



Interplay of the Insolvency and Bankruptcy Code, 2016 with the provisions of the Income Tax Act, 1961

20 November 2023

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The Insolvency and Bankruptcy Code, 2016 (IBC) was enacted on 1 December 2016 to transform the insolvency landscape in India. It was introduced with the objective of providing a speedy mechanism to overhaul the corporate distress resolution regime, and to maximise the value of assets of persons/entities undergoing insolvency resolution.

1 Clean slate principle under the Insolvency and Bankruptcy Code, 2016

Of the concepts underpinning the IBC regime in India, the most critical is arguably the 'clean slate' theory – that is, an applicant taking over an entity undergoing insolvency resolution proceedings should not be saddled with any unexpected claims and should be allowed to commence the business on a 'clean slate'. The clean slate theory is encoded in section 31 of the IBC, in terms of which, an approved resolution plan is binding on all stakeholders, including the corporate debtor and its employees, members, and creditors. The intent of this provision is to ensure that all stakeholders (including government authorities) abide by the terms of the approved plan and refrain from making claims that are not a part of the plan. The preamble of the IBC also states that it seeks to balance the interests of all stakeholders 'including alteration in the order of priority of payment of Government dues'. The clean slate theory has also been propounded by the Indian courts in several decisions including the Supreme Court's decision in the case of *Ghanshyam Mishra & Sons (P.) Ltd.*¹ (*Ghanshyam Mishra*), where the court observed that "...the legislative intent behind this is to freeze all the claims so that the resolution applicant starts on a clean slate and is not flung with any surprise claims...".

The 'clean slate' principle is also recognised internationally. The US bankruptcy laws refer to this concept as a 'fresh start'. Similarly, this concept is also prevalent under the bankruptcy laws of the UK, Poland, and other European nations.

In the domestic context, to ensure that there are no claims on an entity undergoing insolvency resolution proceedings (other than those provided in the resolution plan), several Indian laws (including the income tax law) were amended to provide that in case of a conflict, the provisions of IBC would override and prevail over the other law. Unfortunately, some local value added tax (VAT) laws were not amended on these lines. Due to this, there has been some ambiguity in interpreting the clean slate mechanism provided under the IBC vis-

In a recent development, the Supreme Court dismissed the review petitions filed against its decision in *State Tax Officer v Rainbow Papers Ltd.*, which had disturbed the settled position that in insolvency resolution proceedings, statutory dues (including tax claims) fall in the category of operational debt. Instead, the Supreme Court held that statutory dues qualify as debts owed to a secured creditor, and a resolution plan that ignores such debts is liable to be rejected. The dismissal of the review petitions is likely to have a far-reaching impact on the insolvency law regime in India.

¹ *Ghanshyam Mishra & Sons (P.) Ltd. v Edelweiss Asset Reconstruction Co. Ltd.* [2021] 126 taxmann.com 132 (SC)

à-vis certain state-level VAT laws. This has been compounded by certain court rulings that have been pronounced recently.

2 Judicial decisions interpreting the clean slate principal *vis-à-vis* payment of government dues

To elaborate, as discussed above, the Supreme Court recognised the clean slate principle in Ghanshyam Mishra. It held that government dues would qualify as '*operational debt*' and would stand frozen and extinguished if they do not form part of the approved resolution plan. That is, after the approval of the resolution plan under the IBC, no belated claim can be accepted. The claims as provided under the resolution plan are binding on the corporate debtor and its employees, members, creditors, guarantors, and other stakeholders, including the central government, any state government, or any local authority to whom statutory dues are owed, such as the tax authorities. Consequently, statutory dues, if not part of the resolution plan, shall stand extinguished.

Notably, this principle was also recognised in the case of *Committee of Creditors of Essar Steel India Ltd. v Satish Kumar Gupta*² wherein it was held that once a resolution plan is approved by the committee of creditors, it shall be binding on all stakeholders. This is to ensure that a successful resolution applicant starts running the business on a fresh slate.

3 Contrary view taken by the Supreme Court by treating the government as a secured creditor

Contrary to the above, in a 2022 ruling in the case of *State Tax Officer v Rainbow Papers Ltd.*³ (**Rainbow Papers**), the Supreme Court treated the government as a secured creditor. It further held that if the payment of statutory dues in a proportional manner is ignored in a resolution plan, it is bound to be rejected. The Supreme Court set aside the orders of the National Company Law Appellate Tribunal (**NCLAT**) and National Company Law Tribunal (**NCLT**) wherein it was observed that the government cannot claim first charge over the property or assets of the corporate debtor as the state is not a secured creditor under the IBC, and that section 48 of the Gujarat Value Added Tax Act, 2003 (**GVAT Act**), which provides for tax to be the first charge on the property of the dealer, cannot override section 53 of the IBC, which provides the manner of distribution of proceeds of the sale of assets in cases of liquidation.

Overtaking the rulings of the NCLT and NCLAT, the Supreme Court observed that it was the duty of the resolution professional to examine the books of account of the corporate debtor which would have reflected the liability arising due to statutory demands, and thereafter, to include such liabilities in the information memorandum with a view to provide for these liabilities in the resolution plan. Failing this, the resolution plan cannot be said to be in conformity with the provisions of the IBC and is liable to be rejected. Accordingly, the Supreme Court held that such a resolution plan cannot be considered binding on the government. Further, the Supreme Court observed that as evident from the definitions of '*secured creditor*' and '*security interest*' under the IBC, it is quite clear that the state government is a secured creditor. It further observed that section 48 of the GVAT Act is not contrary to or inconsistent with section 53 or any other provisions of the IBC. Under

² *Committee of Creditors of Essar Steel India Ltd. v Satish Kumar Gupta* (Civil Appeal No. 8766-77 of 2019, SC)

³ *State Tax Officer v Rainbow Papers Ltd.* [2022] 142 taxmann.com 157 (SC)

section 53 of the IBC, the debts owed to a secured creditor, which would include the state under the GVAT Act, are to rank equally with other specified debts.

Therefore, the Rainbow Papers ruling disturbed the settled position emanating from the earlier decision of the Supreme Court in the case of Ghanshyam Mishra.

On 31 October 2023, the Supreme Court dismissed the review petitions filed against its decision in Rainbow Papers. This is an important development since the Rainbow Papers decision diverged from earlier rulings. With this dismissal, the principle laid down in the Rainbow Papers ruling appears to have attained finality. This is likely to have far-reaching consequences for companies undergoing insolvency resolution proceedings under the IBC.

4 Applicability of the Rainbow Papers ruling to income tax matters

At this juncture, it may be worthwhile to briefly discuss section 238 of the IBC. As per this provision, the IBC would override the provisions of any other law for the time being in force that is inconsistent with the provisions of the IBC. This principle has been upheld by the Supreme Court in the case of *Sundaresh Bhatt, Liquidator of ABG Shipyard v Central Board of Indirect Taxes and Customs*⁴ wherein it was held that between two conflicting laws, i.e., the Customs Act, 1962 and the IBC, the provisions of the IBC would prevail. Similarly, in the case of *Duncans Industries Ltd. v A. J. Agrochem*⁵ where the issue under consideration was the interpretation of section 16G of the Tea Act, 1953 (which required the prior consent of the central government for initiating winding up proceedings), the Supreme Court held that the provisions of IBC would override such requirement.

Further to section 238 of the IBC, the Income Tax Act, 1961 (ITA) was amended to ensure a harmonious interpretation of the ITA with the provisions of the IBC. Specifically, section 178(6) of the ITA was amended with effect from 1 November 2016 to provide that section 178 (dealing with a company in liquidation) would override the provisions of any other laws except the IBC. This is different from the situation under the GVAT Act (in the context of which the Rainbow Papers ruling was rendered), wherein no such amendments were made following the enactment of the IBC. Therefore, on a plain and harmonious reading of the ITA and the IBC, it appears that the provisions of the IBC should prevail over that of the ITA. This has been confirmed and upheld in several decisions. Given this, it should be possible to argue against the applicability of the Rainbow Papers ruling to income tax matters.

Unfortunately, there have been instances where the ratio in the Rainbow Papers ruling has seemingly been held to apply to income tax matters as well. In the case of *Assam Company India Ltd.*,⁶ the NCLAT remitted the matter to the NCLT for passing fresh orders after considering the decision of the Supreme Court in Rainbow Papers. In the original order of the NCLT, certain belated claims of the income tax department were rejected on the basis that under the approved resolution plan, a certain amount had already been paid to the tax authorities in discharge of their claims. Further, the plan explicitly mentioned that any claims barring those admitted and forming a part of the approved plan shall stand extinguished. The remanded order of the NCLT is still awaited.

⁴ *Sundaresh Bhatt, Liquidator of ABG Shipyard v. Central Board of Indirect Taxes and Customs* [2022] 141 taxmann.com 471 (SC)

⁵ *Duncans Industries Ltd. v A. J. Agrochem* (Civil Appeal No. 5120 of 2019, SC)

⁶ *Principal Commissioner of Income Tax v. Assam Company India Ltd.* [Company Appeal (AT) (Insolvency) No. 242 of 2022]

5 Developments following Rainbow Papers

The Supreme Court, in a pertinent decision (*Paschimanchal Vidyut Vitran Nigam Ltd. v Raman Ispat Pvt. Ltd. and Ors.*⁷ (**Paschimanchal Vidyut**)) discussing Rainbow papers, albeit not in the context of tax matters, observed that in the Rainbow Papers decision, the waterfall mechanism, providing for hierarchy of claims of various classes of creditors under section 53 of the IBC, was either not brought to the notice of the court or was missed. Therefore, the judgment did not take note of the mechanism that treats the dues of secured creditors at a higher priority than the dues payable to the central or state government. While arriving at this conclusion, the Supreme Court relied on repeated references to lowering the priority of debts owed to the government, in various reports which preceded the enactment of the IBC as well as in the preamble to the IBC. This decision appears to realign the judicial position with the earlier decision in Ghanshyam Mishra. However, since this is not a decision under the tax statute, it is unlikely that the tax authorities would accept this position, particularly given the observations made by the Supreme Court while dismissing the review petitions against the Rainbow Papers decision.

To elaborate, while rejecting the review petitions, the Supreme Court also rejected the observations made in Paschimanchal Vidyut by stating that it is settled law that a co-ordinate bench of the court cannot comment upon the discretion exercised or judgment rendered by another co-ordinate bench of the same strength. Further, it also held that the observation in Paschimanchal Vidyut, that the Rainbow Papers ruling failed to take into consideration the waterfall mechanism contained in section 53 of the IBC, was factually incorrect. The Supreme Court stated that it had taken into account not only section 53 of IBC, but also other provisions of the IBC.

There are a couple of decisions pronounced by the NCLAT wherein a view has been taken in line with Ghanshyam Mishra. For instance, in the case of *Zicom Saas Pvt. Ltd. & Anr.*,⁸ the NCLAT distinguished the decision in Rainbow Papers. In the ruling, the interpretation of section 37 of the Maharashtra Value Added Tax Act, 2002 (**MVAT Act**) was under dispute. The NCLAT observed that section 37 of the MVAT Act specifically uses the expression "*subject to any provision regarding creation of first charge in any central act*" i.e., the waterfall mechanism provided under section 53 of the IBC is to be treated as the law contemplated under section 37 of the MVAT Act. Accordingly, it was held that the state tax department was rightly treated as an operational creditor and was only eligible to the amount allocated to it under the resolution plan. Relying on this decision, the NCLAT in the case of *Shop CJ Network Pvt. Ltd. & Anr.*⁹ again held that the state tax department cannot be treated as a secured creditor. However, these decisions were pronounced prior to the order passed by the Supreme Court dismissing the review petition filed in the case of Rainbow Papers.

In a very recent decision in the case of *Tata Steel Ltd.*,¹⁰ the Delhi High Court held that dues payable to creditors, including statutory creditors, for periods preceding the date of approval of the resolution plan, can only be paid as per the terms contained in the plan. Any dues for which no claim is made before the resolution professional or that are not provided for in the plan would stand extinguished. The Court observed that a successful applicant whose resolution plan has been approved cannot be put in a position where it is called upon to liquidate dues of creditors, including statutory creditors, which were not embedded in the plan. Therefore, the Delhi High Court upheld the '*clean slate*' principle enunciated in the Supreme Court decision in

⁷ *Paschimanchal Vidyut Vitran Nigam Ltd. v. Raman Ispat Pvt. Ltd. and Ors.* (Civil Appeal Nos. 7976 OF 2019, SC)

⁸ *Zicom Saas Pvt. Ltd. & Anr.* [Company Appeal (AT) (Insolvency) No. 246 of 2022]

⁹ *Department of State v Shop CJ Network Pvt. Ltd. & Anr.* [Company Appeal (AT) (Insolvency) No.679 of 2023 & I.A. No.2269 of 2023]

¹⁰ *Tata Steel Ltd. v Deputy Commissioner of Income Tax* [W.P.(C) 13188/2018]

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the case of Ghanshyam Mishra. Interestingly, the ruling does not make any reference at all to Rainbow Papers, even though it was rendered on the same day as the dismissal of the review petitions filed against the Rainbow Papers ruling.

6 Looking ahead

Despite the favourable decisions cited above, the Supreme Court's dismissal of the review petitions in the case of Rainbow Papers may provide some impetus to tax authorities to press their claims for recovery of tax demands against entities undergoing insolvency resolution proceedings. The lack of clarity in this regard is clearly not conducive since it creates uncertainties for the resolution applicant with respect to earlier debt defaults and claims of recovery of such dues. This is also not in line with the legislative intent of the IBC as well as internationally accepted principles. While the dust is yet to settle on this issue, it is quite evident that if the sanctity of the '*clean slate*' principle is not preserved, the entire object and purpose with which the IBC was enacted may be undermined. Given this, it may be worthwhile to introduce legislative changes in the IBC that clearly set out the priority of government dues, the stage at which claims may be brought, and the treatment of belated claims.

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