

PRIORITY OF TAX DUES IN LIQUIDATION

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Editor's Note: IBC, as explicitly laid down in the Preamble itself, seeks to alter the priority of government dues in insolvent resolution/liquidation proceedings. The intent has been made clear in the reports of BLRC. Now, taxing statutes confer power on the authorities to 'attach' properties of the assessee in default – does it amount to a 'security' in favour of the taxing authority, thus scaling up the priority of such dues? The Andhra Pradesh High Court has ruled that the 'encumbrance' created over properties by such taxing laws do not amount to a 'security' and does not confer the status of a secured creditor to the taxing authorities.

In the article below, we have discussed the provisions of the Code vis-à-vis the Income Tax Act while analysing the said ruling.

The manner of distribution of the assets of a company during liquidation is fraught with ambiguity and settlement of such claims arising out of it has inconvenienced the parties concerned since the advent of the Insolvency and Bankruptcy Code, 2016 ("Code"). In a recent ruling, the judgement of the Hon'ble High Court of Hyderabad showed the path to be followed when there arose such conflict regarding priority of settling the dues of the Income Tax authority during liquidation of a Company.

This article essentially deals with the provisions of the Code in juxtaposition to the Income Tax Act, 1961 deliberating upon the judgement of the Hon'ble High Court in the matter of [Leo Edibles & Fats Ltd. Vs. The Tax Recovery Officer \(Central\) IT Dept.](#) (WRIT PETITION No.8560 OF 2018)

Facts of the Case:

Leo Edibles & Fats Limited, the petitioner in the present case, filed a writ petition with the Hyderabad High Court, against the action of the Sub-Registrar, Erragadda, Hyderabad, in refusing to register its purchase of immovable property, in the liquidation proceedings of VNR Infrastructures Limited ("VNR"), since the Income Tax Department claimed charge over such immovable property, pursuant to an earlier notice of attachment for non-payment of tax by the corporate debtor, VNR.

Pursuant to the liquidation order of VNR, passed by the National Company Law Tribunal, Hyderabad, the liquidator formed a liquidation estate. Subsequently, the assets of VNR was sold through e-auction, wherein the petitioner was declared as the highest bidder for one of the properties. The petitioner had deposited 25 percent of the total amount due as consideration and was also issued a letter of sale by the liquidator, calling upon it to deposit the balance sale consideration within fifteen

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- Petitioner filed a writ petition with the Hyderabad High Court, against the action of the Sub-Registrar, Erragadda, Hyderabad
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days. However, at this point, the petitioner came to know that the property purchased by it was subjected to attachment by the IT Department and therefore, the said petition was moved by the petitioner.

The court had passed an interim order to the effect that the petitioner company should deposit the balance sale consideration in respect of the auction, however, the liquidator was instructed not to disburse any of the amounts pending further orders.

The High Court directed the sub-registrar to register sale of the property in favour of the petitioner and instructed the IT Department to submit its claim before the liquidator, who may consider it, in accordance with the priorities set by Section 53 of the Code.

Relevant Provisions of Law:

Income Tax Act, 1961:

Section 178 of the Income Tax Act which lays down the mannerism in which the Income Tax Department may recover the amount which, in the opinion of the Assessing Officer, would be sufficient to provide for any tax which is payable by the company under liquidation. Sub-section (6) of Section 178 further provides the following:

“The provisions of this section shall have effect notwithstanding anything to the contrary contained in any other law for the time being in force”

Insolvency and Bankruptcy Code, 2016:

1. Amendment in the IT Act:

Section 247 of the Code read along with the Third Schedule amends the Income Tax Act, 1961 with the following direction:

“In sub-section (6) of section 178, after the words “for the time being in force”, the words and figures “except the provisions of the Insolvency and Bankruptcy Code, 2016” shall be inserted.”

2. Non-obstante clause:

Section 238 states that “The provisions of this Code shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.” Therefore, the Code clearly overrides the IT Act.

3. Principles of Distribution:

Section 53(1) of the Code lays down the following order of priority in which the proceeds from the sale of the liquidation assets shall be distributed:

1. IRP costs and liquidation costs
2. Workmen’s due for the period of twenty-four months preceding the liquidation commencement date and debts owed to a Secured Creditor

3. Wages and any unpaid dues owed to employees other than workmen
4. Financial debts owed to unsecured creditors
5. any amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period of two years preceding the liquidation commencement date
6. any remaining debts and dues
7. preference shareholders, if any
8. equity shareholders or partners, as the case may be.

The Income-tax Department is clearly not a secured creditor and the debt owed to the Dept. is in the nature of dues that clearly adds to the consolidated fund of the state and thus, should be settled as per the waterfall structure mentioned in Section 53(1)(v).

4. Effect of Moratorium:

As per Section 14 of the Code, the order of the NCLT for initiation of liquidation of the Corporate Debtor would result in a moratorium on the initiation or continuation of legal proceedings by or against the corporate debtor thereby making the contention of the IT department, that the Code did not apply to them in relation to the said property, and the argument that the attachment order predated the initiation of liquidation can certainly not be regarded as valid.

5. Attachment on Liquidation Estate:

Section 36 of the Code states that for the purposes of liquidation, the liquidator shall form an estate of the assets mentioned in sub-section (3), which will be called the liquidation estate in relation to the corporate debtor. Further, Section 36(3)(b) of the Code provides that the liquidation estate assets may or may not be in possession of the corporate debtor, including but not limited to encumbered assets. Therefore, even if the order of attachment constitutes an encumbrance on the property, it still does not have the effect of taking it out of the purview of Section 36(3)(b) of the Code or put a bar on completion of the sale.

Precedents Followed:

In [*Ananta Mills Ltd. \(In Liquidation\) V/S. City Deputy Collector, Ahmedabad*](#), [(1972) 42 Company cases 476] the Gujarat High Court observed that the purpose of attachment appeared to be to prevent private alienations of the property but the attaching-creditor does not acquire, by merely levying attachment, any interest in the property.

In [*Prem Lal Dhar vs. Official Assignee*](#) [(1897) ILR 25 Cal. 179 (P.C.)], the Hon'ble Court considered the effect of attachment prior to the commencement of winding-up proceedings and whether such attachment could continue on the property even in the hands of the purchaser, who bought the property through the official liquidator free of all encumbrances. The court in the said matter held that such attachment of the properties of a company, which was subsequently ordered to be wound

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up, without any further action being taken would be of no consequence or effect against the official liquidator and the property could be disposed of by the official liquidator, since such attachment merely prohibits private alienation by the person whose property is attached but creates no interest in such property.

In the case of [Dena Bank vs. Bhikabhai Prabhudas Parekh & Co. & Ors. \[\(2000\) 5 SCC 694\]](#), it was held that the Crown's preferential right to recovery of debts, over other creditors is confined to ordinary or unsecured creditors and further in the case of [Stock Exchange, Bombay vs. V.S. Kandalgaonkar](#), [CIVIL APPEAL NO.4354 of 2003], the Supreme Court put at rest the ongoing controversy by observing that there is priority of rights of secured creditors over the rights of income tax department.

Conclusion:

The framework for insolvency and bankruptcy Code was proposed with the objective of consolidating and amending the laws relating to reorganisation, and insolvency resolution of corporate persons in a time bound manner for maximization of the value of assets of such persons and to promote entrepreneurship, availability of credit while balancing the interests of all the stakeholders, including alteration in the priority of payment of Government dues. However, certain ambivalences existing in the interpretation of the framework resulted in undue delays in resolution. The thorough interpretation and detailed analysis by the Hon'ble High Court not only settles the long-standing dilemma regarding the ascertainment of the nature of crown debts and the supremacy of the Code over the Income Tax Act, it further clarifies that the interest of secured creditors prevail over crown debts.
