

Tax Hotline

January 12, 2023

POWER OF TAX AUTHORITIES TO RECOVER TAXES

- The power to tax is an inherent attribute and an incident of sovereignty. The power to tax granted to the legislature is unfettered but for the limitation imposed under the Articles of the Constitution of India
- Section 281 of the ITA only declares certain transactions to be void and cannot be understood as creating a charge in favour of the income-tax Department in respect of dues arising under the same
- Section 281 becomes operational only on completion of the proceeding consequent to which sums become payable
- Section 26E of SARFAESI Act and Section 31B of RDPA Act were introduced with a specific purpose to override and grant priority to recovery of debts due to secured creditors over all other debts, taxes, cesses etc., and therefore, must prevail over Section 281 of the ITA, in the event of conflict of priority.

SYNOPSIS

In a recent decision, the Division Bench of the Madras High Court ("HC") held that the interest of secured creditors would prevail over interest of income-tax department. The HC considered the objective of introduction of section 26E of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002¹ ("SARFAESI Act") and section 31B of Recovery of Debts and Bankruptcy Act, 1993² ("RDPA") (hereinafter collectively referred to as "Relevant Sections") and held that it must be understood as prevailing over section 281³ of the Income-tax Act, 1961 ("ITA").⁴ The HC has delved upon certain important aspects with respect to recoverability of taxes and section 281 of the ITA.

FACTUAL BACKGROUND

Certain petitioners i.e. bankers/financial institutions, ("Secured Creditor") had extended financial assistance (in form of credit facilities) to certain borrowers ("Debtors"). The Debtors executed mortgage deeds in favour of Secured Creditors. However, on default in payment of loan amount, the Secured Creditors initiated arbitration proceedings against the Debtors. During the course of arbitration proceedings, the income-tax authorities passed the order of attachment for recovery of the tax dues from the Debtors, in respect of the properties over which mortgages were created.

Aggrieved by the attachment order, the Secured Creditors preferred writ petitions, whereby the Single Judge Bench held that the dues of the income-tax department would take precedence over the dues of the Secured Creditors on account of the principle of 'doctrine of constitutional priority'. The income-tax department also preferred a writ challenging one of the Single Judge Bench's judgment holding Section 281 of the ITA does not create a charge and section 26E of SARFAESI and section 31B of RDPA puts the issue of priority of charge in favour of the Secured Creditors. Both the Secured Creditors and income-tax department preferred the present writ appeals against the Single Judge Bench decision.

In light of the above, the Division Bench of the HC formulated the following issues for consideration:

- What is the nature of taxes and the right of the State to recover the same?
- Whether tax legislations provide for a charge in taxes which are due and what is the kind/nature of such charge?
- Whether Section 281 of the ITA only contains a declaration of voidity in respect of transactions falling within its mischief or does it create a charge in respect of any sum payable under the ITA in favour of the income-tax authorities?
- What is the scope of operation of Section 281 of the ITA and its input vis-a-vis Section 26E of the SARFAESI Act and Section 31B of RDPA?

RULING

We have summarized the findings of the HC below:

a) What is the nature of taxes and the right of the State to recover the same?

- The HC held that the power to tax is an inherent attribute and an incident of sovereignty.⁵ The power to tax granted to the legislature is unfettered but for the limitation imposed under the Articles of the Constitution of India.

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- Taxes are collected for public good and meant for being used by the Government in discharging its constitutional obligation for public welfare and to further the directive principles enshrined under the Constitution.⁶
- While noting the 'doctrine of priority of Crown Debts' the HC noted the following:
 - Between an unsecured creditor and crown debt, crown debt would prevail;⁷
 - Between a secured creditor and a crown debt, the secured creditor would have priority over the crown debt in the absence of any provision which provides for priority in favour of the State's claim;
 - If the legislation provides for a charge or a priority, then, if the crown debt and the private secured creditor concurs in point of time, the crown debt would prevail. If the private secured creditor is prior in time that would prevail. If the State's charge is prior in time, then the State's charge would prevail;
 - If a "first charge" or a "priority" is provided/granted under statutory provisions or if it is expressly provided to override other claims including that of secured creditors, then it appears that it would be the State which would be entitled to preference even over secured creditors.

b) Whether tax legislations provide for a charge in taxes which are due and what is the kind/nature of such charge?

- The HC noted that majority of tax legislations have incorporated provisions providing for priority or creating a charge in respect of dues under the said enactment. The HC noted that the specific provisions under several tax statutes (like Central Excise Act, 1944 and the Customs Act, 1962) creating a charge in respect of tax dues.
- Further, the HC, while referring to the state legislations, highlighted that certain state legislations (viz. Madhya Pradesh General Sales Tax Act, 1958 and Rajasthan Sales Tax Act, 1954) provides for "first charge" in favour of the tax dues, however, certain other state legislations (viz. Tamil Nadu Value Added Tax Act, 2006) while providing for a "charge", does not create a first charge rather makes it subject to certain claims. Therefore, the HC noted that in the absence of provision providing for statutory charge, the recovery mechanism may suffer from inadequacy/deficiency, when pitted against secured creditors. The HC concluded that the recovery mechanism under the ITA suffers from this deficiency.
- The HC rejected reliance on the 'doctrine of constitutional priority' on basis of settled judicial precedents wherein it has been held that while State will have a preferential right to recover over unsecured creditors, such precedence will not apply to secured creditors unless express provisions are incorporated.
- The HC also held that attachment does not constitute a charge. In this regard, the HC highlighted the distinction between a mortgage and a charge observing that charge only gives a right to payment out of a particular fund or particular property without transferring that fund or property, whereas a mortgage is in essence a transfer of an interest in specific immovable property.
- The HC noted that section 281 of the ITA only declares certain transactions to be void and cannot be understood as creating a charge in favour of the income-tax Department in respect of dues arising under the same.

c) Whether Section 281 of the ITA only contains a declaration of voidity in respect of transactions falling within its mischief or does it create a charge in respect of any sum payable under the ITA in favour of the income-tax authorities?

- While referring to section 281 of ITA, the HC observed that the provision is intended to operate during the pendency of any proceeding or after the completion and before the issuance of notice under Rule 2 of the Second Schedule to ITA.
- The HC noted that any charge/transfer that is created during the pendency of any proceeding or after its completion under the ITA and before service of notice under Rule 2 of the Second Schedule shall be '*void to the extent of any sum payable as a result of completion of the said proceedings*'.
- It further observed that the section 281 becomes operational only on completion of the proceeding consequent to which sums become payable. The HC noted that this is due to the reason that there might be instances where on completion of proceedings, there may be no liability for the voidity to operate.
- Section 281 of ITA is not absolute, but comes with exceptions viz. the charge/transfer, may still not be void, if the same is made for adequate consideration and without notice of pendency or made with the permission of the assessing officer.
- The HC while placing the reliance on several precedents⁸ noted that the secured creditor has priority since the mortgages were found to have been created prior to the assessee being treated as an assessee in default or notice having been issued under Rule 2 of the Second Schedule to the ITA.

d) What is the scope of operation of Section 281 of the ITA and its input vis-a-vis Section 26E of the SARFAESI Act and Section 31B of RDBA?

- The HC highlighted that non-obstante clause is a legislative device intended to give an overriding effect and ensure that the provisions have its full operation.
- While referring to the precedents, it was noted that the Relevant Sections were introduced to get rid of deficiency which was contained in Section 35 of the SARFAESI Act and Section 34 of RDBA. While the erstwhile sections provided a non obstante clause, the HC noted that the same would become operational and get triggered only in the event of inconsistency with provisions of other enactment.
- The HC noted that legislators intended to give primacy to the Relevant Sections as evident from the non obstante clause contained therein which is couched in very wide terms as to its scope and operation.
- The newly introduced sections are not limited to enforce its operation in the event of inconsistency, but are intended to give primacy to the rights of secured creditors to recover over all other debts and expressly includes revenues, taxes, cesses or other rates payable to Central Government or State Government or local authority.

- Reiterating the intention of the Parliament, it was held declaration of voidity, in section 281 of ITA, would not prevail over the Relevant Sections (which confers primacy in very wide terms).
- The HC referred the Statement of Objects and Reasons (“**SOR**”) and highlighted that the SOR accorded the priority to secured creditors in repayment of debts in order to augment economic growth and ease of doing business.
- While observing the conflict between section 281 of ITA and the Relevant Sections, the HC applied to rule of ‘purposive construction’. If a purposive construction is not given and primacy to section 281 of the ITA is accorded, it will render the priority accorded to secured creditors nugatory, thereby defeating the object of the Relevant Sections. On application of purposive construction, the Relevant Sections ought to be interpreted in such a manner that would promote and not defeat the object of the Parliament to protect and safeguard the interest of the secured creditors, intended in larger public interest and as a matter of policy.
- The HC referred to another rule of construction viz. when two competing legislations construed to further the purposes behind them produce a conflict; the court may resolve the conflict by taking into consideration as to which Act represents “the superior purpose”.
- Consequently, on application of aforesaid rules of construction, it was noted that the Relevant Sections were introduced with a specific purpose to override and grant priority to recovery of debts due to secured creditors over all other debts, taxes, cesses etc., and therefore, must be understood as prevailing over Section 281 of the ITA, in the event of conflict of priority.

NDA VIEWS

The HC decision is of immense importance. At the outset, the HC has reiterated the principle of sovereignty with respect to imposition of taxes. At the same time, the HC has re-iterated that secured creditors would have priority over crown debt unless there is an express provision in the statute providing otherwise.

Applicability of section 281 of the ITA is a contentious point in most M&A transactions. Often, several representations and warranties are negotiated to ensure adequate protection to the buyer. While the Central Board of Direct Taxes has issued a circular⁹ providing guidelines for granting of prior permission under section 281, the deal timelines and commercial requirements often preclude taxpayers from obtaining prior permission under section 281.

The HC made several interesting findings with respect to section 281 of the ITA. The HC has explicitly held that section 281 does not create an automatic charge in favour of income-tax department. The HC has held that section 281 becomes operational only on completion of the proceeding consequent to which sums become payable. Even in case where a transfer is made during pendency of proceeding, the HC noted that such transfer should not be considered to be void automatically by virtue of section 281. This is a crucial finding in so far as section 281 is concerned and should be borne in mind while undertaking negotiations in a live transaction. Section 281 of the ITA should be read in consonance with the recovery mechanism provided in Second Schedule of the ITA. Therefore, once a tax demand is made against a taxpayer, the income-tax department is obligated to pursue the demand in line with the recovery mechanism provided in the ITA. Sections 220 to 232 of the ITA (contained in Chapter XVII of the ITA) prescribes the modes of collection and recovery of tax.

The HC highlighted that it is important to appreciate the compartmentalization of the recovery mechanism between Section 281 and the Rules of the Second Schedule of the ITA. In this regard, the HC relied on the decision of the High Court of Andhra Pradesh, in case of *ICICI Bank Limited v. Tax Recovery Officer and others* (“**ICICI case**”).¹⁰ In the ICICI case, the court analyzed the recovery mechanism in Second Schedule in detail and held as under:

“26. The only way Section 281(1) can be reconciled with sub-rules (1) and (2) of Rule 16 is to hold that up to the stage of issue of an attachment in terms of Rule 48, the transfers made by the assessee in default can be declared void only if an exercise is carried out by someone (be it the Tax Recovery Officer or a Civil Court). But after an attachment is made, the declaration of voidity under Section 281(1) becomes automatic without any further effort on the part of any one. This is in view of sub-rule (2) of Rule 16...”

29. Therefore, it is clear that the proviso (i) to sub-section (1) of Section 281 provides an escape route for innocent third parties, to whom the property of the assessee is transferred during the pendency of the proceedings, but before an attachment is ordered. This compartmentalization is very important to be noted, in view of the fact that during the pendency of the proceedings for assessment, an assessee does not become an assessee in default. Section 281(1) cannot be interpreted to mean that every assessee is likely to become an assessee in default and therefore, all transfers effected by him even before he becomes a defaulter are null and void.”

Courts have held that that section 281 is merely a substantive declaration of what the law is. It does not provide a complete adjudicatory process.¹¹ Therefore, section 281 should not be seen as a standalone provision for recovery of taxes and merely due to Section 281 transfers should not be considered void – applicability of Section 281 in transactions should be considered in light of the procedure mentioned and should be read in line with the other provisions of the ITA. Merely due to ongoing assessment proceedings, it cannot be considered that the Government has created charge over the property and the right to recover taxes vests with them before the right of secured creditors.

In so far as secured creditors are concerned, the HC decision has unequivocally clarified that section 281 does not prevail over the Relevant Sections. The HC took cognizance to principles of statutory interpretations to arrive at this conclusion. The conclusion of the HC seems to be in line with the intent of the legislature and should further the objects of SARFAESI Act and RDBA. The decision of the HC is favourable for secured creditors and the principle should be applicable in other cases such as ones involving insolvency.

– Ipsita Agarwalla & Ashish Sodhani

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You can direct your queries or comments to the authors

¹ [Priority to secured creditors.

26E. Notwithstanding anything contained in any other law for the time being in force, after the registration of security interest, the debts due to any secured creditor shall be paid in priority over all other debts and all revenues, taxes, cesses and other rates payable to the Central Government or State Government or local authority.

Explanation.—For the purposes of this section, it is hereby clarified that on or after the commencement of the Insolvency and Bankruptcy Code, 2016 (31 of 2016), in cases where insolvency or bankruptcy proceedings are pending in respect of secured assets of the borrower, priority to secured creditors in payment of debt shall be subject to the provisions of that Code.].

² [Priority to secured creditors.

31B. Notwithstanding anything contained in any other law for the time being in force, the rights of secured creditors to realise secured debts due and payable to them by sale of assets over which security interest is created, shall have priority and shall be paid in priority over all other debts and Government dues including revenues, taxes, cesses and rates due to the Central Government, State Government or local authority.

Explanation.—For the purposes of this section, it is hereby clarified that on or after the commencement of the Insolvency and Bankruptcy Code, 2016 (31 of 2016), in cases where insolvency or bankruptcy proceedings are pending in respect of secured assets of the borrower, priority to secured creditors in payment of debt shall be subject to the provisions of that Code.].

³ [Certain transfers to be void

281. (1) Where, during the pendency of any proceeding under this Act or after the completion thereof, but before the service of notice under rule 2 of the Second Schedule, any assessee creates a charge on, or parts with the possession (by way of sale, mortgage, gift, exchange or any other mode of transfer whatsoever) of, any of his assets in favour of any other person, such charge or transfer shall be void as against any claim in respect of any tax or any other sum payable by the assessee as a result of the completion of the said proceeding or otherwise :

Provided that such charge or transfer shall not be void if it is made—

- (i) for adequate consideration and without notice of the pendency of such proceeding or, as the case may be, without notice of such tax or other sum payable by the assessee ; or
- (ii) with the previous permission of the 55[Assessing] Officer.

(2) This section applies to cases where the amount of tax or other sum payable or likely to be payable exceeds five thousand rupees and the assets charged or transferred exceed ten thousand rupees in value.

Explanation.—In this section, "assets" means land, building, machinery, plant, shares, securities and fixed deposits in banks, to the extent to which any of the assets aforesaid does not form part of the stock-in-trade of the business of the assessee.]

⁴ State Bank of India Vs The Tax Recovery Officer (W.A. Nos.1512 of 2021, 60, 1249 and 1385 of 2022 and C.M.P.Nos.9630 of 2021, 6242 and 8950 of 2022).

⁵ Jindal Stainless Ltd v. State of Haryana [(2017) 12 SCC 1].

⁶ Srinivasa Theatre and others v. Government of Tamil Nadu and others [1992(2) SCC 643].

⁷ Builders Supply Corporation reported in AIR (1965) SC 1061.

⁸ The decision of the High Court of Andhra Pradesh, in case of *ICICI Bank Limited v. Tax Recovery Officer and others* [(2019) 411 ITR 518] and the decision of the Hon'ble Supreme Court in case of *Connectwell Industries (P) Ltd. v. Union of India* [(2020) 5 SCC 373 : (2020) 3 SCC (Civ) 314].

⁹ Circular No. 4/2011 [F. NO. 402/69/2010-ITCC], dated July 19, 2011.

¹⁰ Footnote 8 (supra).

¹¹ *Gangadhar Vishwanath Ranade vs. Income-tax Officer* [1989] 177 ITR 163 (BOM.).

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