ENTERPRISE RISK PROFILE
THE REORGANIZATION PERSPECTIVE OF A COMPANY IN ROMANIA VS. THE TAXATION ON REORGANIZATION PROFITS

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Abstract
Through its case studies, this paper captures certain practical aspects that hinder the reorganization of a company in insolvency proceedings in Romania; it also makes some comparisons with certain long-standing insolvency systems, such as the US, France, and Germany.
Starting from the relatively recent EU statistics (2016), according to which 200,000 companies are affected annually by insolvency, which is equivalent to the loss of 1.7 million jobs, identifying models for analyzing the companies' reorganization capacity becomes an increasing challenge. In the absence of official statistics, the different institutions involved in the procedure state that Romanian companies' reinsertion level in the economic circuit is under 3% of the companies undergoing a reorganization procedure.
A company's reintegration in the civil circuit is extremely beneficial to capital owners, as well as in terms of social impact, continuation of trade relationships versus setting up some new ones. Given the incidence of different internal and external factors influencing companies, a more realistic analysis of legal reorganization capacities (to help decision-makers to encourage the reorganization plan) could start from setting the company's risk profile. One of the external factors that influence companies relates to the fiscal policy on the taxation on reorganization profits; the international practice has proven that an insolvency system is effective when tax and insolvency laws are corroborated.

Keywords
reorganization procedure; model for the analysis of the reorganization capacity; hair-cut; debt discharge.

JEL Classification
G33, K33, K34, M40

Introduction

This century brought a rapid change to business and consumption patterns; these transformations came with new opportunities and threats, challenging the society's capacity

to adapt, to make efficient choices for the future, to improve resource utilization, driving value for business and consumers through business model innovation.
The recovery of companies through judicial reorganization procedures represents a topical issue for Romania, playing a special role in the business environment, especially as far as the practical expertise in the field and the need for data structuring are concerned (Laitinen et al., 2016). The issue of a company's decline is extensively debated in the literature (Robbins & Pearce, 1992; Chandler, 1962; Liou & Smith, 2007; Smith & Graves, 2005; Barker & Duhaime, 1997), compared to the reorganization procedure (Laitinen, 2008; Routledge & Gadenne 2004; LoPucki & Dohrety, 2002). Of course, the reasons are numerous and concern the lack of official information, the non-structuring of the available data, the lack of official statistics, and the limited share of companies undergoing this procedure, compared to those in the civil circuit.
At the international level, modern insolvency regulations have been created, and the central element was represented by the approach based on granting the second chance to debtors. Most countries have encouraged this treatment, especially after the Second World War (Gine & Love, 2006), and the model was based on the Bankruptcy Code, adopted in the US in 1979 and substantially modified in 1984.

Reflections on insolvency in Romania
By Law no. 85/2006 on Insolvency Proceedings, which was amended by Law 85/2014 on Insolvency and Insolvency Prevention Proceedings, the Romanian insolvency system took over the American Insolvency Model, implementing the World Bank recommendations summarized in Principles on Insolvency Effectiveness and the Creditors/ Debtors' Rights and in the Report on the Observance of Standards and Codes (ROSC), as well as the Recommendations of the European Commission and the UNCITRAL Legislative Guide.
Thus, the Insolvency Law is based on the recommendations, rules and interpretations inspired by the European Commission's communications:
December 2012 - Communication from the European Commission to the European Parliament, the Council and the Economic and Social Committee, entitled "A new approach to business failure and insolvency" and
March 2014 - Communication from the European Commission, entitled "Commission recommends new approach to rescue business and give honest entrepreneurs a second chance." The purpose declared by the Romanian insolvency law is "to establish a collective procedure for covering the debtor's liabilities, with the possibility of re-establishing its activity, where possible. According to Law no. 85/2014 on Insolvency and Insolvency Prevention Proceedings, the term "insolvency" refers to any phase of the procedure, i.e. observation period (IO), reorganization (R) or bankruptcy (IF), bankruptcy general procedure, IPS - simplified bankruptcy, IT - simplified bankruptcy resulting from voluntary liquidation proceedings (under Law no. 359/2004 and Law no. 31/1990) (Stroie & Mirea, 2016).
According to the statistical data provided by the National Trade Register Office, in Romania, there had been approx. 700 thousand legal entities (PJ) operating between 2009 and 2015. The numerical situation of the insolvency files submitted between 2008 and 2015 is presented in Table no.1, which contains data provided by the National Union of Insolvency Practitioners of Romania.
According to the data provided by the two institutions, i.e. the Trade Registry and the National Union of Insolvency Practitioners of Romania (by removing the IO from the comparison, because it concerns an interim period in insolvency proceedings), between 2009 and 2015, on average, 5% of the Romanian companies underwent insolvency proceedings.

Regarding the specific legislation on liquidation/ insolvency proceedings and the economic crisis, in Romania, during 2008-2015, many companies without assets/ activity/ financial statements were liquidated, through administrative liquidation, under the law of companies. Given the existence of debts and the impossibility of settling them, the vast majority of companies entered the simplified bankruptcy (IT) proceeding. This category of insolvency cases amounted to approx. 16% of the total number of insolvency files in 2008-2015. In terms of the number of files, the judicial reorganization procedure underwent a growing trend in the reference period (2008 -1%, ... 2010- 2%, 2011 - 3%, 2012 - 4%, ... 2015 - 5%), compared to the other insolvency proceedings, which was encouraging for Romania.

Table no. 1 The numerical situation of the insolvency files (2008 – 2015)

Period /Procedure	IT	IO	IPS	IF	R	Total	% R in Total files	Total number PJ	% insolvents in total PJ
2008	8034	2612	2788	16904	320	28046	1%		
2009	7955	2450	3156	18340	406	29857	1%	690021	4%
2010	4022	5243	5645	18875	636	29178	2%	631989	5%
2011	4297	5374	6860	20546	904	32607	3%	653418	5%
2012	5652	4191	7027	22397	1488	36564	4%	695492	5%
2013	5337	4921	7482	22048	1686	36553	5%	719258	5%
2014	4420	2657	15944	19975	1674	42013	4%	747699	6%
2015	3786	2936	11972	17891	1724	35373	5%	773781	5%
Total	43503	30384	60874	156976	8838	270191			

Source: Authors' own research based on the Activity Annual Reports of UNPIR

The evolution of insolvency proceedings in Romania, between 2008 and 2015, related to the number of insolvency files, is presented in Figure no. 1.

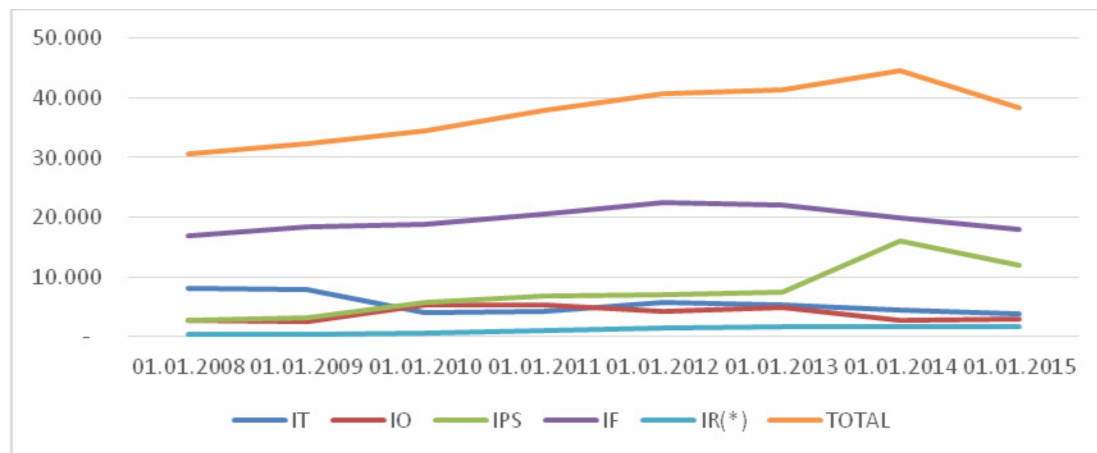

Fig. no. 1 Evolution of insolvency proceedings in Romania, between 2008 and 2015, related to the number of insolvency files

Source: Authors' own research based on the Activity Annual Reports of UNPIR

Research methods

The research methodology was qualitative, based on observation. The paper dealt with the analysis of the legislation specific to the insolvency proceedings in Romania and it also

tackled certain case studies. Moreover, it compared the Romanian insolvency proceedings with the proceedings specific to the USA, Germany and France, i.e. countries whose insolvency systems have a long history and proven effectiveness. The purpose of this study was to highlight one of the causes limiting the success of Romanian reorganization procedures.

In order to analyze the specific taxes on reorganization profits, we tackled the following legal documents: for Romania - the Romanian Tax Code (Law 227/2015); for the US fiscal system - the U.S. Code - Title 26 - Internal revenue code, Subtitle A - Income Taxes (https://www.law.cornell.edu/uscode/text/26); for Germany - the Corporate Taxes/ Profit Tax (KStG - Körperschaftsteuergesetz) (https://www.gesetze-im-internet.de/kstg_1977/) and for France - the Income Tax Act (Loi de l'impôt sur le revenue - L.R.C. (1985), ch. 1 (5e suppl.)) (http://laws-lois.justice.gc.ca/fra/lois/I-3.3/page-1.html).

Before presenting our case study on the impact that the taxation on reorganization profits has on the success of the judicial reorganization procedure, we should clarify that, generally, a reorganization procedure is triggered by the proposal, approval and confirmation of a reorganization plan. As a rule, any honest debtor has the right to a partial debt discharge up to the amount of the liabilities that can be settled in the event of bankruptcy.

Under the accounting regulations, any debt discharge is an income, and according to the Romanian tax legislation, this income, which is not regulated as non-taxable, is, therefore, taxable.

Case study on the reorganization procedure of a Romanian company, subject to the proposal of a reorganization plan with partial debt discharge

Due to the non-recovery of the debts held against other companies, the ABC Ltd company declares its insolvency in 2016, and then it communicates its intention to reorganize.

Consequently, the debtor retains the right to manage the business and proposes a reorganization plan. After opening the insolvency proceedings, the legal administrator notifies the creditors of the company, who make statements of claim. The claims held against the debtor are centralized in the list of creditors. In relation to the accounting provisions, the final list of creditors (including debts, e.g. in the amount of 100 u.m.) must be entered in the accounts.

For example, if certain creditors from the financial and accounting records (e.g. in the amount of 30 u.m.) did not enrol themselves in the list (body) of creditors, the debtor will be required to enter the income resulted from the discharge of the respective claims (30 u.m.). In this case, the operation generates a profit tax/ corporate tax (30 u.m. * 16% corporate tax rate = 4.8 u.m.) in the respective tax period.

Within 30 days of finalizing the list of creditors, the debtor proposes a reorganization plan. After analyzing the current activity, the debtor's assets and the private creditor test (the distribution of claims in case of a possible bankruptcy), the debtor proposes a reorganization plan with a partial debt discharge, i.e. by 50% of the total liabilities from the list of creditors (i.e. 100 u.m. * 50% = 50 u.m. to be paid under a plan within 3 years - maximum estimated). The reorganization plan is approved by creditors and confirmed by the syndic judge. After confirmation, the plan must be entered in the accounting records. The debt discharge by 50% generates a taxable income of 50 u.m., i.e. an additional profit tax of 50 u.m. * 16% = 8 u.m., which is due in the first quarter of the plan. The higher the debt discharges under the plan, the greater the risk of bankruptcy.

In the above example, the generated profit tax is 4.8 u.m. + 8 u.m. = 12.8 u.m., which means 25% of the total estimated payments (i.e. 50 u.m) under the plan, already due in the first quarter, having in view that the debtor envisaged the settlement of the debt of 50 u.m. within 3 years, respectively 4,16 u.m./quarterly. Since these obligations of certain, liquid and exigible nature are huge, in relation to the quarterly payments estimated by the payment

schedule, they may cause the debtor to go into payment default and, consequently, go bankrupt.

Results and discussions

The partial debt discharge, intended to rescue the honest debtors by granting them the chance to reorganize their activity and to reinsert into the civil circuit, must be analyzed by reference to the accounting and tax rules wherewith they are corroborated.

The contradiction between the insolvency proceedings and the accounting/ tax legislation is related, among other things, to this profit tax incurred by the partial debt discharge, which falls due in the quarter immediately following the confirmation of the reorganization plan.

Regarding the reorganization plan, the Romanian accounting rules (Accounting Law and Accounting Regulations) require the entry of the list of creditors and the subsequent enlistment of the debts cancelled through the reorganization plan.

-Under the Accounting Law no. 82/1991 with subsequent amendments and completions - art. 19, "in accounting, profit or loss shall be cumulatively established at the beginning of the financial year; the closure of the revenue and expenditure accounts is usually made at the end of the financial year. (2) The final result of the financial year shall be established upon closure". In accordance with Art. 6 par. (1) of the Accounting Law no. 82/1991, republished, as subsequently amended and supplemented, any economic-financial operation carried out shall be entered upon performance in a document which underlies the accounting records, thus acquiring the status of supporting document.

-Order no. 1802 of December 29, 2014 for the approval of the Accounting Regulations on the individual annual financial statements and the consolidated annual financial statements stipulates at Point 310 the following: “(4) Based on accrual accounting, entities shall enter in the accounts all revenues and expenditures, respectively the claims and liabilities arising from legal or contractual provisions. (5) In the supplier and customer accounts, debts, namely the claims from penalties established in accordance with the contractual clauses, compensation due for pre-terminated contracts and other items of similar nature, are shown distinctly". Moreover, according to the principle of accrual accounting (Article 53), it provides that "the effects of transactions and of other events are recognized when these transactions and events occur (and not as cash or its equivalent is cashed in or paid) and are entered in the accounting and reported in the financial statements of the corresponding periods".

The legal regulation is unclear and it is generated because the debtor’s situation is exceptional. The obligation to enter the list of creditors and/ or the debt discharge is specific only to insolvency proceedings (the period when the principle of activity continuity is not applicable), and the expenditures and revenues are not entailed by an activity carried out under normal conditions.

According to the Romanian accounting rules, if the presentation of a regulation/ provision (such as the declaration of an income resulting from the partial debt discharge under a plan) is not likely to reveal a fair situation of the patrimony (as the declaration of the income generates a reorganization profit, an unreal profit in the circumstances where the company struggles to survive; otherwise we should agree with the assumption that the respective profit can be distributed to shareholders!!!), then the provision does not apply, in order to present the faithful situation of the entity’s assets, debts, financial position, profit or loss. The non-application of such a provision is presented in the explanatory notes to the financial statements together with an explanation of the reasons and its effects on the entity’s assets, debts, financial position and profit or loss.

-OMFP 1802/2014: "19. - (1) Income and expenditure are_elements directly related to the assessment of financial performance, by the profit and loss account.

(2) For the purposes of these Regulations, the terms below shall have the following meanings:
a) income represents increases in the economic benefits entered during the accounting period as inputs or increases of assets or debt discharge, which result in increases in equity other than those resulting from shareholder contributions;
b) expenditures are decreases in the economic benefits entered during the accounting period as write-offs or decreases in the value of assets or debt increases, which result in decreases in equity other than those resulting from their distribution to shareholders.
(3) income is recognized in the profit or loss account when it is credible to estimate an increase in future economic benefits related to the increase in the value of an asset or the decrease in the amount of a debt. Income recognition is made simultaneously with the recognition of asset growth or debt discharge (e.g. net asset growth resulting from the sale of products or services, or debt reduction resulting from debt discharge)".
"23. - The annual financial statements are prepared in a clear and consistent manner with the provisions of these regulations.
24. - The annual financial statements must provide a true and fair situation of the entity's assets, debts, financial position and profit or loss.
25. - If the application of the provisions of these regulations is not sufficient to provide a true and fair situation of the entity's assets, liabilities, financial position and profit or loss, additional information is required in the explanatory notes to the financial statements in order to meet this requirement.
26. - If, under exceptional circumstances, the application of a provision from these regulations is incompatible with the obligations set out in paragraphs 24 and 25, the respective provision shall not apply in order to provide a true and fair situation of the entity's assets, liabilities, financial position and profit or loss. The non-application of such a provision shall be presented in the explanatory notes to the financial statements together with an explanation of the reasons and its effects on the entity's assets, debts, financial position and profit or loss."
"435. - (1) Income from operations includes:
e) other income from current operations, including income from recovered claims, contractual penalties, debts that are prescribed, exempted or cancelled/ discharged under the law, as well as other operating income.
436. - (1) The income resulting from the resumption of provisions or from adjustments for value depreciation or loss shall be entered distinctly according to their nature.
(2) The diminution or cancellation of the established provisions, respectively the reflected adjustments for value depreciation or loss shall be made by entering them as income if it is no longer justified to keep them, if the risk takes place or if the expenditure becomes exigible.
(3) In addition to these provisions, the provisions of points 235 and 236 shall apply".
The tax inspection bodies supplement the accounting regulations mentioned above, by their truncated quotation, truncations that we will quote and underline.
In Romania, certain interpretations highlight the income generated by partial debt discharge as "upfront income". Thus, the profit tax is no longer exigible until the condition stipulated by the insolvency law is verified, i.e. the debtor is reinserted into the economic circuit. Otherwise, if the debtor undergoes the bankruptcy proceedings, the Romanian insolvency law mentions the debt reactivation hypothesis, initially cancelled under the reorganization plan.
-Insolvency Law no. 85/2014:
Article 114 - enrolment in the list of creditors under the proof of claim;
Article 140 (1) When the decision confirming a plan enters into force, the debtor's activity shall be duly reorganized; the claims and rights of creditors and of other interested parties

shall be modified as provided in the plan. In the event of bankruptcy, it shall return to the situation established by the final list of all creditors and claims against the debtor stipulated in art. 112 par. (1), subtracting the amounts paid during the reorganization plan.
Article 148 provides that "in the event of bankruptcy following the confirmation of a reorganization plan, the holders of claims shall participate in distributions according to the value of their claims, as entered in the final consolidated list".
The lack of certain exceptions to tax regulations, regarding the non-taxable income, i.e. the non-taxation of the reorganization income, creates unfairness in applying the rules, since the tax creditor calculates the income tax, thus artificially increasing the value of the insolvent debtor's tax liabilities. This situation occurs even if, theoretically, in such an uncorrected and unclear situation, the Fiscal Procedure Code states that, as a principle, the taxpayer's interest must be respected.
-Article 13 of Law 207/2015 on the Fiscal Procedure Code: "Art. 13, Law interpretation
(1) The interpretation of tax regulations must observe the legislator's will as expressed by the law.
(2) If the legislator's will is not clear from the text of the law, the purpose of issuing the normative act as it results from the public documents accompanying the normative act in the process of elaboration, debate and approval shall be taken into account when establishing the legislator's will.
(3) The provisions of the tax legislation shall be interpreted by means of each other, giving each the meaning resulting from the whole law.
(4) The provisions of the tax legislation that are susceptible to multiple meanings shall be interpreted in the sense that they correspond best to the object and purpose of the law.
(5) The provisions of the tax legislation shall be interpreted in the sense in which they can take effect, and not in the sense in which they cannot take any effect.
(6) If, after applying the interpretation rules provided in paragraphs (1) - (5), the provisions of the tax legislation remain unclear, they shall be interpreted in the taxpayer/ payer's favor".
Regarding the case study presented in this paper, the American, French and German tax laws provide for exceptions so as not to tax the income resulting from debt discharge under a reorganization plan and to grant the debtor the possibility to reorganize. The exceptions are motivated by the fact that the income does not the result from the activity carried out by the company; they do not have a correspondent in the cash flow and, of course, they are corroborated with the essential role played by insolvency proceedings, i.e. granting the second chance to the honest debtor.

Conclusions

By anticipating the blocking of the reorganization plan by the income tax, debtors try to reschedule their liabilities on the reorganization plan, i.e. the payment of those profits until the end of the plan. The measure is favorable and corroborated with the insolvency law. By analyzing the legal provisions, we find that these profits – and consequently the profit tax – are paid if the company does not undergo the bankruptcy proceedings. The only time when this condition can be checked is when the company successfully overcomes the reorganization process. However, because of the lack of procedures and analysis models for such cases, the tax creditor prefers a simple situation, i.e. to impose additional debts on the insolvent debtor, without waiting to see if it can face the reorganization. The profit tax, which is very high, often generates the bankruptcy of the companies and the only obvious conclusion is that the debtor has not reorganized. Analyzing the conditions that made reorganization impossible is only a second, undeclared, aspect, which is not highlighted in official reports.

In our opinion, clear accounting rules and fiscal measures should accompany the encouragement of honest debtors to reorganize their business. The non-corroboration of the insolvency-specific legislation can only have a devastating role in the economy; the direct effect is represented by the social impact of job losses, the lack of confidence displayed by capital owners and investors in the development of new businesses, the loss of commercial relationships, etc.

We are aware of the limitations of our case study since the analysis was carried out starting from the Romanian insolvency system, which was compared with systems that have a long history and that are appreciated as efficient, according to the literature.

The comparison involved only 4 countries, i.e. Romania, the USA, Germany and France, without considering the situation of less developed countries, in order to analyze the results of reorganization procedures.

A qualitative research based on an interview would be required to identify other risks that seriously affect the reorganization of companies; we will try to achieve this in the future.

Furthermore, we intend to create a model for analyzing a company's reorganization capacity based on the risk profile analysis.

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