CHIOMENTI

Focal points of the Italian tax framework applicable to insolvency and restructuring procedures

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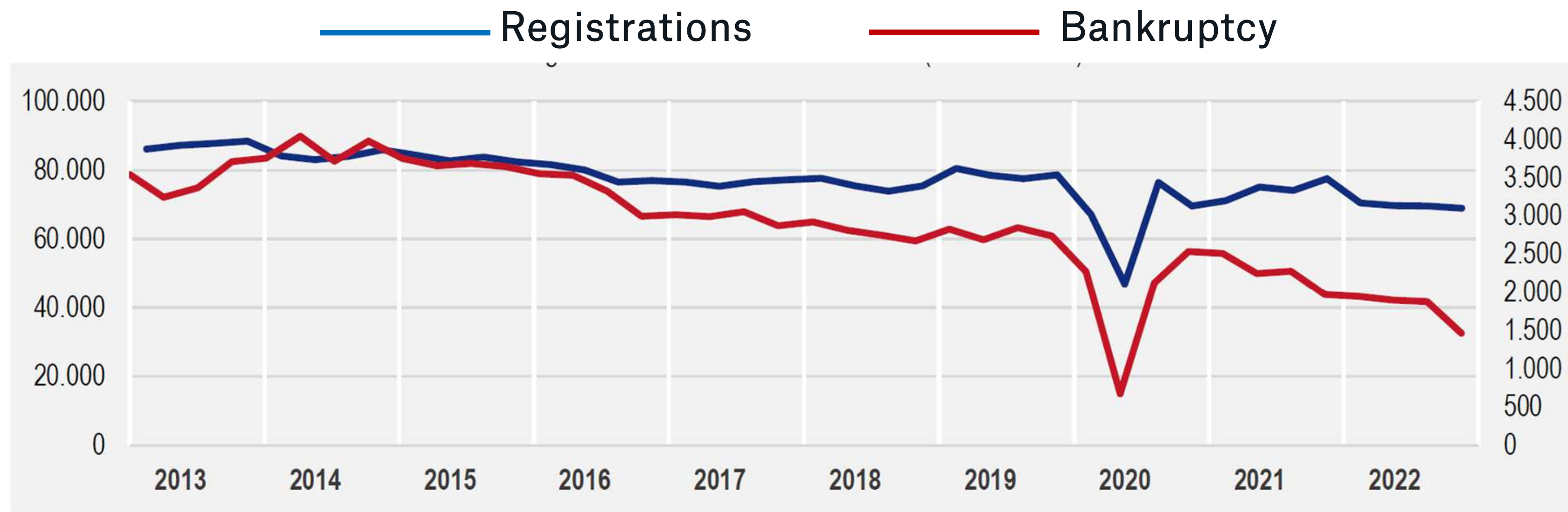
General Overview

Bankruptcy/Insolvency procedures
Bankruptcy composition (*Concordato nella liquidazione giudiziale*)
Pre-insolvency composition for liquidation (*Concordato preventivo liquidatorio*)
Simplified pre-insolvency composition for liquidation (*Concordato semplificato liquidatorio*)
Similar insolvency/bankruptcy procedures provided by foreign law of white-list jurisdictions

Restructuring procedures
Pre-Insolvency composition with business continuity (*Concordato in continuità aziendale*)
Debt Restructuring Agreement subject to homologation (*Accordi di ristrutturazione del debito omologati*)
Certified Restructuring Plan (*Piani attestati di risanamento pubblicati nel registro delle imprese*)
Restructuring plan subject to homologation (*Piano di ristrutturazione soggetto a omologazione*)
Similar restructuring procedures provided by foreign law of white-list jurisdictions

Early warning tool
Negotiated crisis composition tool (*Composizione negoziata della crisi*)

General overview



Bankruptcy procedures

		Industry								Total
		Mining, manufacturing, energy, water supply and waste treatment	Building construction / Real estate	Wholesale & retail	Transportation	Hotel & Food	Media & Communication	Financial services	Healthcare, education, entertainment,	
2022	IQ	340	389	473	126	219	36	280	78	**1942**
	IIQ	326	348	481	145	201	37	285	70	**1893**
	IIIQ	332	348	501	133	186	37	256	82	**1874**
	IVQ	244	292	351	91	163	36	211	73	**1461**

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Tax regime applicable to debt relief and debt restructuring

Tax regime applicable to debt relief and debt restructuring

<u>General rule: Article 88(1) of the Italian Tax Act</u>

«Revenue or other income realized in respect of expenses, losses or liabilities recorded in the financial statements in previous years as well as revenue or other income realized as a consequence of the cancellation or reduction of expenses, losses or liabilities recorded in the financial statements in previous years, are considered a taxable income.»

- ❑ Under the general rule, waivers, conversions, rescheduling and standstill arrangements, in principle, imply a debt relief or debt reduction that give rise to an "extraordinary" taxable income.

- ❑ Such income is subject to the corporate income tax (IRES) ordinarily applicable at a 24% rate.

- ❑ If the reduction of debt concerns a financial liability, in principle the relevant income does not fall into the scope of the Regional business tax (IRAP) applicable at a 3.9% base rate.

Tax regime applicable to debt relief and debt restructuring

- Article 88(4-ter) of the Italian Tax Act provides for differentiated taxation regimes depending on whether the extraordinary income originated by the reduction of debts is achieved by the debtor in the context of bankruptcy/insolvency procedures or restructuring procedures.

- In particular:
  - ✓ <u>in the event of bankruptcy/insolvency procedures</u>, any reduction of debts does not give rise to a taxable extraordinary income;
  - ✓ <u>in the event of restructuring procedures</u>, no taxable extraordinary income arises in relation to the reduction of debts for the amount of such reduction exceeding:
    - ✓ the amount of tax losses carried forward by the debtor;
    - ✓ the amount of the Allowance for Corporate Equity (*i.e.*, the 1.3% notional deduction on equity increases, s.c. «ACE») carried forward by the debtor;
    - ✓ the amount of non-deductible interest expenses carried forward by the debtor as per Article 96 of the Italian Tax Act (*i.e.*, 30% EBITDA interest barrier rule);
    - ✓ the amount of tax losses realized by the debtor and contributed to the fiscal unit, but still outstanding at level of the fiscal unit (*i.e.*, not utilized to offset income of other group entities participating to the fiscal unit).

Tax regime applicable to debt relief and debt restructuring

Bankruptcy/Insolvency procedures	Tax regime of the debt reduction
Bankruptcy composition	Non-taxation of the entire amount of extraordinary income realized by the debtor
Pre-insolvency composition for liquidation	
Simplified pre-insolvency composition for liquidation	
Similar insolvency/bankruptcy procedures provided by foreign law of white-list jurisdictions	

Restructuring procedures	Tax regime of the debt reduction
Pre-Insolvency composition with business continuity	Non-taxation of the amount of extraordinary income exceeding tax losses, ACE deduction and excess interest expenses carried forward by the debtor
Debt Restructuring Agreement subject to homologation	
Certified Restructuring Plan	
Restructuring plan subject to homologation	
Similar restructuring procedures provided by foreign law of white-list jurisdictions	

Tax regime applicable to debt relief and debt restructuring

- The rationale for recognizing a "partial" non-taxation of extraordinary income realized in the context of restructuring procedures is to grant the debtor a tax benefit only to the extent that the debt reduction could give rise to a cash tax payment. For this reason, the debt reduction implies the set-off of tax attributes (*i.e.*, tax losses, ACE deduction, excess interest expenses) available to the debtor, but the income exceeding the amount of such tax attributes is not subject to tax.

- The Italian tax authorities have also clarified that the aim of the rule is to prevent that tax attributes accrued in the hands of the debtor before and during the restructuring phase could be carried forward and set-off against future income realized in the ordinary course of business.

- For this reason, tax losses and excess interest expenses carried forward by the debtor must be set-off against the extraordinary income realized as result of the debt reduction <u>without</u> applying the limitations ordinarily applicable to the utilization of such tax attributes (i.e., up to 80% of the taxable income for the utilization of losses and up to 30% EBITDA for the utilization of interest expenses).

- If the amount of tax losses, ACE deduction and excess interest expenses exceeds the amount of the extraordinary income generated by the debt reduction, the debtor can decide which tax attribute utilize first.

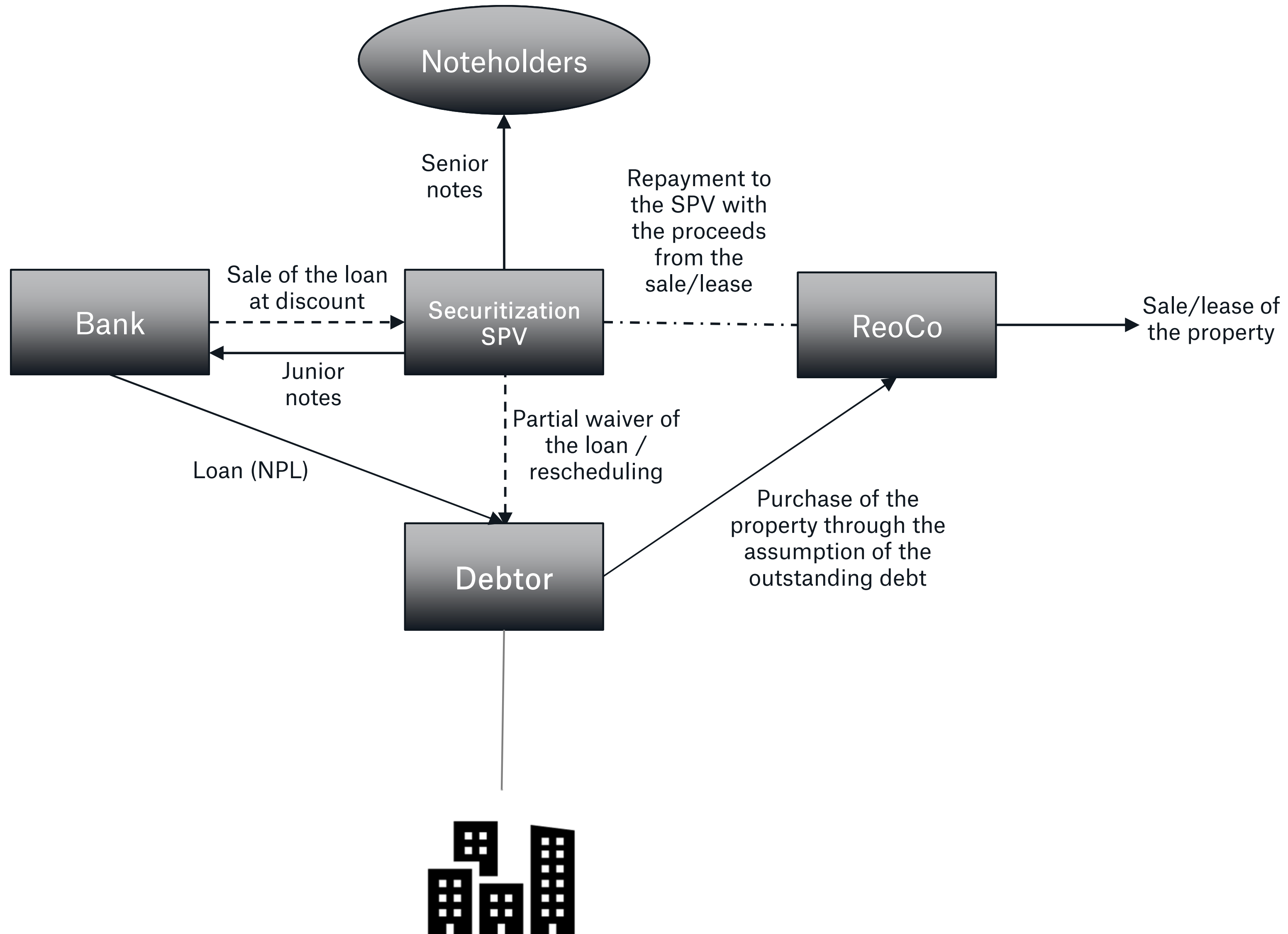
Example no. 1

Bankruptcy/Insolvency procedure	
Extraordinary income for debt reduction (A)	**500**
Other income (B)	100
Overall income of the period (C = A+B)	**600**
Tax losses carried forward by the debtor (D)	200
Non-taxed extraordinary income (A)	**(500)**
Tax losses utilized in the tax period (E = 80% x B)	(80)
Taxable income (B – E)	**20**
Tax losses available for future tax periods (D-E)	**120**

Example no. 2

Restructuring procedure	
Extraordinary income for debt reduction (A)	**120**
Other income (B)	80
Deductible expenses (C)	60
Overall income of the period (D = A+B-C)	**140**
Tax losses carried forward by the debtor (E)	105
Non-taxed extraordinary income (F = A – E)	**(15)**
Taxable extraordinary income (G = A – F)	**105**
Tax losses set-off against the extraordinary income H = G	**(105)**
Taxable income (D – F – H)	**20**
Tax losses available for future tax periods (E - H)	**0**

Repossession through securitization in the context of a restructuring agreement



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Tax regime applicable to the conversion of debt into equity

Tax regime applicable to the conversion of debt into equity

- Pursuant to Article 88(4-bis) of the Income Tax Act, the waiver of credits by shareholders constitutes a taxable extraordinary income for the debtor for the portion of the waived amount that exceeds the tax value of the credit in the hands of the shareholder. This rule was introduced in order to prevent arbitrage.

- For this purpose, the shareholder (creditor) must certify the tax value of its credit to the participated entity (debtor) by means of a self-declaration to be provided upon waiver; in the absence of such declaration, the tax value of the credit is assumed to be zero and, therefore, the waiver gives rise to a taxable extraordinary income in the hands of the debtor equal to the entire amount waived.

- The same rule also applies to the conversion of the debt into equity carried out by the shareholder as well as by third-party creditors. Therefore, in this case, the conversion gives rise to a taxable extraordinary income in the hands of the debtor to the extent that the converted amount of the debt exceeds the tax value of the credit in the hands of the creditor. The self-declaration of the creditor is required also in this case.

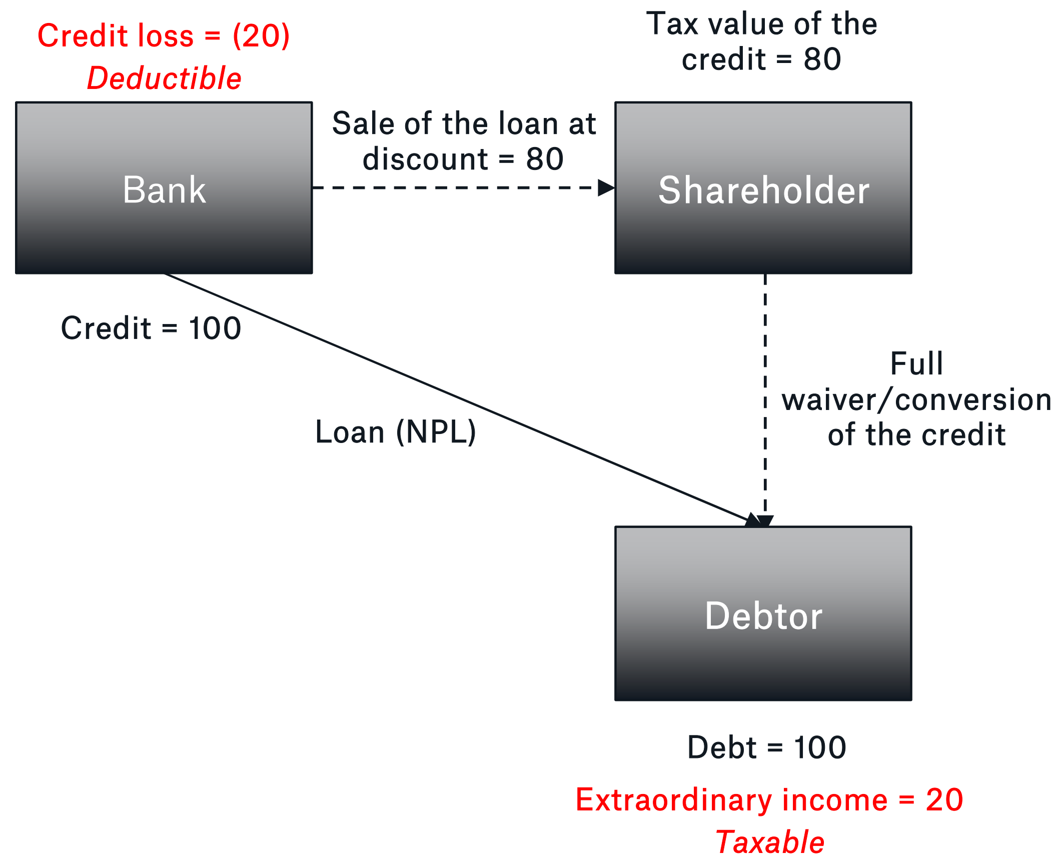
- In case of conversion, the tax value of the equity interest assumed by the creditor as a result of the conversion is equal to the value the converted credit, net of credit loss.

Tax regime applicable to the conversion of debt into equity

- Article 88(4-bis) of the Italian Tax Act applies irrespective of:
  - ✓ the nature (financial or commercial) of the converted credits;
  - ✓ whether the creditor assumes the status of shareholder upon conversion or was already a shareholder previously;
  - ✓ the accounting principles adopted by the creditor and the debtor;
  - ✓ the manner in which the conversion is implemented (*i.e.*, subscription of the capital increase resolved by the debtor paid-in through with set-off of the credit or by means of other transactions);
  - ✓ the fact that the credit originally arose in the creditor's hands or was acquired by the creditor from a third party.

- Pursuant to Article 88(4-ter) of the Italian Tax Act, the full non-taxation regime (in the case of bankruptcy procedures) or the partial non-taxation regime (in the case of restructuring procedures) also applies in relation to waivers by the shareholder, as well as to the conversion of credits into equity interests.
  - ✓ Accordingly, in these cases, the waiver/conversion of credits would not result in a taxable event for the debtor (save for the set-off of tax attributes in case of restructuring procedures).

Waiver by the shareholder



Effects of debt-for-equity swaps in the context of a restructuring procedure

- Apart from the mismatch between the tax value of the converted credit in the hands of the creditor and the value of the debt in the hands of the debtor, a taxable income may also arise due to the accounting effects of the debt-for-equity swap.

- In principle, according to international accounting standards, equity instruments issued by the debtor in favour of a creditor to extinguish - in whole or in part - a financial liability (s.c. "debt-for-equity swaps") are considered equivalent to a consideration paid by the debtor to extinguish the financial liability.

- Upon recognition, equity instruments issued to the creditor must be recognized at their fair value on the date in which the financial liability is extinguished.

- If the fair value of the equity instruments issued cannot be measured reliably, the equity instruments shall be valued to reflect the fair value of the financial liability extinguished.

- The positive difference between the amount of the liability extinguished and the fair value of the equity instruments issued has to be recognized by the debtor directly at Profit&Loss.

Example

Example of conversion	
Value of the credit in the hands of the creditor	1,000
Fair value of the shares issued to the creditor	600

Tax effect for the creditor	
Deductible loss	400
Tax value of the shares received upon conversion	600

Tax effect for the debtor	
Accounting profit	400
Taxable income	0 (save for set-off of tax attributes up to 400)

Special conversion regime for financial intermediaries

- According to Article 113 of the Italian Tax Act, financial intermediaries can opt to not apply the ordinary "participation exemption" regime with respect to participations acquired upon conversion of their credits into the equity of the debtor in the context of restructuring transactions.

- This special regime can be opted-in if the following conditions are met:
  - ✓ The acquisition of the participation in the debtor (through the conversion of the credit) is deemed to be the best way to recover the credit considering the value of the business of the debtor.
  - ✓ The debtor is only temporarily in an insolvency situation and it is expected to restore an appropriate economic and financial position in a reasonable period of time according to a restructuring plan.

- In order to confirm the eligibility for this special regime, financial intermediaries are allowed to file a specific ruling request with the tax authorities in order to get clearance as to the existence of the above conditions.

Special conversion regime for financial intermediaries

- If the option for the special regime is successfully exercised:
  - ✓ Participations received upon conversion keep the same tax regime applicable to the converted credit.
  - ✓ Accordingly, financial intermediaries will be allowed to subsequently deduct any impairment loss accounted for in relation to the participation as if it was a credit loss (while, ordinarily, impairment losses on participations are not deductible due to the participation exemption regime).
  - ✓ The "tax qualification" of the participation as credit also applies with respect to the capital gains/losses realized upon disposal of the participation by the financial intermediary; accordingly, gains realized upon disposal of the participation will be fully taxable (while, under the participation exemption regime, such gains are ordinarily exempted at 95%) and capital losses will be fully deductible for tax purposes (while, under the participation exemption regime, such losses are fully non-deductible).

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Effects of Bankruptcy and Restructuring procedures on the fiscal unit and VAT group regimes

Effect on the fiscal unit regime

- According to the Italian fiscal unit regime, companies belonging to the same group can elect for a domestic tax consolidation. This regime allows the determination of a single taxable base for corporate tax purposes (IRES) by consolidating of the taxable income and losses of each of the participating entities.

- In order to validly elect for the Italian domestic tax consolidation regime, the following conditions must be met:
  - ✓ The consolidating entity must hold, directly or indirectly, more than 50% of the share capital of the consolidated entities.
  - ✓ This control must be in place from the beginning of the first tax period for which the tax consolidation is applied for (the regime lasts 3 years and is automatically renewed).
  - ✓ All companies participating in the fiscal unit must have the same year-end.

- The taxable basis determined by each company participating in the fiscal unit is included in its entirety. No apportionment is made in relation to the percentage of control of the consolidating entity.

- Each eligible group entity may select whether to be included or not, and it is not necessary for all the Italian group/sub-group companies to elect for the fiscal unit (*i.e.*, cherry-picking allowed).

Effect on the fiscal unit regime

- According to the applicable tax rules, companies subject to bankruptcy procedures (*i.e.*, procedures having a liquidation purpose) cannot elect to join a fiscal unit.

- If a company already belonging to a fiscal unit is subject to a bankruptcy procedure, the fiscal unit regime terminates *vis-à-vis* such company. According to the interpretation of the Italian tax authority, in this case the termination occurs since the beginning of the fiscal year in which the relevant company is declared bankrupt.

- If the termination of the fiscal unit occurs *vis-à-vis* a company, such a company must calculate its taxable income on a stand-alone basis and pay the relevant income tax due to the tax authority (if any) with respect to the fiscal year in which the termination occurs. If the exiting company has previously contributed to the fiscal unit any tax losses that have not been utilized at level of the fiscal unit at the moment of the termination, such losses must be reattributed to such company (or, alternatively, remunerated to it by the consolidating entity).

- In principle, restructuring procedures (*i.e.*, procedures aimed at allowing the continuation of the business activity with no liquidation purposes) do not affect the participation of the company under restructuring to the fiscal unit regime.

Effect on the VAT group regime

- According to the VAT group regime, the group itself is considered as a single VAT-taxable person. Therefore:
  - ✓ Transactions carried out between the companies of the group will not be subject to VAT.
  - ✓ Transactions carried out between a group member and a third party will be treated as being made by the VAT group as a single entity.

- The option for the VAT group regime is reserved to companies closely bound by the following financial, economic and organizational links:
  - ✓ They are subject to common control, through direct or indirect participation granting 50% or more of voting rights; this requirement is satisfied even if the common controlling entity is based in a foreign Country with which an exchange of information instrument is in force with Italy (financial link).
  - ✓ They must perform the same core business and economic activities, or, alternatively, the activities must be complementary, ancillary and auxiliary with respect to the other group members (economic link).
  - ✓ A coordination between the decision-making bodies of the involved entities must exist (organizational link).

- Once the election for the VAT group regime is made, all entities fulfilling the requirements must adhere to the group (All-in/All-out) and the option lasts at least 3 years.

Effect on the VAT group regime

- According to the applicable VAT rules, companies subject to bankruptcy procedures (*i.e.*, procedures having a liquidation purpose) cannot be included in the VAT Group.

- Therefore, if a company belonging to a VAT Group is subject to a bankruptcy procedure such company must exit from the VAT Group.

- The exit from the VAT Group occurs at the moment of the issuance by the competent Court of the decision/decree declaring the relevant company under bankruptcy or under a pre-insolvency composition for liquidation.

- In principle, restructuring procedures (*i.e.*, procedures aimed at allowing the continuation of the business activity with no liquidation purposes) do not affect the participation of the company under restructuring to the VAT Group regime.

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Special tax settlement procedure

Special tax settlement procedure in the context of insolvency procedures

- Italian insolvency law provides for a special tax settlement procedure that can be proposed by the debtor in the context of:
  - ✓ The Debt Restructuring Agreement subject to homologation procedure, or
  - ✓ The Pre-Insolvency composition procedure.

- This special settlement procedure can also be applied with respect to social security liabilities of the debtor.

Special tax settlement procedure in the context of insolvency procedures

- In the case of Debt Restructuring Agreement:
  - ✓ The debtor can propose the partial payment and/or the deferral of any tax liabilities governed by Italian tax authorities and tax collection offices.
  - ✓ The tax settlement proposal must be supported by a third-party expert report proving the convenience of the debtor's proposal compared to a judicial liquidation scenario. Such report is subject to assessment by the Court.
  - ✓ The proposal together with the supporting documentation is filed with the competent offices of the tax authorities for acceptance.
  - ✓ If the tax office accepts the tax settlement proposal it is also deemed to have accepted the Debt Restructuring Agreement with other creditors, which can then be homologated by the Court.
  - ✓ If the tax office does not accept the tax settlement proposal, the Court may anyway force the homologation of the Debt Restructuring Agreement if, in its opinion, this is convenient compared to the satisfaction of the tax authorities in a liquidation scenario (s.c. "cram down“).
  - ✓ The tax settlement concluded in the context of a Debt Restructuring Agreement is declared null by operation of law if the debtor does not fulfil its tax obligations within 60 days from the agreed deadline.

Special tax settlement procedure in the context of insolvency procedures

- In the case of Pre-Insolvency composition procedure, the applicable special tax settlement rules are similar to those applicable in case of Debt Restructuring Agreement, with the following main deviations:
  - ✓ The tax settlement can be proposed if the composition plan provides for the satisfaction of tax liabilities for an amount not lower than the one that would be realized in case of liquidation of the debtor's assets that are subject to a privilege in favour of the tax authorities, as indicated in a report prepared by a third-party expert.
  - ✓ In any case, with respect to tax credits assisted by a privilege, the tax authorities must have a better treatment compared to other creditors having a lower degree of privilege.
  - ✓ The proposal together with the supporting documentation is filed with the competent offices of the tax authorities. Within 30 days from the filing, the tax officers must certify to the debtor the amount of all tax bills already final as well as of tax liabilities that are still under dispute, for their inclusion in the composition plan.
  - ✓ If tax offices do not accept the composition plan, "cram down“ by the Court is still possible.

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Thanks.