How can a Subsidiary become Free from Foreign Parent Debt

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Many multinational companies have experienced rather difficult times doing business in developing countries for the last five years, given that even economies in developed countries are still struggling to fully recover from the global financial crisis. Under these circumstances, one can quite often see those global companies restructuring their network of subsidiaries in emerging economies to restore a healthy business and get the books in order. This is important for refinancing or attracting investment. Simple cost cutting and divesture of less performing industries and markets is also the reason for such restructuring.

In Ukraine, such global companies quite often face some common concerns. One of those concerns is often a substantial debt of the Ukrainian subsidiary company to its parent company abroad under a long-term intra-group loan. The management and other corporate officers quite often face a dilemma of the most cost efficient way to write-off such debt. Such debt is problematic if, for instance, a transnational company has made a decision to withdraw its business from Ukraine. In order to dissolve the subsidiary, it must be free from any debt, while the voluntary dissolution allows avoiding the lengthy and costly bankruptcy procedure.

In this article, we tried to sum up the options available to management in consummating such debt restructuring. The analysis is, however, devoted only to limited liability companies that have been registered in Ukraine since transnational corporations overwhelmingly chose this corporate vehicle to do their business on the Ukrainian market.

Debt-to-equity swap

A debt-for-equity swap implies that the parent company exchanges its debt for bigger equity in the subsidiary company. It is one of the most standard mechanism utilised worldwide for debt restructuring purposes.

Under Ukrainian company law, there seems to be no direct prohibition to consummate debt-to-equity swap, though the success of its implementation mostly depends on the individual interpretation of the law by relevant state authorities. The mechanics of such a transaction imply a charter capital increase and contribution by the parent company of its debt claims towards the Ukrainian subsidiary to the charter capital of the latter. Once the charter capital increase is registered, the subsidiary becomes the owner of the debt. The debt is thus cancelled by operation of law as the borrower and lender are combined into one person.

It was confirmed, in practice, that it is possible to accomplish the debt-for-equity swap procedure and register the charter capital increase with such in-kind contribution (conversion of receivables into shares). There seems to be no statutory rules that allow the state registrar to refuse to register the share capital increase in this regard.

If the state register still somehow denies the registration of the charter capital increase with such contribution of receivables, there is a possibility, in theory, to force the state registrar in a court. However, there is little court practice on this matter and it is quite hard to predict the outcome of such a case.

Even though the dept-to-equity swap may be executed from a purely legal perspective, this restructuring option may still turn out to be not so cost efficient. Given the lack of established practice in this regard, the tax authorities may view the transaction as debt forgiveness and apply the respective taxes as those discussed further.

Debt forgiveness

A more straightforward option for writing-off a debt is debt relief where the parent company forgives the subsidiary a part or all of the debt. The respective agreement should be a lawful instrument from the point of view of Ukrainian law.

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The MONEY contributed to the CHARTER CAPITAL is NOT TAXABLE in Ukraine

However, one must make due regard to the other laws applicable to the parent company's activity.

In Ukraine debt forgiveness would imply that the Ukrainian subsidiary has a taxable gain. Therefore, a corporate profit tax of 19% should apply to the respective tax base. Of course, the tax consequences may be delayed or even mitigated. In particular, the respective loan agreement can be prolonged for as a long period of time as possible. Furthermore, in the following year of 2014, the tax rate will be reduced by 3 percentage points to 16%.

Actual money transfers (to Ukraine and back abroad)

Given the tax consequences of alternative options above, actual cash transfers seem to be the most cost efficient way to cancel the debt of the Ukrainian subsidiary that it owes to its foreign parent company. The mechanics envisage a contribution of the actual funds into the Ukrainian legal entity and further repayment of the debt with the contributed cash. In other words, the money is first transferred to Ukraine from the parent company as contribution to the increased share capital and then moved back to the parent company as repayment of debt.

Under limited circumstances, this transaction may be even free from any taxes on the Ukrainian side. The money contributed to the charter capital is not taxable in Ukraine. The repayment of the principal amount is also free from withholding taxes as a return of investment. Only the interest accrued for the years of a loan's existence is subject to a general 15% withholding tax under Ukrainian tax law. However, this rate may be as low as 2% under some double taxation treaties that Ukraine has with some countries. The parent companies from those countries enjoy the benefits if they prove their respective residence.

However, the cash options implies a risk that once the cash is credited on the subsidiary company's account, this money may fall under enforcement procedures initiated by other creditors or even bankruptcy.

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Each option above has its advantages and disadvantages, and each requires careful planning and a cautious approach, as many other factors should be taken into account before consummating any actions.

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