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September 2023

Tax settlement for distressed businesses: a new balance is to be reached

Expert's opinion

Tax settlement and its potential

Fabrizio Garofoli

Head of Insolvency
Bernoni Grant Thornton

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Manager Bernoni Grant Thornton

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Partner Bernoni Grant Thornton

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Supplemento Notizie flash n° 107 del 25 febbraio 1984

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Overview

Tax settlement: its origin and the reasons underlying its widespread publicity

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Manager Bernoni Grant Thornton

The tax settlement for distressed businesses represents a particular settlement procedure between the Tax Authorities and taxpayers, which can be applied only within arrangement with creditors insolvency procedures and debt restructuring agreements and allows taxpayers to reduce and/or defer their tax debt, in case of both ordinary and privileged credit.

The tax settlement procedure, introduced based on the definition of "settlement" under art. 1965 of the Italian Civil Code, represents an innovation in the Italian tax system, since, going beyond the general principle of inalienability of the tax credit, it allows public institutions to accept partial payment proposals, i.e. to waive part of their credit, or deferred payment proposals, according to rules that are distant from the ordinary ones regulating the procedures to avoid tax litigation.

Commonly referred to as "tax settlement", it rather admits the settlement not only of tax and ancillary amounts due to the tax authorities, but also of contributions due to social security, welfare, and insurance (against invalidity, old age, and for survivors) institutions, as well as their relevant ancillary amounts.

Therefore, the concerned institutions are – besides the Revenue Office – INPS, INAIL and any other private social security and welfare institutions that impose the payment of mandatory contributions.

Referring to the provisions under the Italian Insolvency Law of 1942 and, then, under the Business crisis and Insolvency code of 2019, it is possible to make settlement proposals to the Revenue Office and to social security and welfare institutions, provided that the following conditions occur: i) advantage compared to the liquidation alternative (i.e., bankruptcy); ii) prohibition to set worse conditions.

Substantially, institutions can accept proposals or enter into agreements with taxpayers in difficulty if such proposals are "advantageous", both as regards the amount payable and in relation to payment terms, compared to what they would receive in case of starting a liquidation procedure and provided that the proposal does not provide worse conditions compared to the proposals made to other creditors belonging to the same category or to lower categories.

This procedure, introduced in the first years of 2000, has gone through significant modifications over years.

In its original formulation, the tax settlement was referred to as "settlement of tax bills" and was only applicable to amounts entered in the taxpayers' roll relevant to taxpayers resulting as insolvent in enforcement procedures. Later, in order to safeguard creditors and the going concern, the group of admitted debtors was extended by introducing the "tax settlement" and art. 182 ter of the bankruptcy law in 2005.

In following years, concerned debtors were further extended, by including agricultural entrepreneurs in 2011, and the scope of the provision was also extended, by introducing the cut of VAT and of applied but unpaid withholdings in 2016.

Among the most relevant updates, there is the one introduced with art. 3, para. 1 bis, of Law Decree no. 125 of 2020, which introduced the so-called tax "cram down", i.e., the power of the Court to remedy the lack of acceptance, by Institutions, of the proposals made by taxpayers through an imposition, if: i) the proposal is actually "advantageous" compared to the liquidation alternative; ii) voting results as determining to reach the majorities established by law.

Due to the above further provisions, aimed at making up for the inefficiencies of Institutions, which often put off their answers due to rigid internal bureaucratic processes, or did not answer in order to avoid incurring personal liabilities of their officers, the tax settlement procedure and, therefore, both procedures it is related to, reached great success and an extended utilisation by Italian companies.

In fact, in recent years, the number of Italian companies, most of all SMEs, whose debt structure is totally or almost totally made up by tax and social security debts, has increased considerably, up to constituting the greatest part of applicants for insolvency procedures.

There are many reasons underlying the fact that tax and social security debts are the most part of the total debt of Italian companies. On the one hand, among the possible creditors of a company, the Revenue Office and social security institutions are often those able to act less promptly and effectively towards taxpayers, as they often require years before starting enforcement measures that can preclude business activities; moreover, on the other hand, the means made available by the revenue office over years have allowed taxpayers to postpone the fulfilment of their obligations at an often minimal cost – e.g., possibility to pay by instalments, voluntary settlement procedure, "write-off" of tax bills, and the many procedures to avoid litigation – up to reaching such a number of debts that cannot be borne.

However, in August 2023, the law set a limit to the excessive use of this instrument, by providing that the tax cram down could be requested only in case of non-liquidation plans and based on a minimum settlement of 30%-40% of tax and social security debts.

This last amendment is analysed on the Focus On article of this TopHic issue.

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The possibility to "negotiate" with the Tax Authorities and social security institutions is certainly a considerable advantage for distressed entrepreneurs and businesses.

As already mentioned, those persons that apply for insolvency procedures are commonly those having debts due to the tax authorities and other public entities.

Therefore, the new provisions are aimed at helping distressed businesses as much as possible, also on a going concern basis, however, many question the fact that the tax settlement procedure is applicable only to judicial procedures, i.e., arrangement with creditors and debt restructuring agreement, therefore excluding the "certified reorganization plan" and the newly introduced "negotiated settlement of the business crisis".

The exclusion of out-of-court procedures from the application of the tax settlement procedure has certainly reduced their significance and, subsequently, limited their use.

Both the abovementioned out-of-court procedures are based on the achievement of agreements with creditors without the participation of the judicial authority but, as it happens for the obtainment of safeguard measures within the abovementioned negotiated settlement of the business crisis, a proper appeal should be filed with the Court and, similarly, a specific court validation of the tax settlement agreement could have been provided for both procedures.

The lack of a similar provision is even more manifest in the certified reorganization plan, since, while in the negotiated settlement of the business crisis the only possible proposal to the involved Institution is an extraordinary deferment of debt up to 10 years, in this case no proposal can be made and the amount due must be fully paid within the ordinary terms.

However, in the case of court procedures, which the tax settlement can be applied to, limits to its use are provided as well.

For example, within debt restructuring procedures, it is more and more believed that it is impossible to reach an agreement with creditors in case of a "single" creditor, most of all if this is the Revenue Office. At the end of the recent years' discussion, in which both law and case law had opposite opinions on the possibility to validate an agreement with the single creditor, the latest and recent judgments of the Florence Court of Appeal – no. 370/20022 – and the Milan Court of Appeal – no. 1125/2022 –, clarified its inadmissibility.

On the one hand, the rationale under the above judgments is understandable and right, as they are aimed to prevent the Tax Authorities from being the only creditor to pay the price of restructuring, however, on the other hand, their limitation contrasts with the current Italian situation which is characterized by companies than need only – or almost only – to manage their unbearable debt with the Revenue Office and social security institutions.

The current formulation provides that the tax settlement proposal is to be submitted to concerned Institutions no later than 90 days before the filing of the court validation application, in the case of a debt restructuring procedure, or at the moment of filing of the appeal in the case of an arrangement with creditors procedure. The concerned institutions will then evaluate the content of the application and issue their reply on the same.

Such evaluation will concern the advantage of the proposal compared to that obtainable through the liquidation procedure.

According to the regulation and to Circular Letter of the Revenue Office no. 34E of 2020, such "advantage" should be the only condition to be evaluated and, therefore, no further conditions should be considered, such as the past conduct of the concerned debtor or if the same "deserves" to be helped, the degree of satisfaction of the proposal, or further hypotheses or actions that the debtor may take.

Nevertheless, it could be ascertained that the opinion of Institutions – and, subsequently, their acceptance or refusal – is strongly influenced by other elements, such as the debtor's conduct in the years preceding the application, the origin of debt, and the reasons underlying its increase over time, the "effort" requested to the concerned Institution compared to that proposed to other creditors, the efforts made by the concerned entrepreneur to resolve the crisis, and the relation between the original credit due and the one actually offered.

Without making any generalization on the behaviour of Institutions in evaluating proposals, it can be affirmed that the economic "advantage" of the proposal is not the only element to be considered and, therefore, that offering a higher amount compared to that obtainable through the bankruptcy procedure would not be sufficient to obtain acceptance by the concerned Institution of the proposed tax settlement terms.

A further critical aspect related to the methods adopted for the analysis of proposals is the territorial factor, as it could be noted that

Institutions and Courts have shown different interpretations and opinions in the case of request for a Court validation. Therefore, this aspect should be preliminarily analysed, too, with respect to each specific case.

However, to mention one positive aspect, there is a general and higher attention to those cases where the tax settlement procedure is applied for by entities having a considerable number of employees, since a refusal of the proposal by the Institutions would imply an almost certain default.

Despite the critical aspects that are still present, the tax settlement procedure is certainly a very useful instrument to be applied carefully, and the contribution of new external financial resources is the determining element that can lead to the approval of the proposal by concerned Institutions. The financial factor is the one which clearly determines the "advantage" mentioned by the regulation, excluding any possible interpretations of other evaluation factors or other unclear elements related to the proposal.

Focus on

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The business crisis and insolvency code (Legislative Decree no. 14/2019) entered into force on 15 July 2022, replacing insolvency law of 1942, following a long regulatory process and many delays due to the pandemic, as well as the need to adapt the instrument originally provided by the code to European Directive (EU) no. 1023/2019 on debt restructuring and insolvency. This is a crucial reform for the safeguard of companies' value and of creditors, and for the economic system as a whole.

In this context, the tax settlement plays an important role, manly in the current historical moment, and it is even more important due to the economic difficulties of businesses, which determined an increase in the applications for insolvency procedures to settle the relevant debts. Therefore, application problems related to the tax settlement are of topical interest.

To this regard, critical modifications were recently introduced to the bankruptcy law (in 2017), in order to implement the judgment of the EU Court of Justice and replace the previous rule providing for the impossibility to settle VAT and WHT at a reduced amount or through a deferred payment.

Based on the principles of the reform, the possibility to reduce the debt to be settled to the Revenue office is part of the more general possibility to reduce the debt to be settled to any priority creditor, provided that they are not subject to worse conditions than those under the liquidation alternative.

Therefore, there is a realignment between the companies' and their creditors' interests, rather than a prevalence of the latter, which can be, on the contrary, evident in a bankruptcy context, where there are no further business or labour interests to safeguard. Therefore, such realignment of interests also applies to tax and social security creditors, which no more benefit from an automatically favourable treatment compared to the liquidation option.

However, in order to prevent the risk of abusing of such procedure and pending the entry into force of the relevant supplemental or amendment legislative decree, Law Decree no. 69 dated 13 June 2023, during its conversion into Law no. 103 dated 10 August 2023, has recently introduced important updates with reference to the settlement of tax and social security debts within debt restructuring agreements, regulated under art. 63 of Legislative Decree no. 14/2019 (Business crisis and insolvency code).

The previous version of the regulation provided, even lacking acceptance by the tax authorities or social security institutions, for the possibility to proceed with a "forced" validation of debt restructuring agreements by the competent Court; this process is defined as tax cram down.

The new provision (introduced by art. 1-bis of the law decree) is however stricter than the previous one and provides that the Court can validate debt restructuring agreements, even lacking an acceptance by the tax authorities or social security institutions, as long as the following conditions are met:

Agreements cannot be aimed at the company's liquidation;

Acceptance by the tax authorities is determining to reach the percentages established under art. 57, para 1 (60%), and art. 60, para. 1 (30%), of the business crisis and insolvency code;

The total credit due to other creditors joining the restructuring agreements must be equal to at least 25% of the total credit amount;

The settlement proposal to the tax authorities and other mentioned institutions must be advantageous compared to the liquidation alternative, which must be specifically evaluated by the Court before validating the agreement;

The settlement of debts due to the tax authorities and social security or welfare institutions must be equal to at least 30% of the amount of the relevant debts, including interest and penalties.

Should the total debt due to other creditors be lower than 25% of their total amount, save for the other conditions required, the minimum percentage to settle debts due to the tax authorities and social security and welfare institutions increases to 40%. Moreover, payment cannot be deferred for a period longer than ten years, including payment of legal interest related to the requested deferment.

The above specified modifications impact exclusively debt restructuring agreements and not tax settlement procedures defined within arrangement with creditors procedures.

The modification of the tax settlement procedure was also decided following recent validations by the Court of debt restructuring agreements through the tax Cram down process, which provided for the write-off of the value of debts due to the tax authorities and social security and welfare institutions even exceeding 90%.

Therefore, in order to avoid a distorted use of the tax Cram down (though consistent with the current law provisions), the Government introduced, during the conversion into law of Law Decree no. 69/2023, the updates specified above and, in particular, the minimum settlement limit of debts due to the tax authorities, equal to 30% or 40% depending on the specific cases.

The new conditions for the application of the tax settlement procedure, as established by the Government, will make it difficult to use it within debt restructuring agreements and, therefore, a sagging review of the minimum settlement percentages would be desirable, in order to favour a higher use of this procedure and, however, avoid the presentation of "illicit" proposals to reach an alignment between the companies' and the creditors' interest.


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