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**IMPACT OF PRIORITIZING TAX CLAIMS IN CORPORATE INSOLVENCY:
ANALYSING THE RAINBOW JUDGMENT**

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IMPACT OF PRIORITIZING TAX CLAIMS IN CORPORATE INSOLVENCY: ANALYSING THE RAINBOW JUDGMENT

Aditi Dehal* & Shubham Singh Bagla**

[Abstract- *The Supreme Court in the State Tax Officer v. Rainbow Papers Limited (2022) judgment ruled that state governments should be considered secured creditors for tax dues under the Insolvency and Bankruptcy Code, aligning with the ongoing re-evaluation of tax dues treatment by the Department of Revenue and Ministry of Corporate Affairs. This case review examines the facts and decisions in Rainbow, analysing it in light of current discussions and academic deliberations. It delves into the debate over prioritizing tax dues during the resolution process, presenting arguments both for and against such prioritization. Further, it explores the policy considerations, aiming for a balance between long-term economic strategies involving absorbing losses and the importance of tax revenue. Finally, the review engages with the opinions to propose the optimum equilibrium between long-term economic strategies through loss absorption and tax revenue reflections to understand the potential benefits and costs.*]

Keywords: *Insolvency, Rainbow judgment, tax dues, incentives*

I

Introduction

“Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.”¹

~ Adam Smith

The Supreme Court, on September 6th, 2022, in a division bench, pronounced its judgment² in favour of granting priority to the State Government tax claim given under the Insolvency and Bankruptcy Code, 2016 (IBC). The *State Tax Officer v. Rainbow Papers Limited* (referred to as '**Rainbow**') favoured giving precedence to State Government tax claims within the framework of the IBC. The judgment asserted that State Governments should be recognized as 'secured creditors' under Section 53 of the IBC's statutory hierarchy. This decision has sparked

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¹ Dugald Stewart, ACCOUNT OF THE LIFE AND WRITINGS OF ADAM SMITH 322 (1792).

² *Sales tax Officer v. Rainbow Papers Ltd.*, (2022) SCC Online SC 1162 [53]-[57]

discussions regarding the prioritization of government tax claims during insolvency proceedings. This review seeks to analyze the Rainbow judgment rigorously and contribute to the ongoing debate by outlining the underlying policy arguments supporting and opposing the prioritization of tax claims in corporate insolvency. The authors have tried to delve into the question as to why the state has left the setup of distribution of assets completely at the sweet will of the committee of creditors.

The authors have endeavoured to explore why the state has relinquished control over the allocation of assets entirely to the discretion of the committee of creditors. One conceivable explanation for this could be the laissez-faire policy, where the market operates freely for individual gain. During the company's operation, it availed itself of various resources such as space, land, electricity, and law enforcement, among others, and its existence contributed significantly to public welfare. Consequently, now that it has encountered insolvency, the state bears a loss. Hence, a question arises: why not intervene in this process before the company reaches insolvency?

Historical Perspective of Insolvency and Bankruptcy Code, 2016

In India, there was a notable absence of a singular law governing the insolvency and bankruptcy of corporates, firms, and individuals. The regulations pertaining to the closure of companies, including voluntary closure, were encompassed within the broader legislation concerning companies, namely the Companies Act. However, a structured legal framework for addressing financial distress was lacking, aside from debt restructuring schemes orchestrated by banks or financial institutions under the directives of the Reserve Bank of India (RBI). Dues recovery relied on civil suits, entangled with extensive delays due to the substantial backlog in courts, exacerbating the challenge of promptly recouping outstanding amounts.

The Sick Industrial Companies Act of 1985 (SICA) was enacted to rehabilitate identified or potentially ailing companies. While its intention was to tackle industrial deterioration, it proved largely ineffective in promptly resolving viable companies and expediting the liquidation of unviable ones through the Board for Industrial and

Financial Reconstruction. Notably, there was an absence of such mechanisms catering to individuals undergoing financial distress.

The legal infrastructure to expedite the retrieval of debts owed to banks and financial institutions emerged in 1993 through the Recovery of Debts Due to Banks and Financial Institutions Act. Debt Recovery Tribunals were established under this Act to promptly handle cases concerning dues owed to these entities. However, these measures fell short, leading to the introduction of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act in 2002. This act aimed to facilitate the recovery of secured loans by enforcing security interests and managing or selling assets pledged as collateral. It also introduced provisions for resolution through asset reconstruction. Nonetheless, these measures proved ineffective in addressing financially distressed companies that couldn't be salvaged through asset reconstruction or reorganization. Liquidation remained the only recourse to recover asset value to settle claims. For companies, this was executed through the Companies Act, while individuals and firms were subject to insolvency and bankruptcy proceedings under the Presidency Towns Insolvency Act of 1909 and the Provincial Insolvency Act of 1920, respectively. The absence of an effective resolution framework and the prolonged legal process for dues recovery from asset sales affected individuals and firms similarly to companies.

The Asian financial crisis and subsequent global financial turmoil emphasized the necessity for reforms in the insolvency regime. This urgency, compounded by the escalation of non-performing assets in the financial and banking systems, prompted the introduction of comprehensive legislation for insolvency and bankruptcy in India. The Insolvency and Bankruptcy Code of 2016 was enacted to address these issues comprehensively, covering the resolution of insolvency for companies, firms, and individuals, as well as provisions for liquidation and bankruptcy if resolution efforts fail. The Insolvency and Bankruptcy Code superseded SICA and eventually replaced the procedures outlined in the Companies Act for winding up and liquidation. Moreover, it was envisioned that the provisions of the Insolvency and Bankruptcy Code would eventually replace the processes for bankruptcy of individuals and firms governed by the Presidency Towns Insolvency Act of 1909 and the Provincial Insolvency Act of 1920.

Facts and Holding

The recent Rainbow case ruling by the Supreme Court established that the first charge outlined in Section 48 of the Gujarat Value Added Tax Act, 2003, pertaining to tax, interest, or penalty owed to the State Government, qualifies as 'security interest' under Section 3(31) of the IBC.³ Consequently, the State Government is recognized as a 'secured creditor' under the IBC, gaining a higher priority in the statutory hierarchy outlined in Section 53. However, it is noted that 'any amount due' to Central or State Governments still ranks lower than secured creditors in this hierarchy.⁴ This precedent is expected to have significant implications throughout the Indian credit markets.

At the outset, it may be useful to highlight the facts of the decision in a nutshell. The case involved the Gujarat Government seeking INR 47.63 crore from a corporate debtor under the GVAT Act. This claim was considered a contingent liability and waived off under a resolution plan. Subsequently, the State Government contested the approval of the plan, losing in both the National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT). Their primary grounds for appeal were the belated filing of the claim after the Committee of Creditors (CoC) had approved the plan and the argument that the State Government lacked a first charge over the debtor's property under the GVAT Act due to not being a 'secured creditor' under the IBC. This led to an appeal to the Supreme Court.

The State Government relied on Section 48 of the GVAT Act, which grants a statutory first charge to the State Government over a person's property for amounts owed in taxes, interest, or penalties under the statute. Based on this provision, the State Government contended that the tax claim under the GVAT Act fits the definition of 'security interest' under Section 3(31) of the IBC. Therefore, they should be recognized as a 'secured creditor' under Section 3(30) of the IBC and entitled to the priority granted to such creditors under Section 53. As the resolution

³ See, *Sales tax Officer v. Rainbow Papers Ltd.*, (2022) SCC Online SC 1162 [53]-[57]. This position was also recently followed by the NCLAT in *Principal Commissioner of Income Tax, Dibrugarh v. Assam Company India Ltd* (2023) MANU/NL/0108/2023 (NCLAT).

⁴ Insolvency and Bankruptcy Code, S. 53(1)(e)(i).

plan did not treat the State Government as a 'secured creditor,' they argued that the NCLT should have rejected the plan.

The Supreme Court found merit in the argument, affirming that Section 48 of the GVAT Act aligns with Section 53 of the IBC. Therefore, the State Government, recognized as a 'secured creditor' under Section 48 of the GVAT Act, should similarly hold this status within the statutory hierarchy in Section 53 of the IBC. Consequently, the Court stated that if a resolution plan disregards such statutory dues owed to any State Government, the NCLT must reject the plan. Additionally, the Court emphasized that delaying the filing of a claim cannot be the sole reason for dismissing the claim.

The Rainbow ruling emerges amidst ongoing reconsideration of tax dues treatment under the IBC. There are divergent views between the Department of Revenue, contemplating a circular to ensure settling 'agreed tax claims' by new buyers of distressed businesses, and the Ministry of Corporate Affairs proposing equal treatment for debts owed to governments, unless the security interest is established through a specific transaction.⁵ This commentary aims to delve into various critical issues such as the treatment of tax dues held in trust, the government's position as an involuntary creditor and its ability to handle losses versus private creditors, balancing the priority of government tax dues while ensuring their recovery incentives, and considering government priority alongside private financial creditors and their access to the IBC.⁶

Moreover, the article will examine the existing literature on the Rainbow judgment, aiming to contribute to the legal and public policy discourse. These perspectives seek to guide policymakers in shaping the future trajectory of this area of law.

⁵ Anuradha Shukla, *Circular in works on tax recovery from cos under IBC*, THE ECONOMIC TIMES, (December 2022) available at: <https://economictimes.indiatimes.com/news/economy/policy/circular-in-works-on-taxrecovery-from-cos-under-ibc/articleshow/96356944.cms> accessed 18 Nov., 2023.

⁶ Ministry of Corporate Affairs, Government of India, '*Invitation of comments from the public on changes being considered to the Insolvency and Bankruptcy Code, 2016*' (January 2023) available at: <https://ibbi.gov.in/uploads/whatsnew/7f55e29ae9c0023184a3895f849cd2ef.pdf> accessed 18 Nov., 2023.

II

Jurisprudential Critique on the Rainbow Judgment

The Rainbow decision has faced substantial critique, as outlined in current literature. Critics have pointed out key discrepancies with established legal precedents.⁷

Firstly, they note a direct conflict with a prior Supreme Court ruling in *Ghanashyam Mishra and Sons Private Limited v. Edelweiss Asset Reconstruction Company Limited*.⁸ In this particular case, it was held that dues of various government bodies, including tax authorities, fall under the scope of 'operational debt' defined in Section 5(21) of the IBC. This contrasts sharply with the *Rainbow* decision. Moreover, commentators highlight conflicts with other precedents indicating the supremacy of IBC over similar tax statutes. For instance, the decision of the Supreme Court in *Sundaresh Bhatt v. Central Board of Indirect Taxes and Customs*⁹ emphasized the overriding effect of IBC on the Customs Act, despite the Act creating a statutory charge for customs authorities. Likewise, in *PR Commissioner of Income Tax v. Monnet Ispat and Energy Limited*, the Supreme Court established that income tax dues, classified as crown debts, do not supersede secured creditors.¹⁰ Further, the Andhra Pradesh High Court ruling in *Leo Edibles and Fats Limited v. Tax Recovery Officer* clarified that income tax authorities cannot be equated to secured creditors and, therefore, cannot claim priority.¹¹ Critics also cite the subsequent Bombay High Court decision in *Jalgaon Janta Sahakari v. Joint Commissioner of Sales*, which highlighted that even a 'first charge' stipulated by statute can be subject to hierarchical adjustment. The court

⁷ Sikha Bansal and Neha Sinha, 'Supreme Court Holds Tax Authorities to be Secured Creditors: Quandary Revived' INDIA CORPLAW, (September 2022) available at: <[https://indiacorplaw.in/2022/09/supreme-court-holds-taxauthorities-to-be-secured-creditors-quandaryrevived.html#:~:text=Earlier%20this%20week%2C%20in%20State,2003%20\(GVAT\)](https://indiacorplaw.in/2022/09/supreme-court-holds-taxauthorities-to-be-secured-creditors-quandaryrevived.html#:~:text=Earlier%20this%20week%2C%20in%20State,2003%20(GVAT))> accessed 18 Nov., 2023.

⁸ *Ghanashyam Mishra and Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co. Ltd.*, (2021) 9 SCC 657.

⁹ *Sundresh Bhat v. Central Board of Indirect Taxes and Customs*, (2022) SCC Online SC 1101.

¹⁰ *Chitra Sharma and Ors., v. UOI and Ors.*, (2018) SCC Online SC 984.

¹¹ *Leo Edibles and Fats Ltd., v. Tax Recovery Officer and Ors.*, (2018) 4 ALT 700.

emphasized that a crown debt, being unsecured, does not hold precedence over secured debts.¹²

Secondly, it contradicts the suggestions of the Bankruptcy Law Reforms Committee (**BLRC**) which proposed that a law on insolvency should take precedence over other laws in this area.¹³ The BLRC recommended placing the claims of government bodies lower in the hierarchy during liquidation, below both secured and unsecured creditors. This was seen as a way to encourage easier access to credit, foster unsecured financing markets like bonds, and ultimately boost economic growth by reducing capital costs and promoting entrepreneurship, which in turn would increase government revenues.¹⁴ However, the Supreme Court's stance in *Rainbow* appears to directly oppose these recommendations.

Thirdly, critics argue that the *Rainbow* decision goes against the explicit wording of the Insolvency and Bankruptcy Code (IBC). Section 53(1)(b)(ii) of the IBC clearly prioritizes debts owed to secured creditors over dues to government authorities, placing the latter further down in the liquidation hierarchy in Section 53(1)(e)(i). Additionally, according to Section 3(31) of the IBC, a 'security interest' can only be established through a transaction securing payment or performance of an obligation; it cannot arise solely through the operation of law. Therefore, a statutory charge cannot qualify as a 'security interest' under the IBC.

Fourthly, Commentators have noted a conflict between the interpretation of the Insolvency and Bankruptcy Code (IBC) in the *Rainbow* decision and Section 26E of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest

¹² *Janta Sahakari Bank Ltd. v. Jt. CST*, 2022 SCC OnLine Bom 1767 para 82.

¹³ Aparna Ravi, 'Indian Supreme Court's Judgment on Priority of Tax Dues in Insolvency — A Setback for the IBC?' (OXFORD BUSINESS LAW BLOG, 28 October 2022), Available at: <<https://blogs.law.ox.ac.uk/blog-post/2022/10/indiansupreme-courts-judgment-priority-tax-dues-insolvency-setback-ibc>> accessed 15 November 2023; Bansal and Sinha (n 10); Shreya Prakash, 'SC ruling in *Rainbow Papers* has stirred up a hornet's nest' THE HINDU BUSINESSLINE (29 September 2022) <www.thehindubusinessline.com/opinion/sc-ruling-in-rainbow-papers-has-stirred-up-ahornets-nest/article65951579.ece> accessed 15 November 2023.

¹⁴ Bankruptcy Law Reforms Committee, *The Report of the Bankruptcy Law Reforms Committee – Volume 1: Rationale and Design* (4 November 2015), Available at: <https://ibbi.gov.in/BLRCReportVol1_04112015.pdf> accessed 15 November 2023.

Act, 2002 (**SARFAESI Act**).¹⁵ This particular provision, introduced as an amendment in 2016 to align the SARFAESI Act with the newly enacted IBC, explicitly prioritizes 'secured creditors' over various debts and government revenues.¹⁶ Notably, the definition of 'secured creditor' within the SARFAESI Act excludes Central or State Governments. Consequently, despite state laws granting priority to unpaid tax dues, a State Government cannot be deemed a 'secured creditor' under the SARFAESI Act. This contradicts the IBC interpretation in the Rainbow judgment.

Fifthly, commentators have voiced legitimate concerns about the potential repercussions of this decision. For instance, it might prompt homebuyers, potentially covered by statutory charges under laws like the Maharashtra Ownership of Flats Act and the Transfer of Property Act, to argue for recognition as secured creditors. Conversely, it could dissuade potential bidders due to increased risks stemming from pending or potential government demands.

The ongoing discourse in India post-Rainbow decision primarily revolves around interpreting relevant statutes and anticipating the decision's impact. This article aims to contribute by presenting arguments both for and against prioritizing tax claims within corporate insolvency laws, aiming to enrich the ongoing discussion on this matter in India.

Departure from Objectives of IBC on Treatment of Government Dues

The treatment of dues owed to government or statutory authorities as secured creditors was seen as a departure from the objectives of IBC. The Report of the Bankruptcy Law Reforms Committee of November 2015 provides as follows:

“The Committee has recommended to keep the right of the Central and State Government in the distribution waterfall in liquidation at a priority below the unsecured financial creditors in

¹⁵ Soumitra Majumdar and Utkarsh Bandhu, *Rainbow Papers judgment: Clouds loom over IBC*, INDIA BUSINESS LAW JOURNAL, (14 December 2022), Available at: <<https://law.asia/rainbow-papers-judgment-exposed-ibc/>> accessed 15 November 2023.

¹⁶ Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act 2016, S. 18.

addition to all kinds of secured creditors for promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets). In the long run, this would increase the availability of finance, reduce the cost of capital, promote entrepreneurship and lead to faster economic growth. The government also will be the beneficiary of this process as economic growth will increase revenues. Further, efficiency enhancement and consequent greater value capture through the proposed insolvency regime will bring in additional gains to both the economy and the exchequer.”

Further, the Preamble to the IBC provides as follows:

“An Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.”

In January 2023, the Ministry of Corporate Affairs had put up certain proposed changes to IBC for public comments. One of the proposals was to neutralize the disruptive effect of Rainbow Papers by introducing an amendment to provide that all debts owed to government or statutory authorities will be treated at par with other unsecured creditors, irrespective of any statutory provisions creating a first charge, except in cases where a security interest has been created in favour of the government pursuant to a “transaction” between it and the borrower.

Certain judgments dealing with applicability of Rainbow Papers to Government Dues arising under other statutes

Rainbow Papers saw an increase in demands from various statutory authorities to be given the same treatment as “secured creditors” resulting in delays in approval / implementation of resolution plans. Further, the Adjudicating Authorities were also examining whether the resolution plans pending for approval before them were in compliance with Rainbow Papers. The National Company Law Appellate Tribunal in *Department of State Tax v. Ashish Chhawchharia Resolution Professional for Jet Airways (India) Ltd. & Anr.*, (Judgment dated October 21, 2022)

("Jet Airways") was dealing with the issue of whether the Department of State Tax can be treated as a 'secured creditor' for the purposes of IBC pursuant to provisions of Section 82 of Maharashtra GST Act, 2017 which provides as follows:

"Tax to be the first charge on the property. Notwithstanding anything to the contrary contained in any law for the time being in force, save as otherwise provided in the Insolvency and Bankruptcy Code, 2016 (31 of 2016), any amount payable by a taxable person or any other person on account of tax, interest or penalty which he is liable to pay to the Government shall be a first charge on the property of such taxable person or such person."

Placing reliance on *Sundaresh Bhatt, Liquidator of ABG Shipyard vs. Central Board of Indirect Taxes and Customs*, 2022 SCC Online SC 1101¹⁷, the NCLAT held that provisions of Section 82 of the Maharashtra GST Act, 2017, contains an exception with regard to IBC and therefore, on the strength of dues under Maharashtra GST Act, 2017, no charge can be claimed on the assets of the corporate debtor. In our view, the NCLAT correctly held that Rainbow Papers will not be applicable to dues under the Maharashtra GST Act, 2017 in view of the specific exclusion of IBC under Section 82. Going by the same analogy, the reasoning of Rainbow Papers will not be applicable to other statutes which contain a specific exclusion of IBC in their charging provision such as the Customs Act. On July 17, 2023, the Supreme Court in *Paschim Anchal Vidyut Vitran Nigam Limited vs. Raman Ispat Private Limited and Others* 2023 SCC OnLine SC 842 ("**Raman Ispat**")¹⁸, while dealing with the interplay between the Electricity Act, 2003 and the IBC, held that Section 238 of the IBC overrides the provisions of the Electricity Act, 2003 despite the latter containing two specific provisions which open with non-obstante clauses (i.e., Section 173 and 174). While dealing with the issue at hand, the Supreme Court held that:

- i. Rainbow Papers did not notice the 'waterfall mechanism' under Section 53 – the provision had not been adverted to or extracted in the judgment;

¹⁷ *Sundaresh Bhatt, Liquidator of ABG Shipyard v. Central Board of Indirect Taxes and Customs*, 2022 SCC Online SC 1101.

¹⁸ *Paschim Anchal Vidyut Vitran Nigam Limited v. Raman Ispat Private Limited and Others* 2023 SCC OnLine SC 842.

- ii. Whilst the GVAT Act creates first charge in favour of the State, the separate and distinct treatment of amounts payable to secured creditor on the one hand, and dues payable to the government on the other under the waterfall mechanism in Section 53 clearly signifies Parliament's intention to treat the latter differently - and in the present case, having lower priority. This is also evident from the Preamble to the IBC; and
- iii. Rainbow Papers has to be confined to the facts of that case alone. It was felt that *Raman Ispat* will provide the necessary course correction and ensure that the object of IBC to accord lower priority to government and statutory dues

III

Prioritising Tax Claims: Understanding The Trade Offs

Granting priority to government's tax dues in corporate insolvency has been widely debated in other common law jurisdictions such as the United Kingdom, Canada, Australia, and the United States of America. This Section highlights the main policy arguments in favour of as well as against granting such priority to government dues. Accordingly, it seeks to highlight the trade-offs involved in the policy choices in this regard.

Giving Priority to Government Tax Claims –Arguments in Favour is the Tax Dues held in Trust

Tax claims in insolvency could be classified into two types – taxes collected directly by the state and agent-collected taxes on behalf of the state. In the case of agent-collected taxes, the corporate debtor is essentially a tax collector rather than a taxpayer. For instance, in case of Value Added Tax ('VAT'), the seller company charges VAT to the buyer, and subsequently pays this VAT to the state. Now, consider a scenario where such a seller company (corporate debtor) itself becomes insolvent. In such cases, unless some measure of priority is accorded to the state for moneys collected on its behalf by the insolvent corporate debtor, it would result in an unfair wealth transfer from the state to the

general body of creditors of the corporate debtor.¹⁹ Therefore, there is a clear policy rationale for giving priority under insolvency law to agent-collected taxes held in trust by the corporate debtor on behalf of the state. However, such priority should be limited to tax dues for a reasonable period that a diligent tax collector would need to collect such money from the corporate debtor.²⁰

An example of this approach is seen in the United Kingdom's actions since March 2020, where certain debts owed to Her Majesty's Revenue and Customs (HMRC) were granted the status of a secondary preferential creditor in insolvency proceedings. These tax dues, including VAT, PAYE income tax, Employee National Insurance Contributions, construction industry scheme deductions, and student loan repayments, were given priority in the order of repayment, falling behind fixed charge holders and certain preferential debts like employee claims but ahead of floating charge holders and unsecured creditors.²¹

Even the IBC implicitly recognises this principle. Assets held by the corporate debtor in 'trust' for a third party are not included in the liquidation estate and cannot be used for recovery in liquidation.²² The same also stands true in cases of corporate insolvency under the IBC.²³ This principle is further supported by the current Indian tax jurisprudence. For instance, in *Commissioner of Income Tax v. Khushi Ram Bhagwan Das* ('**Bhagwan Das**'),²⁴ the Punjab and Haryana High Court clarified that sales tax receipts are deductible while calculating income tax. In other words, since sales tax is collected by the assessee on behalf of the State, the same cannot be treated as income of the assessee. Following the same logic, it could be reasonably argued that taxes collected by the corporate debtor on behalf of the government are held by it in 'trust' for the government. Therefore, policymakers may consider keeping such tax dues outside the general creditors' pool

¹⁹ Kenneth Cork, *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) ('**Cork Report**').

²⁰ Richard Tarling, 'The Crown Preferred' (2019) 40 *Comp Law* 283, 286.

²¹ Ashurst, '*The Return of Crown Preference – a backwards step*' (ASHHURST INSIGHTS, 30 November 2020), available at: <www.ashurst.com/en/news-and-insights/insights/the-return-of-crown-preference---a-backwards-step/> accessed 15 November 2023.

²² Insolvency and Bankruptcy Code 2016, S. 36(4)(a).

²³ Insolvency and Bankruptcy Code 2016, explanation to S. 18.

²⁴ *Commissioner of Income Tax v. Khushi Ram Bhagwan Das*, (2004) SCC Online P&H 1277.

during resolution or give such tax dues priority over private creditor dues in the insolvency waterfall.

Giving Priority to Government Tax Claims – Arguments Against

a) Government's Incentive to Recover

Granting the tax dues of the government a higher priority in insolvency proceedings could lead to a moral hazard. Such precedence might reduce the government's incentive to diligently pursue timely recovery from the insolvent corporate debtor. This situation would be ironic considering the government possesses unique powers like entry, search, and seizure, not available to ordinary creditors.²⁵

Unlike private creditors who often seek security or priority payment before a transaction, taxes are levied after the taxable event, leading to a delay in determining the tax amount. Tax authorities, therefore, operate after the occurrence of the event, lacking the ability to demand security or priority akin to private creditors.

Overall, it suggests that the government's unpaid tax dues might warrant higher priority only if they haven't been collected within a reasonable period before the insolvency application date. Essentially, this implies granting higher priority solely to tax liabilities arising within a specified timeframe before the insolvency application date.

b) Incentive of the Financial Creditor to use the IBC

Giving the government's tax dues a higher priority under the IBC could impact how financial creditors approach taking a corporate debtor through the IBC process. If the tax dues owed to the government are higher than or significantly cover the value of resolving the corporate debtor, financial creditors might lose motivation to use the IBC for such cases. Instead, they might find it more advantageous to enforce their securities outside the IBC or utilize alternative restructuring methods under the Reserve Bank of India. In the worst-case scenario, they might just consider these loans as losses. This could, on a larger scale, raise the overall cost of borrowing money. It is crucial for policy-makers to weigh these consequences when making decisions regarding this matter.

²⁵ See Customs Act 1962, ch XIII and Income Tax Act 1961, S. 132.

Giving Priority to Government Tax Claims – Finding a Balance

The size of the income of the government plays a role in deciding its eligibility for priority treatment. In cases of non-payment, a financially strong government is likely to withstand the impact better than a private creditor. A robust government can spread revenue losses among many taxpayers, minimizing its impact. Conversely, a similar loss could significantly affect a private creditor, potentially leading to further insolvencies.

The ability of the government to absorb losses could justify giving lower priority to its tax dues in insolvency cases. However, some argue that this capacity isn't the main issue. The fundamental question is whether private creditors' debts should be paid before tax debts owed to the community.²⁶ Prioritizing private debts could limit government funds for development projects but might foster unsecured financing and benefit the corporate bond market, generating positive effects. Policymakers need to weigh the potential advantages and drawbacks of prioritizing private debt or government tax dues, considering the broader philosophical question at hand.²⁷

Review of Rainbow Papers

Five review applications were filed against Rainbow Papers which were allowed by the Supreme Court for hearing on November 13, 2022. On October 31, 2023, the Supreme Court in *Sanjay Kumar Agarwal v. State Tax Officer (1) & Anr.*, [Review Petition (Civil) No. 1620 of 2023 in Civil Appeal No. 1661 of 2020]²⁸ ("*Rainbow Papers Review judgment*") dismissed the various review petitions (and connected intervention / impleadment applications).

Impact of the Dismissal of the Review Petitions

The dismissal of the review petitions in relation to the Rainbow Papers will mean that the decision of the Rainbow Papers will continue to be applicable in CIRP cases. However, in our view, the analysis of Rainbow Papers will be applicable only in such cases where the statutory

²⁶ See BLRC Report (n 12), para 4.3.2.

²⁷ See Cork Report (n 15), para 1410.

²⁸ *Sanjay Kumar Agarwal v. State Tax Officer (1) & Anr.*, [Review Petition (Civil) No. 1620 of 2023 in Civil Appeal No. 1661 of 2020].

provision creating first charge in favour of the relevant government or statutory authority is pari materia with the provision of Section 48 of the GVAT Act. Rainbow Papers does not support the argument that all government dues will be secured dues under all circumstances. Basis the Supreme Court's view in Rainbow Papers, the classification of government dues will have to be undertaken in a two-pronged manner as follows:

STEP 1: examination of the provisions of the governing legislations (both Central and State) to ascertain whether or not a charge is created in favour of the relevant government and statutory authority in respect of their claim.

STEP 2: whether or not the provisions of such governing legislation are expressly made subject to IBC or have a provision pursuant to which IBC is given primacy.

If the concerned governing legislation creates a charge and is not subject to IBC (as was the case in the relevant statute which was subject matter in Jet Airways), then such statutory authority will have to be classified as a "secured creditor" for the purposes of Section 53 and accordingly, will be eligible for distribution in terms of Section 53(1)(b) (ii) of the IBC.

Going by the aforesaid, it may be noted that the dues owed to Customs authorities (by virtue of Section 142A of The Customs Act, 1962, as amended) as well as to the GST authorities (by virtue of Section 82 of Central Goods and Services Act, 2017, as amended) will not have first charge as the respective provisions have been specifically made subject to IBC. It may also be noted that the Income Tax Act, 1961, as amended, does not have a provision for creation of first charge. This has been upheld by the NCLAT in the Jet Airways case. Further, this also finds support from the decision of a 3-Judge Bench of the Supreme Court in *Lalu Prasad Yadav & Others v. State of Bihar & Others* (2010) 5 SCC 1.²⁹ Section 30(2)(b) provides that one of the mandatory contents of a resolution plan is that it must provide for the payments of debts of operational creditors which shall not be less than: (i) the amount to be paid to such operational creditors in the event of a liquidation of the corporate debtor under Section 53; or (ii) the amount that would have

²⁹ *Lalu Prasad Yadav & Others v. State of Bihar & Others*, (2010) 5 SCC.

been paid to such operational creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of Section 53, whichever is higher. Accordingly, the assessment whether a government or statutory authority is a 'secured creditor' within the meaning of IBC will have to be made while deciding on matters of distribution of proceeds to operational creditors. Rainbow Papers itself provides that a resolution plan must provide for uniform proportionate reduction of claims of all secured creditors. Therefore, the secured operational creditors will not have any priority over such secured financial creditors who have a first charge on the relevant assets or vice versa. All secured creditors (both financial and operational) will have to be paid as per the provisions of Section 53(1)(b) of IBC. Accordingly, in case of resolution plans, the secured operational creditors must have at least the same percentage recovery as the similarly placed financial creditors having first ranking pari passu charge over the assets of a corporate debtor. to be made while deciding on matters of distribution of proceeds to operational creditors. Rainbow Papers itself provides that a resolution plan must provide for uniform proportionate reduction of claims of all secured creditors. Therefore, the secured operational creditors will not have any priority over such secured financial creditors who have a first charge on the relevant assets or vice versa. All secured creditors (both financial and operational) will have to be paid as per the provisions of Section 53(1)(b) of IBC. Accordingly, in case of resolution plans, the secured operational creditors must have at least the same percentage recovery as the similarly placed financial creditors having first ranking pari passu charge over the assets of a corporate debtor.

Who Should Get the Priority: A Model for Deciding the Hierarchy

The authors have aimed to develop a model for determining priority in cases of company insolvency, deviating from the perspective outlined in the judgment. Their proposition involves a capital contribution test, wherein those who have invested in the company's capital hold primary entitlements, while those benefitting from the company's profits hold secondary entitlements. This approach remains devoid of emotional bias, focusing solely on the redistribution of limited assets among those who contributed to their creation. The company itself is not the

originator of these assets but rather an entity that augmented assets provided by promoters, contributors, and debtors extending credit to the company.

According to our understanding, the state's involvement should be limited. Drawing parallels from tax law, where after a certain period (e.g., 8 years), reassessment is not permissible, the state's claim becomes invalid. This mirrors the scenario in insolvency proceedings – if taxes were indeed owed, they should have been claimed when the company was solvent, not during insolvency. Similarly, the Limitation Act of 1963 stipulates a timeframe of 12 years for possession suits related to immovable property or title-based interests. However, the government holds a 30-year limitation period as per Article 112. The crux lies in the notion of prioritizing welfare, where creditors, taking the most substantial risks by contributing capital during the company's conceptual stage, should be positioned atop the hierarchy.

The Supreme Court's assertion of the state adhering to the agency or trusteeship theory prompts an argument asserting tax as a sovereign power, inherently non-delegable by the state. As a sovereign entity, the state cannot assign this power to another, implying that once delegated, the state forfeits the right to collect taxes subsequently. In the context of tax insolvency, akin to the demise of a company, the question arises: how can tax be collected at this juncture? This judgment, as per its interpretation, seems to overlook the fundamental essence of insolvency, aimed at safeguarding the interests of creditors positioned at the apex of the hierarchy. This prioritization allows them the freedom to extend credit in the future, particularly considering the state's limited credit facility initially delegated to market players. Consequently, the state cannot now emerge portraying itself as a shareholder, for in company law, preferred shareholders hold precedence in claiming income, receiving dividends prior to common shareholders. In a corporate setting, the government is treated equivalently; thus, the hierarchy proposed by the Insolvency and Bankruptcy Code (IBC) appears justifiable, viewing the government not as sovereign but as an individual. Imagine, a state is itself responsible for the collapse of a firm due its own policies, then how come a wrongdoer be superseded to claim of the bonafide?

The legal precedent set by the case of *State of Rajasthan v. Vidyawati*³⁰ highlights the state's equal liability alongside other entities for its employees' actions. The notion of sovereign immunity, often epitomized by the adage 'King can do no Wrong,' no longer holds sway. Acts such as the Crown Proceedings Act have curtailed this unfettered immunity in Common Law countries. Furthermore, our constitution envisages a Republican form of Government, aiming to establish a Socialistic State involved in diverse industrial and other activities, employing a considerable workforce. Hence, there is no inherent justification, either in principle or in the public interest, for absolving the State from vicarious liability for its servants' tortious acts. In a similar vein, the IBC operates in a non-sovereign capacity, prioritizing preferences based on economic reasons rather than inherent sovereignty.

Under English common law, government dues (denoted as crown debts) prevail over the dues/rights of an ordinary citizen. The principle evolved in England was that whenever the right of the Crown and the right of a subject with respect to payment of a debt of equal degree come into competition, the Crown's right prevails. *However, the precedence enjoyed by the Crown is only with respect to unsecured creditors. Secured debts stand on an entirely different footing and are not 'equal in degree' with government dues.*

IV

Conclusion

On a plain reading, it appears that Rainbow Papers is at odds with one of the stated legislative intents behind IBC viz. to accord a lower priority to Government dues as against dues owed to secured lenders/banks/financial institutions. The said intent is manifest not only in the Preamble to the IBC but also from other provisions of the IBC and the regulations framed thereunder. The various reports of expert committees including the Bankruptcy Law Reforms Committee and the Insolvency Law Committee also bear out the same. It is appropriate that the law laid down in Rainbow Papers is re-considered by a larger bench of the Supreme Court, if a suitable corrective amendment does not come

³⁰ *State of Rajasthan v. Vidyawati*, Supp. 2 SCR 989.

through swiftly. In any event, as discussed above, the decision in Rainbow Papers has limited application and it is incorrect to rely upon Rainbow Papers to contend that all government dues are secured dues. Rainbow Papers does not lay down that all government departments/authorities will automatically have status of 'secured creditor' for the purpose of IBC. The said position depends on the language and intent of the underlying legislation which regulates the relevant government dues. The Rainbow decision has evoked much criticism from various quarters. Despite the inherent weakness in the legal arguments underlying the decision, it comes at a time when there appears to be a larger policy rethink on the treatment of tax dues under the IBC. This article adds to the ongoing discourse on this topic in India. It highlights the underlying policy arguments for and against prioritising tax claims in corporate insolvency. It argues that agent-collected taxes on behalf of the government may legitimately require priority over private creditor dues. However, any priority given to unpaid tax dues must be limited only to dues not recovered within a reasonable period before the date of admission of the insolvency application. Tax liabilities that arose before such a period should ideally not be given priority over private creditor dues. Overall, any deeper rethink on prioritising the government's tax dues must engage with the underlying policy arguments highlighted in this article. Therefore, In light of this, it is advisable that the Supreme Court revisits the instant judgment and clarifies law on this point. It is very evident that if the current position in law is allowed to perpetrate then it will act as a detriment to the purpose which the Code is intended to serve. As an aftermath, any prospective resolution applicant is likely to be discouraged with the additional obligation of meeting present or potential government and legislative dues. It may ultimately result in fewer resolution applications, lower values of the assets, and more haircuts for creditors.