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Navigating Tax Complexity: Assessing the Transformative Impact of the Insolvency and Bankruptcy Code on Indian Tax Laws

HARSHITHA ULPHAS¹

ABSTRACT

This essay explores the intricate intersection of the Insolvency and Bankruptcy Code (IBC) in India with tax laws, emphasizing the evolving legal landscape. Focused on government dues prioritization, post-IBC tax law changes, and the challenging interplay between GST and IBC, the essay delves into crucial judgments and implications for businesses and creditors. Examining tax liabilities during the Corporate Insolvency Resolution Process (CIRP), it addresses challenges, judicial interventions, and nuances surrounding tax recovery through a corporate debtor's property. The article offers recommendations for policymakers and practitioners to enhance the efficiency of the insolvency framework, advocating for harmonization, clarity in GST provisions, reforms, capacity building, adoption of best practices, and timely judicial intervention. As the legal scenarios continue to unfold, collaboration between stakeholders remains crucial for fostering economic revitalization and ensuring the resilience of the corporate sector.

Keywords: Bankruptcy, Corporate Insolvency, GST (Goods and Services Tax), IBC (Insolvency and Bankruptcy Code), Tax Laws.

I. INTRODUCTION

The Insolvency and Bankruptcy Code (IBC) in India stands as a transformative legal framework designed to address financial distress, emphasizing resolution, asset value maximization, and credit availability. This essay delves into the intricate landscape where the IBC intersects with tax laws, particularly focusing on the prioritization of government dues, changes in tax laws post-IBC enactment, and the challenging interplay between the Goods and Services Tax (GST) and IBC. It explores the evolving relationship between these legal realms and their profound implications on businesses, creditors, and the broader economic landscape.

II. UNDERSTANDING THE LANDSCAPE

The Insolvency and Bankruptcy Code (hereinafter referred to as IBC and/or the Code) in India

¹ Author is a LL.M. student at NALSAR & IICA, India.

which emphasizes its supremacy over other laws, has three primary objectives²- resolution, maximizing the value of assets, and ensuring the availability of credit while balancing conflicting interests. The disbursement of a corporate debtor's assets during the Insolvency Resolution Process follows a statutory mechanism known as the waterfall mechanism, outlined in Section 53 of the IBC. This mechanism establishes priorities for various claims, including insolvency resolution costs, workmen's dues, debts owed to secured creditors, and government dues, among others.

Interestingly, the IBC has an overriding effect on tax laws, as stated in Section 238 of the IBC. Additionally, the legislature has always leaned towards the supremacy of corporate insolvency laws over any other law³. This provision ensures that the IBC takes precedence over any inconsistent provisions in other laws. The principle of interpretation applied here is "*Generalia specialibus non derogant*," suggesting that specific statutes (such as the IBC) take precedence over general ones.

With respect to the priority of government dues under IBC, it is pertinent to note that the "Fresh Slate Theory," in the IBC, highlights a shift in the treatment of government dues under the Code. While tax dues were previously given priority, as is evident from the *Dena Bank Case*⁴ the IBC, aimed at maximizing the value of a corporate debtor's assets and ensuring its revival, has redefined the order of priority. Government claims, including tax dues, are now categorized as operational debts and given a lower priority in the repayment hierarchy⁵ in accordance with the Waterfall Mechanism.

However, this shift in priority has led to challenges for tax authorities in recovering outstanding tax dues. After the completion of the Corporate Insolvency Resolution Process (CIRP), tax departments have sought to recover remaining tax dues from the revived entity or the successful resolution applicant. These actions have been contested, citing Section 31(1) of the IBC, which binds the corporate debtor, its employees, members, and creditors to the approved resolution plan.

The judgments from the Hon'ble Rajasthan High Court in the case of *Ultra Tech Nathdwara Cement v. Union of India*⁶ and the Hon'ble Jharkhand High Court in the case of *Electrosteel Steels Ltd. v. The State of Jharkhand*⁷, are some instances which have taken different approaches

² Preamble, Insolvency and Bankruptcy Code, 2016

³ Section 238, Insolvency and Bankruptcy Code, 2016

⁴ *Dena Bank v. Bhikhabhai Prabhudas Parekh & Co.* 2000 (5) SCC 694]

⁵ Section 53, Insolvency and Bankruptcy Code, 2016.

⁶ *Ultra Tech Nathdwara Cement Ltd. v. Union of India*, (2020) 37 GSTL 289.

⁷ *Electrosteel Steels Ltd. v. The State of Jharkhand* (2020) 77 GSTR 174.

to challenges against tax department actions post-CIRP. These judgments are crucial in understanding the legal landscape surrounding the resolution of tax dues under the IBC.

The interaction between the IBC and the Goods and Services Tax (GST) in India is also something to be noted. Both IBC and GST have significantly influenced the way business is conducted, with potential consequences for corporations facing the choice between resolution and liquidation. The IBC, introduced in December 2016, aimed to revolutionize the resolution process for insolvent companies, emphasizing the maximization of asset value and the revival of corporate debtors, meanwhile, the GST Act, implemented shortly after the IBC, brought about a substantial transformation in the taxation system, unifying various indirect taxes into a single comprehensive tax.

The convergence of the IBC and GST has had profound implications for businesses and their promoters, ushering in a new era where the fear of losing control over a company has become a tangible concern. The GST authorities have played a pivotal role in instilling a sense of accountability among businesses, particularly targeting bogus billers and leading to the formalization of the economy. Moreover, the stringent measures enforced by GST authorities, including arrests, have compelled even influential individuals, formerly part of the legislative process, to exit the country.

In the context of corporate insolvency, the companies facing financial distress now confront a dual choice: either pursue a resolution process to identify the best bidder and maximize the company's value or opt for liquidation. However, it must be noted that the liquidation of companies has become a reality for a substantial number of entities, as indicated by the data from the Insolvency and Bankruptcy Board of India (IBBI)⁸.

Both GST and IBC as legislations have had transformative impact on corporate behaviour, economic formalization, and the overall resolution and liquidation landscape in India and their interplay will be explored further during the course of this article.

III. CHANGES IN TAX LAWS WITH THE ENACTMENT OF IBC

The intricate nature of tax dues in the context of insolvency proceedings inevitably garners attention to various legal judgments that have shaped the treatment of tax liabilities under the Insolvency and Bankruptcy Code (IBC) in India.

⁸ 'Only 15% Insolvency Cases reach Resolution during October-December 2022' *Economic Times* (India 26 March 2023) <https://economictimes.indiatimes.com/news/company/corporate-trends/only-15-percent-insolvency-cases-reach-resolution-during-october-december-2022/articleshow/99011780.cms>.

To begin with, in the *Om Prakash Agarwal Case*⁹ before the National Companies Law Appellate Tribunal (NCLAT) involving the deduction of 1% tax at source under section 194-1A of the Income Tax Act (IT Act), the NCLAT ruled that such deductions interfere with the IBC's prescribed waterfall mechanism, disrupting the priority of government dues.

This decision aligns with a previous ruling of the *Leo Edibles Case*¹⁰ by the Hon'ble Andhra Pradesh High Court, emphasizing that Tax Recovery Officers cannot claim priority based solely on pre-liquidation attachment orders. Additionally, the NCLAT, in the case of *Synergies Dooray Automotive Ltd. & Ors*¹¹, clarified that entities entitled to receive dues under existing laws fall under the category of "operational creditors," with their claims not superseding those of secured and other creditors.

In contrast to the above mentioned, the Hon'ble Supreme Court, in the case of *Rainbow Papers Limited*¹², upheld the priority of the State under the Gujarat VAT Act, suggesting that the prioritization of tax or statutory dues depends on the specific language of each statute.

Post introduction of the Goods and Services Tax (GST) and the IBC, both of which are considered as landmark legislative reforms in India, which underscore significant impact wherein GST is hailed as India's most substantial tax reform, and the IBC as a contemporary law aimed at resolving non-performing assets and positively influencing long-term bank credit availability.

However, the relationship between GST and IBC is depicted as challenging one for companies undergoing insolvency resolution, primarily because the IBC's distribution mechanism during insolvency resolution results in crystallized liabilities exceeding liquid assets, and under the resolution plan, all creditors receive a fraction of their outstanding dues in a defined order of priority. This conflicts with GST, where old tax dues must be settled before addressing present and future obligations, creating hardship for companies in resolution¹³.

Several high-profile Indian conglomerates, such as Essar Steel, Bhushan Steel, Bhushan Power & Steel, Alok Industries, Monnet Ispat, and Jet Airways, which have entered the resolution process under the IBC, as a result of facing financial and legal stress. The challenges posed by the clash between IBC regulations and tax department claims are evident, underscoring the need

⁹ *Om Prakash Agarwal v. Chief Commissioner of Income Tax Company Appeal (AT) (Insolvency) No. 624 of 2020*. Available here: <https://nclat.nic.in/sites/default/files/migration/upload/155180032160212e9286f98.pdf>.

¹⁰ *Leo Edibles & Fats Ltd. v. The Tax Recovery Officer, IT Dept* (2018) 407 ITR 369.

¹¹ *Synergies Dooray Automotive Ltd. & Ors*. 2019 SCC OnLine NCLAT 691.

¹² *State Tax Officer v. Rainbow Papers Ltd*. 2022 SCC OnLine SC 1162.

¹³ Rajat Mohan, 'How companies undergoing insolvency resolution face hardships due to probable clash of GST with IBC', *Financial Express* (India 19 September 2019).

for companies and insolvency professionals to navigate potential conflicts and seek judicial intervention.

All these instances point toward the necessity for reforms in GST law to align with the IBC, urging clarity from tax authorities on the tax-neutral status of business transfers under resolution plans among many other issues that need attention. It calls for a formal communication from the Ministry of Finance and the Ministry of Corporate Affairs to address the IBC-GST disagreement, promoting ease of doing business and safeguarding corporations from extinction.

IV. TAXES IN CIRP AND RESOLUTION PLANS

(A) Tax Liabilities After the Onset of the Moratorium Period

The Corporate Insolvency Resolution Process (CIRP) initiates with the appointment of an Interim Resolution Professional (IRP), marking the commencement of the CIRP from this juncture. As per Section 15(1) of the Insolvency and Bankruptcy Code (IBC), the IRP is obligated to issue an immediate public announcement within three days of their appointment. This comprehensive announcement encompasses details about the corporate debtor, its registration particulars, the deadline for claim submissions, and penalties for false claims. Regarding claim submissions, creditors are entrusted with the responsibility to present their claims within fourteen days from the IRP's appointment. Nevertheless, an amendment to the provisions grants creditors failing to meet this deadline the leeway to submit claims within ninety days from the initiation of insolvency. This regulatory framework places a substantial burden on creditors to submit their claims within this ninety-day window to become part of the resolution plan. The complexity and limited timeframe often lead to the omission of tax claims from the Resolution Plan, creating a challenging scenario for the corporate debtor facing insolvency proceedings and simultaneous tax claims from revenue authorities.

In response to the potential disruption posed by such challenges, the government introduced the concept of a 'moratorium period'¹⁴. Section 14 of the IBC outlines the moratorium period, which spans the entire CIRP duration. During this period, any judicial proceedings for recovery, sale or transfer of assets, or the conclusion of essential contracts are prohibited against the corporate debtor. The language of this section unequivocally favours the corporate debtor, emphasizing asset preservation during the resolution of default by creditors. Section 31 of the IBC further provides relief to distressed corporate debtors by disallowing claims outside the resolution plan. This provision stipulates that, upon resolution plan approval during the CIRP,

¹⁴ Section 14, Insolvency and Bankruptcy Code, 2016.

all claims that come to light de facto become extinguished¹⁵. Moreover, claims included in the plan are frozen, binding on all concerned parties, and crucially, no fresh proceedings are permitted for claims not encompassed in the resolution plan.

Despite these protective measures, challenges persist as taxpayers continue to receive notices from tax departments, including reassessment notices under Section 148 of the Income Tax Act, even after the declaration of a moratorium period by the resolution professional. Tax authorities often assert such demands, seemingly oblivious to the provisions of the IBC. In response to these issues, the Apex Court delivered much-needed clarity in the case of *Ghanashyam Mishra*¹⁶. The court unequivocally held that outstanding dues not part of the resolution plan would be considered extinguished, and no proceedings could be initiated to recover such dues. Emphasizing the clean slate concept, the court highlighted that the legislative intent of the IBC was to impose a standstill period, pausing all claims to allow the resolution applicant to engage with creditors with a clean slate. Acknowledging this theory, based on the idea that the business is rejuvenated and poised for a fresh start, is crucial to fulfilling the entire purpose of the code. The legal position is unequivocal and implies that the resolution plan cannot succeed if new claims continually arise.

Another issue surfaced regarding receiving notices during the moratorium period in the case of *Dishnet Wireless Ltd*¹⁷. The corporate director received numerous re-assessment notices under Section 148 of the IT Act immediately after CIRP proceedings were initiated. The corporate debtor, aggrieved by these notices, sought remedy through a writ petition under Article 226 to the Madras High Court. The revenue argued that proceedings under Section 148 of the IT Act were not included in the “list of moratorium prohibitions” provided by the IBC. The argument was based on the claims under the IT Act that were yet to be crystallized, deeming it unfair to consider them extinguished. Surprisingly, the Madras High Court upheld the Revenue’s arguments, stating that both the IRP and the NCLT were wrong in not considering the department’s claims when approving the resolution plan. The court emphasized that since the Code’s proceedings were initiated a few days before the initiation of proceedings under Section 148 of the Income Tax Act, it was incumbent on the petitioners to ensure proper notice to the Income Tax Department and obtain a concession in CIRP.

(B) Tax Dues Post Approval of the Resolution Plan

¹⁵ Section 31, Insolvency and Bankruptcy Code, 2016.

¹⁶ *Ghanashyam Mishra & Sons Private Limited v. Edelweiss Asset Reconstruction Company Limited* (2021) 9 SCC 657.

¹⁷ *Dishnet Wireless Ltd. v. ACIT* (2022) 446 ITR 227.

Several judicial precedents have contributed to establishing clarity on whether tax proceedings should be entertained after the Adjudicating Authority has approved the resolution plan. Notably, Section 31(1) of the IBC was specifically amended in 2019 to make the resolution plan binding on government authorities. The scope of creditors outlined in section 31(1) of the IBC now includes the central government, state governments, and local authorities holding debts related to payments arising under any law, i.e., statutory dues. This expansion of scope resulted from amendments to Section 7 of the IBC. Despite these amendments, government authorities persist in initiating income tax proceedings or sending demand notices, even after the moratorium period has been declared or the resolution plan has been approved. These scenarios have led to multiple court appearances, with benches striving to establish a concrete legal position.

In this context, the judgment in the *Essar Steel Case*¹⁸ is pertinent, where the court stated that it would be unjust for the resolution applicant to suddenly face undecided claims after plan approval, hindering their ability to run the corporate debtor's business. The Bombay High Court further clarified this issue in the *Murli Industries Ltd. Case*¹⁹, especially concerning the initiation of proceedings when dues have not yet crystallized. In this instance, notices under Section 148 of the IT Act were addressed to the corporate debtor for an assessment year falling before the date of resolution plan approval. The revenue argued that the claimed amount should be kept outside the resolution plan since it had not yet crystallized. The court, however, held that the Revenue must act diligently to verify the previous year's assessment, raising a claim within the prescribed time for the Resolution Plan. The court deemed it appropriate to extinguish such belated claims due to the Revenue's failure to fulfil its due diligence.

A recent judgment by the Customs Excise and Service Tax Appellate Tribunal (CESTAT) in the case of *Ultratech Nathdwara Cement*²⁰ further adds to this discourse. The taxpayer filed an Application before the Tribunal for disposing of an Appeal following the approval of a resolution plan under CIRP. The taxpayer asserted that no such dues existed against them, rendering the demand involved in the order irrecoverable for the department, making the appeal infructuous. The CESTAT held that, according to the resolution plan approved by the NCLT and in light of the Hon'ble Supreme Court's judgment in the case of *Ghanashyam Mishra*²¹, it

¹⁸ *Committee of Creditors of Essar Steel India Limited (through authorized signatory) v. Satish Kumar Gupta and Others* [2020] 8 SCC 531.

¹⁹ *Murli Industries Limited v. Assistant Commissioner of Income Tax & Ors.*, (2022) 324 CTR 355.

²⁰ *Ultratech Nathdwara Cement Ltd. v. C.C. Jamnagar (Prev)* (CESTAT, Ahmedabad Bench Customs Appeal No. 45 of 2012 Judgment dated 20.10.2022).

²¹ *Ghanashyam Mishra & Sons Private Limited v. Edelweiss Asset Reconstruction Company Limited*, (2021) 9 SCC 657.

prima facie appears that the department cannot recover the adjudged dues. However, the CESTAT also emphasized that the department should decide this issue rather than the tribunal. This directive was grounded in two reasons – firstly, the Customs and Central Excise Act lacks provisions to give effect to NCLT proceedings, and secondly, CESTAT, as a creature under the Customs Act, cannot conclusively decide whether the adjudged amount can be recovered by the department. Therefore, the CESTAT urged the Central Board of Indirect Taxes & Customs (CBIC) to consider issuing guidelines/procedures for cases where IBC proceedings have been initiated against the assessee's company.

(C) Tax Dues Recovery through Corporate Debtor's Property

In certain indirect tax cases, tax authorities exercise their rights over the taxpayer's goods and properties in their possession, attempting to recover dues based on such property. A recent judgment in the case of *Sundaresh Bhatt, Liquidator, ABG Shipyard*²², sheds light on this matter. ABG Shipyard had imported goods stored in a Customs Bonded Warehouse and Container Freight Station, availing the benefits of the Export Promotion Capital Goods Scheme (EPCG Scheme). Insolvency resolution proceedings were initiated against ABG, prompting the liquidator to seek the disposal of goods in the customs warehouse. The Customs Department issued notices seeking customs duty for non-fulfilment of EPCG Scheme obligations. ABG approached the NCLT, seeking directions for the goods' disposal, which was granted with the condition that the Customs Department could lodge a claim before the liquidator. Subsequently, the Customs Department issued a notice under Section 72(1) of the Customs Act, demanding customs dues for warehoused goods.

To delve into the legal aspects, Sections 71 and 72 of the Customs Act come into play. Section 71 allows the removal of goods from a warehouse under specific situations, and Section 72 is a recovery provision for warehoused goods. The Customs Department appealed to the National Company Law Appellate Tribunal (NCLAT), which directed the disposal of goods in the customs warehouse according to the Customs Act. The NCLAT reasoned that the goods did not belong to ABG, as it had relinquished title by not filing bills of entry or claiming the goods. ABG appealed to the Supreme Court, raising two primary issues – whether the provisions of IBC prevail over the Customs Act and whether the customs department could claim title and sell goods during the liquidation process. The Supreme Court held that, as per Section 142A of the Customs Act and Section 238 of the IBC, the IBC supersedes the Customs Act during

²² *Sundaresh Bhatt, Liquidator, ABG Shipyard v. Central Board of Indirect Taxes & Customs* 2022 SCC Online SC 1101.

insolvency proceedings. Consequently, customs duty does not carry the first charge on the assets of the assessee. The court emphasized that the customs department could only determine duty, interest, and penalties, enforcing their claim under the determination matrix outlined in Section 53 of the IBC.

Therefore, navigating the intersection of tax liabilities and insolvency proceedings involves complex legal considerations. The evolving landscape, shaped by legislative amendments and judicial pronouncements, seeks to strike a balance between protecting the rights of creditors, ensuring a fair resolution for distressed corporate debtors, and maintaining the integrity of the insolvency process. As cases continue to unfold, further refinements and clarifications in legal frameworks may emerge to address the nuanced challenges posed by tax dues in insolvency scenarios.

V. CONCLUSION AND RECOMMENDATIONS

In navigating the complex interplay of tax liabilities and insolvency proceedings, this essay unravels the multifaceted challenges faced by businesses, tax authorities, and the legal system. The shift in prioritizing government dues under the IBC, challenges post-approval of resolution plans, and recovery through corporate debtor's property exemplify the dynamic legal landscape. As stakeholders grapple with these challenges, there is a critical need for proactive measures from policy makers and practitioners to enhance the efficiency and effectiveness of the insolvency framework.

Recommendations include:

- **Harmonization of Laws-** Policymakers should consider further harmonization of tax laws with the IBC to minimize conflicts and ensure a seamless resolution process. This could involve a comprehensive review of existing tax statutes to align them with the spirit and objectives of the IBC.
- **Clarity in GST Provisions-** The clash between GST and IBC requires specific attention. Policymakers should provide clear guidelines on the treatment of GST dues during insolvency resolution, addressing the challenges faced by companies in settling both past and present tax obligations.
- **Reforms in GST Law-** There is a pressing need for reforms in the GST law to align it with the IBC. Clarity from tax authorities on the tax-neutral status of business transfers under resolution plans and other pertinent issues should be communicated to facilitate a smoother resolution process.

- **Capacity Building-** Practitioners involved in insolvency proceedings, including resolution professionals and legal advisors, should undergo specialized training to navigate the intricate intersection of tax laws and the IBC. Capacity-building initiatives can enhance their ability to address challenges effectively.
- **Adoption of Best Practices-** Policymakers can explore global best practices in insolvency frameworks to enhance the Indian system. Learning from successful models elsewhere can contribute to the continuous improvement of the IBC.
- **Timely Judicial Intervention-** The judiciary plays a crucial role in interpreting and clarifying legal provisions. Timely and well-considered interventions by the judiciary can set important precedents, providing guidance for future cases.

As cases continue to unfold, further refinements and clarifications in legal frameworks may emerge. The collaboration between policymakers, practitioners, and the judiciary is paramount in fostering an environment that promotes economic revitalization, protects stakeholders' interests, and ensures the resilience of the corporate sector.
