TAX CONSIDERATIONS FOR

NON-PERFORMING LOAN RESOLUTION IN CROATIA

Finance & Markets Global Practice
The World Bank Group

October 2016

TAX CONSIDERATIONS FOR NON-PERFORMING LOAN RESOLUTION IN CROATIA

I. EXECUTIVE SUMMARY

1. The Croatian banking sector is still burdened with a high portion of Non-Performing Loans, which must be resolved in order to support normalized credit conditions in the economy. With Non-Performing Loans (NPL) amounting to 16.6%[1] of total loans at the end of 2015 and as much as 30% of loans in the corporate sector[2], Croatia has one of the highest levels of NPLs across the European Union. High stock of NPLs poses a significant strain on the Croatian financial system and resolving NPLs is essential to strengthen the financial system and restore normalized lending. From the perspective of borrowers, resolving unsustainable debt levels and restoring credit is equally vital to business recovery and economic growth. The European Commission Country Report Croatia 2016 highlights that the high stock of NPLs remains a challenge for the banking sector and the Council opinion on the 2016 National Reform Programme of Croatia recommends that the government facilitate the resolution of NPLs, and in particular by improving the tax treatment of the resolution of non-performing loans.[3]

2. NPLs are resolved primarily in one of three ways: sale of the loan, restructuring of the debt, and legal collection and enforcement. A sale of the loan to a third party may be the easiest and most efficient method to dispose of an NPL; it allows credit institutions to mitigate losses, avoid costly collection efforts, and concentrate on lending. Debt restructuring is preferred where good customers with viable businesses can be restored either by rescheduling debt payments to lower payment obligations, or in more drastic cases to forgive some portion of debt so that there is higher likelihood of recovering the remaining debt. The third option of collection and enforcement is generally pursued where a borrower is uncooperative or has no prospect for rehabilitation, in which case legal action through the courts is seen as the last remaining option to recover some amount and write-off uncollectible amounts from the banks' balance sheets.

3. Tax treatment considerations for NPL resolution first arise from the deductibility of provisions for expected losses on the loans of banks. Banks classify loans on their balance sheets based on the level of risk of nonpayment, which in turn depends on several factors such as the duration of a payment default and the potential for recovery taking into account the status of the borrower, quality of collateral, etc. Based on this loan classification, Central Bank regulations

[1] Source: Croatian National Bank (CNB) as of the end of 2015.

[2] The present focuses primarily on corporate NPL resolution, given the much higher corporate NPL ratio in Croatia, although some recommended tax-related measures could also improve the environment for resolution of retail NPLs.

[3] This report analyses tax impediments to NPLs in Croatia, widely considered to create barriers to effective and expeditious resolution of corporate NPLs. It complements an earlier joint report by the World Bank and EBRD broadly assessing key impediments to NPL resolution in the Croatian banking system (March 2016). Findings in that report identified, among other problems, the significant role that tax treatment plays in the incentives and disincentives of market participants in resolving, restructuring and recovering debt.

oblige banks to make provisions for the expected losses of the loans, which are tax-deductible expenses in the tax year in which they arose.

4. Specific tax attributes of NPL resolution methods create additional incentives and disincentives to stakeholders. Tax considerations legitimately impact business decisions on structuring transactions to resolve NPLs. Tax disincentives may therefore contribute to inefficiencies that clog the banking system with bad assets, adversely impact lending, and distort prudential practices. For example, parties may opt to reschedule debt rather than grant partial debt forgiveness to avoid taxation if debt forgiveness is considered taxable income for the borrower, thereby leaving the company with an unsustainable level of debt that may eventually cause the company to fail. Or creditors may allow fully-provisioned (and fully deducted) bad debts to remain on the books rather than face costly litigation and collection. Value added taxes or real estate transfer taxes can further increase losses to creditors that ultimately increase the overall costs of credit in the market.

5. The tax treatment of NPLs in Croatia is perceived by market participants as a major obstacle to NPL resolution. Main problems identified relate to unclear, inconsistent, and overly strict interpretation of tax rules on write-off. For banks, this includes the conditions and measures to assure write-off of value adjustments previously taken. The rules are also unclear with respect to portfolio sales of NPLs. Tax rules related to debt forgiveness are unaccommodating with respect to troubled businesses by taxing the amount of debt forgiven at the corporate tax rate, which discourages parties from engaging in proper debt restructuring. Other taxes such as Value Added Tax (VAT) and Real Estate Transfer Tax (RETT) triggered by property transfers in the context of foreclosures further add costs to collection or disposition efforts.

6. The Ministry of Finance should consider targeted tax measures to improve the efficiency of resolving NPLs and to promote recovery of viable businesses. Recommended tax measures include clarifying and/or harmonizing certain tax rules (e.g. write-off of value adjustments, VAT/RETT rules), introducing key tax reforms (e.g. exception for tax treatment of portfolio NPL sales, income exemption for debt forgiveness in the context of formal debt/corporate restructuring proceedings, waiver of certain VAT/RETT taxes on asset sales in the context of foreclosure), and strengthening institutional capacity to ensure a more consistent tax policy interpretation.

7. The fiscal impact of adopting key recommendations (excluding the VAT/RETT waiver) is estimated to be EUR 33-112 million over three years, which is relatively small compared to the potential benefits. Net potential fiscal impact on tax revenue over a period of three years is estimated to range from HRK 250-844 million (EUR 33-112 million), exclusive of impact of a VAT/RETT waiver. These projections do not factor in available mitigating rules or structures that banks often use and which could significantly reduce the potential fiscal impact. The estimated fiscal costs are relatively small and should be weighed against the significant

potential benefits to Croatia of restoring access to credit, revitalizing the business sector through rational debt restructuring, and promoting transparency in regulation.

II. TAX DEDUCTIBILITY OF PROVISIONS

8. Prudential provisioning rules in Croatia appear to be sound and properly implemented. The Croatian National Bank (CNB) regulations require banks to timely provision for expected losses, resulting in average coverage of NPLs of 54.4%[4] of NPLs at the end of 2015, which is comparable to other EU countries. New rules introduced in 2014 require banks to increase provisions by 5% of principal every 6 months while a payment default continues until provisions reach 100%.[5] New IFRS provisioning rules also afford banks more discretion to determine their expected losses. Banks are allowed to adjust the value of claims for tax purposes if the claims "are due for more than 60 days at the end of the tax period, and if they are not collected 15 days before filing the tax return for the respective period."[6]

9. Bank provisions are tax deductible albeit with certain areas of potential ambiguity including the distinction between on- and off-balance sheet items.[7] The tax deductibility of provisions incorporated in the Corporate Profit Tax (CPT) Law was introduced when the CNB regulations prescribed obligations of banks to make provisions for expected losses and to maintain parity between the CPT Law and the CNB regulations.[8] The CPT Law failed to incorporate subsequent amendments containing different wording to differentiate between treatment of balance sheet and off-balance sheet items, thereby creating a potential ambiguity in the application of Art. 11/3 of the CPT Law to current banking practice. This ambiguity arises because Art. 11/3 refers to tax treatment of "provisions", while the CNB regulations refer to adjustments on the basis of balance sheet items. Notwithstanding the difference in language, local experts consider that Art. 11/3 continues to apply so long as the amounts provisioned comply with current CNB regulatory practice. Another ambiguity relates to whether the deduction allowance for provisions under Art. 11/3 overrides the more onerous measures contained in Art. 9/2 to recognize value adjustments of

[4] Source: Croatian National Bank (CNB) as of the end of 2015.

[5] Decision on the classification of placements and off-balance sheet liabilities of credit institutions, entering into force on 31 March 2014 [hereinafter, Classification Decision]. Pursuant to the Classification Decision, loans must be classified based on possibilities of collection into Categories A (no impairment), B (partial impairment), and C (full impairment), with Category B further sub-divided into 3 categories B-1 to B-3, representing increasing degrees of impairment. Art. 13. A loan must be downgraded to category B after payment delinquency where the bank fails to take legal action for collection, in the minimum amount of at least 10% of principal, increasing to 20% after one year of delinquency. Art. 15(4). Failure to collect within two years requires a provision of at least 30%, with an additional 5% for each additional 180-day period. Art. 15(5). These are mandatory minimums, but value adjustments and provisioning must be evaluated based on a debtor's credit-worthiness, timeliness in meeting obligations, and based on quality of collateral (Art. 5).

[6] Article 9/1 of the Law on Profit Tax, Official Gazette No. 177/2004, 90/2005, 57/2006, 146/08, 80/10, 22/12, 148/13, 143/2014 [hereinafter, CPT Law].

[7] Article 11 (3) of the CPT Law, expressly provides that "Provisions made by banks for risks of potential losses are recognized as costs in the calculated amount, which may not exceed the amounts prescribed by the CNB."

[8] CNB Decision of 2003.

a claim only if all collection measures have been taken prior to expiration of the "statute of limitations for tax collection". The question is whether Art. 11/3 constitutes an exception for banks with respect to provisions from the general rule on tax deductibility for claims contained in Art. 9/2-3.[9]

10. Despite these potential ambiguities, the tax deductibility of provisions seems to be working adequately for banks. Banks do not report major concerns regarding the tax treatment of provisions, which encourages them to report losses and asset quality in a timely manner. It should be noted however that Article 11/3 only applies to financial institutions, and that ordinary creditors holding an account receivable against a debtor that has defaulted on his obligations are out of scope. These creditors, who must also make provisions for value adjustments under applicable accounting legislation are subject to more cumbersome requirements to be able to deduct their losses.[10]

III. TAX DEDUCTIBILITY OF WRITE-OFFS

11. The tax and accounting treatment of NPL write-offs are not fully aligned in Croatia. When a loan becomes impaired[11], its value is adjusted and provisions for the expected loss are made. Such losses are tax deductible if provisioned following CNB regulations. Although impaired, the NPL remains on the bank's books at its face value and the bank continues to pursue recovery and collection, until such point that it becomes clear that the loan cannot be fully recovered. At this point, any loan losses can be written-off and removed from the bank's books for accounting purposes, although the deductibility of those losses is not always allowed in Croatia.[12]

12. The CPT Law is ambiguous and narrowly interpreted by examiners with respect to tax deductibility of loan write-offs, discouraging banks from writing-off NPLs. Banks that have properly provisioned for expected losses, and taken tax deductions along the way, face a risk of having to reverse the deductions for failure to comply with a narrow interpretation of the law.[13]

---

[9] Article 9/2 of the CPT Law provides: "The value adjustment of a claim is recognized if the claim is recorded in the business records as revenue and if *all measures for debt collection have been taken* in accordance with best management practices." (emphasis added) Article 9/3 states that the measures in 9/2 are considered taken "if a legal action was instituted for the claims, or an enforcement procedure was taken, if the claims were reported in the bankruptcy proceedings or if a settlement has been reached with the debtor, who is not a natural or related person, in a restructuring or bankruptcy procedure."

[10] The tax treatment of NPLs for non-financial institutions (as creditors) is outside the scope of this report and should be analyzed separately, although in principle they would be subject to the general rules contained in Article 9/1-3, consistent with the treatment described below.

[11] A loan is considered to be impaired when it is probable that not all of the related principal and interest payments will be collected.

[12] From a tax standpoint, the distinction between value adjustment and write-off is significant because deductions are taken when the loss is recognized (i.e., point of adjustment) but such deductions can be reversed at the point of write-off, if the requisites for write-off under the CPT Law have not been met.

[13] Article 9/1-3 of the CPT Law

Such risk largely varies depending on the method selected by the bank to take the write-off, which according to the law may be in the context of either (i) collection activities, which include a restructuring of the loan, or (ii) a sale of the NPL. In both cases, should the risk of a reversal of the deduction materialize, some or all of the prior tax deductions would be declared invalid and the banks would assume an additional tax payment obligation for amounts previously deducted. As such, banks often consider a "do-nothing" approach – leaving fully-provisioned loans on their books – as less costly and risky than pursuing worthless claims.

13. The general rule on tax deductibility of value adjustments for NPLs in the context of collection activities requires that banks take all measures for debt collection. The general rule on value adjustments and write-off of loans is that such adjustments are deductible "if *all measures for debt collection have been taken* in accordance with best management practices."[14] A taxpayer is deemed to have satisfied the requirement of "all measures" if: (i) legal action was instituted for the claims <u>or</u> an enforcement procedure was taken; (ii) the claims were reported in the bankruptcy proceedings or a settlement has been reached with an unrelated debtor (who is not a natural person) in a restructuring or bankruptcy procedure.[15] If collection measures have not been taken before the statute of limitations expires (typically 3 years), any value adjustments taken in previous years on such claims must be included as revenue.

14. In practice, these measures for debt collection seem to require an objective court determination and preclude out-of-court settlements or settlements not enforced by a court judgment. The measures identified are designed to ensure that creditors pursue commercially reasonable collection efforts to recover their claims before deducting the loss. In practice, this clause requires an objective determination by a court or other body with respect to the ultimate value of the claim and prospects for recovery.[16] While the basic principle of requiring some objective proof regarding collectability of a debt is sensible, the rule seems to preclude the possibility of reaching an out-of-court settlement, or even a settlement within a proceeding, unless recognized and enforced by a court judgment. Aside from the regulation, which provides minimal elaboration, there are no further details indicating when parties have met the requirements, and when they should be allowed to suspend or avoid pursuit of collection efforts because the costs of collection clearly outweigh the benefits. Considering the lack of further guidance, a reasonable interpretation is that a deduction could be claimed after a taxpayer has either (i) pursued collection

[14] CPT Law, Art. 9/2 (emphasis added).

[15] CPT Law, Art. 9/3.

[16] Legal measures for collection listed in CPT Law Art. 9/3 are further elaborated by Art. 33 of the CPT regulation, which indicates that legally binding decisions issued in a bankruptcy reorganization, arbitration or mediation proceeding also qualify for tax deductibility. CPT Bylaw, Art. 33/1 provides: "Value adjustment from impairment of receivables for goods and services supplied according to Article 9 Paragraph 1 of the CPT Law, are recognized as tax expense if <u>a settlement with the debtor</u> - who is not a natural person or a related person - <u>is reached</u>, if a debtor is <u>in the process of reorganization</u> - which is <u>carried out according to the decisions of the creditors or government bodies</u>, as well as based on the ruling reached in the <u>legally prescribed arbitration</u> procedure or based on settlement in the <u>legally prescribed mediation procedure</u>".

or enforcement (where collateral or assets exist) or (ii) where the debtor is in a bankruptcy procedure, filed a claim that is accepted by the administrator or creditors in the proceeding. The rationale for providing a deduction would be that in all such legal proceedings there is an independent neutral party and process to verify the unrecoverable portion of the claim. This reasonable interpretation does not prevail in practice.

15. In the context of ambiguity, tax examiners appear to interpret the rules narrowly, giving little weight to feasibility and usefulness of collection efforts. While the rules seem sensible, they are often reportedly interpreted unreasonably in practice by tax examiners. For example, the requirement to institute legal actions or enforcement is generally interpreted to mean exhausting all applicable legal remedies through process, appeals, and enforcement or executions against the debtor and any guarantors, which might take as long as a decade, even if it is clear that any potential recovery would not be worth the costs of pursuing the claim. Similarly, examiners apparently interpret having one's claim reported in the bankruptcy proceeding to require a final order of distribution in a liquidation proceeding. Indeed, the only situation where the write-off appears to be clear is in the context of the Pre-Bankruptcy Settlement (PBS) procedure, now integrated in the Bankruptcy Act, where it is clear that a write-off is fully recognized. However, creditors are only entitled to such deduction upon approval of the PBS plan, although it remains unclear whether a write-off can occur up front following plan acceptance and approval or only following completion of the plan.[17] The effect of these delays causes creditors to bear the full risk of unpaid claims for years, even though the losses may be immediate and real. Meanwhile, the state would not necessarily recover less taxes if the timing for the deduction were accelerated. This is because the creditor would initially take a deduction and would then reclaim as income any unexpected recoveries received from the exposure in the future.

16. Reportedly, examiners also appear to engage in a degree of second guessing of bank management decisions. This could be reflected by questioning the initial loan terms, valuations of assets, and taking measures earlier to protect or recover the credit. Such positions would appear to contradict the language of the statute, which expressly qualifies the pursuit of debt collection measures to be taken as being "in accordance with best management practices." It is not best management practice to pursue in endless litigation a claim against a borrower where either the cost of recovery will be higher than the claim or the likelihood of recovery is very low.

17. The CPT Law and regulations on collection measures are equally unclear when read in light of other provisions and as to what constitutes unsuccessful collection. Article 9 of the CPT Law and Article 33 of the CPT Bylaw provide sufficiently clear rules on collection measures

[17] Bankruptcy Law, Art. 62/3 provides: "The amount of receivable written-off in line with the pre-bankruptcy agreement represents tax-deductible expense for the creditor." Likewise, old PBS Law, Art. 85/4 stated that: "Value adjustments represent tax-deductible expense in the amount of write-offs according to the pre-bankruptcy settlement approved in line with this Law." In theory, such deductions should be available upon implementation of the plan at the time the waiver is granted and enforceable, or at the time the debt has been exchanged for another debt or for equity. The problem arises in leaving the timing of the write-off open to interpretation.

to be performed in order for value adjustments to be tax deductible but fail to adequately explain what constitutes unsuccessful collection. For example, the rules only mention settlement with the debtor in a bankruptcy or restructuring of the debtor and a ruling reached in an arbitration / mediation procedure, while final court ruling is not mentioned. Moreover, the relationship between Articles 9 (Value adjustments and write-off of receivables), 10 (Value adjustment of stock and financial assets) and 11/3 and 6 (Bank provisions) is unclear.

18. This general rule on the "exhaustion of measures" was nuanced by a recent amendment designed to make it easier for credit institutions to write-off bad loans and encourage business restructuring. As an exception to the so-called "exhaustion of measures" rule, an amendment excepting credit institutions from the onerous requirements of Art. 9/2-3 under prescribed conditions was introduced in 2013. The exception, contained in Art. 9/7, provides that a value adjustment of receivables against unrelated parties for entrepreneurial loans will be tax deductible "*if it is determined that liabilities based on granted loans significantly jeopardize development of investment projects or continuation of business activity, i.e. result in ending the business activity*."[18] It is understood that this exception should apply to credit institutions that engage in debt write-offs for financially distressed companies or in those cases where failure to grant the write-off could lead to the failure or bankruptcy of the borrower.

19. Although this exception could be a useful tool to promote informal restructurings, as is the case in other countries, credit institutions in Croatia have not yet utilized it. Under this exception, tax deductibility seems to be afforded for value adjustments in the context of "informal" restructurings, where the business would be jeopardized absent the write-off. This reading complements the Art. 9/3 deduction for losses claimed in the context of "formal" PBS proceedings and was described by the Croatian Tax Administration (CTA) as adopting a policy to support recovery of natural persons on social or economic grounds (Art. 9/5-6) or businesses (Art. 9/7). This approach is also similar to tax treatment afforded in other countries e.g., Austria, Germany, UK and US. Nevertheless, credit institutions rarely use Art. 9/7 and express uncertainty about recognition of tax deductions for value adjustments involving write-offs for a "troubled business".

20. The exception may be underutilized because it is still fairly new or banks may still fear it will be too narrowly applied. Most income tax returns are reviewed only after several years, and the exception was only introduced in 2013, so examiners would only now be reviewing tax returns that relied on this exception. Another explanation could be that stakeholders, relying on past experience with examiners, believe that the criteria in Article 33/5-6 of the CPT Bylaws may be narrowly construed to avoid granting tax deductions for write-offs. Examiners may exercise often wide discretion in deciding whether failure to grant a write-off would "*significantly jeopardize … continuation of [the borrower's] business activity*"[19] and such discretion for

[18] CPT Law, Art. 9/7 (emphasis added).

[19] CPT Bylaws, Art. 33/6 provides: "A credit institution, which in line with the adopted criteria and procedures performed write-off under Article 9 Paragraphs 5, 6 and 7 of the CPT Law, *is obliged* - depending on the determined

examiners exposes banks to uncertainties about tax deductibility even under a reasonably well-crafted exception.

21. Tax deductibility of value adjustments arising from distressed asset sales seems to be reliable, although such deductions may be challenged as well. Article 10/1 of the CPT Law establishes the general rule that costs of value adjustments for stock and financial assets are deductible in the period in which assets are sold or otherwise disposed. Tax deductibility is preserved if: (i) NPLs are recorded as financial assets; (ii) sales are conducted at a market price or on a competitive basis; and (iii) the sale is not to a related party. The regulations do not separately define "financial assets", but generally follow accounting rules and definitions, which would include loans.[20] The value adjustment in a sale may be challenged if adjustments were not taken in line with CNB regulations (Art. 11/3), collection measures were not timely pursued prior to expiration of the statute of limitation (Art. 9/2), or write-offs were inconsistent with the "business jeopardy" exception (Art. 9/7). Examiners reportedly have challenged the tax deduction because timely and aggressive collection actions were not previously pursued prior to the sale, or on grounds that collateral was insufficient from the beginning.

22. Value adjustments in the context of NPL sales are evaluated on a loan-specific basis, rather than a portfolio basis. Sales prior to 2015 were largely of individual loans. Provided the above conditions were met, such sales typically occurred without incident. In 2013, CNB issued rules governing portfolio loan sales[21] and several large NPL portfolios were sold in arms-length auction procedures at which the purchaser paid an average price for the portfolio (e.g., an average percentage of the nominal value of all loans in the portfolio).[22] In evaluating such transactions, tax examiners reportedly challenged the sale price on individual loans in the portfolio where it was evident that those loans had generated in fact a higher recovery price than the average portfolio sales price.[23] Value adjustments from these loans were required to be revalued at the higher rates, with the difference between the sale price and the nominal value included in taxable income. Yet,

---

objectives for the write-off (economic, social and other objectives in line with the Law) *to provide data relevant for deciding on the write off and establishing the facts relevant for taxation*, in particular:

1. contents of the credit file drawn up in accordance with special regulations,
2. the amount due and the amount of outstanding obligations of the borrower towards the credit institution, the total amount due and outstanding obligations of the borrower on the day of write-offs (balance) or records of claims and liabilities on the date of the write-off, if such data are not part of the credit file,
3. criteria, policies and procedures of the credit institution, which according to the rules on loan risk management were applicable at the time of approval of the loan and on the day of the write-off,
4. data on parties related to the credit institution and
5. *other data necessary for determining facts relevant for taxation*.

(emphasis added).

[20] It should be noted that the definition of financial asset is limited to accounts receivable that have an economic right attached (interest), and that the sale of any account receivable not included in this definition will not be eligible for a tax deduction under Article 10.

[21] Decision on the sale of placements by credit institutions (Official Gazette No. 67/2013).

[22] Of some 41 billion Kuna of NPLs, approximately 3.2 billion Kuna (7.5%) were sold in 2015.

[23] This information was available because, pending closing, the seller continued to collect on the portfolio assets for the benefit of the buyer, and some recoveries yielded a higher recovery rate.

examiners reportedly did not revalue assets where the recoveries were below the average portfolio price, which on the same theory should have resulted in a further downward adjustment of the assets. This type of interpretation tends to undermine the purpose of a portfolio sale and an "average" portfolio price, because sellers and buyers recognize that not all assets are equally valued, and some will realize a higher value while others fetch a lower value.

23. Uncertainty in the context of portfolio NPL sales increases transaction costs and contributes to a more cautious approach. In reviewing the question of tax deductibility of loan sale/purchase transactions, the Ministry of Finance (MoF) has recognized that the CNB Decision on Credit Institutions' Loan Sale/Purchase does not regulate terms and methods of sale, nor treatment of expenses of sale, which are governed by tax regulations. It notes that the procedure for sale does not of itself establish tax deductibility of expenses, which must be "determined by assessing the underlying facts according to their economic nature and justifiability, taking into consideration the specific circumstances of every individual case." For this reason, banks currently in the process of preparing portfolios for sale have adopted an approach of valuing assets on a loan-specific basis for purposes of value adjustment, even though the bid price may be based on a portfolio average, fully expecting to have some value adjustments challenged and reversed.

IV. TAX TREATMENT OF DEBT RESTRUCTURING WITH DEBT FORGIVENESS

24. Debt forgiveness is used to rehabilitate a financially distressed or insolvent debtor and the relevant tax treatment may create incentives or disincentives to rationally restructure debt. Debt forgiveness decreases a debtor's excessive debt in an effort to restore viability of the business and increase prospects of collecting the remaining portion of the debt. Debt forgiveness can take a variety of forms, such as debt reduction of penalties, interest or principal, exchanging one form of debt for another, transferring debt to third parties, writing off debt in exchange for collateral or converting some portion of debt into equity. This approach is chosen to avoid a liquidation of the company where claim recovery is almost certain to be less favorable. The tax implication of debt forgiveness may be a significant obstacle to corporate workouts and restructurings[24] while an income exemption can promote incentives for corporate rescue. Annex A provides examples of the tax treatment of debt forgiveness in select developed countries.

25. Debt forgiveness in Croatia is treated as income to the corporate debtor, taxable at the corporate profit tax rate of 20% with no exceptions. According to Art 5/1 of the CPT Law: "*increases of economic value for goods and services supplied and on other basis in the form of inflows or increases of assets or decreases of liabilities, resulting in an increase of equity"* are considered taxable income. There are no exceptions to this rule, even when debt is forgiven in the context of informal debt restructurings or formal insolvency proceedings (e.g., PBS or bankruptcy

[24] When the debtor is a natural person, debt forgiveness also raises social concerns around the individual's ability to live with dignity and retain ownership over certain essential assets.

reorganization). The Bankruptcy Act expressly provides that "business events and transactions in connection with the accounting effect of the PBS are recognized, measured and evaluated in line with accounting regulations."[25] Accounting regulations require that debt forgiveness be recorded as extraordinary income to the debtor, while CPT regulations do not exclude debt forgiveness income from the tax base in PBS, reorganization or bankruptcy proceedings. No special rules exist under the bankruptcy laws.[26] Notably, the Bankruptcy Act only allows a maximum of 20% of debt to be forgiven.[27]

26. The treatment of debt forgiveness in the context of a debt-to-equity exchange is unclear. In cases of debt-to-equity exchanges, there are doubts as to whether the full amount forgiven should be treated as income or, alternatively, the taxable amount should be based on the actual fair market value increase in the value of the equity of a company, which may not be directly proportional to the amount of debt forgiven. For example, a company whose equity is worth zero, because the company's debts exceed its assets by 1 million kuna, will not realize an increase in equity value if a creditor forgives 100,000 kuna of debt. Rather, the net increase in value of the equity may be zero. Taxpayers report that the full amount of the waiver is treated as equity, meaning no deduction would be allowed, and any prior deduction taken would be treated as income. Debt-to-equity exchanges appear not to be CPT taxable subject to prescribed conditions being met.[28] Exchanges by creditors who are shareholders would be treated as a capital contribution, if permitted by the articles of incorporation, in which case there would be no income treatment to the debtor.[29] There are no specific rules governing exchanges in the context of a bankruptcy reorganization, while in a PBS proceeding the law states that no valuation of assets and rights for obligations toward creditors is required for debt converted into equity.[30]

---

[25] PBS Law, Art. 85.

[26] The same is not true for natural persons, where debt forgiveness is excluded from income under the Personal Income Tax Law (Official Gazette No. 177/04, 73/08, 80/10, 114/11, 22/12, 144/12, Constitutional Court decision - 120/13,125/13, 148/13, Constitutional Court decision - 83/14, 143/14, 136/15) [hereinafter, "PIT Law"].

[27] While noting that this 20% cap on debt forgiveness in a PBS proceeding may be unduly restrictive and insufficient to restore viability to some businesses, amendments to the Bankruptcy Law are outside the focus of this note. For tax purposes, it suffices to note that the 20% cap on debt forgiveness also limits the impact of an exception for debt forgiveness income.

[28] CPT Bylaw, Art. 10: Contribution into registered capital is tax neutral, and contribution into non-registered capital (capital reserves) is tax neutral if the assets (rights, here: loan claims) being contributed do not originate from operational business of the company, the contribution is supported by the Articles of Association / written decision of the shareholder, contributed assets must gain the status of company's assets (there should not be any current or future obligation of the company based on the contribution), the company should possess the assets and be able to freely dispose of them.

[29] CPT Bylaw, Arts. 9/2 and 10/1-3. For example, this could be the case where a shareholder is also a creditor by virtue of providing credit, goods or services to the debtor. Reduction or write-off of the claim in exchange for equity, would be treated as a capital contribution. The same may be the case for creditors that are not shareholders, although the rule is less clear, and the portion of the claim that represents the difference in amount between the claim and the value of the equity may be treated as debt forgiveness (i.e., taxable income).

[30] PBS Law, Art. 46/7.

27. There are legitimate policy reasons for not taxing debt forgiveness in the context of restructuring financially distressed companies. Assessing a corporate profit tax on forgiven debt when the business is financially distressed benefits the state at the expense of those creditors who made a sacrifice to help restore the borrower to viability. Absent such debt write-downs, the borrower's business could fail. The tax also creates a new debt to replace the one forgiven (albeit smaller), thereby increasing the debt burden again on a financially struggling business. In such a context, the tax is both unfair to the forgiving creditors, while also making it more difficult for struggling businesses to survive. Moreover, the rule discourages parties from engaging in rational debt restructurings (e.g., more debt forgiveness, debt-exchanges, debt-to-equity conversions, and transfers of collateral in satisfaction of debt) and often results instead in a rescheduling of the full amount of the debt over a longer period of time to avoid paying taxes. Thus the companies remain over-leveraged and less credit-worthy, jeopardizing their ability to access new credit or attract new investment, and generate more fiscal tax revenue in the future.

28. Debt forgiveness to individuals is tax deductible, subject to certain conditions. Articles 9.5 and 9.6 of the CPT Law ensure that debt forgiveness to individuals is tax deductible for the creditor in the context of debt forgiveness of housing loans. However, a favorable treatment to the individual borrower is not sufficiently clear. Articles 32/2 and 32/3 of the Personal Income Tax (PIT) Law adopts a rather broad definition of the term "receipt" that may be interpreted to consider debt forgiveness as taxable income, although this argument seems to contradict the PIT By-Laws and recent CTA decisions.[31] While debt forgiveness granted to individuals raises social concerns that are absent in the case of corporate debtors, the majority of arguments mentioned above apply in both scenarios.[32]

29. Additional tax attributes such as Loss Carry-Forward (LCF) rules may provide additional incentives for NPL resolution. Recognizing that business cycles vary depending on the business, and profits and losses fluctuate from year to year, LCF rules enable companies to offset current or past losses against future profits for a specified period of time.[33] Most countries have LCF rules that enable businesses to compete more effectively, usually with reasonable limits on the length of time in which losses can be carried forward and offset against profits (e.g., 4-5 years). Some countries place no limit on the amount of loss that can be offset against profits in the

[31] See Article 8.14 of the PIT By Laws as well as Tax Administration Opinion 410-01/05-01/1349, among others.

[32] Arguably, these same social concerns for natural persons can be applied equally in the context of corporate debtors facing insolvency where workers (natural persons) would be adversely affected by a liquidation.

[33] To illustrate, if we assume a business has 1 million in losses in a given year, those losses can be used to offset profits in the next five years as follows:

YR	LCF	Profit/<Loss>	Net P/<L>	YR	LCF	Profit/<Loss>	Net P/<L>
1	<1,000,000>	200,000	0	4	<250,000>	200,000	0
2	<800,000>	400,000	0	5	<50,000>	300,000	250,000
3	<400,000>	150,000	0				

If there were losses in Year 5, instead of profits, the LCF of <50,000> would go unused for year 5, and the new losses would be carried forward until the earlier of 5 years or the losses are fully offset against profits.

year realized and subsequent years (e.g., US), while others impose some limits so as to assure that some taxes are being paid.[34]

30. In Croatia, tax losses can be carried forward and offset by reducing the tax base in the following five years.[35] Tax losses are generally transferrable to the legal successor in status changes (mergers, spin offs), but they cannot be transferred if a legal predecessor was not engaged in business activity for the previous two years, or if a successor significantly changed the business activity of a legal predecessor within two years following the status change. Under these conditions, losses will also not be transferrable if there is a more than 50% change in the ownership structure of the taxpayer over the tax period.[36] An exception to the "significant change of business activity" rule does not apply if the change of business activity is intended to preserve jobs or restructure the business.[37] While this treatment is generally in line with international practice, it is important to highlight that LCFs may be applied to offset potential tax liability arising from debt forgiveness income.

V. TAX TREATMENT OF SALE OF NPLS

31. Taxes on sale of assets in the context of restructuring or enforcement can impose additional burdens on creditor recoveries that stifle NPL resolution. Real estate transfer taxes (RETT) and Value Added Taxes (VAT) in particular can increase the cost of creditor recoveries or in some cases discourage asset sales that might otherwise be necessary to raise cash as part of the restructuring efforts. In the case of creditor recoveries and enforcement, taxes are imposed on assets sold for the benefit of creditors seeking to mitigate their losses through execution and foreclosure of collateral. To accelerate NPL resolution and restructuring, some countries have introduced a waiver of transfer and sales taxes in the context of a workout where the asset transfer is a pre-condition for or necessitated by the restructuring (e.g., forced sale, transfers in lieu, or asset sales to raise capital). Waivers do not apply to taxes on goods that are typically sold as part of the ordinary business of the debtor.[38]

32. In Croatia, transfer of real estate in the enforcement procedure triggers either a 5% RETT or 25% VAT, substantially increasing the cost of NPL resolution. Generally VAT only applies to "new" buildings and construction land (if the supplier is VAT payer), while RETT applies to "old" buildings and agricultural land. New buildings are those supplied before their first occupation or use, or where not more than two years have passed from the date of the first

[34] For example, in Germany, the first EUR 1 million can be fully offset against profits, with the balance being able to offset only up to 60% of the remaining profits
[35] CPT Law, Art. 17.2.
[36] CPT Law, Art. 17/5-7. Similarly, the US preclude NOL carry-forward with more than 50% change of ownership.
[37] CPT Law, Art. 17/8.
[38] Notable examples include Turkey, under the Istanbul Approach following the Turkish financial crisis, and more recently, Ukraine has adopted similar tax exemptions.

occupation or use to the date of the next supply. All other buildings are considered old.[39] Rules vary depending on whether the buyer is VAT registered. [40] Transfer taxes or other fees due on the transfer of assets may substantially increase the cost of NPL resolution, where most of the banks' lending in Croatia is secured by real estate and unsecured debt is not as common as in other jurisdictions. Many banks believe that these costs are unfair as they are not truly buying the assets, but rather temporarily taking title (through the foreclosure process) in satisfaction of a debt.

33. Adverse VAT and RETT implications result from unclear rules on tax treatment in the context of a foreclosing party with the primary objective to make a follow-on sale of the asset. Such interim possession of an asset (such as collateralized property) is typically done to mitigate losses to the creditor, either because a suitable offer has not been made for the property or because market conditions make it difficult to realize a fair market value. Rather than leave the property under control and possession of the defaulting borrower, it is preferable to take interim possession, maintain the property and sell it at the earliest meaningful opportunity. In such cases, any VAT/RETT should be paid by the ultimate buyer, as opposed to the financial institutions, since such institutions are not in the business of owning such properties.[41] Similarly, in the context of a corporate rescue and restructuring efforts, assets are sometimes transferred or sold to make a restructuring of the business possible raising the prospect of VAT and RETT taxes that can either stifle such sales or come at the expense of creditor recoveries. Given the high levels of NPLs in sections related to construction, and somewhat lower in real estate, these sectors may be particularly susceptible to VAT and RETT taxation issues that may need to be examined more carefully to consider whether such taxes create impediments to efficient NPL resolution.

VI. TAX REVIEW AND INTERPRETATION

34. Banks have expressed a lack of clarity on the interpretation of certain decisions of the CTA. There are two types of decisions issued by the CTA. The first are general decisions of interpretation, which are broadly relied upon by examiners and taxpayers to understand key provisions of the law. The second are specific decisions that relate to questions that parties have about the specific tax treatment of particular transactions that parties intend to enter. Frequently, general decisions have not clearly explained the interpretation of a law. Moreover, such decisions have no *res judicata* (legally binding) effect if the parties rely on them. Specific decisions are issued somewhat more regularly, in part because the parties must pay for these, but such decisions are said to be vague, inconclusive and open to multiple interpretations on how a particular

[39] See Article 40/1,4 of the Value Added Tax Law (Official Gazette No. 73/13, 148/13,143/14; Constitutional Court resolution 99/13, 153/13) [hereinafter, "VAT Law"]; See Articles 4/1,2 and 5 of the Real Estate Transfer Tax Law (Official Gazette No. 69/97, 153/02, 22/11, 143/14; Constitutional Court resolution No. 26/00) [hereinafter, "RETT Law"].

[40] See VAT Law, Articles 40/1,4, 75/3; VAT Bylaw, Art. 21/1; and RETT Law, Art. 4/1,2, and Art. 5.

[41] Indeed, capital adequacy rules restrict the value of assets from real estate that can be counted in capital, thereby discouraging such holdings. Other regulations may prohibit possession property exceeded stated asset thresholds.

transaction will be examined.[42] As of 2015 however, these decisions are legally binding for the tax authorities.

35. Despite a legal mandate of the central office to unify and interpret tax law and issue binding decisions, there are discrepancies within the CTA around interpretation. According to the Law on Tax Authorities,[43] the central office of the CTA has authority with respect to coordination of the CTA units, unification of the existing criteria for interpreting tax law, issuing opinions, instructions or interpretations that are binding on tax examiners and that increase legal certainty and predictability of the tax system. Nevertheless, a disconnection seems to exist between senior policy advisors at the central office and the tax examiners in charge of the tax audits of banks. While the former have expressed an understanding of the less strict interpretation of certain tax provisions, the latter are perceived by market participants as being overly rigorous and inflexible, in practice adopting positions that deviate from the ultimate rationale of the tax law. Such disconnect may be explained by the lack of substantial decisions of interpretation that may help unify the criteria among tax examiners, and the impossibility for these decisions to be binding on tax authorities.

36. The process for resolving challenges to adverse tax determinations is slow, with contested tax decisions taking from 3-7 years to resolve appeals to the administrative courts. There are no tax courts in Croatia, and taxpayers have either no or limited ability to appeal from any adverse decision. Initial tax audits can be challenged before a 1st level resolution body under MoF/CTA, which takes about one year, and can be followed by another challenge to a 2nd level resolution body under the MoF/CTA, which takes approximately 2-3 years. Thereafter, a lawsuit can be filed with an administrative court, which can take another 2-3 years, and such courts are said to have great difficulty in dealing with tax issues and interpretation of the tax laws. It was reported that challenges to a tax decision or examination ruling is only reversed in about 2% of cases.[44] This is mainly a problem for the companies that have to pay the liability, and then wait years for their tax challenges to be vetted, during which time many such companies are forced into bankruptcy.

[42] Tax Authorities can issue binding opinions ex-ante upon request of an interested party. However, these decisions are only applicable to the specific transaction at hand and do not apply to taxpayers in a similar situation.
[43] Official Gazette 148/13, 141/14
[44] Although we believe there are no official statistics on the number of appeals that are finally successful, such percentage was mentioned repeatedly by tax advisors that provide advice on tax disputes on a daily basis in Croatia.

VII. POLICY RECOMMENDATIONS

37. Croatia should consider tax rule clarifications or policy reforms to promote a more conducive tax treatment of resolving NPLs. Recommendations fall into four categories pertaining to problems of: (1) interpretation (ambiguities, inconsistencies and gaps related to write-offs); (2) efficiency (collections measures and portfolio sales versus individual sales); (3) restructuring incentives (debt forgiveness); and (4) institutional/administrative constraints. See Annex B for itemized list of policy recommendations. Annex C addresses specific considerations about business tax policy in the context of the EU State Aid Rules.[45]

38. Rules on write-offs of NPLs should be clarified to remove ambiguities in interpretation and to ensure harmonization. Clarification for example is necessary to harmonize among the CNB regulations, IFRS and tax treatment with respect to write-offs. Clearer rules will lead to greater certainty and efficiency in the application of rules, and will encourage banks to take timely action to address and resolve bad loans. It will also accelerate the process of removing uncollectible loans from the banks' books.

39. Specific rules should be introduced to authorize NPL sales by means of a portfolio sale. These rules should specifically address the problem of having a portfolio sales price, as opposed to individually priced loans. In particular, tax examiners evaluating NPL portfolio sales should take into consideration the average sale price of a loan portfolio and compare it against the average recovery of the portfolio, rather than comparing the average sales price against individual recoveries. This will remove legal risk inherent in the process that results in asset revaluations and reversal of deductions. More favorable rules supporting portfolio sales will encourage a quicker resolution of NPLs and support development of a secondary market for distressed debt.

40. Authorities should revisit the taxation of debt forgiveness at the corporate level to support more effective debt restructuring. An income exception should be introduced for debt forgiveness that occurs in the context of restructuring of troubled or insolvent businesses, which will encourage rational debt restructuring to support corporate recovery.

41. Specific rules could be introduced to ensure an efficient tax treatment of asset sales. In particular, VAT regulations should clearly define whether the option to apply VAT on the transfer of old buildings and agricultural land is available in the enforcement procedure. Similarly, a waiver of certain VAT and RETT taxes on asset sales in the context of enforcement could be introduced.

[45] As the discussion in Annex C reveals, tax policies that apply equally to all economic agents in a Member State, not intended to single out or favor particular businesses or industries, are treated as general tax measures that do not constitute State Aid. The authors believe that all tax recommendations in this note fall into the category of general tax measures.

42. Additional measures may be considered to promote greater certainty, consistency and efficiency in tax interpretation and application. Such measures may include appointing specialized judges within administrative court, reducing appeals times, and issuing appropriate decisions to clarify rules on write-off, debt sales, debt forgiveness, and restructuring related to businesses in difficulty. Capacity building and training would also improve consistency in downstream interpretation.

VIII. ESTIMATED FISCAL IMPACT FOR CORPORATE NPL RESOLUTION & MORAL HAZARD

43. The fiscal impact of measures related to corporate portfolio NPL sales and debt forgiveness was estimated at a total of EUR 33-112 million over a period of three years. The fiscal impact was estimated for corporate NPLs when adopting an NPL portfolio sales exception and introducing debt forgiveness in the context of informal and formal business rescue.[46] The estimated fiscal impact on tax revenues from the additional resolution of corporate NPLs is small at HRK 250 - 844 million (EUR 33 – 112 million) in the period 2016-2018, compared to the total government tax revenues of HRK 68 billion in 2015. Reasonable assumptions about potential impact were applied based on current practice, experience and expectations of market stakeholders, as described in the methodology in Annex D.

44. The fiscal impact from adopting an NPL portfolio sales exception range from HRK 85 to 512 million (EUR 11-68 million) over a three-year period. This impact was estimated assuming banks may treat write offs in the context of NPL sales using an average portfolio price (measure 6, in combination with clarification 4c in Annex B). Based on interviews with banks, portfolio sales focus primarily on corporate NPLs so this estimate does not include any fiscal impact from sales of retail NPLs. Assumptions for these amounts are explained in the methodology to Annex D. The primary difference between the lower and upper bounds of the range is the assumptions on the structure of the transaction – as portfolio of individual priced loans or as a portfolio average – and the sales price obtained as an average percentage of face value. Financial institutions interviewed are aware of the portfolio sales issue and are organizing their portfolio sales to comply with the current loan-by-loan sales criteria, which would suggest the actual potential fiscal impact to be on the lower end, which assumes that approximately 20% of the nominal value of NPL loans in the portfolio could be subject to a tax deduction reversal.

45. The fiscal impact from debt forgiveness measures is estimated to range from HRK 166-334 million (EUR 22-44 million) over a three-year period. This impact was estimated assuming an income exemption for debt forgiveness granted in the context of formal and informal

[46] The potential fiscal impact from measures 11 and 12 on VAT and RETT is outside the scope of the present paper and remains to be examined in the context of property foreclosures in Croatia. It is possible that potential impact may be small as banks currently do not typically engage in foreclosures given the possibility of double taxation of the law and instead go through multiple rounds of auctions to eventually find a buyer and avoid holding the property as an intermediate step. In addition, capital adequacy regulations further restrict banks' real estate holdings.

debt/corporate restructuring proceedings involving financially distressed or insolvent businesses companies along with related measures regarding debt-to-debt and debt-equity swaps (measures 7, 9, and 10 in Annex B).[47] This figure is somewhat hypothetical because the tax only arises if a creditor is willing to forgive some or all of its debt and the estimated potential tax revenue losses need to be balanced against gains by rescuing and growing businesses that will contribute tax revenue in the longer term. The amount indicated also does not factor in any tax attributes that may be available to reduce tax liability, such as through loss carry-forwards, credits or other attributes, which would lower the overall fiscal impact.

46. Policy recommendations related to clarifications of write offs should have a tax neutral fiscal impact. Measures related to clarifications, especially as they relate to write-offs are presumed not to have a fiscal impact (recommendations 1-5 in Annex B). Approximately 10% of all corporate loans are fully impaired/provisioned or substantially impaired and provisioned at a level of approximately 83%. Rules on the ability to fully write-off a debt are confusing for banks, even though the tax benefits for such impaired loans have been largely taken. The likely result of a clarification of rules could be to accelerate the timing in which a write-off on a bad debt is recognized, with the result that previously adjusted loans and deductions would not be at risk of being reversed. The alternative to this is for such loss recognition to be established at the point of sale of a NPL or after exhausting collection efforts, which could take some additional years. Ultimately, it is assumed that exhausting such measures would result in no increase in tax liability but would have cost credit institutions more to pursue collection, thereby potentially reducing the tax revenue by such collection costs. A second area of clarification relates to whether Art. 9/7 serves an exception allowing financial institutions to write-off debt forgiven in the context of a restructuring of a "troubled business". If the exception is applied as described, there should be no fiscal impact for adjustments made, provided the restructured amount of the debt at or below the adjusted loan amount. Where the debt forgiven is above the adjusted amount, this would result in an increase in income for the difference in amount forgiven and amounts adjusted. For purposes of fiscal impact, such amounts are not included as they would in any event be paid by tax payers based on a realization higher than the tax base of the asset.[48] Clarifications will also promote consistency in tax policy interpretation and application in practice. If rules are clarified as discussed in this note, based on understood intent by the CTA central policy makers, there should be no actual tax impact from applying the rules as intended.

[47] There would also be a fiscal impact from measure 8 regarding debt forgiveness to individuals but this is out of the scope of this paper.

[48] Conceivably, Article 9/7 of the CPT Law would not be interpreted as written in which cases there could also be an increase in tax liability to banks for any amounts "forgiven" in the context of informal workouts. While such amounts could range from HRK 248-840 million, it is more likely that creditors would adopt the practice of rescheduling debt as opposed to restructuring, or would restructure debt mainly under the PBS procedure where it is clear that the financial creditors are entitled to write-off the amounts forgiven, notwithstanding CPT Art. 9/7.

47. Broader institutional and administrative policy recommendations are also assumed to have neutral fiscal impact but would support a more efficient and transparent process of NPL resolution. It is assumed that policy measures relating to institutional capacity, tax review, and harmonization (13-18 in Annex B) would not directly result in a fiscal impact. Such measures would greatly benefit the efficiency of resolving NPLs by reducing banks' risks and costs, thereby contributing to resumption of normalized lending, while also promoting transparency in regulation and application of tax law.

48. The potential for moral hazard associated with the policy changes would be relatively low in the current context. Clear tax policy and its interpretation and application are essentials for any market and create no incentive not to pay taxes. Similarly, the change associated with the NPL portfolio sales is expected to have short term implications with the aim of accelerating resolution of NPLs. A clearer policy and exception recognizing portfolio sales will encourage a more proactive transfer of bad assets and support the development of a secondary market for distressed loans, which is important to improve efficiencies in the financial system with respect to collection and to mitigate credit risk. Finally, tax policies with respect to debt forgiveness are aimed solely at troubled companies that are capable of being rehabilitated. Such a policy is unlikely to encourage behavior of not paying loans for the primary benefit of getting tax relief if the company needs to go through a restructuring or formal insolvency.

Annex A

International Comparative Experience

In the context of corporate restructuring, an "income" exemption on debt forgiveness and debt write-offs can promote incentives for corporate rescue and accelerated resolution of NPLs. Such an exemption is particularly important in the context of a financial crisis or in cases where the banking system is struggling under significantly elevated levels of NPLs. Rules on debt forgiveness vary considerably from country to country and are complicated by other rules governing losses for tax attributes that may be applied against future losses. Following are a few examples of how countries tax debt forgiveness for distressed corporate borrowers:

- **Austria**: Income based on debt forgiveness is in principle taxable to the borrower. Taxes are partly waived in the context of formal insolvency proceedings, provided the debt waiver was made for the purpose of assisting the turnaround or recovery of the company, and it continues to operate.[49]

- **Australia**: Debt forgiven must first be offset against any number of tax attributes that may otherwise be available to the taxpayer to offset profits, such as non-capital and capital loss carry-forwards, depreciable properties and non-depreciable capital properties, reduction of current or prior year capital losses, and income inclusion.[50]

- **Canada:** Amounts forgiven are first applied on a mandatory basis against specified attributes, and can then be applied on an elective basis against other attributes, with half of any remaining balance treated as income.[51]

- **Germany**: Debt forgiveness in principle triggers taxable income, to the extent not qualified as a shareholder contribution. An exception exists on debt waivers provided the corporation needs "rehabilitation", the transaction is entered into for the express purpose of restoring the corporation to a sound financial position, and the waiver is capable of achieving this purpose. A company is deemed to need rehabilitation if it would not have been possible to conduct the business at a profit without the waiver.[52] There is a presumption that the waiver is for rehabilitation if several creditors waive their claims, but must be proven when only one creditor waives its claim.

- **United Kingdom**: An "income" exemption exists for the debtor when debt is forgiven in the context of a statutory insolvency arrangement or formal insolvency proceeding. Notably, under the Finance Act 2015, the exemption was also extended to "corporate

[49] See Austria Corporate Income Tax Act (2003 & 2010), Section 23a.
[50] See, e.g., Australian Income Tax Assessment Acts (1936 & 1997), Schedule 2C.
[51] Canadian Income Tax Act, Section 80.
[52] *German Tax & Business Law Guide 2001* paras. 133-200, (CCH Europe).

rescue" situations.[53] Under the new provisions, accounting credits arising when debts of companies are released (forgiven) or modified are exempt from a charge to tax (income) if it is reasonable to assume that immediately before the release, modification or replacement there would be a material risk that within the next 12 months the company would be unable to repay its debts. The exemption for "corporate rescue" situations applies where a debtor and creditor company to a loan relationship become connected, and the debt release occurs within 60 days of either (i) the acquisition of the loan, or (ii) of the companies becoming connected. The corporate rescue conditions require that the debt was acquired or companies became connected in an arm's length transaction, and immediately before the first debt was acquired or parties become connected it was reasonable to assume that, absent the transaction, there would be a material risk that the debtor would be unable to repay its debts within the next 12 months.

- **United States**: pursuant to an "income" exemption, there are no tax implications to the debtor when debt is forgiven with respect to an insolvent company.[54] An insolvent debtor may exclude cancellation of debt (COD) income from gross income to the extent of its insolvency immediately before the debt is cancelled. Insolvency for this purpose equals excess liabilities over the fair market value of assets. In the context of a bankruptcy proceeding, however, the debtor can exclude the full COD income, whether it is technically solvent or insolvent, without proving insolvency or limiting amounts excluded. As a condition to using the income exception, income must be applied to reduce favorable tax attributes, including NOLs, general business credits, minimum tax credits, capital losses, or to reduce tax basis, etc. However, any excess COD income that remains after offsetting tax attributes simply goes untaxed in the bankruptcy proceeding. Notably, a creditor can still take a tax deduction for a bad debt, even though the debtor does not recognize income. Prior to 1995, the US IRC also included a stock-for-debt exception pursuant to which debt forgiveness occurring as part of a debt-equity swap in bankruptcy reorganization would not be taxable nor applied to offset tax attributes.

An income exemption is also frequently applied for debt forgiveness as part of a debt-to-debt or debt-to-equity exchange. Notably, in some countries, a debt-for-debt exchange may be exempt from debt forgiveness rules, resulting in a better outcome for the debtor (e.g., Canada), and sometimes exceptions are granted in context of insolvency for debt-to-equity exchanges (e.g., US prior to 1995). With respect to a debt-to-equity exchange, most (but not all) countries tend to value the amount of debt forgiven based on the fair market value of the securities received, as opposed to valuing the income based on the amount of debt actually forgiven.

[53] UK Corporate Tax Act (CTA) 2009, section 322, as amended by Finance Bill Sch. 7, and section 323A (as amended by the Finance Act 2015.
[54] See US Internal Revenue Code ("IRC"), Section 108(a)(1)(B), (a)(3), and (d)(3).

Annex B

Tax Policy Recommendations

1. Terminology used in Articles 9, 10 and 11 of the CPT Law should be defined and aligned with respect to: value adjustments; provisions; write offs, financial assets, etc.
2. Art 9 and 11 of the CPT Law and Art 33 of the CPT Bylaw should be aligned with the Law on Credit Institutions and CNB's Decision on the Classification of Placements and Off-balance Sheet Liabilities of Credit Institutions with respect to the value adjustments and provisions (definitions, conditions for tax deductibility).
3. The relation between Art 10/1 and Art 11 should be clarified in the context of financial assets (bank loans are also financial assets).
4. The following issues should be clarified:
    a. applicability of Art 9/3 (and/or 9/7) to bank provisions;
    b. mutual exclusion of Art 9/3 and Art 9/5-7; and
    c. conditions under which Art 10/1 and 9/7 are applicable to portfolio.
5. Write-off and conditions for write-off should be clearly defined (within Art 9 or separately in the CPT Law) for all creditors and banks.
6. A specific exception should be introduced recognizing and clarifying treatment of debt sales by means of a portfolio sale process and addressing write-offs with respect to an average portfolio sales price.
7. Consider introducing an income exemption for debt forgiveness in the context of formal debt/corporate restructuring proceedings involving financially distressed or insolvent businesses (i.e., PBS, or bankruptcy reorganization).
8. Similarly, consider an income exemption for debt forgiveness granted to individuals in the context of personal bankruptcy proceedings or individual enforcement procedures.
9. Consider minimizing debt forgiveness income for financially distressed companies (i.e., "businesses in difficulty") in the context of informal restructurings, where liabilities exceed a fair market value of assets immediately prior to the debt forgiveness.
10. Rules on debt-to-debt and debt-to-equity exchanges should be reviewed to incentivize rational debt restructuring for financially distressed companies.
11. VAT regulations should clearly define whether the option to apply VAT on the transfer of old buildings and agricultural land is available also in the enforcement procedure (under condition that both buyer and seller are VAT registered payers and the buyer has the right to full deduction of input tax).

12. Consider a waiver of certain VAT and RETT taxes on asset sales in the context of enforcement where a bank is foreclosing with the aim of directly passing on the asset to another prospective buyer.
13. For those provisions that cannot be addressed specifically in the law, tax authorities should adopt and disseminate a unified interpretation while in parallel ensuring a uniform implementation of such interpretation throughout tax audits.
14. Tax policy related to tax treatment and deductibility of NPLs needs to be reviewed and harmonized with CNB regulations and internally with other provisions of the CPT Law and Bylaws.
15. Consider a) encouraging a greater degree of specialization on tax matter within judges that would handle reviews in lieu of the administrative courts, and b) Shorten the review process, either to a single level review and the tax court, or to minimizing the review at the 2d level resolution body under the MoF/TA.
16. Issue clearly written and detailed tax decisions on the interpretation of tax treatment of NPLs, so that taxpayers and examiners have a much better understanding of how the law should be interpreted.
17. Issue specific tax decisions with sufficient clarity and *res judicata* effect so that parties relying on the decisions cannot have their transactions re-evaluated by examiners.
18. Examine the process for downstream interpretation and application of the law by examiners and strengthen examiner capacity through sufficient internal procedures, manuals, and training.

Annex C

European Union State Aid Rules

The European Union State aid provisions prohibit state aid of "any form whatsoever" that distorts or threatens to distort competition favoring certain undertakings, insofar as it affects trade between States.[55] To avoid harmful tax competition, the Commission subsequently developed a code of conduct for business taxation in 1997, and prepared more detailed guidelines on the application of state aid rules to direct business taxation.[56] The Commission Taxation Notice makes clear that "the principle of incompatibility with the common market and the derogations from that principle apply to aid 'in any form whatsoever`, including certain tax measures."[57] What tax measures qualify as "aid" is the subject of the Commission Taxation Notice. Not all tax measures are scrutinized as potentially impeding the functioning of the internal market. The Commission laid out the following cumulative criteria for a tax measure to qualify as state aid:

1. The tax measure must confer on recipients an advantage that relieves them of charges normally borne by their budgets, such as:
    - reduction in tax base (special deductions, special or accelerated depreciation arrangements or entering reserves on the balance sheet);
    - total/partial reduction in amount of tax (i.e., exemption or tax credit);
    - deferral, cancellation or even special rescheduling of tax debt.
2. The advantage must be granted by the State or through State resources. (For example, loss of tax revenue is considered equivalent to use of State resources.)[58]
3. The measure must affect competition and trade between Member States; and
4. The measure must be specific or selective in that it favors 'certain undertakings or the production of certain goods`.[59]

State aid is distinguishable from general tax measures, "which are open to all economic agents operating within a Member State." General measures must apply to all firms on an equal basis and may not be narrowed or altered in scope at the discretion of the State, provided, however, this does not preclude a Member State from deciding on economic policy considered appropriate to spread the tax burden. For example, measures that do not constitute state aid include: (1) tax measures of a purely technical nature (e.g., setting tax rates, depreciation rules, and rules on loss-carry forwards, as well as provisions to prevent double taxation and or tax avoidance); (2) measures

[55] See Treaty on the Functioning of the European Union (TFEU), Art. 107(1) (1 December 2009), formerly called the Treaty Establishing the European Community (TEC).
[56] Commission Notice on the application of the State aid rules to measures relating to direct business taxation (OJ C 384, 10/12/1998, pp.3-9) [hereinafter, the "Commission Taxation Notice"].
[57] Ibid, para. 2.
[58] The Commission qualifies that "State support may be provided just as much through tax provisions of a legislative, regulatory or administrative nature as through the practices of the tax authorities." Ibid, para. 10.
[59] Ibid, paras. 9-12.

supporting general economic policy objectives (e.g., offsetting research-development, or support of training, employment, and environmental goals). It is immaterial that some sectors may benefit more than others.[60]

Would measures recommended in this note be treated as state aid?

1) **Clarification of write-off rules for tax deductibility of bad debts for credit institutions.** The Croatian tax rules governing the particular timing of recognizing write-offs are measures that should apply to all entities equally. To the extent that there are some measures pertaining to credit institutions (Art. 9/7, 10, and 11), such measures may well single out the banking sector for advantageous treatment, by means of State resources (possible loss of tax revenue), but the recommendations are intended to harmonize tax treatment with CNB regulations to promote sound prudential practices within the financial system. Moreover, there is no particular advantage to financial institutions, as they are already obliged by CNB regulations to provision for expected losses and entitled under international accountings standards (IAS 39) to expense such costs. The same rules apply equally to all credit institutions, whether local or foreign banks operating in Croatia, making it difficult to see how this creates a competitive advantage or distortion in the internal market. Treatment vis-à-vis other creditors required to rely solely on Art. 9/2 and 9/3, however, does admittedly confer an advantage on credit institutions over general creditors. That said, the advantage already exists in the CPT Law and not be virtue of the recommendations. The proposals recommended herein would level the playing field more closely among financial institutions and other creditors, by enabling such creditors to potentially claim losses for bad debts earlier and more efficiently, without necessarily having to exhaust all legal measures imaginable under CPT Law Arts. 9/2-3.

2) **"Income exemption" for debt forgiveness in the context of formal insolvency or corporate rescue proceedings**. The recommended "income exemption", granted in formal insolvency and corporate rescue proceedings, most likely would be construed as a general measure of a purely technical nature that applies equally to all entities without discrimination. It is substantively similar to other tax measures like depreciation rules, or can be said to promote a general economic objective of promoting rescue of viable businesses, thereby preserving greater market competition and jobs. The treatment would also be available equally to all businesses in difficulty that meet the specified criteria, so that no particular undertaking or sector gains an advantage as a result of the tax measures adopted. While some sectors or industries are more likely to be beneficiaries of the treatment (i.e., construction and real estate), this alone is not akin to singling out specific undertakings or sectors for an advantage. Some precedent for this measures exists in other Member States (e.g., UK).

[60] Ibid, paras. 12-14. For example, some labor-intensive sectors will benefit more from policies supporting labor.

3) **VAT and RETT exemptions in foreclosure contexts**. The proposals on VAT and RETT are a bit more complicated. With respect to a measure of general application that avoids imposition of VAT or RETT in the context of enforcement proceedings, or where a credit institution (or other creditor) are merely serving as a conduit for the ultimate disposition of the asset, the measures proposed might well fall into the category of measures of a general technical nature designed to avoid double taxation. Again, the rules should be applied equally and should not single out particular undertakings or sectors. With respect to particular exemptions from VAT, RETT and other taxes in the context of corporate rescue or restructuring, the argument could be made that the exemption is designed to promote a general policy support economic objectives, similar to the "income exemption". Again, it is important that any measures adopted apply equally and without discrimination.

Annex D

Fiscal Impact Assessment Methodology and Tables

Methodology used for fiscal impact assessment

Table 1: Corporate Loan Classifications by Economic Activities and Adjustments by Loan Categories

Table 1 contains Corporate NPL data as of end 2015 by category and by provisions, ranked by sector with the largest loans. The top 3 largest sectors are also aggregated separately for comparative purposes to consider whether a targeted approach to these sectors may be warranted. Primary focus of the impact concentrates on the corporate NPL portfolio.

Table 2: Projected NPL Resolution based on methods of collection

The tables in Table 2 estimate potential recoveries based on conventional recovery techniques in Croatia, for which proposed tax policy recommendations could have some impact. (Tax impact is estimated in Table 3.) Table 2.A presents a potential break-down of the NPL portfolio by resolution alternative, while Table 2.B presents the specific recovery obtained under each resolution alternative. All variables marked in blue are projections about disposition levels by category of NPLs, based on discussions with market participants about their risk management and recovery practices and expectations. The following assumptions were applied to disposition methods:

- **NPL Sales**: This category attempts to measure NPL sales by category to assess what portion of the portfolio may be subject to a reversal of tax deductions already taken (see table 2.B for this). Banking sector representatives estimate that as much as 50% of the NPL stock could be sold in 2016-2018, as supported by the fact that approximately HRK 12.8 billion (EUR 1.7 billion) of NPL portfolios are currently in various stages of preparation/tender, excluding retail loans. Our estimates reflect aggregate NPL sales of approximately HRK 14.6 billion (EUR 1.94 billion) based on a reasonable projections of the percent of NPLs by category likely to be included in portfolio sales. A higher loan quality (e.g., B-1) is less likely to be sold, as such loans represent more credit-worthy clients. Thus, only 10% of B-1 loans are included in the portfolio for sale.

- **Informal workouts**: This category attempts to measure the potential amounts written-off in the context of out-of-court restructuring for the purposes of estimating the debt forgiveness received by debtors. The majority of NPL debt is typically resolved informally or out-of-court, either by rescheduling or by a debt restructuring that includes a discount. Almost no debt-to-equity swaps occur, so we have not included these amounts, although they may be reflected in some portion of debt forgiveness. B-1 loans are of higher quality, meaning most will be rescheduled (67%) rather than restructured with debt forgiveness (17%). B-2 reflects lower levels of rescheduling (25%) and higher levels of debt forgiveness (20%), while B-3 loans are expected to be largely sold in NPL sales, with those retained being restructured with steeper discounts. No C category loans are projected to be resolved by workout.

- **Formal PBS proceedings**: This category attempts to measure the potential amounts written-off in the context of PBS procedures to estimate debt forgiveness received by debtors. Almost no formal reorganizations occur under full bankruptcy procedures. Under the PBS, a debtor must repay at least 80% of the debt to creditors to qualify, and maximum 20% debt forgiveness is allowed. Accordingly, we have relegated a smaller percentage of NPL debt to be restructured under the PBS procedure and especially for Cat. B-3 loans (3%).

- **Collection (Enforcement/Liquidation) proceedings:** This category attempts to quantify the proportion of NPLs likely to be submitted for collection through court proceedings to obtain a judgement, execute on assets, foreclose on property or recovery through bankruptcy liquidation proceedings. An estimated 10% of the NPL portfolio is projected to be recovered through collection proceedings. As noted, the likelihood of pursuing collection by enforcement increases as the assets deteriorate in quality or the claim goes unpaid for longer periods of time. Collections measures are among the measures required to establish a basis for write-off.

NPL sales table: The second table measures maximum potential reversal of provisions in the context of NPL portfolio sales, where the tax authorities may not recognize the write-off of the difference between (i) the "adjusted value" of the loan and (ii) the "average portfolio sales price". The "adjusted value" is defined as (i) the nominal value of the loan, less (ii) the average provisions by class. The "average portfolio sales price" is either 15% or 20% of the nominal value of the loan portfolio. To date, the highest portfolio sales price has been about 20%, with future sales expected to be closer to 15%. Thus, Category B-1 loans with average provisions to cover expected losses of 13.92% (see Table 1) would result in presumed adjusted value of 86.08% of nominal value of the NPLs. The maximum potential amount to be reversed at 20% sales price would be 86.08 - 20 = 66.08. The difference decreases as the loan quality is adjusted at higher rates, and in Cat. B-3 and C, arguably the result is a negative value, meaning that the average portfolio sales price would be higher than the adjusted values of the assets.

Informal workout table: The informal workout table measures expected discounts applying three levels of discount in cases where debt forgiveness is applied - 15%, 20%, and 25%. These would be the amounts formally 'forgiven' to debtors. In categories with higher qualify NPLs, lower discounts are expected to be applied (e.g., 15%). Thus, in B-1, where provisions for expected losses average only 13.92%, it is unlikely that a discount of 15% would be granted. In the portfolio, there will be a percentage of loans that are higher than 15%, possibly ranging closer to 30%. Accordingly, the discount at 15% or 20% is a reasonable assumption based on market experience. Categories B-2 and B-3 reflect higher percentages of the loans with higher levels of discount, as one would expect. Market stakeholders indicated that discounts above 20% were less common. Given that category B-2 loans are 50.4% provisioned, however, a higher discount seems warranted for some of the loans. In Category B-3, all discounts are either 20% or 25%. No informal restructuring is expected to include Category C debt.

Formal restructuring PBS table: This table assumes that all debt restructured through a formal proceeding will be done through a PBS procedure, in which the debtor is obligated to repay at least 80% of the debt, meaning it can receive no more than a maximum discount on debt of 20%. Accordingly, the same 20% has been applied across all categories, although the volume is slightly higher in B-2 and lower in B-3, recognizing the likelihood of debt restructuring where the loan

quality has deteriorated more significantly. No informal restructuring is expected to include Category C debt.

Table 3: Fiscal Impact of Key Tax Policy Recommendations.

The two tables on spreadsheet Table 3 attempt to quantify the actual tax effect of applying the recommended tax policies, each of which carries a corporate profit tax rate of 20%, either to the financial institutions (NPL sales) or to the debtor (debt forgiveness). The first table measures the potential maximum deductions reversible in NPL portfolio sales and projected maximum amounts of debt to be forgiven. The second table measures the tax impact in each category. The tax rate applied is the same for each method and each category at 20%. Thus, total potential adjustment reversed under NPL sales in Category B-1 would amount to approximately HRK 460 million, resulting in a taxable portion of HRK 91.9 million. All tax assumptions are made to cover the three year period of 2016-2018.

The base amount of the aggregate taxes is further adjusted to identify a possible range. On the lower end of the range, we assume that most NPL portfolio sales will be structured on a loan-by-loan basis with a deduction reversal rate of only 20% of the total and average portfolio sales price of 20%, further minimizing the tax impact to the portfolio, while debt forgiveness is projected to be at 75% of the estimated totals. On the upper end of the range, the NPL sales price is estimated to be at 15% resulting in a higher amount of deductions reversed, and excluding any loans on which a higher value was recovered on the basis that such loans were sold at a profit relative to the tax basis in the asset. At the same time, the amount of forgiven debt is projected to be 50% higher than the totals estimated, which would be a rather significant increase over reported market practice to date.

Additional Assumptions

1. The fiscal impact will be largely contained within the taxable period of 2016-2018, assuming recommended policies were adopted with effect from 2016, as most NPLs will have been resolved by the end of this period, and NPLs thereafter would return to more or less normal levels.

2. Corporate NPLs are all taxable at the CPT rate of 20% and not under the PIT Law. If there are any entrepreneurial or sole-proprietorship or other loans included in the corporate portfolio that would be taxable under the PIT Law, the net effect would be to reduce the fiscal impact, as such loans are subject to more favorable tax treatment, including exemptions for debt forgiveness.

3. Tax clarifications should not result in loss of tax revenue, or if it does, such losses in revenue would be legitimate in that they result from a proper interpretation of the law. The primary impact of such clarifications could be to accelerate the timing of certain write-offs, which may have an impact in earlier years, as opposed to later years, but the overall net impact should be neutral, without consideration to time value of payments.

4. Assumptions of potential tax liability are based solely on simple calculations of taxes that may be assessed in the case of deductions reversed or debt forgiveness granted. No attempt has been made to deter mine whether such tax liabilities would arise in light of other available offsetting tax attributes, such as loss carry-forwards, credits, etc. Indeed, such attributes to the extent available may completely offset any liability for individual tax payers.

TABLE 1: CORPORATE LOAN CLASSIFICATIONS AND VALUE ADJUSTMENTS

CORPORATE LOAN CLASSIFICATIONS BY ECONOMIC ACTIVITIES, AS OF 31 DECEMBER 2015

(in HRK 000s)

Industry	% Total	Total Loans	Cat. A *unimpaired* (0%)	Cat. B-1 *partly impaired* (1-30%)	Cat. B-2 *partly impaired* (30-70%)	Cat. B-3 *partly impaired* (70-100%)	Cat. C *fully impaired* (100%)
Construction	25.47%	**25,728,616**	17,559,313	859,872	4,470,108	1,866,586	972,737
Manufacturing	19.71%	**19,916,052**	13,040,099	2,165,316	2,271,339	1,304,361	1,134,937
Trade, repair of motor vehicles and motorcycles	17.19%	**17,361,436**	11,292,229	1,467,995	2,217,618	1,191,409	1,192,185
Accommodation and food service activities	7.83%	**7,906,548**	6,330,687	637,395	758,224	86,296	93,946
Real estate activities	6.53%	**6,599,346**	4,120,151	440,519	1,432,768	474,827	131,081
Agriculture, forestry and fishing	4.57%	**4,619,951**	3,837,303	259,997	303,464	105,424	113,763
Professional, scientific, technical, administration and support service activities	4.16%	**4,206,080**	2,538,432	419,476	824,718	195,542	227,912
Transportation and storage	2.99%	**3,018,088**	2,549,762	141,179	147,912	61,628	117,607
Information and communication	2.23%	**2,256,201**	1,207,262	263,254	385,423	283,716	116,546
Mining and quarrying	0.51%	**512,782**	347,526	28,547	45,687	62,517	28,505
Other activities	8.81%	**8,897,298**	7,782,250	272,637	501,783	171,225	169,403
Total (all categories)	**100%**	**101,022,398**	**70,605,014**	**6,956,187**	**13,359,044**	**5,803,531**	**4,298,622**
Total Cat. as % of total corp. loans			69.89%	6.89%	13.22%	5.74%	4.26%
(in thousands, EUR)		13,433,829.52	9,388,964.63	925,024.87	1,776,468.62	771,746.14	571,625.27
(in thousands, USD)		15,352,948.02	10,730,245.29	1,057,171.28	2,030,249.85	881,995.59	653,286.02

(in HRK 000s)

Total loans in top 3 sectors	62.37%	**63,006,104.00**	**41,891,641.00**	**4,493,183.00**	**8,959,065.00**	**4,362,356.00**	**3,299,859.00**
% of top 3 sectors by cat. to total loan in cat.			59.33%	64.59%	67.06%	75.17%	76.77%
% of top 3 sectors by cat. to total corp. loans			41.47%	4.45%	8.87%	4.32%	3.27%

VALUE ADJUSTMENTS OF BANK LOANS TO CORPORATES (ESA 1995), BY ACTIVITIES AND RISK CATEGORIES

Industry	% Prov'n to Total Prov'n	Total	Cat. A *unimpaired* (0%)	Cat. B-1 *partly impaired* (1-30%)	Cat. B-2 *partly impaired* (30-70%)	Cat. B-3 *partly impaired* (70-100%)	Cat. C *fully impaired* (100%)
Construction	27.98%	5,011,082	167,839	127,245	2,188,868	1,554,381	972,749
Manufacturing	21.84%	3,911,152	248,521	283,394	1,170,004	1,074,295	1,134,939
Trade, repair of motor vehicles and motorcycles	21.03%	3,766,071	178,502	226,712	1,171,955	996,717	1,192,185
Accommodation and food service activities	4.01%	717,935	97,850	49,927	409,722	66,490	93,946
Real estate activities	7.87%	1,410,074	86,063	74,188	730,413	388,329	131,081
Agriculture, forestry and fishing	2.50%	447,815	65,133	23,428	155,201	90,289	113,763
Professional, scientific, technical, administration and support service activities	5.02%	899,570	43,026	75,255	394,064	159,314	227,912
Transportation and storage	1.72%	308,522	42,208	21,276	75,888	51,543	117,607
Information and communication	3.06%	547,273	15,540	33,450	173,379	208,362	116,541
Mining and quarrying	0.63%	112,117	6,192	7,435	19,847	50,137	28,505
Other activities	4.34%	776,989	150,230	45,803	270,306	141,247	169,403
Total	**100%**	**17,908,601**	**1,101,103**	**968,113**	**6,759,647**	**4,781,105**	**4,298,633**
(in thousand, EUR)		2,381,462.90	146,423.32	128,738.40	898,889.27	635,785.25	571,626.66
(in thousand, USD)		2,721,671.89	167,340.94	147,129.60	1,027,302.02	726,611.71	653,287.62
% of prov by cat. to total corp. provisions			6.15%	5.41%	37.75%	26.70%	24.00%
% of prov by cat. to total corp. loans by cat.		17.73%	1.56%	13.92%	50.60%	82.38%	100.00%

Total provisions in top 3 sectors	70.85%	**12,688,305.97**	**594,861.36**	**637,350.60**	**4,530,827.25**	**3,625,393.78**	**3,299,872.97**
% prov'n in top 3 sectors to total prov'n in cat.		70.85%	54.02%	65.83%	67.03%	75.83%	76.77%
% prov'n in top 3 sectors to total corp prov’ns			0.94%	0.71%	12.22%	8.68%	5.43%

TABLE 2: PROJECTED NPL RESOLUTION BASED ON METHODS OF COLLECTION

TABLE 2.A: METHODOLOGIES FOR NPL RESOLUTION BY CATEGORY*

(in HRK 000s)

NPL Resolution methods	%	Cat. B-1 1-30%	%	Cat. B-2 30-70%	%	Cat. B-3 70-100%	%	Cat. C 100%	Total Cat. B&C	% of Tot NPLs
NPL Totals by class (*as of 31/12/15*)		**6,956,187**		**13,359,044**		**5,803,531**		**4,298,622**	**30,417,384**	
1. NPL sales	10%	695,619	45%	6,011,570	80%	4,642,825	75%	3,223,967	**14,573,980**	47.91%
2. (a) Informal workout: rescheduling	67%	4,660,645	25%	3,339,761	0%	0	0%	0	**8,000,406**	26.30%
2. (b) Informal workout: forgiveness	17%	1,182,552	20%	2,671,809	10%	580,353	0%	0	**4,434,714**	14.58%
3. Formal - PBS : w/debt forgiveness	6%	417,371	5%	667,952	3%	174,106	0%	0	**1,259,429**	4.14%
4. Collection: Enforcement/Liquidation	0%	0	5%	667,952	7%	406,247	25%	1,074,656	**2,148,855**	7.06%
Total	100%	6,956,187	100%	13,359,044	100%	5,803,531	100%	4,298,622	**30,417,384**	

* Estimated percentages are variables selected based on discussions with market participants pertaining to actual experience and expectations.

TABLE 2.B: RESTRUCTURING ASSUMPTIONS

(in HRK 000s)

1. NPL portfolio sales (max adjustment reversals)	%	Cat. B-1 1-30%	%	Cat. B-2 30-70%	%	Cat. B-3 70-100%	%	Cat. C 100%	Total Cat. B&C
Est. book value (nominal - average adjustment)	86%	598,789	49%	2,969,715	18%	818,066	0%	0	**4,386,570**
Estimated portfolio sales price	20%	139,124	20%	1,202,314	20%	928,565	20%	644,793	**2,914,796**
Estimated portfolio sales price	15%	104,343	15%	901,735	15%	696,424	15%	483,595	**2,186,097**
Net max potential deductions reversed at 20% SP		459,665		1,767,402		-110,499		-644,793	**1,471,774**
Net max potential deductions reversed at 15% SP		494,446		2,067,980		121,642		-483,595	**2,200,473**

(in HRK 000s)

2. (b) Informal Workout: Debt forgiveness Amount	%	Cat. B-1 1-30%	%	Cat. B-2 30-70%	%	Cat. B-3 70-100%	%	Cat. C 100%	Total Cat. B&C
Debt forgiveness - 15% discount	80%	141,906	33%	133,457	0%	0	0%	0	**275,363**
Debt forgiveness - 20% discount	20%	47,302	33%	177,942	50%	58,035	0%	0	**283,280**
Debt forgiveness - 25% discount	0%	0	33%	222,428	50%	72,544	0%	0	**294,972**
Total discounted debt		**189,208**		**533,827**		**130,579**		**0**	**853,615**

(in HRK 000s)

3. Formal PBS Proceeding: Debt forgiveness Amount	%	Cat. B-1 1-30%	%	Cat. B-2 30-70%	%	Cat. B-3 70-100%	%	Cat. C 100%	Total Cat. B&C
Debt forgiveness - 20% discount*	100%	83,474	100%	133,590	100%	34,821	0%	0	**251,886**
Total discounted debt		**83,474**		**133,590**		**34,821**		**0**	**251,886**

* PBS mandates repayment of at least 80% of debt

TABLE 3: FISCAL IMPACT OF KEY TAX POLICY RECOMMENDATIONS

Tax policy recommendations

1. Loan Write-off clarification (Arts, 9/2-3, 9/7, 10, 11) - **impact neutral**
2. Loan write-off (portfolio sales) - **potential impact**
3. Debt forgiveness - Income tax exemption for debtors. Creditors can claim bad debt write-off - **hypothetical impact**

					(in HRK 000s)	(in EUR 000s)
Total Projected Sales & Discounts	**Cat. B-1** 1-30%	**Cat. B-2** 30-70%	**Cat. B-3** 70-100%	**Cat. C** 100%	**Total Portfolio**	**Total Portfolio**
1. NPL Sales - max potential deductions reversed	459,665	1,767,402	(110,499)	0	2,116,567	281,458
2. Debt forgiven in informal workouts	189,208	533,827	130,579	0	853,615	113,513
3. Debt forgiven in PBS proceedings	83,474	133,590	34,821	0	251,886	33,495
Total - adjustment reversal & debt forgiveness	**732,347**	**2,434,819**	**54,901**	**0**	**3,222,068**	**428,467**

Budget Impact from Tax Exemptions	Tax Rate	**Cat. B-1** 1-30%	Tax Rate	**Cat. B-2** 30-70%	Tax Rate	**Cat. B-3** 70-100%	Tax Rate	**Cat. C** 100%	**Total**	**Total** low	**Total** high
1. NPL Sales - portfolio exception	20%	91,933	20%	353,480	20%	(22,100)	20%	-	423,313	84,663	512,485
2. Debt Forgiveness income exception (informal)	20%	37,842	20%	106,765	20%	26,116	20%	0	170,723	128,042	256,085
3.Debt Forgiveness income exception (PBS)	20%	16,695	20%	26,718	20%	6,964	20%	0	50,377	37,783	75,566
Total Budget Impact 2016 to 2018		**146,469**		**486,964**		**10,980**		**0**	**644,414**	**250,488**	**844,135**
(in thousands EUR) (at EUR/HRK 7.52)		19,477		64,756		1,460		0	85,693	33,310	112,252
(in thousands USD) (at USD/HRK 6.58)		22,260		74,007		1,669		0	97,935	38,068	128,288

Notes:

Low estimate assumes: portfolio sales are priced on individual loan basis with maximum 20% being revalued; debt forgiveness estimated at 75% of projected levels.
High estimate assumes: NPL sales are revalued as in medium, and B-3 recoveries above adjustments are income; debt forgiveness is estimated at 25% higher.