

# Study on the Conflict of Tax Laws in Corporate Bankruptcy

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**Abstract:** Taxes are more special than other bankruptcy claims in the bankruptcy procedure because of their large amount and the main body of collection is the state, meanwhile, the bankruptcy law involves more legal problems due to its strong externality, and there are fewer provisions on the taxation of the bankrupt enterprises, which requires a complete legal system to match and connect with the bankruptcy law. Therefore, this paper focuses on analyzing and discussing the tax-related problems in the bankruptcy law, including the settlement of late payment and the settlement of newborn tax. It compares the relevant provisions of the tax law and the bankruptcy law, enumerates their legal conflicts and deficiencies, and analyzes the differences in their essential legislative concepts, and puts forward suggestions for the subsequent legislation and modification to fully take into account the particularities of the situation of the bankrupt enterprises, reasonably balance the interests of the state and the interests of the individuals, and appropriately limit the priority of the tax claims.

**Keywords:** bankruptcy law, tax law, equitable discharge, tax preference

## 1. Introduction

Insolvency law is recognized as one of the key components of the modern business system due to its strong social and economic development impact. The closure of a company may trigger numerous issues related to the handling of financial liabilities and the redistribution of wealth, as well as secondary effects, such as the organization of employees' work and social security assistance, that need to be attended to and resolved. In addition, a fully functioning market must be supported by effective external laws, regulations and social institutions to ensure its stability and sustainability. The experience of many developed countries demonstrates the importance of this - they have successfully resolved a large number of attendant complex problems (e.g. how to provide cost-of-living support to distressed workers) and developed a range of relevant policy measures to address them.

However, various socially relevant laws and systems for the implementation of the bankruptcy law have not yet been fully established in our country. The Government has not yet introduced appropriate regulations to systematize the social problems arising therefrom. As a result, the direct or indirect provision of support and services by local governments has become a common state of affairs in the implementation of the bankruptcy law at this stage. Taxation, as an unavoidable and crucial part of the bankruptcy process, indirectly affects the subsequent development of the bankrupt enterprises. Now that the bankruptcy law has entered the revision process, it is crucial to analyze and sort out the aspects of the existing tax regulations that are in conflict with the bankruptcy law and revise them in a timely manner, so as to gradually transition from local government support to the formation of a perfect supporting legal system and to provide safeguards for the subsequent implementation of the bankruptcy law in the market-oriented manner.

## 2. Analysis of Tax-related Issues in Insolvency Proceedings

### 2.1 Settlement of Late Fees

Enterprises subject to insolvency proceedings are usually unable to pay their debts as they fall due or clearly lack the capacity to do so, and tax arrears have become the norm. In practice, therefore, there are many disputes regarding the repayment of the resulting late payment fees. According to Article 61 of the Provisions of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases, the following claims do not belong to the second paragraph of the bankruptcy

claims, i.e., "the late payment fees for the debtor's failure to pay the sums due to it after the acceptance of the bankruptcy case by the people's court, including late interest and labor insurance premiums, which should be doubled for the debtor's failure to implement the effective legal instruments ". As can be seen, late payment fees arising after the bankruptcy proceedings are not disputed; they are not treated as a bankruptcy claim, but after the ordinary claims have been paid. Therefore, only late fees owed by the enterprise prior to the bankruptcy proceedings need to be considered. According to Article 32 of the Tax Collection and Management Law it is known that late payment is based on tax and has a certain incidental nature. The nature of late payment is still a big controversy in the academic world, and there are interest, administrative penalty, damages (contractual default), administrative coercion, etc.<sup>[1]</sup>. The mainstream view is that it has the dual attributes of economic compensation and punitive, the taxpayer fails to pay the tax in accordance with the provisions of the tax, occupies the tax that should belong to the state, during this period of time caused losses to the state, so it is necessary to make economic compensation to the state. However, taking the principal amount of the tax as the base, calculating the late payment fee according to the standard of five ten-thousandths of a cent per day (equivalent to the adult rate of 18.25%), which is much higher than the bank loan interest rate (4.35%) in the same period, clearly reflects the punitive nature, and determines the nature of the late payment fee to lay the foundation for the subsequent analysis of the specific order of its liquidation.

Article 113 of the Bankruptcy Law provides for the order of satisfaction of bankruptcy claims, in which tax claims have a general priority and are given priority over ordinary claims as the second order of satisfaction. However, the article does not mention the order of settlement of late payment, according to the provisions of Article 45 of the Tax Administration Law, the tax priority includes the tax and the corresponding late payment. It can be seen that if late payment is included in the scope of tax priority, the proportion of tax claims to be satisfied in the process of bankruptcy debt settlement will increase significantly, seriously threatening the rights and interests of ordinary creditors. This will lead to a further reduction in the already low rate of satisfaction of ordinary claims in practice and generate negative bankruptcy sentiment. Therefore, in 2012, the Supreme People's Court, in its reply to the relevant admissibility issue, indicated the court's attitude towards the issue of late payment in bankruptcy cases, recognizing it as an ordinary claim and not giving it priority. Due to the existence of contradictions between the tax authorities and the court regulations, this issue continued until 2019, when the State Administration of Taxation issued a notice, the attitude of the tax authorities changed, and it also showed that there is now a preliminary consensus on the issue of the settlement of late payment in bankruptcy proceedings, but these are only relevant judicial interpretations, and there are no clear legal provisions, while the acceptance of the enterprise's bankruptcy procedures before the At the same time, it is still necessary to consider whether it is really reasonable to categorize the late payment fees owed before the acceptance of the enterprise's bankruptcy procedure as ordinary bankruptcy claims.

Then it can be found that the Tax Administration Law provides for the calculation of late payment of taxes, but does not specify its upper limit. Practice to deal with the upper limit of the tax, that it refers to the "People's Republic of China Administrative Compulsory Law" Article 45, "the amount of fines or late fees shall not exceed the amount of the obligation to pay money." However, it is not reasonable because the administrative coercive measures are based on administrative penalties, and the late payment fee is based on taxes, and the payment of taxes is the fundamental obligation of the taxpaying citizens rather than the administrative penalties, so there is a lack of law<sup>[2]</sup>. The principle of balance of interests in the bankruptcy law also indicates that the core of the bankruptcy claim system lies in the fair liquidation among creditors. The bankruptcy procedure lists the tax claims as special claims in the second liquidation, which has already given enough priority to the tax payments. This obviously destroys the mechanism of balancing interests and is not in line with the concept of fair liquidation of the bankruptcy law. Therefore, the subsequent legislation may also consider equating the late payment of taxes owed before the bankruptcy acceptance to the late payment of taxes owed after the bankruptcy acceptance, which are treated as lagging behind the ordinary claims.

## **2.2 Newborn Tax Reimbursement Issues**

According to the "Tax Administration Law" and the "Bankruptcy Act", the company maintains its legal existence from the beginning to the end of the bankruptcy process and has the status of a legally liable person, so they are still liable for the payment of taxes - this is called Newborn Tax. As such, they are still liable for taxes - known as Newborn Tax. Typically, this new source of income can be generated in a number of ways, including the payment of amounts from the ongoing execution of outstanding contracts, the disposal of company assets in the course of a new management process, and

real estate transaction fees for businesses that own property. The characterization of the new tax is not clear in the Enterprise Bankruptcy Law, but it can be excluded from being recognized as a bankruptcy claim in the first place, because there is a clear time requirement for bankruptcy claims, which need to be generated before the bankruptcy acceptance and already existed at the time of the bankruptcy acceptance, whereas the new tax was generated after the commencement of bankruptcy proceedings, which obviously does not meet the necessary pre-conditions. It is also worth noting that Articles 41 and 42 of the Bankruptcy Law provide a detailed description of the use of bankruptcy expenses and common interest debt. As the law does not make a clear definition of newborn tax also leads to greater controversy over its liquidation in practice, the existing judicial precedents on the determination of newborn tax are not uniform, although most of them are recognized as bankruptcy expenses and common interest debt, but their reasonableness has been widely discussed by the academia. widely discussed by academics. Although the newly created tax came into existence after the commencement of the bankruptcy proceedings, it is still based on the use of public power and is considered a unilateral acquisition, a characteristic that makes it different from bankruptcy expenses and co-beneficial debts. The former are necessary expenses to ensure the smooth running of the bankruptcy process, while the latter are required to satisfy a benefit that is shared by all creditors, thus they are characterized by exchange value and two-way street<sup>[3]</sup>.

The exemption of corporate restructuring debt from income tax has attracted a great deal of attention in the current corporate reorganization process. Typically, a corporate restructuring program is achieved by management and shareholders agreeing on certain repayments of their liabilities, and most of the time, investors make compromises in order to protect the continued operation of the company and to maintain its competitiveness. However, under the Bankruptcy Code, this liability can be temporarily or permanently removed without any risk of default - making it a natural, non-statutory way of demanding payment: i.e., the contractual relationship can be dissolved without the obligation to pay. So from this point of view, it is an advantage for the debtor, but at the same time a loss for the creditor. Based on this situation, we need to follow the debt restructuring income tax regulations, the part that has been given up as a source of profit for the taxpayer to calculate the corresponding value-added tax rate to collect the corresponding amount of money as a part of the state's financial contribution to support the country's economic construction work. However, after an in-depth study, we can see that the current tax system in China has not fully considered the importance of enterprise bankruptcy and reorganization and made reasonable assessment and judgment on this special type of situation, which has led to some misunderstandings. In the process of reorganization, the concessions made by the creditors are the decisions forced by the reality in order to revitalize the resources of the enterprise when the debtor is unable to repay. To a certain extent, the operational risks of the enterprise are borne by the creditors, which is a fundamental difference from the gratuitous relief that occurs under the rules of fair exchange in a conventional business environment. In fact, the company does not receive an immediate cash benefit from the debt restructuring, and the so-called "debt restructuring proceeds" are merely "proceeds" on the books, but the company does incur a real tax liability. Taxing debt relief during the reorganization phase may touch on the interests of other creditors and may impede the future reproduction benefits of the company. If this is considered a bankruptcy expense or a public debt, it can put too much pressure on future company growth, which is a key factor in the frequent practice of companies having to fall back into liquidation due to financial difficulties. Nowadays, encouraging the reorganization of bankrupt enterprises has become a general trend, but how to guarantee the smooth reorganization of enterprises is what the existing laws and regulations need to consider, and should be stipulated in full consideration of the special characteristics and complexity of bankrupt enterprises.

### **3. Analysis of The Underlying Causes of The Conflict**

According to the first clause of China's Enterprise Bankruptcy Law, the main objective of the law is to protect the rights and interests of bankrupt creditors and establish a set of perfect bankruptcy processes. Often, once a company is in a state of insolvency, the limitations on its ability to pay make the conflicts between various claims obvious, which will undoubtedly weaken the effectiveness or even lead to the invalidation of the maintenance of normal claims. Therefore, bankruptcy laws are designed to ensure that the majority of ordinary creditors are fairly compensated, while at the same time providing all creditors with as equal protection as possible, taking into account the complexities that characterize the field of bankruptcy. In addition, the bankruptcy law also involves a relief function for debtors, helping bankrupt enterprises to exit the market mechanism in a timely and orderly manner, which in turn also promotes the healthy development of the social economy. Article 1 of the Tax

Administration Law embodies the concept of tax collection in the field of tax law, which is more in the field of safeguarding the interests of taxes, with a relatively strong color of tax administration, emphasizing the regulation of tax payment by taxpayers. In China, tax revenue is an important part of the state's financial income, and is an important economic basis for the state to fulfill its public economic management functions, thus the Tax Administration Law focuses on the protection of tax interests, and strengthening the collection of taxes from taxpayers is its core concept, giving full play to the original and basic functions of taxation. The difference between the legislative concepts of the two laws also reflects the difference between public law and private law, therefore, under the circumstance of guaranteeing the absolute priority of public law, the guarantee of private rights should also be fully considered, therefore, in the bankruptcy procedure, while fully guaranteeing the tax power of the state, it should also give more consideration to the special circumstances of the enterprise in a state of distress, and gradually go from state-centeredness to individual-centeredness<sup>[4]</sup>.

#### 4. Directions for Improvement

The 2020 trial data released by the Shanghai Bankruptcy Court shows that of the 141 bankruptcy cases concluded, the average liquidation rate of ordinary claims was 1.7%. Most of the country's national tax revenues come from VAT, consumption tax, and corporate income tax from normal business operations. Yet an over-emphasis on the balance of state revenues and expenditures may be detrimental to individual asset interests. While the closure of some enterprises will bring some pressure on the state's liabilities, but the overall impact is not too great, but for ordinary borrowers their economic difficulties may lead to more similar problems or even further exacerbate the incidence and severity of the phenomenon. On the other hand, improving the repayment capacity of private borrowers could reduce the cost and risk of government expenditures in dealing with such problems, thereby reducing public expenditures.

There is a clear tendency in both developed and transition countries to reduce the priority of tax claims in bankruptcy: for example, Austria abolished the priority of all tax and other pre-existing debts in 1982; Finland stopped all priority for commercial bankruptcy cases in 1992; Germany followed the legal framework of the Comprehensive Bankruptcy Improvement Program (CBIP) in 1999 and completely deprived all priority for pre-existing debts<sup>[5]</sup>. Other countries such as the United States, France, Poland, Chile and others advocate that no special priority should be given to direct personal income taxes; and some countries such as the United States, France, Poland and Chile advocate that no special priority should be given to direct personal income taxes. [Other countries, such as Canada, New Zealand and Chile, have argued that no special priority should be given to direct personal income taxes; and countries such as the United States, France, Poland, Portugal, and others, have made changes to their bankruptcy statutes in the early part of the 21st century by limiting the time frame in which a tax debt is incurred in order to determine the percentage of priority to be given to its payment, usually 6-48 days before the commencement of the insolvency process. usually between 6-48 months before the commencement of the insolvency process. Drawing on the practice of the above countries, we in China can also adopt a compromise approach. At present, it is not necessary to eliminate the priority nature of tax immediately, but it is necessary to appropriately constrain it, and we can choose the two-tier restriction strategy of "time + quantity" to make it clear that only the original amount of taxpayers' money enjoys the priority in bankruptcy, and does not include the penalties, late payment fees, interest and other forms of payment, penalties, late payment fees, interest, etc.

#### 5. Conclusion

There is a certain contradiction between the provisions of the bankruptcy law and the tax law on the settlement of late fees arising before bankruptcy. The Supreme People's Court stipulates that they are ordinary bankruptcy claims, while they are included in the Tax Priority in the Tax Administration Law, which leads to disputes on the issue of late payment settlement and threats to the rights and interests of ordinary creditors. Although the attitude of the Supreme People's Court and the attitude of the tax authorities have reached a preliminary consensus in 2019, there is still a lack of clear legal provisions, in addition, due to the lack of legal provisions on the upper limit of late payment whether it is really reasonable to categorize the late payment owed by the enterprise before the acceptance of the bankruptcy procedure as an ordinary bankruptcy claim needs to be thought about; similarly, for the issue of the newborn tax repayment has not been explicitly provided for in the Bankruptcy Law and is mostly categorized as a bankruptcy expense or public welfare debt in practice. Bankruptcy expenses or

public welfare debt, and the lack of specific provisions in the tax law for insolvent enterprises only to be analogous to the application of tax provisions related to the reorganization of enterprises in the normal operating conditions, so that the phenomenon of bankruptcy and reorganization of enterprises with excessive tax burden into liquidation again. In order to solve these problems, it is necessary to further improve the relevant laws and regulations, give full consideration to the special situation of bankrupt enterprises, reasonably balance the interests of the state and personal interests, and appropriately limit the priority of tax claims. Future research can further explore how to improve the relevant laws and regulations in order to solve the conflicts and deficiencies between the bankruptcy law and the tax law on tax-related issues.

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