

**CASE COMMENT – PRIORITISING TAX CLAIMS IN CORPORATE INSOLVENCY: BOON OR
BANE?**

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Abstract: *In September 2022, the Supreme Court in State Tax Officer v. Rainbow Papers Limited interpreted the Insolvency and Bankruptcy Code, 2016 to treat the State Government as a secured creditor for the tax dues claimed. This decision coincides with the ongoing broader policy reassessment on the treatment of tax dues under the Code by the Department of Revenue and the Ministry of Corporate Affairs. In this case comment, we discuss the facts and holding of Rainbow and critically examine the case through the current observations and post-Rainbow scholarly discourses. Further, the comment inquires into the question of the prioritisation of tax dues in the resolution process by laying out the arguments in favour and those against. Finally, the comment engages with the policy arguments to propose for the optimal balance between long-term economic strategies through loss absorption and tax revenue considerations to understand the potential costs and benefits.*

I. INTRODUCTION

A. Background

By a judgment dated 6th September 2022, a two-judge bench of the Supreme Court of India in *State Tax Officer v. Rainbow Papers Limited* (**‘Rainbow’**) delivered its verdict in favour of granting priority to State Government’s tax claims in the statutory waterfall mechanism given under the Insolvency and Bankruptcy Code, 2016 (**‘IBC’**). It was held that the State Government ought to be treated as a ‘secured creditor’ under the statutory waterfall in Section 53 of the IBC. This has stirred discussion pertaining to the priority of government tax claims in the insolvency sphere. This article aims to critically analyse the *Rainbow* judgment, review the existing literature analysing the judgment and contribute to the ongoing discourse on this issue by highlighting the underlying policy arguments for and against prioritising tax claims in corporate insolvency.

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B. Facts and Holding

The Supreme Court in *Rainbow* recently held that the statutory first charge created under Section 48 of the Gujarat Value Added Tax Act, 2003 (**‘the GVAT Act’**), with respect to the amount payable to the State Government on account of tax, interest, or penalty, would qualify as ‘security interest’ under Section 3(31) of the IBC.¹ Consequently, such a State Government would be a ‘secured creditor’ for the purposes of the IBC and accordingly enjoy a higher rank in the statutory waterfall under Section 53, although ‘any amount due’ to Central or State Governments clearly ranks lower than secured creditors in the statutory waterfall.² This precedent is likely to have ripple effects across the Indian credit markets.

At the outset, it may be useful to highlight the facts of the decision in a nutshell. The Gujarat Government had claimed INR 47.63 crore as due and payable from the corporate debtor under the GVAT Act. Their entire claim was treated as contingent liability and waived off under the resolution plan. Consequently, the State Government challenged the resolution plan. They lost before the National Company Law Tribunal (**‘NCLT’**) as well as the National Company Law Appellate Tribunal (**‘NCLAT’**) primarily on two grounds: *firstly*, the State Government had filed its claim at a belated stage after the plan had been approved by the Committee of Creditors (**‘CoC’**); *secondly*, the State Government could not claim first charge over the property of the corporate debtor under the GVAT Act since it was not a ‘secured creditor’ under the IBC. Consequently, the State Government appealed to the Supreme Court.

The State Government relied on Section 48 of the GVAT Act. This Section provides statutory first charge to the State Government on the property of any person in respect of any amount payable by such person on account of tax, interest, penalty etc. under the said statute. In view of this provision, the State Government argued that the tax claim under GVAT Act falls within the definition of ‘security interest’ under Section 3(31) of the IBC. Therefore, the State Government should be treated as a ‘secured creditor’ under Section 3(30) of the IBC and must enjoy priority accorded to any ‘secured creditor’ under Section 53 of the IBC. Since the resolution plan did not treat the State Government as a ‘secured creditor’, the State Government argued that the resolution plan ought to have been rejected by the NCLT.

¹ (2022) SCC Online SC 1162 [53]-[57] (Supreme Court). 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).

² IBC, s 53(1)(e)(i).

This argument resonated with the Supreme Court. The court held that there is no inconsistency between Section 48 of the GVAT Act and Section 53 of the IBC.³ The State Government being a ‘secured creditor’ by operation of law vide Section 48 of GVAT Act,⁴ should be treated as a ‘secured creditor’ under the statutory waterfall in Section 53 of the IBC, too.⁵ The Court concluded that if a resolution plan ignores such statutory demand payable to any State Government, the NCLT is bound to reject the resolution plan.⁶ It also held that delay in filing a claim cannot be the sole ground for rejecting the claim.⁷

The *Rainbow* decision comes at a time when there appears to be a larger policy rethink on the treatment of tax dues under the IBC. On one hand, the Department of Revenue is apparently mulling a circular that may require new buyers of distressed businesses through IBC resolution to settle ‘agreed tax claims’ once a resolution plan is approved.⁸ On the other hand, the Ministry of Corporate Affairs has, *inter alia*, suggested that all debts owed to the Central Government and the State Government, irrespective of whether they are secured creditors, pursuant to a security interest created by a mere operation of statute, shall be treated equally with other unsecured creditors. Further, it will be clarified that only where the security interest is created pursuant to a transaction of the Central Government or a State Government with a Corporate Debtor, the Government in question will continue to be treated as a secured creditor in the order of priority.⁹

In this context, this case comment tries to encapsulate issues such as the question of tax dues held in trust, consideration of stresses on the government due to its role as an involuntary creditor, the ability of the government to absorb losses as opposed to private creditors, balancing the higher priority given to government tax dues whilst retaining their incentive to recover, highlighting the need to consider higher priority of government in light of private financial creditors and their recourse to the IBC. In this light, this comment will review the existing literature analysing the *Rainbow* judgment and seek to contribute to the existing

³ *Rainbow* (n 1) [56].

⁴ *ibid* [57].

⁵ *ibid* [56].

⁶ *ibid* [52].

⁷ *ibid* [58].

⁸ Anuradha Shukla, ‘Circular in works on tax recovery from cos under IBC’ *The Economic Times* (Gurugram, 20 December 2022) <<https://economictimes.indiatimes.com/news/economy/policy/circular-in-works-on-tax-recovery-from-cos-under-ibc/articleshow/96356944.cms>> accessed 20 December 2022.

⁹ Ministry of Corporate Affairs, Government of India, ‘Invitation of comments from the public on changes being considered to the Insolvency and Bankruptcy Code, 2016’ (18 January 2023) <<https://ibbi.gov.in/uploads/whatsnew/7f55e29ae9c0023184a3895f849cd2ef.pdf>> accessed 11 May 2023.

literature from a legal as well as public policy perspective. These perspectives would aid policymakers to consider the way forward in this area of law.

II. LITERATURE REVIEW

The decision in *Rainbow* has evoked much criticism. This Section reviews the current literature on this issue.

First, several commentators have highlighted that this decision is not in conformity with existing precedents.¹⁰ For instance, it has been pointed out that this decision directly conflicts with an earlier ruling by a three judge bench of the Supreme Court in *Ghanashyam Mishra and Sons Private Limited v. Edelweiss Asset Reconstruction Company Limited*.¹¹ In that case, it was held that dues of Central Government, any State Government, or local authority including tax authorities would come under the ambit of ‘operational debt’ as defined under Section 5(21) of the IBC.¹² Additionally, it has been pointed out that the *Rainbow* decision conflicts with several other precedents which have held that IBC overrides other similar tax statutes.¹³ For instance, the Supreme Court in *Sundaresh Bhatt v. Central Board of Indirect Taxes and Customs* had held that the IBC has an overriding effect on the Customs Act (which, too, creates a statutory charge in favour of the customs authorities).¹⁴ Similarly, in *PR Commissioner of Income Tax v. Monnet Ispat and Energy Limited*, the Supreme Court had held that income tax dues, being in the nature of crown debts, do not take precedence even over secured creditors.¹⁵ Lastly, in *Leo Edibles and Fats Limited v. the Tax Recovery Officer*, the Andhra Pradesh High Court had held that income tax authorities cannot be equated to secured creditors, and thus cannot claim priority.¹⁶ Commentators have also cited the subsequent Bombay High Court decision in *Jalgaon Janta Sahakari v. Joint Commissioner of Sales* which held that there is no

¹⁰ Sikha Bansal and Neha Sinha, ‘Supreme Court Holds Tax Authorities to be Secured Creditors: Quandary Revived’ (*IndiaCorpLaw*, 9 September 2022) <[https://indiacorplaw.in/2022/09/supreme-court-holds-tax-authorities-to-be-secured-creditors-quandary-revived.html#:~:text=Earlier%20this%20week%2C%20in%20State,2003%20\('GVAT'\)](https://indiacorplaw.in/2022/09/supreme-court-holds-tax-authorities-to-be-secured-creditors-quandary-revived.html#:~:text=Earlier%20this%20week%2C%20in%20State,2003%20('GVAT')>)> accessed 1 November 2022.

¹¹ (2021) 9 SCC 657 (Supreme Court); Amar Gupta, ‘In a Nutshell Series: Rainbow Papers Judgment — A Step Backwards in Insolvency’ (*Lexology*, 20 September 2022) <www.lexology.com/library/detail.aspx?g=6b67b89b-2058-4a40-9c0f-0e72dbcad7fc> accessed 1 November 2022; Dikshat Mehra and Honey Chandnani, ‘Are Government Dues prioritised over Banks? A New Horizon To IBC’ (*Bar and Bench*, 10 October 2022) <www.barandbench.com/view-point/are-government-dues-prioritised-over-banks-a-new-horizon-to> accessed 1 November 2022.

¹² (2021) 9 SCC 657 [91] (Supreme Court).

¹³ Bansal and Sinha (n 10).

¹⁴ (2022) SCC Online SC 1101 (Supreme Court).

¹⁵ (2018) SCC Online SC 984 (Supreme Court).

¹⁶ (2018) 4 ALT 700 (Andhra Pradesh High Court).

magic in the words ‘first charge’.¹⁷ Even a ‘first charge’, by express statutory intent, can be made subordinate or subservient to a paramount charge.¹⁸ Further, the Court had categorically observed that a crown debt, being an unsecured debt, enjoys no priority over secured debt.¹⁹

Second, commentators have also contended that the decision in *Rainbow* militates against the spirit of the recommendations made by the Bankruptcy Law Reforms Committee (‘BLRC’).²⁰ The BLRC recommended that a parliamentary law on insolvency and bankruptcy could override other laws on the subject matter. It recommended that the rights of the Central and State Government in the distribution waterfall in liquidation be kept at a priority below the unsecured financial creditors in addition to all kinds of secured creditors. This would help promote the availability of credit and develop a market for unsecured financing including the bond markets. It was also observed by the BLRC that, in the long run, this subordination of government dues would increase the availability of finance, reduce the cost of capital, promote entrepreneurship and lead to faster economic growth, leading to increased government revenues.²¹ The Supreme Court’s reasoning in *Rainbow* is clearly at odds with these categorical observations in the BLRC report.

Third, commentators have also argued that the *Rainbow* decision goes against the plain text of the IBC. For instance, Section 53(1)(b)(ii) explicitly accords a higher priority to debts owed to a secured creditor relative to the dues owed to government authorities, which are dealt with further down in the liquidation waterfall in Section 53(1)(e)(i).²² Similarly, ‘security interest’ as defined under Section 3(31) could be created in favour of a secured creditor only by way of a ‘transaction’ which secures payment or performance of an obligation. Evidently, such ‘security interest’ cannot be created by the operation of law. Therefore, a statutory charge clearly cannot qualify as a ‘security interest’ for the purposes of the IBC.²³

¹⁷ Bansal and Sinha (n 10).

¹⁸ (2022) SCC Online Bom 1767 [82] (Bombay High Court).

¹⁹ *ibid* [86].

²⁰ 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) <<https://blogs.law.ox.ac.uk/blog-post/2022/10/indian-supreme-courts-judgment-priority-tax-dues-insolvency-setback-ibc>> accessed 1 November 2022; 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-a-hornets-nest/article65951579.ece> accessed 1 November 2022.

²¹ Bankruptcy Law Reforms Committee, *The Report of the Bankruptcy Law Reforms Committee – Volume 1: Rationale and Design* (4 November 2015) <https://ibbi.gov.in/BLRCReportVol1_04112015.pdf> accessed 11 May 2023.

²² Ravi (n 20).

²³ Bansal and Sinha (n 10); Prakash (n 20); Ravi (n 20).

Fourth, commentators have also highlighted that the legal interpretation of the IBC under the *Rainbow* decision does not square with Section 26E of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('SARFAESI Act').²⁴ This provision was inserted by way of amendment in 2016 to harmonise the SARFAESI Act with the newly enacted IBC.²⁵ This provision explicitly overrides all other statutes to provide 'secured creditors' priority over all other debts and all revenues, taxes, cesses and other rates payable to the Central Government or State Government or local authority. It has been correctly highlighted that the definition of 'secured creditor' under Section 2(1)(zd) of the SARFAESI Act does not include Central or State Governments.²⁶ Therefore, a State Government cannot be considered to be a 'secured creditor' under the SARFAESI Act even if its unpaid tax dues enjoy first charge under a state law. This explicit position under SARFAESI Act is clearly at odds with the interpretation of IBC in the *Rainbow* judgment.

Fifth, commentators have expressed valid concerns regarding the potential implications of this decision. For instance, it may prompt homebuyers — who may also enjoy statutory charge under laws like respective state real estate authorities acts, e.g., Maharashtra Ownership of Flats (Regulation of the Promotion of Construction, Sale, Management, and Transfer) Act, 1963 and the Transfer of Property Act, 1882— to argue that they should be considered as secured creditors.²⁷ On the other hand, it may deter potential bidders due to additional risks and uncertainty on account of pending or potential statutory and government demands.²⁸

It is evident from the above literature review that the ongoing discourse in India in the wake of the *Rainbow* decision has largely been focused on the legal interpretation of the relevant statutory provisions and the decision's potential implications. This article adds to this literature. It provides policy arguments for and against granting priority to tax claims under corporate insolvency laws with a view to enriching the ongoing discourse on this subject in India.

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

²⁴ Soumitra Majumdar and Utkarsh Bandhu, 'Rainbow Papers judgment: Clouds loom over IBC' (*India Business Law Journal*, 14 December 2022) <<https://law.asia/rainbow-papers-judgment-exposed-ibc/>> accessed 15 December 2022.

²⁵ Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act 2016, s. 18.

²⁶ Majumdar and Bandhu (n 24).

²⁷ Mehra and Chandnani (n 11).

²⁸ Gupta (n 11).

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.

A. Giving Priority to Government Tax Claims – Arguments in Favour

1. 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.²⁹ 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.³⁰

It would be pertinent to note here that from March, 2020, the United Kingdom has given the status of a secondary preferential creditor for certain debts due to Her Majesty's Revenue and Customs ('HMRC'). This means that certain tax dues collected by a company on behalf of another business were given secondary preferential status in the insolvency waterfall — ranking behind fixed charge holders' claims and ordinary preferential debts (e.g., preferential employee claims) but ahead of floating charge holders' claims and unsecured creditors.³¹ The tax dues which were given such priority were VAT, PAYE income tax, Employee National Insurance Contributions, construction industry scheme deductions, and student loan repayments.³²

²⁹ Kenneth Cork *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) ('**Cork Report**').

³⁰ Richard Tarling, 'The Crown Preferred' (2019) 40 *Comp Law* 283, 286.

³¹ Ashurst, 'The Return of Crown Preference – a backwards step' (*Ashurst Insights*, 30 November 2020) <www.ashurst.com/en/news-and-insights/insights/the-return-of-crown-preference---a-backwards-step/> accessed 5 December 2022

³² *ibid.*

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.³³ The same also stands true in cases of corporate insolvency under the IBC.³⁴ 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’*),³⁵ 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 during resolution or give such tax dues priority over private creditor dues in the insolvency waterfall.

2. *Government as an Involuntary Creditor*

A fundamental difference between private creditors’ dues and the government’s tax dues is that private creditors are voluntary creditors, while the government is an involuntary creditor. Private creditors voluntarily assume the risk of debtor’s insolvency purely out of profit motive and therefore, cannot complain if that risk materialises. The government, in contrast, is required to provide public goods (including bankruptcy services) for everyone including the corporate debtor. For instance, the government provides for infrastructure, police, sanitation, etc., which creates positive externalities benefitting everyone including the corporate debtor. Neither does the government voluntarily assume the risk of debtor’s insolvency, nor does it expect or anticipate any profit from it.³⁶ Hence there is a case for according a higher priority to government tax dues in an insolvency scenario.

B. Giving Priority to Government Tax Claims – Arguments Against

1. *Government’s Incentive to Recover*

If the government’s tax dues are accorded a higher priority, it may create a moral hazard. The government may not have an incentive to be alert in recovering its dues from the corporate debtor on time. That would be particularly ironic since the government usually has recourse to

³³ Insolvency and Bankruptcy Code 2016, s 36(4)(a).

³⁴ Insolvency and Bankruptcy Code 2016, explanation to s 18.

³⁵ (2004) SCC Online P&H 1277 (Punjab and Haryana High Court)

³⁶ *ibid.*

exceptional remedies which are not available to the ordinary creditor.³⁷ These include powers of entry, search, and seizure.³⁸

On the other hand, tax becomes due only after the taxable activity has occurred rendering for quantification of the tax amount. There would definitely be a significant lapse of time after the transactions giving rise to tax liability.³⁹ Therefore, tax authorities necessarily operate after the event.⁴⁰ Consequently, it cannot ask for security or priority payment like private creditors can.

Overall, this would suggest that the government's unpaid tax dues may be accorded a higher priority only if they have not been recovered within a reasonable period of time before the date of admission of the insolvency application. In other words, higher priority may be accorded only to tax liabilities that have arisen within a specified period before the date of admission of the insolvency application.

2. *Financial Creditor's Incentive to Use the IBC*

Granting a higher priority to the government's tax dues under the IBC may also affect the financial creditors' incentives to take a corporate debtor to the IBC. If the government's tax dues exceed or substantially cover the resolution value of a corporate debtor, financial creditors may have little incentive to use the IBC against such corporate debtor. For instance, secured financial creditors may be better off enforcing their securities outside the IBC or using the out-of-court restructuring tools under the aegis of the Reserve Bank of India. In the worst-case scenario, they may simply write off such loans. At a macro-level, this may lead to increasing the cost of debt capital. Policymakers must consider such ramifications while deciding on this issue.

C. Giving Priority to Government Tax Claims – Finding a Balance

It could be argued that the scale of a particular government's income is an important factor while determining its worthiness for priority treatment. In the event of non-payment, a fiscally robust government would likely sustain a smaller impact than a private creditor. The government is likely to better absorb revenue losses due to idiosyncratic corporate insolvencies.⁴¹ It can effectively distribute those losses among millions of taxpayers. In

³⁷ Tarling (n 30) 285.

³⁸ For instance, *see* Customs Act 1962, ch XIII and Income Tax Act 1961, s 132.

³⁹ Tarling (n 30) 284.

⁴⁰ *ibid.*

⁴¹ Shanker (n 31).

contrast, the loss of a similar sum may cause substantial hardship to a private creditor, which in turn, may generate further insolvencies as a direct result of its insolvency losses.⁴² Therefore, the government's greater loss absorption capacity could serve as a policy justification for granting lower priority to government's tax dues in an insolvency scenario.

One could, however, argue that the government's loss absorption capacity is a second order issue. The larger first order question is — should debts owed to private creditors be paid in priority over the tax debts owed to the community? For instance, on one hand it may, to an extent, starve the government of funds which could have been used for development projects. On the other, it would certainly aid in the development of unsecured financing including the development of the corporate bond market, creating widespread positive externalities.⁴³ Policymakers must consider such potential costs and benefits of prioritising private debt over government's tax dues and *vice versa*, while answering the larger philosophical question.⁴⁴

IV. CONCLUSION

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 which arose before such period should ideally not be given priority over private creditor dues. Overall, any deeper rethink on prioritising government's tax dues must engage with the underlying policy arguments highlighted in this article.

⁴² Tarling (n 30) 284; Cork Report, para 1410.

⁴³ BLRC Report (n 21), para 4.3.2.

⁴⁴ Cork Report (n 29), para 1410.