

INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS



Open Access, Refereed Journal Multi Disciplinary
Peer Reviewed

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THE CONSTITUTIVE AND LEGISLATIVE INTERSECTION OF TAXATION AND INSOLVENCY IN INDIA: A COMPREHENSIVE ANALYSIS

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Abstract

The crossroad of the Insolvency and Bankruptcy code (IBC), 2016 and the income tax act, 1961 is one of the most complicated jurisdictions in Indian corporate law. This article offers a detailed discussion of the changing priority of tax claims following bankruptcy administration, discussing the move of the old doctrine of Crown Debt to the present umphasizing of Creditor-in-Control. The Clean Slate Theory lies at the heart of this research and it is important to ensure that a successful candidate in the resolution process is not weighted by the hidden liabilities in terms of taxes. In a discussion of the leading case law, such as decisions of the Supreme Court in Ghanashyam Mishra and Rainbow Papers, this study sheds light on the statutory attempts to reconcile the recovery of taxes with the larger goal of corporate rescue. The analysis also provides an analysis on particular statutory reliefs that are availed by the Acts of Income Tax like the softening of Section 79 and MAT provisions that are critical fiscal stimulus in the process of rescuing troubled assets. Finally, the article suggests that even though the IBC upholds supremacy through Section 238, a balancing act between the economic stability and interests of the state revenue is necessary as the game between the tax and insolvency regime continues.

Keywords: *Insolvency and Bankruptcy Code, Taxation, Clean Slate Theory, Crown Debt Doctrine, Waterfall Mechanism, Corporate Rescue.*

INTRODUCTION

The establishment of the Insolvency and Bankruptcy Code (IBC), 2016 was a watershed event in the economic history of India as it changed the rights of both creditors and debtors. Before this there had existed a patchy system of laws; SARFAESI law and SICA law (Sick Industrial

Companies law) with government agencies often purporting to have a first priority claim on the assets of a failed company. Such a priority of Crown Debt often stopped the resolution of commercial distress, with the private lenders severely impoverished in recovery, and thus no incentive to invest in troubled assets. One of the objectives the IBC intended to achieve was to substitute this inefficiency with an asset-based, time-limited and unified process, designed to maximize the value of resources and facilitate entrepreneurship.¹

But this mission is often in conflict with the Tax Laws of India, which are based on the sovereign right of the State to raise revenue to develop the country in accordance with Article 265 of the Constitution. This is most apparent in the priority of claims. According to the old tax law the State regarded itself as a priori creditor, but the IBC classifies tax dues as Operational Debt, which ranks much further down the priority ladder in comparison to secured financial creditors. This reclassification is underpinned by the provisions of the IBC under Section 238 under which a non-obstante clause is provided that means that the Code will have overriding effect on any conflicting acts. With the judiciary still working on perfecting this relationship, it has taken a new direction of providing new investors with certainty-a factor it can guarantee under the doctrine of Clean Slate. This paper examines these realities and the manner in which the law balances the conflict between the Right to Tax and the Duty to Rescue.²³

ARTICLE 265 v. SECTION 238 OF THE IBC

The clash of constitutional proportions between tax recovery and insolvency resolution is a legal tussle. Article 265 states that taxation shall not be imposed or levied without a lawful basis, and this has always been construed by revenue officials to imply that their claims should be given precedence over personal contractual debts. Over decades the doctrine of Priority of Crown Debts has dominated in the Indian courts holding that the State bears a pre-eminence right to receive satisfaction out of the property of a debtor.

The IBC upset this doctrine by Section 238 that says that the provisions of this Code shall have effect, in spite of anything inconsistent therewith in any other law, which is in force at the time. In such situations as PR the Supreme Court. Commissioner of Income Tax v. Monnet Ispat and Energy Ltd., has categorically believed that in the event of a clash, the IBC shall prevail over

¹ Sick Industrial Companies (Special Provisions) Act, 1985 (SICA); Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act).

² IBC, 2016, Section 238 (Non-obstante clause).

³ Constitution of India, 1950, art 265: 'No tax shall be levied or collected except by authority of law.'

the Income Tax Act. This is to the effect that the Tax Department has the lawful powers to impose tax but the actual collection thereof in the event of insolvency can only comply strictly with the hierarchy of procedure defined in the IBC. The purpose of the legislation is obvious: the existence of the corporate entity as a going concern is a more important good to the people than is the immediate collection of a particular arrear of tax.⁴

OPERATING DEBT CATEGORIZATION OF TAX DUES

Financial Debt and Operational Debt are the two key differences in the IBC architecture. Financial debt is usually the payment of money as opposed to the consideration of the time value of money (loans, bonds), as opposed to the provision of goods or services, such as employment, which constitutes operational debt.

Has it been Statutorily Interpreted?

Under Subclause 5(21), the term operational debt is given a definition as a claim with respect to the payment of dues accruing under any law in existence at the time and payable to the Central Government, any State Government or any local authority. Income Tax, GST, Customs duties and even municipal taxes by this definition are operational debts. The consequences of such a classification are tremendous:⁵

The Committee of Creditors (CoC): Tax authorities do not typically form part of the CoC which consists of financial creditors. The government therefore does not vote on the issue of whether to approve or disapprove a resolution plan.

Priority of payment: In a Resolution Plan, the operation creditors are required to receive an amount that is equal or greater than what they would have received in the liquidation case. Since government dues are given low priority in the liquidation waterfall, this minimum can be zero or a tiny fraction of the entire claim.

The Lack of Voting Power

Due to the nature of tax departments considered as operational creditors, they do not have a say in the commercial wisdom of the CoC. This will make the resolution process run by people who have a direct financial interest in the future of the company (banks and lenders) as opposed to the government, whose main concern is the revenue that is due.

⁴ PR Commissioner of Income Tax v Monnet Ispat and Energy Ltd (2018) 18 SCC 232.

⁵ IBC, 2016, Section 5(21): 'Operational debt means a claim in respect of the provision of goods or services including employment or a debt in respect of the repayment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority.'

THE WATERFALL MECHANISM: THE ANALYSIS OF SECTION 53

Section 53 of the IBC is a section which gives a liquidation process of the Waterfall Mechanism. It determines the sequence of giving out the proceeds of the sale of the liquidated assets.⁶

- i. Rank 1: Insolvency Resolution Process Costs (IRPC) and Liquidation Costs.
- ii. Rank 2 Workmen's dues (during the 24 months before that time) and Creditors who have granted their security to the insolvent party and then surrendered their security interest.
- iii. Rank 3 Wages and unpaid dues to the employees (excluding workmen) during the 12 months before date of balance sheet.
- iv. Rank 4: Unsecured Financial Creditors.
- v. Rank 5: Government dues (taxes) and any amounts that remain due to a secured creditor after security has been granted.
- vi. Rank 6: Uncollected debts and dues.
- vii. Rank 7: Preference Shareholders.
- viii. Rank 8: Equity Shareholders.

The fact that tax dues have been ranked 5 is a policy decision to save the banking sector and labor. In case the first four ranks cannot be paid off using the assets of a company, the Tax Department will not be paid. This practically makes the claims of the sovereign as a revenue secondary to the requirements of the stability of banking and social security of labor.

JUDICIAL EVOLUTION: THE CLEAN SLATE THEORY

The Clean Slate Theory is the greatest judicial input to the success of the IBC. This doctrine was established in the historic ruling in the case of Ghanashyam Mishra and Sons Private Limited v. Edelweiss Asset Reconstruction Limited (2021).⁷

The Supreme Court ruled that, once a resolution-plan is passed by the NCLT, it was binding on all the stakeholders including the Central and State Governments. The Court noted that a resolution applicant cannot be made to expect that he/she has been presented with unresolved claims upon taking the business over. In case the tax authorities did not submit their claims within the CIRP or their claims under the approved plan were cut short, they cannot initiate a fresh recovery action subsequently.⁸

⁶ IBC, 2016, Section 53 (Distribution of assets).

⁷ Ghanashyam Mishra & Sons Pvt Ltd v Edelweiss Asset Reconstruction Co Ltd (2021) 9 SCC 657.

⁸ IBC, 2016, Section 31(1) (Approval of resolution plan by NCLT).

The theory also guarantees the company a clean balance sheet in terms of default on its former years. The Court made it very clear that any claim that does not constitute part of the resolution plan is extinguished. This gives the required commercial security to investors who would otherwise be reluctant to assume control of a company in case of any hydra-headed tax claims that are bound to appear after the resolution.

THE CONTROVERSY AND CORRECTION OF THE RAINBOW PAPERS

The decision of the Supreme Court in State Tax Officer case in 2022 caused a big stir in the legal circles. The Court decided that where a state statute (such as the Gujarat VAT Act) establishes a prima facie charge of property (such as a first or first priority), then the government must be considered a Secured Creditor under the IBC.⁹

The decision posed a significant threat to the waterfall, as it aimed to shift government dues from Rank 5 to Rank 2 within the waterfall mechanism, potentially pushing aside the claims made by banks and implying that a statutory charge is equivalent to a contractual security interest.

The Raman in Corrected Space (2023) case highlights that the judiciary subsequently proceeded to stem the consequences of Rainbow Papers; the Court stated that the Section 53 waterfall of IBC is sacrosanct and stressed the fact that although a state law establishes a first charge, it should meet the special priorities that are stipulated in the IBC. This brought back the old hierarchy where the IBC is the ultimate decision maker on the allocation of assets in case of insolvency.¹⁰

PARTICULAR STATUTORY RELIEFS OF THE INCOME TAX ACT

Understanding that firm attempts to comeback to life with stringent enforcement of the tax laws, the legislature came up with a few amendments to the Income Tax Act, 1961 that were described as tax-neutral or tax-incentive amendments.

The provision of Section 79 is known as Carry Forward of Losses.

Usually, when a majority of over 51 percent of the shareholding of a company alters, the company ceases being entitled to bring forward its previous business losses. This would have been catastrophic to the IBC where there is always a need to change the ownership. Section 79

⁹ State Tax Officer v Rainbow Papers Ltd (2022) 13 SCC 1.

¹⁰ Paschim Gujarat Vij Co Ltd v Raman Ispat Pvt Ltd (2023) SCC Online SC 808.

was later modified to enable corporations in the IBC process to carry forward the losses even when the ownership of the shareholding completely changes as long as the jurisdictional Principal Commissioner of Income Tax is granted a hearing opportunity. This tax refuge adds a lot of value to the distress firm.¹¹

Section 115JB: Minimum Alternate Tax (MAT) Companies in insolvency have high paper-based book profits because they have the loans waived by banks, yet they do not actually have a cash flow. In order to avoid the taxation of this notional profit, an amendment was done to Section 115JB. It enables IBC companies to offset the total figure of the unrecognized losses and unabsorbed depreciation as they compute MAT making their tax liability close to zero at the recovery stage.¹²

Section 56(2)(x): Deemed Income imposes taxes on the recipient in case he/she buys shares at a lower price than the Fair Market Value. This would have caused an enormous tax hit since the IBC bidders often purchase shares at pennies on the dollar. The CBDT has made a couple of circulars and amendments to the exemption of transfers under an approved plan of resolution to this provision.¹³

LANDMARK CASE ANALYSIS: INSOLVENCY AND TAXATION FRAMEWORK

State Tax Officer v. Rainbow Papers Ltd. (2022) 13 SCC 1¹⁴

The Statutory Charge challenge. The Resolution Plan of Rainbow Papers Ltd. in this case was appealed by the Gujarat State Tax Department, which argued that the state possessed a first charge on property of the dealer under Section 48 of the Gujarat Value Added Tax (GVAT) Act, 2003. While the NCLT and NCLAT had earlier dismissed this argument and classified the tax department as an Operational Creditor as per the normal IBC hierarchy, the Supreme Court stated that where a state statute establishes a first charge against the property, the Government was required to be a Secured Creditor. The Court held that the definition of a secured creditor under Section 3(30) of the IBC is liberal enough to accommodate a creditor whose collective

¹¹ Income Tax Act, 1961, Section 79 (as amended by Finance Act, 2021, s 59, to allow carry forward of losses for companies undergoing CIRP).

¹² Income Tax Act, 1961, Section 115JB (as amended to permit set-off of unabsorbed losses and depreciation while computing book profit for MAT purposes during CIRP).

¹³ Income Tax Act, 1961, Section 56(2)(x); CBDT Circular No 2/2018; Finance Act, 2022 amendment exempting transfers under approved resolution plans.

¹⁴ State Tax Officer v Rainbow Papers Ltd (2022) 13 SCC 1. The Supreme Court held that a statutory first charge under state VAT law qualifies as a security interest, entitling the State to be treated as a Secured Creditor under the IBC.

interest is established by reason of law and not simply by contract. Additionally, the Court noted that a Resolution Plan that totally disregards statutory dues or regards them with utter disparity could not be deemed as being in obedience to the law. This case brought enormous turmoil into the banking industry because, by transforming a "Statutory Charge" into a "Security Interest," it posed a risk of moving tax dues in the Waterfall Mechanism from Rank 5 to Rank 2, successfully contending that the sovereign right of the State to develop a charge through legislative measure could circumvent the particular will of the IBC to place financial lenders first.

Ghanashyam Mishra & Sons v. Edelweiss Asset Reconstruction (2021) 9 SCC 657.¹⁵

The "Clean Slate" Manifesto. A number of tax authorities (Income Tax, GST, and Customs) tried to commence the recovery action against corporate debtors when their Resolution Plans received the approval of the NCLT. The departments claimed that they were not part of the resolution process or their individual claims were not properly considered. The Supreme Court came up with a unanimous decision which constituted the Clean Slate Theory. The Court decided that when any resolution plan has been passed under Section 31(1), all the dues, undisclosed or unclaimed, of the Central Government or the State Government, were extinguished. The would-be person who is successful in the resolution cannot be burdened with past surprises. This is the most important precedent to investors. It also secures that the economic demise of the previous management befalls a clean cut to the company. It makes the Tax Departments responsible in the vigilance; failing to do it through the e-filing portals at the time of the CIRP, they forfeit their right to the money forever.

Paschim Gujarat Vij Co. Ltd. v. Raman Ispat Pvt. Ltd. (2023) SCC Online SC 808.¹⁶

The Reproduction of the Waterfall. After the mess created by the Rainbow Papers judgment, this case put aside the question of Statutory Charges in the limelight. The electricity department (PGVCL) asserted a first security interest on the assets of the corporate debtor in its supply code, and made an effort to jump the waterfall of liquidation. The Supreme Court gave such a required clarification and course correction to the Rainbow papers decision. The Court

¹⁵ Ghanashyam Mishra & Sons Pvt Ltd v Edelweiss Asset Reconstruction Co Ltd (2021) 9 SCC 657. The Supreme Court unanimously held that all dues not forming part of an approved resolution plan stand extinguished, establishing the Clean Slate Theory.

¹⁶ Paschim Gujarat Vij Co Ltd v Raman Ispat Pvt Ltd (2023) SCC Online SC 808. The Court clarified that Section 53 of the IBC is sacrosanct and that statutory first charges must yield to the IBC's specified priority order, limiting the scope of Rainbow Papers.

determined that Section 53 of the IBC is sacrosanct. It held that, although a statute establishes a first charge, it has to give way to the special precedence of allocation as set out in the IBC. The Court pointed out that the main category of Secured Creditors that are entitled to get the benefits of Rank 2 of the waterfall includes those that possess a contractual security interest and have assigned the same to the liquidation estate. This ruling had the effect of regaining trust in the banking sector. It restricted Rainbow Paper to its own facts, which supports the fact that the IBC is a special, subsequent law that takes effect over general state tax laws through Section 238.

PR Commissioner of Income Tax v. Monnet Ispat and Energy Ltd. (2018) 18 SCC 232.¹⁷

The Supremacy of Section 238. The Income Tax Department has tried to undertake its assessment and recovery actions during the moratorium period especially on the basis of the Income Tax Act being a special central legislation, which ought not be impeded through the insolvency process. The Supreme Court made a short but potent order that the NCLAT was correct in determining that the IBC has the over-riding effect over the Income Tax Act. The Court referred to Section 238 that the moratorium under the Section 14 covers all the government proceedings including revenue department proceedings. The case created the Inter-departmental Hierarchy. It clarified the fact that though the Income Tax Department is an independent body, it is de jure so that its powers will be suspended once a firm goes into the NCLT. This means that the company assets will be conserved to the advantage of all the creditors of the company instead of being emptied by one aggressive tax department.

Essar Steel India Ltd., Committee of Creditors v. Satish Kumar Gupta (2020) 8 SCC 531.¹⁸

The Doctrine of Commercial Wisdom involved a huge litigation that concerned the dividing of money between Financial Creditors and Operational Creditors (including tax departments). NCLAT had proposed equity or equality in the percentage of recovery of both classes of creditors, but the Supreme Court overturned the order of the NCLAT and reinstated the Commercial Wisdom of the CoC. The Court ruled that the CoC can determine the amount to be paid to various groups of creditors so long as they satisfy the minimum requirements of

¹⁷ PR Commissioner of Income Tax v Monnet Ispat and Energy Ltd (2018) 18 SCC 232. The Supreme Court affirmed that the IBC overrides the Income Tax Act by virtue of Section 238, and the moratorium under Section 14 applies to all government recovery proceedings.

¹⁸ Committee of Creditors of Essar Steel India Ltd v Satish Kumar Gupta (2020) 8 SCC 531. The Supreme Court upheld the commercial wisdom of the CoC in distributing resolution proceeds, confirming that operational creditors (including tax authorities) need only receive the liquidation value under Section 53.

operation creditors in terms of the minimum liquidation value, as the IBC does not require that the various types of creditors should be treated in the same way. To the tax authorities, this implies that they have no legal right to require a pro-rata share that are equal to those received by the banks; the Resolution Plan is legally valid as long as it would give them what they would have got under the Rank 5 liquidation waterfall (which is usually nil), which strengthens the Subordination of Tax Dues in the interest of the financial system stability.

CONCLUSION

The relationship between the IBC and Tax has evolved and this is a demonstration of the modernization of the commercial law in India. The law seeks to accept that a functioning tax-paying company tomorrow will be more valuable to the State than a liquidated company today by prioritising tax claims to the purpose of corporate rescue.

The Clean Slate doctrine and the primacy of Section 238 have given the stability that the strained-asset market enjoys. But the Rainbow Papers controversy is a lesson that the natural propensity of the State to guard its revenues will ever provide a source of irritation. The way ahead demands that the NCLT and the Supreme Court watch all the time to make sure that the waterfall mechanism is not beaten around by the statutory charges. Since the e-courts project is in the process of digitising the judicial records, there is need to refine the liaising between the NJDG and the Income Tax Department so that all claims are submitted in time, the Clean Slate does not remain a mere theory of the law, but a working reality.