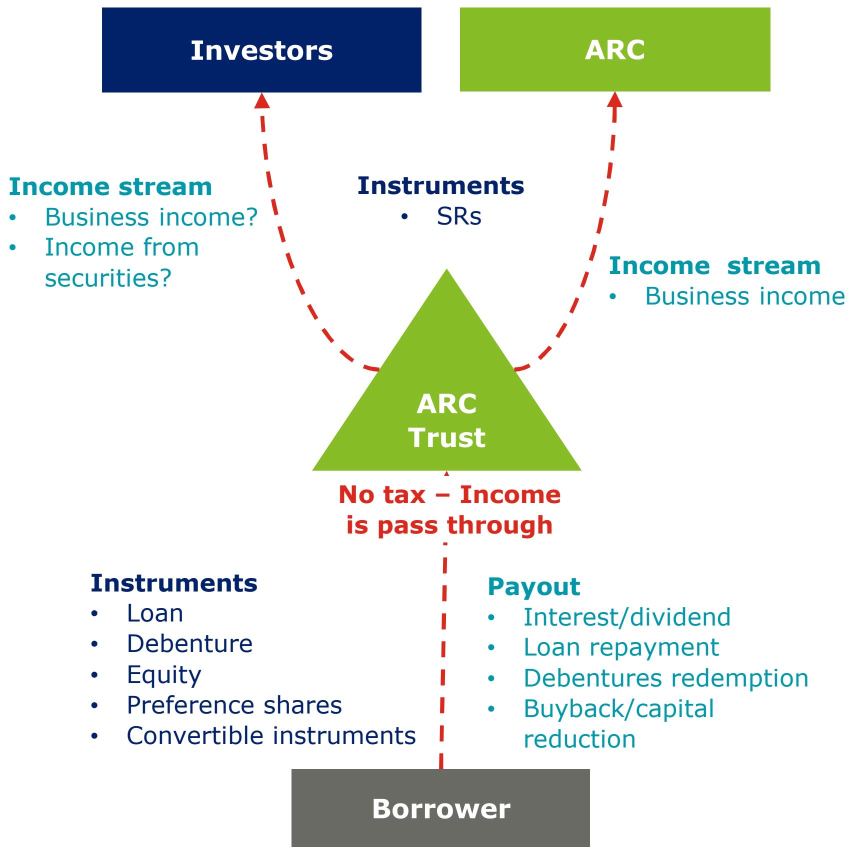
- **Tax implications for banks**
  - Banks are allowed to offer income on NPA on receipt basis or accrual basis, whichever is earlier
  - Provision for bad, doubtful debts and/ or NPA recognized as per RBI regulations is not deductible under tax laws and deduction is allowed on an adhoc basis at 5% of the total income
  - Bad debts written off are allowed as deduction, to the extent it exceeds the provisions already allowed as deduction in earlier years
  - Sale consideration in excess of $ 25 not taxable and goes to capital since the provision (to the extent of 5%) was not deductible in the year of provisioning – i.e., provision reversal in excess of 5% is tax neutral

# Resolution plan – regulatory, accounting and tax considerations
## Implications for ARC and investors

- **Financial statements of ARC**
  - Consolidation/“control” assessment of investment in SPVs based on stake held, kick out rights, variability and magnitude
- **Financial statements of SPV (ARC trust)**
  - Initial recognition of loan acquired at fair value
  - Classification of loans acquired based on business model and cash flow characteristics
  - Classification of SRs issued and their valuation
  - Expected credit loss allowance on loans which are at amortized cost
  - Interest income is recognized as per effective interest method
  - Appropriation of payments received from borrower towards principal and interest will be based on contractual terms
- **Financial statements of investor**
  - SRs issued by SPV are accounted for at fair value on initial recognition
  - Subsequent measurement is at fair value based on business model and contractual cash flow characteristics

# Resolution plan – regulatory, accounting and tax considerations
## Implications for ARC Trust and ARCs

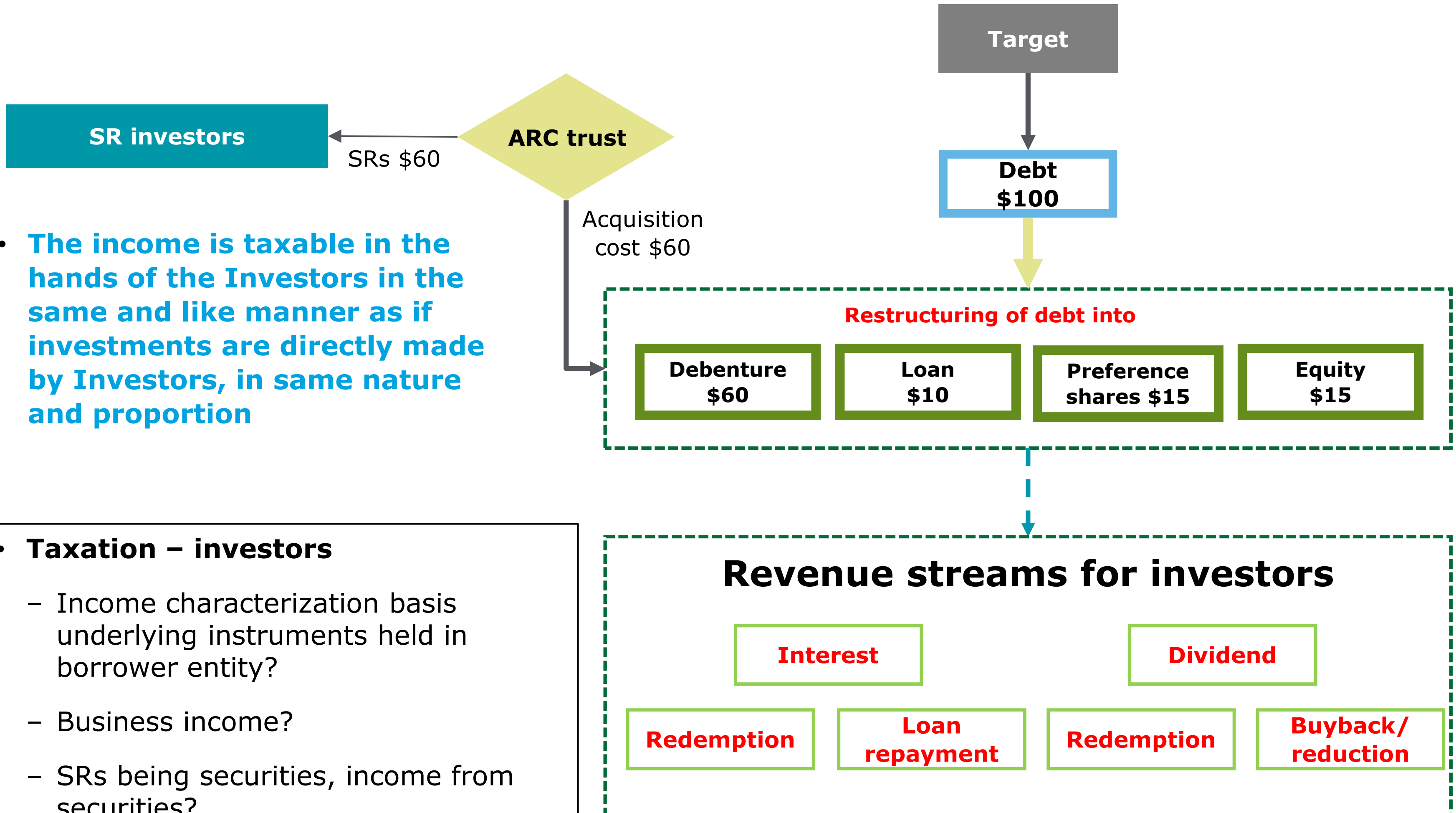
**Income flow**
**Borrower – ARC trust – investors/ARC**




- **Key implication for the ARC trust**
  - ARC Trust is pass through; income is exempt
  - Taxable in the hands of the investors in the same and like manner as if investments directly made by the investor, in same nature and proportion
  - Undistributed income is deemed to be credited to investors at the end of the financial year
  - ARC trust is required to withhold tax on the income distributed or accrued
  - Prescribed reporting by ARC trust to investor and tax authorities (break up of nature and proportion of income)
- **Taxation – ARC**
  - Income recognition in books only after principal is recovered – legal accrual of income under transaction documents to be aligned with accounting principles
  - Income received by ARC taxable as business income

# Resolution plan – regulatory, accounting and tax considerations

## Loan restructuring and implications for investors




- **The income is taxable in the hands of the Investors in the same and like manner as if investments are directly made by Investors, in same nature and proportion**

- **Taxation – investors**
  - Income characterization basis underlying instruments held in borrower entity?
  - Business income?
  - SRs being securities, income from securities?

# Resolution plan – regulatory, accounting and tax considerations

## Tax rates in the hands of investors

| Instrument | Transaction | FPI | Domestic investors |
|---|---|---|---|
| **Loan** | **Repayment of loan** | • **View 1**: business income @ 40%;<br>• **View 2**: income from securities @20%. | • **View 1**: business income @ 30%;<br>• **View 2**: capital gains @ 20% |
| **Loan** | **Interest payout** | • **View 1**: business Income @ 40%;<br>• **View 2**: interest Income @ 20%. | • **View 1:** business Income @ 30%<br>• **View 2:** interest @ 20% |
| **Debenture** | **Interest payout** | • **View 1**: interest @ 5% - 20%<br>• **View 2**: business Income @ 40% | • **View 1:** taxable @ 30%<br>• **View 2:** capital gains @ 20% |
| **Debenture** / **Equity** | **Debenture redemption** / **Sale of shares** | • **View 1:** capital gains<br>- Long term and listed @10%<br>- Long term unlisted @ 10%/20%<br>- Short term listed equity @ 15%<br>- Short term unlisted @ 30%<br>• **View 2:** business income<br>• **View 3:** redemption of debentures could be taxed as interest @ 5% or 20% | • **View 1:** capital gains<br>- Long term and listed @10%<br>- Long term unlisted @ 20%<br>- Short term listed equity @ 15%<br>- Short term unlisted @ 30%<br>• **View 2:** business income @ 30%<br>• **View 3:** redemption of debentures could be taxed as interest income or capital gains |
| **Equity** | **Dividend payout** | • Exempt from tax under the Act, subject to section 115BBDA | • Exempt from tax under the Act, subject to section 115BBDA |

Note: The tax rates above are excluding surcharge and cess

# Resolution plan – regulatory, accounting and tax considerations

## Implications for borrower company

- **Financial statements of borrower**
  - De-recognition of borrowing based on quantitative assessment (“10 per cent test”) and qualitative assessment
  - Examples of factors considered for qualitative assessment – change in currency, addition or deletion of a substantial equity conversion feature, etc.
  - If restructuring leads to a substantial modification, then borrower has to de-recognize the existing borrowings and recognize new instruments at fair value
  - Difference between fair value of new borrowings/instruments and carrying amount of existing borrowings is recognized in profit and loss account

# Resolution plan – regulatory, accounting and tax considerations

## Implications for borrower company

- For borrower, the resolution plan could entail restructuring/waiver of loan, alteration of loan terms, conversion of loan/interest to equity, debt instruments, etc. This could have tax implications, both under normal and MAT provisions

- **Outstanding interest**
  - On conversion to equity, not tax deductible
  - On conversion to loan, deductible on loan repayment
  - On waiver, no tax implications

- **MAT implications**
  - Fair value gain/loss on restructuring of loan impacts MAT liability
  - Waiver of loan and/ or outstanding interest impacts MAT liability

- **Deemed income**
  - Any write back to profit and loss account on a waiver of loan taxable, if end-use of loan is for revenue purposes
  - Waiver of outstanding interest does not have tax implications under normal provisions

# Concluding remarks

# Questions and answers

# Glossary

| | |
|---|---|
| $ | United Sates Dollar |
| ~ | Approximately |
| Act | Income-tax Act, 1961 |
| ARCs | Asset Reconstruction Companies |
| AUM | Asset Under Management |
| BIFR | Board for Industrial and Financial Reconstruction |
| CCD | Compulsorily Convertible Debenture |
| CDR | Corporate Debt Restructuring |
| FDI | Foreign Direct Investment |
| FI | Financial Institution |
| FPI | Foreign Portfolio Investor |
| FY | Financial Year |
| IBC | Insolvency and Bankruptcy Code, 2016 |
| Ind-AS | Indian Accounting Standard |
| INR | Indian National Rupee |
| JLF | Joint Lenders Forum |
| MAT | Minimum Alternate Tax |
| mn | Million |
| NBV | Net Book Value |
| NCLT | National Company Law Tribunal |
| NOF | Net Owned Funds |
| NPA | Non-Performing Assets |
| OTS | One-Time Settlement |
| RDBFI | Recovery of Debts Due to Banks and Financial Institutions |
| RBI | Reserve Bank of India |
| S4A | Scheme for Sustainable Structuring of Stressed Assets |
| SDR | Strategic Debt Restructuring |
| SMA | Special Mention Account |
| SC | Securitisation company |
| SPV | Special Purpose Vehicle |
| SR | Security Receipts |
| RC | Reconstruction company |
| Takeover Code | Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeover) Regulation, 2011 |

Thanks for joining today’s webcast.

You may watch the archive on PC or mobile devices via Apple Podcasts, RSS, YouTube.

Eligible viewers may now download CPE certificates. Click the CPE icon at the bottom of your screen.

Join us 6 September at 2:00 PM HKT (GMT+8) for our Special Edition webcast:

**Malaysia Service Tax: New rules for foreign digital services providers**

For more information, visit www.deloitte.com/ap/dbriefs

# Contact information

**Vishal Agarwal**
Tax Partner
Deloitte Mumbai, India
agarwalvishal@deloitte.com

**Rajesh Agarwal**
Financial Advisory Partner
Deloitte Mumbai, India
rragarwal@deloitte.com

**Shashikant Shenoy**
Audit Partner
Deloitte Mumbai, India
shshenoy@deloitte.com