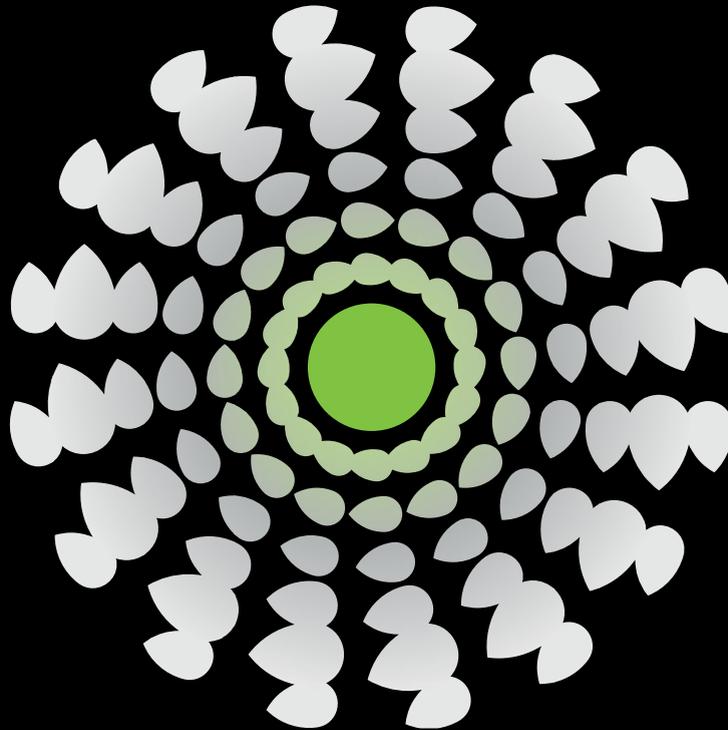


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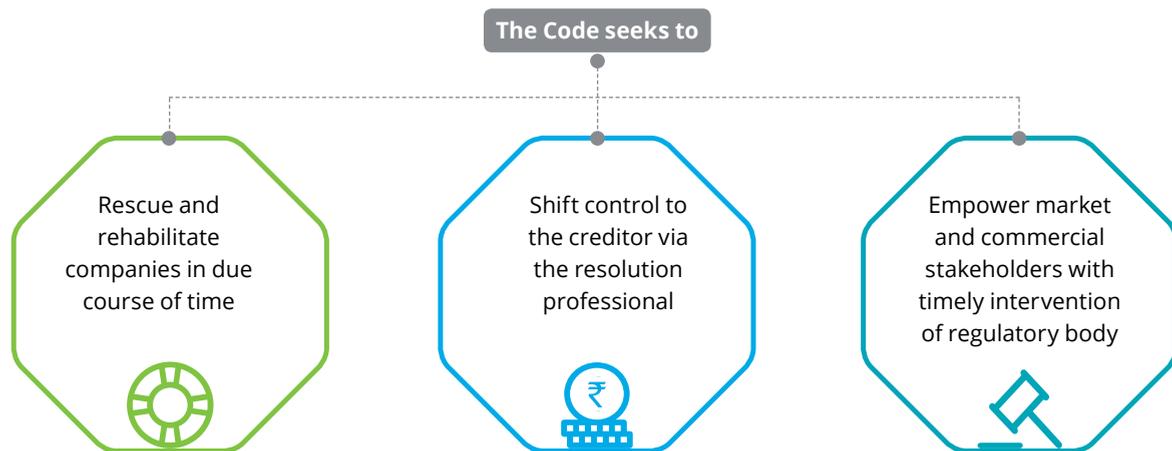
Insolvency and Bankruptcy Code

Beyond the tip of the iceberg

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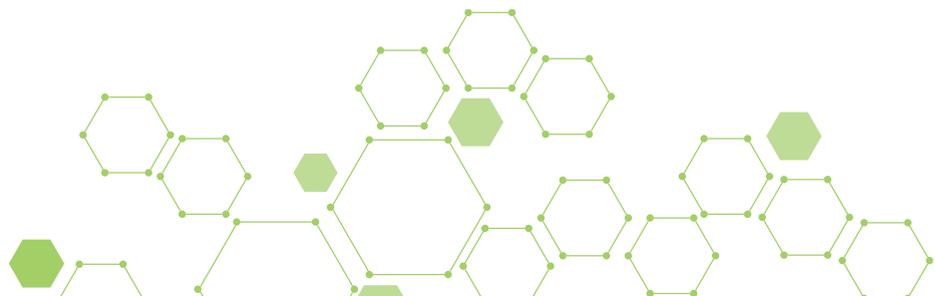
Insolvency and Bankruptcy Code

While the Goods and Service Tax (GST) has been widely described as independent India's biggest tax reform after the economic liberalisation of 1991, the Insolvency and Bankruptcy Code (Code), yet another landmark contemporary law, is just beginning to be assessed for efficacy. Rightly hailed as an important legislative reform, the Code is expected to resolve the prevailing non-performing assets (NPA) crisis, the resultant logjam in availability of credit, and the consequential impact on growth.



The government and the Reserve Bank of India (RBI) have, inter alia, taken the following initiatives to ensure that the law is put to effective use:

- Amendment to the Banking Regulation Act to enable RBI to ensure that banks file the details of defaults under the Code;
- An initial list of companies prepared by RBI that accounts for at least 50 percent of total NPAs.



Before introduction of the Code, legislations relating to insolvency and bankruptcy proceedings were many but scattered, as there were multiple legislations dealing with such proceedings:



The Code aims at consolidating all existing insolvency related laws as well as amending multiple legislations covering insolvency implications. Per Section 238 of the Code, the Code has an overriding effect on all other laws relating to insolvency and bankruptcy.

There are several potential issues involved while undergoing resolution under the Code. It is imperative to understand these while framing the resolution plan. Drafting a resolution plan is relevant since there could be potential tax liabilities in the hands of acquirer due to restructuring of shareholding or haircut of liabilities.



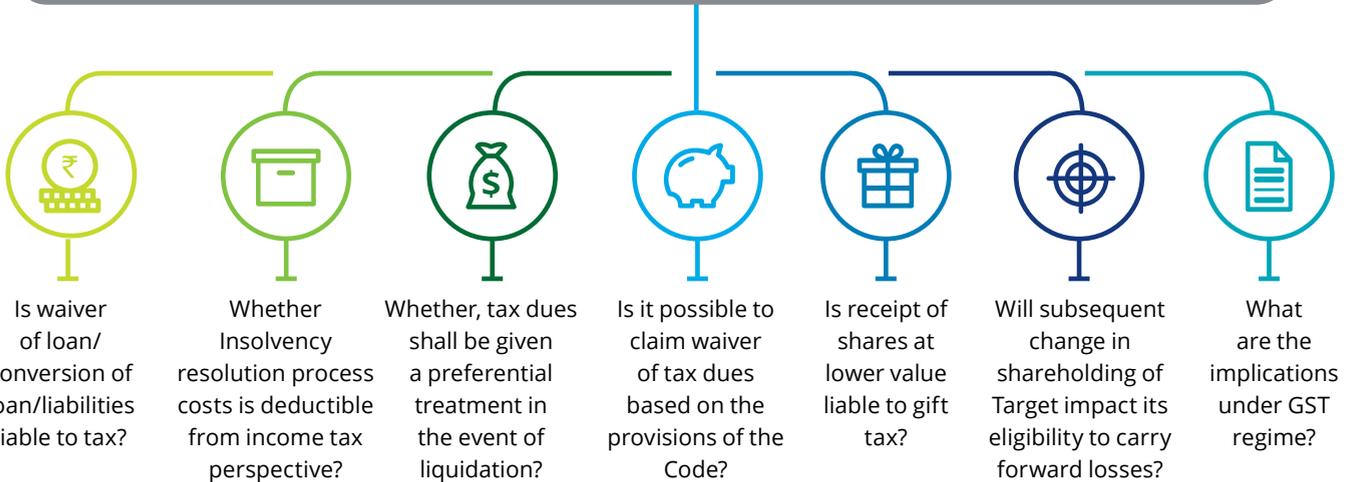
Points to ponder

The government's decision to abolish multiple laws on debt trap companies and to have a single law has garnered built lot of positive vibes around the ease of doing business in India.

While the objective of the Code is to restructure debt, and improve financial capabilities of corporate debtors, there however exist leakages on account of tax attributes. As an investor, an acquirer would critically evaluate costs and benefits associated with the potential acquisition and cash flow mechanics of the target. As tax leakages would result in impacting both and, in turn, also impact the return on investment, such slippages have been gaining significance in boardroom discussions.



There are questions evolving with the rise in companies undergoing insolvency proceedings:



These questions are just the tip of the iceberg. Practical questions and difficulties faced by parties have been increasing multiple-fold based on facts of each case.

The ensuing paragraphs shall throw light on each of the above questions in further detail:



Is waiver of loan/conversion of loan/liabilities liable to tax?

Key trigger point:



Loans/advances waived/written off have recently obtained more importance for companies under the Code. As lenders may waive some part of their loans under the resolution, the question therefore has been whether such loan waiver results in taxable income under the Income Tax Act, 1961 (Act) in the hands of the company?

Impact under normal tax provisions:



The taxability of loans/advance waived/written back has been a subject of discussion before various courts and there have been contradictory judgments for determination of nature of waiver, capital or revenue; taxability under Minimum Alternate Tax (MAT) etc.

The Hon'ble Supreme Court (**SC**) in its recent decision¹ held if a loan was obtained and utilised for acquiring a capital asset and no deduction was claimed in respect of such a loan in any of the previous years, then the waiver of such a loan is akin to a capital receipt and should not be subject to tax as business income.

The above decision may be relevant only in cases of remission of loans taken for capital purposes. If the waiver includes outstanding interest which has been claimed as a deduction in earlier years or loan obtained for the purpose of business, then such waiver may continue to be subjected to tax in the hands of the borrower as ruled by the Madras HC².

Further, there is also a risk that tax authorities may contend that monetary benefit has been received by the Target on account of the waiver, and accordingly proceed to tax the entire remission or waiver as income from other sources, on the ground that the company has received money without consideration.

Impact under MAT provisions:



The other issue is to determine whether the loan waiver would result in MAT implications which would depend on exact accounting for the write-back.

Takeaway:



This is an issue which will persist in all cases under the Code as the resolution plan in majority cases would involve write-off/waivers of huge sums and accordingly tax implications will play a crucial role. There is therefore a need to find a way where specific aspects that emerge out of a resolution plan accepted by the committee of creditors and the NCLT, do not result in undue tax hardship.

¹ CIT v. Mahindra and Mahindra Limited (2018) 93 taxmann.com 32 (SC)

² CIT v. Ramaniyam Homes (P) Ltd, (2016) 384 ITR 530 (Madras HC)

Whether Insolvency resolution process costs is deductible from income tax perspective?

Key trigger point:



Insolvency process results in various costs, both in the hands of the acquirer and the target. The Code defines “insolvency resolution process costs” as costs for raising interim finance, fees of Resolution Professional (RP), costs incurred by RP in running day-to-day business, costs incurred to facilitate resolution process including costs on restructuring. The question arises if such cost is deductible under the provision of the Act.

Impact on Lenders – Conversion of loan to equity/Future exit:



Judicial precedents³ support classification of restructuring expenses as revenue expenditure. However, no clarification has been issued by CBDT till date on treatment of insolvency resolution process related cost as a revenue expenditure or a capital expenditure.

Takeaway:



In absence of any specific provision in law regarding treatment of such insolvency process related expenses, the view is divided on this issue. Amendment in law/clarification may aid to iron out such challenges.

³ PCIT vs. Akzo Nobel India Ltd [2018] 94 taxmann 38 [Kol]



Whether, tax dues shall be given a preferential treatment in the event of liquidation?

Key trigger point:



An important aspect that needs to be discussed is the priority of payment of all outstanding dues of the Target. Tax authorities would in the interest of revenue, insist on preferential treatment. Clarity in this regard is essential for the Acquirer company as this could impact its cash flow requirements.

Key discussion points:



The High Court⁴, in this regard, has upheld that income tax department cannot claim any priority on the ground that the order of attachment of assets is issued by them prior to the initiation of liquidation proceedings under the Code. The same should apply for indirect tax dues as well. Furthermore, no provisions in the Code require setting-aside assets of the Target for payment of outstanding tax dues.

Takeaway:



In absence of any specific provision, judicial precedents could provide roadmap for such issues arising during the resolution process. Nevertheless, the Code should continue to be tweaked to address live issues as above that come up from time to time.

Is it possible to claim waiver of tax dues based on the provisions of the Code?

Key trigger point:



In the interest of IBC companies, a resolution plan may seek relief from certain statutory dues outstanding including past income tax and indirect tax dues. However, the tax authorities may not readily accept such loss of revenue. In such cases it is relevant to understand the possibility of getting a waiver of tax dues under the Code.

Key discussion points:



The Code expressly does not grant any relief from outstanding tax liabilities of the Target. However, in some rulings, the NCLT has rejected the proposal which included in the resolution plan, waivers of liabilities which may arise due to ongoing tax litigations.

Takeaway:



In absence of any clarity, one will have to wait and watch the view adopted by judiciary and tax authorities.

Is receipt of shares at lower value liable to gift tax?

Key trigger point:



Section 56(2)(x) was introduced by the Finance Act 2017 as an anti-abuse provision to tax receipt of any property, including money from any person, for no consideration or inadequate consideration (applicable to property). In light of this provision, there exists a risk on account of acquisition of shares of company under IBC at a value less than prescribed fair value.

In cases of insolvency, where as a part settlement or debt restructuring, the banks/ lenders convert their outstanding loans into equity of the borrower company at a price which is less than the prescribed fair market value of such shares, the difference between the prescribed fair market value of such shares and the price at which shares are converted into equity may be subject to tax as gift in the hands of the banks/ lenders ('deemed taxation').

Impact on Acquirer – Infusion/future restructuring:



In case of companies under insolvency, acquisition price would be a function of several factors—the resolution plan, business fundamentals, haircut available, etc. Thus, the acquisition price could not only be at a significant discount to the fair value, but actually be negligible/nominal, given that the company's equity may have no value at all. This could bring in an immediate tax burden on the acquirer as explained above.

Impact on Lenders – Conversion of loan to equity/Future exit:



In cases where the lenders are issued shares against their loans (i.e., conversion of loan to equity) and there is an agreement to buyback/repurchase the equity at pre-agreed price which may be lower than prescribed fair value at the time of buyback/conversion, deemed tax implications need to be evaluated for such pre-arrangement.

Takeaway:



In such cases it would be important to structure the acquisition and restructuring related steps appropriately, keeping in mind deemed taxation rules.



Will subsequent change in shareholding of Target impact its eligibility to carry forward losses?

Key trigger point:



In the current context, one area of concern for companies under IBC is eligibility to carry forward losses where, inter-alia, restructuring measures such as acquisition of shares by the acquirer, issuance of shares to the lender in lieu of liabilities, post-acquisition merger of target with acquirer/subsidiary of acquirer or any future restructuring are adopted. The Finance Act 2018 has provided relaxation for continuity of losses when there is a change in shareholding as a result of resolution plan. This brought some relief to Acquirer/lenders. It is yet unclear whether future restructuring by an acquirer shall also be provided relaxation in terms of continuity of losses and whether shareholding at immediate/indirect level should be evaluated for continuity of losses.

Relaxation applicable to future restructuring?



In the absence of an express intent to widely cover continuity of losses in the hands of Acquirer even in case of future restructurings, it would be a far stretched assumption that there will be no impact on losses in case of future change in shareholding.

Impact on subsequent change in shareholding – Will it impact losses?

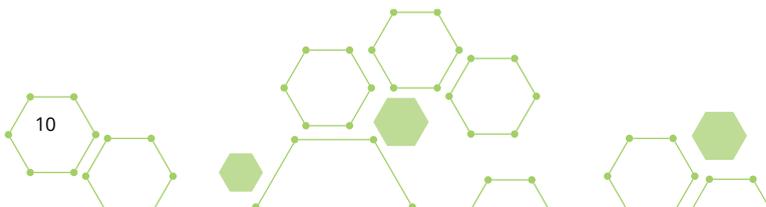


There still exists a grey area on whether shareholding at immediate/ultimate beneficiary level should be evaluated for continuity of losses? Various judicial precedents exist stating that a change in direct shareholding in spite of same ultimate control, shall result in lapse of losses. Conversely, there are judicial precedents supporting that if ultimate shareholding continues to be the same, losses shall continue.

Takeaway:



On account of future restructuring of target, in case the target is not a widely held public company, there could be lapse of losses. In the absence of clarity, these issues will need attention from a structuring aspect.



What are the implications under GST regime?

Key trigger point:



Transparency in IBC provisions with respect to GST implications and other aspects triggering other indirect tax implications is required. Some of them have been discussed below.

GST impact on business transfer:



Per the Code, “resolution plan” means a plan proposed by resolution applicant for insolvency of the corporate debtor as a going concern. Further, the interim resolution professional is required to take necessary action to protect and preserve the value of property of the corporate debtor and manage the operations of the corporate debtor as a going concern.

In respect of transfer/ sale of business as a going concern, a question arises as to whether there is a requirement to discharge GST liability on such transfer/ sale of business. To answer this question, it is to be ascertained whether transfer of business as a going concern would be treated as supply under GST? If yes, whether it would be a supply of goods or services?

Schedule II of the Central Goods and Services Tax Act, 2017 provides a list of activities to be treated as supply of goods or supply of services. Serial No. 4(c) of this schedule states that, where any business is transferred as a going concern, such transfer does not amount to supply of goods. Since the said transaction shall not be treated as supply of goods, no GST would be applicable.

Further, schedule II does not cover the transactions involving transfer of a business as a going concern. No GST is payable on “services by way of transfer of a going concern, as a whole or an independent part thereof”, by way of an exemption notification⁵.

The above view has also been upheld by the Authority for Advance Rulings, in Karnataka⁶.

Given the above, GST is not payable on transfer of business as a going concern, as the same does not qualify as supply of goods. Also, services in respect of transfer as a going concern, are otherwise exempt from GST.

⁵ Notification No. 12/2017- Central Tax (Rate), dated 28 June 2017.

⁶ In the case of M/s Rajashri Foods Pvt Ltd. – Advance Ruling No. KAR ADRG 06/2018 dated 23 April 2018.



GST implications on activities of resolution professional:

The Code defines “resolution professional” as an insolvency professional appointed to conduct the corporate insolvency resolution process and also includes an interim-resolution professional.

Under the GST law, insolvency, and receivership services are classified under the heading 9982 40 and are chargeable at the GST rate of 18%.

Given the above, services provided by resolution professional/ insolvency professional will be chargeable to applicable GST (IGST, CGST and SGST/ UTGST).

Further, in case of liquidation of a company, the liquidator would sell the immovable and movable properties, and actionable claims of the corporate debtor in liquidation, by way of public auction or private contract. The liquidator also has the power to transfer such property to any person or body corporate, or to sell the same in parcels in such manner as may be specified. Such transactions would be treated as supply of goods (other than actionable claims) under the GST law; hence, applicable GST would be required to be charged on such supplies.



GST implications on services of other professionals

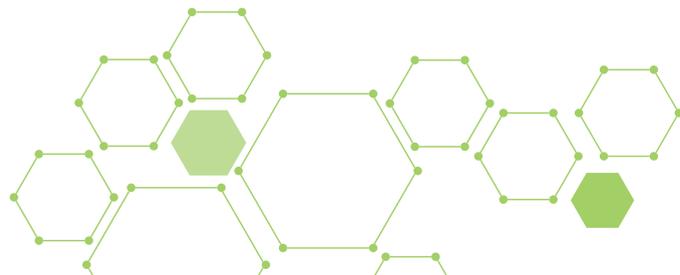
Under the Code, an interim resolution professional or a resolution professional has an authority to inter alia appoint accountants, legal or other professionals as may be necessary. Such professionals would charge applicable GST on the services provided by them. In case of legal services, GST would be payable under reverse charge mechanism.

Similarly, in case services of an auctioneer are used, during liquidation proceedings, GST would be payable on such services.



Takeaway:

Transfer of business as a going concern is typically not liable to GST whereas incidental and ancillary services to the resolution proceedings could be liable to GST. In the absence of any judicial precedents, it needs to be seen how GST implications work under IBC regime.



Summary

The Code has started an interesting journey and is a step in the right direction. It appears that the intention of the legislature has been to not burden a stressed company with tax levies, while it is undergoing reorganisation for survival. While the Finance Act 2018 has provided some relaxation, there exist various areas where more clarifications or relaxations could be provided. There are various issues/questions being faced by corporates/investors who embark on acquisition of these assets. These clarifications could go a long way in providing certainty to the acquirer and support the overall intention of timely, faster, and efficient resolution of NPAs in India.



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