

# COMPOSITION AS SEEN FROM THE TAX ASPECT

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***A topic currently discussed by both tax advisors and trustees in bankruptcy in the Slovak Republic is the possibility of speeding up blocked bankruptcy proceedings that have taken on the nature of tax disputes extending over several years or which require the consent of the tax authority as one of the principal creditors to a debtor in order for that settlement may be carried out. Among tax advisors and bankruptcy trustees, the precise term of “composition” has begun to acquire a slang connotation of also meaning “tax settlement”, even though this technical term is not contained in any of the Acts.***

## Absence of professional methodology

By way of introduction, we would like to direct the reader's attention to the provisions of §§ 95 and 95a of Act No. 511/1992 Zb. on the Administration of Taxes and Imposts and on Changes in the System of the Territorial Fiscal Authorities, as amended, which also contain a section concerning composition procedure in accordance with Act No. 328/1991 Zb. on Bankruptcy and Composition, as amended. Since the issue of composition procedure including its tax aspect is not comprehensively covered in professional literature, the stated judicial institute has so far not been used in business and taxation practice in Slovakia to the desirable extent. Since however this represents a flexible instrument constituting an alternative to accelerating long, drawn-out disputes extending over many years especially in the case of taxable entities in bankruptcy, it needs to be addressed and appropriate interpretations need to be set out to facilitate its practical utilisation.

A decision on whether to apply the institute of composition must draw upon its purpose. The purpose of composition is to make it possible for a debtor to continue in his business activities so as to enable the debtor to settle his obligations as offered on the basis of these activities, providing that such a settlement is approved by creditors. The composition must satisfy the conditions stipulated under §§ 58a and 58b of the Bankruptcy and Composition Act. A side effect, may however be the settlement by a debtor (entrepreneur, tax subject) of certain tax arrears in favour of the government, provided that the competent director of the tax authority, together with his expert team, have judged, upon a thorough legal and economic analysis, the composition as reasonable and appropriate also in terms of returns to be gained

from the collection of taxes for the government. In practice, he may deem so chiefly on the grounds of the so-called time value of money.

## Advantages and disadvantages in the light of tax risks

Insofar as a tax authority analyses a particular case of proposed composition, it can be reasonably assumed that from the tax aspect the following reasons in particular will be deemed as acceptable and taken as principal advantages:

- the flexibility of this institute, giving the opportunity to recover, within a relatively short time, a part of tax arrears from a debtor in favour of the state budget,
- providing for employment in the region concerned because of the taxable entity continues in its business activities and maintains jobs or even creates new ones,
- the creation and settlement of new tax liabilities can be expected,
- the possibility of filing a petition for bankruptcy or initiating a tax execution in respect of claims that have arisen after the validity of an order confirming the composition (§ 52(2e) of the Bankruptcy and Composition Act),
- claims that as of the date of approving the composition have not become payable will not cease (the second sentence of § 52(3) of the Bankruptcy and Composition Act),
- under § 54(1c) of the Bankruptcy and Composition Act, the right to preferential satisfaction in composition pertains to: tax liabilities that have arisen following the approval of composition and are not satisfied from assets pledged as security in favour thereof, court costs associated with a tax execution



procedure, discontinued under §§ 49(3) and 52(2f) of the Bankruptcy and Composition Act.

Experts on executions from the tax administration envisage that the following factors in particular will be considered as the main disadvantages in terms of taxation and are likely to be taken into account in any analysis made by a tax authority after a composition is filed by a tax subject:

- interest, including penalty interest for a period following the approval of a composition is excluded from the amount to be settled (§ 53(2) of the Bankruptcy and Composition Act),
- from the approval of composition onwards, it is not possible to impose sanctions that could have been levied up until the approval of composition (§ 95a(3) of the Act on the Administration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities, as amended),
- claims that have fallen due as of the day of approving the composition and have not been filed within the time limit fixed by the court, even though the creditor must have known of the composition, will cease (the first sentence of § 52(3) of the Bankruptcy and Composition Act,
- tax liabilities and parts thereof, which the debtor did not have to discharge under the approved forced settlement plan will cease (the first sentence of § 95a(7) of the Act on the Administration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities),
- tax liabilities or parts thereof that have arisen prior to the approval of the composition, which cannot be discharged under the composition, will cease (the second sentence of § 95a(7) of the Act on the Administration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities),
- sanctions and parts thereof that it was not possible to levy since the approval of the composition, but relate to tax claims (i.e. tax liabilities) that have arisen prior to the approval of composition, will cease (the third sentence of § 95a(7) of the Act on the Administration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities).

### Other envisaged aspects of examination

It can be reasonably assumed that the initiative in making proposals will be taken by a debtor, and/or a trustee in bankruptcy, but not by a tax authority. Nevertheless, in exceptional cases it can be the other way round. This will always depend on the qualities and distinctive features of the particular case subject to review.

Prior to the filing of a composition petition, negoti-

ations are usually led at the debtor's initiative as regards the conditions of composition, during which a tax authority should in particular consider the following:

- expected and/or estimated rate of satisfaction of taxes claimed under bankruptcy (where such factors as a tax debtor's overall indebtedness, the number of his creditors, the amounts claimed by them, the number of separate creditors and the amounts claimed by them, the order in which tax claims with the right to separate satisfaction are to be satisfied, the size of the debtor's assets, expected proceeds from the liquidation of assets and the distribution thereof, expected duration of the composition, etc. should for example be taken into account),
- expected degree of satisfaction of taxes claimed in composition (for instance, what amount is offered by the debtor in settlement of tax claims, the existence of collateral in favour of the tax administrator giving rise to his right to separate satisfaction, expected satisfaction of also other creditors from the assets encumbered by the collateral, the amounts claimed by other creditors, what position will the tax administrator have in voting as a result of the amount of taxes claimed, etc.),
- time scales of settling the claims and/or parts thereof,
- employment in the region,
- the debtor's future fate as a going concern potentially giving rise to new tax liabilities and their payment.

### Legal propriety and accountability

Also in the SR, corruption is a part of the contemporary era that cannot be wished away. Often even the innocent are intentionally and tendentiously accused of having taken a bribe or rake-off. Quite naturally, when assets and tax transactions worth millions are at stake, a suspicion of improper legal procedure may frequently arise in the course of tax proceedings. This is one side of the coin of why directors of tax authorities shy away from pursuing composition more actively. The other side of the coin is that there is a real lack of convincing professional literature to interpret powers pertaining to this field. What is the situation in terms of law - may or may not a director assume responsibility and approve a composition without the consent from a superior authority?

Under § 4(4) of Act No. 150/2001 Z.z. (on tax authorities...), as amended, tax offices are competent to participate, within the scope of their authority, in court proceedings and act singly before the courts.



The scope of powers of tax authorities as regards taxes is defined in § 1 of the said Act, where under (a) reference is made to separate legislation specifying these powers (the Act on the Administration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities and substantive taxation legislation). This authority corresponds with the authority pursuant to § 95(9) of the Act on the Administration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities, under which an authorised employee of a tax administration or tax directorate shall act in bankruptcy and composition proceedings on behalf of the tax administrator. This implies an authority to proceed in composition procedure (which is a court procedure) on all issues governed by the Bankruptcy and Composition Act.

### **A progressive tool to reduce tax liabilities**

Despite the fact that a tax administrator is not given express authority to consent to a composition, and thereby also to its consequence in that a portion of a tax receivable is not paid, such an authority does not only ensue from the Bankruptcy and Composition Act itself, but also from the Act on the Admi-

nistration of Taxes and Imposts and on Changes in the System of Territorial Fiscal Authorities, since under § 65a(1) thereof, the legislator has arranged the possibility of writing down such a tax claim with the effect of its cessation.

In the event that a tax subject, i.e. a tax debtor in bankruptcy, opts for composition, there still remains the risk of the tax administrator (the director of the respective geographically competent tax authority) not agreeing. This makes sense as there is a certain risk involved, since the tax office itself is overseen by a superior authority (such as the Tax Administration of the SR, the Supreme Audit Office), which, after a certain period of time, may take a different analytical opinion in judging the given case.

The director of a tax authority must always carefully consider, on an individual basis, whether from the point of view of state interests it would be effective to apply the institute of composition or not, but the decision is fully up to his discretion. The institute of composition is one of the progressive tools to speedily redress tax arrears. Since the provisions laid down in law, which give a theoretical opportunity, have so far been scarcely used in the Slovak practice, I believe that an active discussion needs to be initiated among professionals on this issue.