भारतीय दिवाला और शोधन अक्षमता बोर्ड
Insolvency and Bankruptcy Board of India

IBC के आठ वर्ष

शोध एवं विश्लेषण

2024

978-81-947537-9-7

Title: IBC के आठ वर्ष : शोध एवं विश्लेषण

Published by:

Insolvency and Bankruptcy Board of India
7th Floor, Mayur Bhawan, Connaught Circus, New Delhi - 110001
Email: research@ibbi.gov.in

ISBN: 978-81-947537-9-7

Designed, Printed and Bound by:

M/s. Indu Cards & Graphics
New Delhi - 110006

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TAXATION AND INSOLVENCY: TOWARDS A FOUNDATIONAL UNDERSTANDING

M P Ram Mohan and Sai Muralidhar K

ABSTRACT

Taxation and insolvency laws, as critical economic legislations, play a key role in regulating economic activities. This article aims to chart a path toward understanding the source of the divergences between these two fields at a foundational level by examining their theoretical roots. The theoretical foundations of tax law that have formed the current principles of taxation have been examined against the backdrop of the creditor's bargain and communitarian theories of insolvency. In India, the right of the State to tax corporations and individuals is espoused by the Constitution of India. This right is examined against the broader objectives of India's Insolvency and Bankruptcy Code, 2016 (IBC/Code). In the last few years, there have been several cases in India, specifically on tax disputes during the insolvency resolution process. Examining the theoretical interplay between tax and insolvency enables us to see how insolvency and taxation laws could synergise and create positive outcomes for stakeholders.

Keywords: Insolvency and Tax, Communitarian Theory, Creditors Bargain Theory

INTRODUCTION

Taxation laws and the Insolvency Code are among the few significant economic legislations whose functioning impinges on a myriad of sectors such as employment, creation and sustaining of enterprises, financial stability, economic growth, etc.

Any insolvency or bankruptcy proceeding involves an attempt to satisfy competing interests and claims with a limited pool of assets. Given the competing interests over limited resources of the insolvent company between a host of other creditors, including taxation authorities, tension exists among various stakeholders in this issue.[1] The government's dual role in raising revenue and aiding financially distressed companies and the underlying competition between these interests is at the forefront of this study. The issue of the treatment of taxation in insolvency merits a more fundamental enquiry into the very nature of these subjects to analyse theoretical inconsistencies and divergences. Understanding the interplay between tax and insolvency laws would be incomplete without understanding their fundamental objectives, goals, and theoretical evolution. Further, any attempt to harmonise their interplay to benefit all the stakeholders, i.e., creditors, tax authorities, society, and the distressed company, would be unsustainable and transient unless the source of this divergence is more deeply examined.

This article looks beyond the statutory conflicts and aims to create a theoretical framework for a corporate insolvency tax system, meeting the broad objectives of both these critical legal fields. Most of the scholarly work in India covers judicial interpretation between specific provisions of the IBC and taxation statutes.[2] The authors take assistance from the work of Dr. Sylvia Villios, which explored the theoretical foundations for corporate insolvency taxation by examining the theoretical perspectives of Australian insolvency and taxation law. [3]

The article is structured as follows: Firstly, the authors discuss the theoretical foundations of tax law and its operation within a contractarian model of insolvency. This is done by analysing the development of taxation and examining its historical justifications and internationally recognised taxation principles. It is followed by examining the operation of the theoretical underpinnings of taxation in the context of a communitarian model of insolvency. The next section analyses the theoretical perspectives of insolvency and taxation in India from the lens of the Indian Constitution to understand better the source of the conflict and friction that exists today. The authors conclude the study with some suggestions on how to move forward to better understand the divergences in the operation of tax in insolvency proceedings.

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[1] Staff, *Supreme Court Ruling Revives the Quandary, Holds Tax Authorities to Be Secured Creditors – Vinod Kothari Consultants*, https://vinodkothari.com/2022/09/supreme-court-ruling-revives-the-quandary-holds-tax-authorities-to-be-secured-creditors/, (Nov. 1, 2023).

[2] Rahul Verma and Siddharth Hemani, *Unavoidable Interplay Between IBC and Tax Laws*, https://papers.ssrn.com/abstract=4582664,(Feb. 9, 2024) ; Bhumika Indulia, *Interplay between Tax Laws and IB Code during Liquidation*, SCC Blog, https://www.scconline.com/blog/post/2021/01/23/interplay-between-tax-laws-and-ib-code-during-liquidation/, (Nov. 1, 2023); Dhruva, Parikh, Kushal, Bheda, and Mehul, *The Interplay of India's New Insolvency Code with Income Tax Law*, Pro Quest, https://www.proquest.com/docview/2377194371?pq origsite=gscholar&fromopenview=true&sourcetype=Scholarly%20Journals,(Feb. 9, 2024).

[3] Sylvia Villios, *A Framework for Corporate Insolvency Taxation: The Crossroads of the Theoretical Perspectives in Taxation Law and Insolvency Law*.

[4] Monica Bhandari, Philosophical Foundations of Tax Law, Chapter 1 byJohn Snape, The "Sinews of the State" (Oxford University Press 2017), https://doi.org/10.1093/acprof:oso/9780198798439.003.0002, (Dec. 11, 2023).

[5] John Snape, The Political Economy of Corporation Tax: Theory, Values and Law Reform (Hart Publishing 2011).

TAXATION AND INSOLVENCY: JUSTIFICATION AND GOALS

A tax, simply put, is a compulsory levy imposed by the legislature, payable to the government, intended for a public purpose.[4] Taxation, which defines the state's and citizens' duties in collecting revenue, forms a part of public law.[5] The law of taxation reflects the relationship between the market, the state, and the citizens.[6] Taxation as a concept has existed across different social and political orders since early; it has evolved through feudal, absolutist times and the parliamentary and administrative state.[7]

Taxation in the modern administrative state saw a shift from merely ensuring the security of property to focusing on wealth redistribution and regulation and the creation of enterprises.[8] Collecting taxes is no longer only for defending the state and property rights but also to prioritise fairness, promote social and welfare policies, build infrastructure, and thus enhance the broader economy.[9] Taxes in the administrative state are supported by legal compulsion and legislative competence and operate as a broad public law.[10] Today, it operates through several principles, some discussed below.

Principles of Taxation

The modern taxation system as it exists today is deeply influenced by the canons of taxation laid down by Adam Smith in the celebrated book *An Inquiry into the Nature & Causes of the Wealth of Nations,* in which he conveys:[11]

a) The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

b) The tax each individual is bound to pay should be certain and not arbitrary. The time of payment, the manner of payment, and the quantity to be paid should all be clear and plain to the contributor and every other person.

c) Every tax ought to be levied at the time or in the manner most likely convenient for the contributor to pay it.

d) Every tax ought to be contrived, both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the state's public treasury.

While Smith's ideas of taxation significantly influenced tax policy and design the world over, an effective administrative state requires control over property rights and their intersection with taxation.[12] Here, Hobbes philosophical backing lays the foundations for the state's dominance over the individual in matters of tax and property rights.[13] Hobbes' theory of taxation postulated that the tax levy is made on man's estate and rightfully justified by the

[6] Allison Christians, *Sovereignty, Taxation and Social Contract* [2009] Minnesota Journal of International Law, https://scholarship.law.umn.edu/mjil/245.
[7] Snape, *supra note* 4.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Adam Smith, An Inquiry into the Nature & Causes of the Wealth of Nations (Facsimile of 1904 ed edition, University of Chicago Press 1977).
[12] Snape, *supra note* 4.
[13] *Id.*

sovereign as the price for security and the price for certain benefits.[14] Further, he believed in the equal imposition of taxes on all persons.[15] In Hobbes's view, benefits extend beyond security and involvement and are to be assessed based on consumption.[16] Hobbes, therefore, believes that a law of taxation is a combination of prudential and moral rules.[17]

Another key contributor to the principles that govern taxation is classical economist Charles F Bastable, who laid down the Cannons of Taxation, which states that taxation should be productive, economical, justly distributed, an elastic system, certain, and convenient. Bastable believed that the productivity of taxation is to be measured by the amount of revenue collected by the imposition of a tax.[18] He linked the productivity of taxation to the economic nature of tax by arguing that tax collection should be inexpensive and not hurt economic growth.[19] Further, he argued that the elasticity of a tax system was the agency through which the dual goals of productivity and economy could be achieved.[20]

These principles have broadly shaped most tax systems across the world. These are also reflected in the policies adopted by the Organisation for Economic Cooperation and Development (OECD). The OECD identifies the following principles as critical considerations for a country's tax policy and design[21] -

a) **Neutrality** - This principle postulates that taxation systems must apply equally to all forms of business enterprises.

b) **Efficiency** - The efficiency of a taxation system is determined first by the cost of compliance by taxpayers and second by the cost of administration and implementation by the state.

c) **Certainty and Simplicity** – Taxation systems are to be simple and easy to understand.

d) **Effectiveness and Fairness** – Tax systems must be designed to collect the right amount of revenue at the right time while minimising avoidance and evasion.

e) **Flexibility** – Tax systems must be flexible and able to adapt to changing societal, economic, and technological conditions.

f) **Equity** – Equity in taxation involves vertical and horizontal equity. Horizontal equity requires persons who are similarly placed to be similarly taxed. Vertical equity requires more affluent persons to bear a more significant tax burden.[22]

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[14] *Id.*

[15] *Id.*

[16] Dudley Jackson, Thomas Hobbes' Theory of Taxation (1973) 21 Political Studies 175.

[17] *Id.*

[18] Charles Bastable, Public Finance(2nd ed, Macmillan, and Co 1895), https://books.googleusercontent.com/books/content?req=AKW5Qaf5oTtqLC5UQ7HuZDDf5Y_FvwQPwjoHW2i073eZg4PdFLym_QnD7MwMbpbiT31oBsU6Th2rTzRDFb6EDtw8ESm3syPon7GT0xJ3UebBeqiNbzfaoYgvwbprAubyMeI4-iTCniIbN5sWAxLeT5HW-zEUTBqxCL-Td2Uda46B0gBUWCZPyDfeXCOJDTdbv3BQ0-4jysfbQ944-iG_cLXJXJirvaCbbN_JTXRIzyiruA1uz6FlKiaS5LP7Zx2on2BH6Jz5yyj5, (Feb. 12, 2024).

[19] *Id.*

[20] *Id.*

[21] OECD, *Fundamental Principles of Taxation* (OECD 2014), https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy/fundamental-principles-of-taxation_9789264218789-5-en, (Feb. 5, 2024).

[22] David Elkins, *Horizontal Equity as a Principle of Tax Theory* (2006) 24 Yale Law & Policy Review 43; See also Peter J Lambert, *Income Taxation and Equity* (2003) 4 Baltic Journal of Economics 5.

It is important to note that these principles do not operate independently but in a taxation system in consonance with other principles, including the socio-economic policies of the state. For instance, a neutral tax system ensures optimal allocation of resources and thereby aids in improving the efficiency of the state's operation.[23] Similarly, complex taxation systems lead to increased tax planning and strategies that cause greater costs of compliance, extended legal disputes, and hurt the tax system's efficiency.[24]

Modern taxation systems play a vital role in the administrative state. Today, taxes pay for a host of public services and are crucial for funding social programs and development projects.[25] The efficiency of taxation systems is also a determiner of business investment and growth. Tax administration profoundly influences companies' willingness to invest in the nation.[26]

Taxation systems in various countries often reflect the level of priority given to each of the above-discussed factors. The evolution of these principles of taxation, both globally and in the context of India, is key to understanding the underlying friction with the theoretical framework of insolvency laws.

Goals of Insolvency Law

The development of corporate insolvency laws can be traced to several practical problems that emerged as a consequence of the failure of businesses. The failure of a business enterprise in the absence of an insolvency law would be a free-for-all among all the creditors of the business to try and recover as much of their debt as possible within the limited asset pool of the debtor.[27] This would lead to inefficient and unfair outcomes for several creditors, particularly those late to enforce their rights.[28] The core objective of insolvency law is efficient reorganisation, enabling creditors to recover their dues through an orderly debt recovery and collection exercise.[29]

A consensus exists that the goals of modern insolvency law have come through the Report of the Review Committee on Insolvency Law and Practice 1982,[30] chaired by Sir Kenneth Cork.[31] The Cork Committee Report has influenced modern insolvency systems, including the IBC, which adopted a rehabilitative approach to distressed entities.[32] Finch, citing Cork Report, summarises the objectives of a modern insolvency system as follows:[33]

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[23] OECD, *supra note* 21.

[24] *Id.*

[25] 'Why It Matters in Paying Taxes - Doing Business - World Bank Group' <https://subnational.doingbusiness.org/en/data/exploretopics/paying-taxes/why-matters#2> accessed 28 May 2024.

[26] Enterprise Surveys Indicators Data - World Bank Group, https://www.enterprisesurveys.org/en/enterprisesurveys,(May 28, 2024).

[27] Vanessa Finch and David Milman, Corporate Insolvency Law: Perspectives and Principles (3rd edition, Cambridge University Press 2017).

[28] *Id.*

[29] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design (Bankruptcy Law Reforms Committee 2015), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf,(Dec. 11, 2023).

[30] Department of Trade: Insolvency Law Review Committee: Reports and Papers (1976) files and papers.

[31] Vanessa Finch, *The Measures of Insolvency Law* (1997) 17 Oxford Journal of Legal Studies 227.

[32] Insolvency & Bankruptcy Board of India, *IBC: Idea, Impressions and Implementation* (2022),https://ibbi.gov.in/uploads/whatsnew/b5fba368fbd5c5817333f95fbb0d48bb.pdf, (June 12, 2024).

[33] Finch, *supra note* 31.

1. Support the credit system.
2. To enable early insolvency assessment and resolve it immediately.
3. Prevent conflicts among creditors.
4. Realise value from debtors' assets with minimum delay and expense.
5. Fair distribution of realised proceeds among creditors.
6. Ensuring honest realisation and distribution proceedings.
7. Ascertain the cause of insolvency.
8. Safeguarding the interests of not just debtors and creditors but other members of society affected by such failure.
9. Preserving viable enterprises that can contribute to the nation's economy.

A combination of the various theoretical perspectives guides the goals of modern insolvency law. While several schools of thought exist on insolvency, two schools, the *traditionalist* and the *proceduralist*, have been adopted widely by scholars.

While several theories have evolved from the traditionalist and proceduralist schools of thought, two theories have gained traction. Firstly, the creditor bargain theory was propounded by Baird and Jackson, who rely on proceduralist principles and contractarianism.[34] Secondly, the Communitarian theory of insolvency has developed from traditionalist thinkers. Proceduralists believe in a streamlined bankruptcy system that aims to maximise creditors' recovery. Traditionalists believe that insolvency is a tool to rehabilitate the company and protect the interest of all stakeholders while securing creditor wealth maximisation goals.

While the traditionalists propose a more inclusive approach to resolving corporate insolvency that takes into consideration the interests of all stakeholders, Proceduralists contend that insolvency law should address issues that arise only within bankruptcy and non-insolvency creditors should not be protected by law unless doing so maximises value for creditors. We briefly discuss both these theories below to understand how they interact with the principles of taxation.

TAXATION IN A CONTRACTARIAN MODEL OF INSOLVENCY

To understand how the principles of taxation operate within a contractarian model of insolvency, we explore the creditors' bargain theory of insolvency, which is rooted in the nexus of contracts perspective adopted by proceduralists. Those who view insolvency from a proceduralist perspective have adopted the Creditor's Bargain Theory and the Contractarian Perspective. They view insolvency as a limited process driven by the market to create the optimal outcome for creditor wealth maximisation.

[34] "The contractarian theory posits that the relationship between the managers and shareholders of a public corporation is contractual."Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later* (2007) 31CorpL779 The Journal of Corporation Law, https://law.stanford.edu/wp-content/uploads/2015/06/31JCorpL779.pdf,(May 2, 2024).

Proceduralist Perspective of Insolvency

The proceduralist perspective of insolvency views the existence of a firm as a market-driven process, and bankruptcy should not be a tool for deciding whether firms are to live or die in a market.[35] Proceduralists, as the name suggests, are deeply invested in the manner in which bankruptcy is conducted and its effect on external players' behaviour and investment patterns.[36] Proceduralists also consider the adjudicating authority as a neutral party that considers the biases of creditors, investors, managers, etc., to resolve the dispute optimally.[37] They do not subscribe to traditionalists' redistribution goals of insolvency unless such redistribution is to enhance value for the creditors.[38] They also do not find any inherent value in ensuring that the distressed entity can continue operating as a going concern but focus on preserving the entity's value to allow market solutions to resolve the company's ultimate fate.[39] Professor Ted Janger summarised the determinative factors to differentiate traditionalists from proceduralists –

> According to Douglas Baird, three litmus test questions, or axioms, determine a scholar's affiliation. These questions are (1) whether the Bankruptcy Code should seek to rehabilitate firms; (2) whether bankruptcy judges should alter non-bankruptcy entitlements in order to rehabilitate firms; and (3) whether bankruptcy judges are capable of distinguishing likely candidates for reorganisation from firms that are destined to fail. The paradigmatic proceduralist answers "no" to each question, while the paradigmatic traditionalist answers "yes" to all three.[40]

Baird argues that the objective of insolvency should neither be liquidation nor reorganisation but should ensure that the firm's assets are used optimally.[41] In his view, bankruptcy should exist to ensure that the market decides when a firm fails and that the lack of funds to repay creditors should not determine the failure of a firm. Further, he contends that the bankruptcy law cannot be justified if used to prolong bad companies' lives. Proceduralists largely adopt a contractarian perspective of corporations in insolvency. The creditor's bargain theory adopted by proceduralists is rooted in contractarianism.[42]

Contractarianism in Insolvency: The Creditors Bargain Theory

The creditor's bargain theory is rooted in the nexus of contract perspective,[43] which proceduralists adopt. The nexus of contracts perspective suggests that every corporate entity, at its core, is an amalgamation of bilateral contracts among shareholders, investors, lenders,

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[35] Douglas G Baird, *Bankruptcy's Uncontested Axioms* (1998) 108 The Yale Law Journal 573.Thomas H Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors Bargain* (1982) 91 The Yale Law Journal 857.

[36] Baird *supra note* 39, at 578.

[37] *Id.,* at 579.

[38] Charles W Mooney, *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure* [2003] SSRN Electronic Journal, http://www.ssrn.com/abstract=425120, (Dec. 11, 2023).

[39] *Id.*

[40] Edward J Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design* [2001] SSRN Electronic Journal, http://www.ssrn.com/abstract=260598,(Feb. 16, 2024).

[41] Baird, *supra note* 39, at 582.

[42] Finch, *supra note* 31.

[43] Christopher F Symes, Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status (1st edition, Routledge 2016).

directors, managers, etc.[44] The creditor's bargain theory finds utility in a contractarian interpretation of corporations. Contractarianism emphasises shareholder wealth maximisation. Professor Ian Ramsay and Dr Robert Austin expounded on the shareholder primacy envisaged in contractarianism, who argue that a competitive market creates a greater incentive to maximise shareholder wealth than specific legal rules and regulations.[45]

The creditor's bargain theory, as envisaged by Jackson and Baird, acts as a debt collection mechanism in which the creditors of the enterprise agree beforehand on the *collective procedure* to enforce their claims.[46] This reflects a notional agreement that would have been formed had the creditors been given the chance to bargain with each other before granting credit to the debtor.[47] Jackson argues that the cost of transferring the debtor's property to the creditors would be kept to a minimum through an ex-ante pre-determined *collective procedure*.[48] Creditors bargain theory indirectly shows what real-world parties would agree to in such a hypothetical agreement if all parties acted rationally.[49] The ex-ante nature of the creditor's bargain supposes that the existence of such a bargain would lead to the creditors renouncing their independent claims and instead enforcing a single collective claim, thereby addressing the inefficiencies that arise with the 'first in time, first in priority' scheme of asset distribution.[50]

Professor Christopher Symes expounds on the contractarian roots of the creditor's bargain theory –

> However, the notion of shareholder primacy that underpins the contractarian perspective can be substituted in an insolvent corporation by the concept of creditor primacy - a requirement to act in the interests of creditors and to maximise their distribution from the estate.[51]

Symes argues that just as a contractarian view of a corporation exists with a notion of shareholder primacy, a contractarian view of an insolvent corporation would exist with a notion of creditor primacy, which is a crucial element of the IBC.

Criticisms of Creditors Bargain Theory

Nevertheless, the creditor's bargain theory has been criticised for several reasons, including its focus on pre-insolvency rights, lack of consideration of corporate rescue and other non-

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[44] Villios, *supra note* 3.

[45] Ian Ramsay and Robert Austin, Ford, Austin and Ramsay's Principles of Corporations Law, (17th edn, Lexis Nexis Butterworths 2018), https://store.lexisnexis.com.au/products/ford-austin-and-ramsays-principles-of-corporations-law-17th-edition-skuprinciples_of_corporations_law_17th_edition,(Feb. 16, 2024).

[46] Douglas Baird and Thomas Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy* (1984) 51 University of Chicago Law Review, https://chicagounbound.uchicago.edu/uclrev/vol51/iss1/5.

[47] Symes, *supra note* 43.

[48] Baird and Jackson (n 46).

[49] Thomas H Jackson and Robert E Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain* (1989) 75 Virginia Law Review 155.

[50] Ruzita Azmi, Adilah Abd Razak and Siti Nur Samawati Ahmad, *The Theories Underpinning Personal Insolvency Or Bankruptcy Law: A Legal Overview* (2018) Public Law Remedies In Government Procurement: Perspective From Malaysia European Proceedings of Social and Behavioural Sciences, https://www.europeanproceedings.com/article/10.15405/epsbs.2018.12.03.49,(Dec. 11, 2023).

[51] Symes, *supra note* 43.

economic values such as moral, political, social, and personal considerations, as detailed below.[52]

In Finch's view, one of the criticisms of the creditor's bargain theory is that creating a common pool of assets prior to insolvency would not be logical since repayments are ordinarily made on income, not from the asset sale.[53] Furthermore, it is contended that income generated arises not merely from the asset but from the entire structure and network of a particular distressed entity.[54] The creation of a pool of assets arises only from insolvency, and not prior to insolvency, she argues –

> It is, indeed, insolvency law itself that creates an estate or pool of assets and this undermines any assertion that insolvency processes should maximise the value of a pre-existing pool of assets and should not disturb pre-insolvency entitlements.[55]

Finch believes that any ex-ante bargain that takes place would reflect the disparities in the creditors' skill, leverage, and wealth.[56] Such an ex-ante bargain would likely be oppressive to weaker creditors and lead to inefficient outcomes.[57]

The second major criticism of the creditor's bargain theory is its failure to consider the distributional consequences of such an ex-ante bargain. Since the creditor's bargain takes place ex-ante, consensual creditors would be the only category of creditors involved in this bargain who have provided credit through a formal contractual arrangement. This disregards several non-consensual creditors, such as employees, income tax claims, tortious claims, etc, which would not arise at the time of extension of credit by contract creditors. The distributional consequences of the creditor's bargain theory disregard the community interests, which may, in turn, have negative consequences on the economy. According to Korobkin, the creditor's bargain model does not factor in creditors who would exist outside of formal contractual agreements and lack pre-insolvency rights due to being non-consensual creditors. This leads to unfair outcomes, given that those creditors with formal pre-insolvency rights do not bear all the costs of business failure.[58] Korobkin instead posits a "principle of inclusion" –

> Let us call this the "principle of inclusion." The principle of inclusion, it should be emphasised, does not speak at all to which particular demands should ultimately be recognised and which should be denied. It provides only that no persons should be disqualified from pursuing their aims merely by virtue of the position that they occupy.[59]

The creditor's bargain theory is also criticised for its inability to consider corporate rescue in conditions where the economic value of the corporate entity does not exceed the immediate

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[52] Villios. *supra note* 3.
[53] Finch and Milman, *supra note* 27.
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] Villios, *supra note* 3.
[58] Donald R Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law* (1992) 71 Texas Law Review 541.
[59] *Id.*

value that could be obtained by liquidating the company assets.[60] Professor Korobkin argues that corporations are moral, political and social agents and not merely economic agents.[61] He, therefore, says that insolvency by acting in a rehabilitative manner would be able to account for political, moral, and social considerations that the corporation's failure would cause.[62] These criticisms of the creditor's bargain theory led to its evolution and modification.

The modification of the creditor's bargain theory by Scott and Jackson in 1989 addressed some of the concerns that had arisen. They incorporate into the bargain a risk-sharing theory where "Secured creditors would agree that whenever insolvency is triggered by common risks (interrelated technological events with unpredictable effects), they would share with unsecured creditors and equity some of the asset pool otherwise reserved to them. Such an arrangement would provide a method of diversification for those risks that cannot be successfully reduced by individualised risk bearing."[63] Jackson developed the risk-sharing theory as a response to criticism that the creditor's bargain theory does not account for the distributional consequences of bankruptcy. The risk-sharing theory broadly identifies two risks: common economic industry-wide risks and company-specific risks.[64]

Taxation in Creditors Bargain Theory

Having examined the scope and evolution of the creditor's bargain theory, we examine how principles of taxation operate within this theory. The creditor's bargain theory does not provide any standing for statutory dues, including taxation dues that a company owes to tax authorities.[65] The hypothetical bargain conducted by the ex-ante would not include non-consensual creditors who do not have formal rights.[66] The tax authorities, being non-consensual creditors, would not be a part of the ex-antehypothetical bargain in the creditor's bargain theory and, as a result, would not be eligible to recover any money. Jackson argues that taxation losses as a consequence of firms entering insolvency have to be accounted for while setting the rates of taxation –

> Finally, the state is itself likely to be a claimant (oftentimes, as in its taxing capacity, a non-consensual one), in which case the level of priority it provides is a part of the cost calculus it has decided on in setting its rates (whether tax rates or otherwise).[67]

The argument that inconsistencies in revenue collection due to firms entering insolvency are to be resolved by adjustments in tax rates leads to a conflict between the distributional goals of the creditor's bargain theory and the ability of the taxation systems to ensure fiscal adequacy and avoid complex tax systems, which are fundamental principles of effective tax systems.

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[60] Villios, *supra note* 3.
[61] *Donald R Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy* (1991) 91 Columbia Law Review 717.
[62] *Id.*
[63] Jackson and Scott, *supra note* 49.
[64] Medha Shekar and Anuradha Guru, *Theoretical Framework of Insolvency Law.*
[65] Villios, *supra note* 3.
[66] *Id.*
[67] Jackson, *supra note* 35.

The *collective procedure* undertaken by creditors in recovering debt under the creditor's bargain theory is linked to the *pari passu* principle,[68] which prescribes that creditors be awarded an equal stake in the distribution of assets during insolvency.[69] The *pari passu* principle within the creditor bargain model considers equality only among the secured creditors with formal pre-insolvency rights.[70] Equity prescribed in taxation would be defeated by such an application of equity in insolvency as it would effectively mean that the tax burden is not equally distributed among all taxpayers.[71] The *paripasu* principle effectively shifts the tax burden onto society without accounting for the cost of the distribution of assets.[72] Herein arises another source of friction between the creditor's bargain model of insolvency and equitable taxation principles. It has also been theorised that a particular value shift under the creditors' bargain theory imposes costs on middle-class taxpayers and distributes benefits to higher-income taxpayers.[73] Therefore, there exists a theoretical tension between the basis of the creditor bargain theory and modern principles of taxation, with the creditor's bargain model not providing any leeway for the functioning of tax during insolvency. This would inevitably lead to conflicts that would show up during insolvency proceedings.

TAXATION IN COMMUNITARIAN THEORY OF INSOLVENCY

Having examined how the principles of taxation operate within the contractarian perspective of insolvency law based on proceduralism (creditor bargain theory), this section explore show these principles operate within a communitarian perspective of insolvency based on a traditionalist perspective.

The traditionalist perspective sees the role of insolvency as one that enables the rehabilitation of distressed firms.[74] They contend that in the absence of insolvency laws, the distressed firms would likely fail and would cause job losses and economic damage to the community at large.[75] This school of thought maintains that insolvency rules and their design would not affect creditors' behaviour and willingness to enter into arrangements with various business enterprises.[76] They view the insolvency resolution process in its entirety as a self-contained process. Insolvency law, accordingly, must give adjudicating authorities broad and flexible powers, as insolvency law cannot be designed to be applied commonly to different types of communities. From the traditionalist's viewpoint, the underlying objective of insolvency is to enable financially distressed entities to avoid being liquidated and maintain the entity's value as a going concern.[77]

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[68] The Pari Passu principle postulates that creditors appropriate an equal portion rate of the assets of the insolvent. See Andrew Keay, *Insolvency Law: A Matter of Public Interest?* (2000) 51 Northern Ireland Legal Quarterly 509.
[69] Villios, *supra note* 3.
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] Frances R Hill and Frances A Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach* (1996) 50 The Tax Lawyer 103.
[74] Baird, *supra note* 35.
[75] *Id.*
[76] *Id.*
[77] Shekar and Guru, *supra note* 64.

Communitarian Theory

While the creditor's bargain theory follows a contractarian perspective that emphasises the private rights of creditors, the communitarian theory of insolvency views insolvency as public law and considers the interests of multiple stakeholders.[78] Communitarian theory propounds that corporations have a responsibility to multiple stakeholders, including but not limited to creditors, clients, employees, local communities, etc.[79] Finch describes the distributional goals envisaged in the communitarian vision as -

> It accordingly countenances the redistribution of values so that on insolvency high priority claimants may to some extent give way to others, including the community at large, in sharing the value of an insolvent.[80]

Professor Andrew Keay argues that public interest must be essential in insolvency law. Keay refrains from defining the exact scope of public interest but envisions it as:

> For the purposes of insolvency law, that the public interest involves taking into account interests which society has regard for and which are wider than the interests of those parties directly involved in any given insolvency situation, that is, the debtor and the creditors.[81]

Professor Donald Korobkin ascribes to the communitarian vision of insolvency through a value-based theory.[82] The value-based theory suggests that insolvency considers the distributional impacts on those who are not technically creditors or lack formal legal rights in the distressed entity.[83] It is multi-dimensional and looks at economic, social and political challenges that arise from insolvency.[84] Elizabeth Warren, another proponent of a multi-dimensional/multi-value, views insolvency as an elastic and interconnected subject.[85] The Value-based theory outlined by Finch states–

> Multiple values/eclectic approaches as exemplified by Warren and Korobkin see insolvency processes as attempting to achieve such ends as distributing the consequences of financial failure among a wide range of actors; establishing priorities between creditors; protecting the interests of future claimants; offering opportunities for continuation, reorganisation, rehabilitation; providing time for adjustments; serving the interests of those who are not technically creditors but who have an interest in continuation of the business (for example, employees with scant prospect of re-employment, customers, suppliers, neighbouring property owners and state tax authorities); and protecting the investing public, jobs, the public and community interests.[86]

The communitarian perspective received support from the Cork Report in 1982, where the insolvency law was deemed to have three parties, i.e., the creditor, debtor, and society.[87] The

[78] Symes, *supra note* 43.
[79] *Id.*
[80] Finch, *supra note* 31.
[81] Keay, *supra note* 68.
[82] Korobkin, *supra note* 61; Korobkin, *supra note* 58.
[83] *Id.*
[84] Shekar and Guru, *supra note* 64.
[85] Elizabeth Warren, *Bankruptcy Policy* (1987) 54 The University of Chicago Law Review 775.
[86] Finch and Milman, *supra note* 27.
[87] Symes, *supra note* 43.

communitarian perspective also inspired the Indian Insolvency law. The Bankruptcy Law Reforms Committee (BLRC), while preparing the IBC, referred to two design principles, namely, that creditors who were not part of the process must have their interests represented. Secondly, the rights of all creditors must be respected equally.[88] The IBC follows a value-based theory espoused by Korobkin. It adopts a traditionalist approach that considers the interests of all stakeholders to try and ensure the entity retains value as a going concern.[89] The manner in which the principles of taxation operate in the communitarian theory is discussed below to understand the root of theoretical divergences.

Taxation in a communitarian theory of insolvency

Unlike the creditor's bargain theory, the communitarian theory of insolvency allows non-consensual creditors' interests to be considered during the insolvency resolution process.[90] The concern about protecting community interests would effectively require creditors and the company to bear some of the costs of failure, such as tortious claims, environmental damage, etc, instead of passing the burden onto the taxpayers.[91] Further, the communitarian perspective focuses on distributional outcomes and ensures that the costs are not externalised to those who lack formal pre-insolvency rights.[92] The reduction in the costs being externalised itself would benefit the level of tax revenue being collected. The focus on rehabilitation creates the opportunity for future tax revenue to arise from the restructured entity.[93] The notions of equity in tax law (horizontal and vertical equity) are also far more compatible with this theory due to the focus on a more equitable distribution scheme being the focus of insolvency law.[94] Adopting a broader economic model of efficiency that looks beyond ensuring only the highest return for creditors secures the broader interests of the community.[95] The focus on transaction cost efficiency that aims at achieving the results of insolvency at the least cost and effort compliments notions of efficiency in taxation.

Both these theories of insolvency, by their very nature, treat tax dues to the state differently. The communitarian theory is far more harmonised with the broader theoretical and principled frameworks in which taxation exists. This shows the theoretical divergences between various insolvency theories and taxation principles. Given the greater harmonisation with the principles of taxation, the question remains as to why legislations framed with communitarian objectives, such as the IBC, continue to clash with taxation statutes and claims. The answer to this is explored by examining the state's taxation powers in India from the lens of India's Constitution.

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[88] Shekar and Guru, *supra note* 64; The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, *supra note* 29.
[89] Shekar and Guru, *supra note* 64.
[90] Villios, *supra note* 3.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] Finch, *supra note* 31.

APPLICATION OF CONSTITUTIONAL TENETS OF INDIAN TAXATION IN INDIAN INSOLVENCY

In India, the field of taxation is broadly governed by the Income Tax Act of 1961[96] and the Central Goods and Services Act of 2017.[97] The field of Insolvency is governed by the Code.[98]

Tax revenue collection is crucial to the government's ability to redistribute wealth, target inequality, and fund vital public services.[99] Ineffective revenue collection and protracted legal disputes are detrimental to the State and the private sector alike.[100] The number of tax disputes in India is growing at a rate faster than the judicial system can clear.[101] In 2023, the Government stated that its priority was increasing the appeals disposal rate to reduce the burden on taxpayers and the system.[102] The Indian taxation system, for the longest time, was characterised by the compensatory tax theory, which was only recently deemed as a wrong interpretation of the right to tax as granted by the Constitution of India. The compensatory tax theory was developed to reconcile the freedom of trade under Article 301 and the state's sovereign right to tax. Under this theory, a tax would be justified when the state provided some facilities or services commensurate with the tax levied. While the compensatory tax theory never intersected with the IBC in practice, examining its intersection would help better understand the evolving divergences between these two fields.

Communitarian vision of IBC

The earlier Indian insolvency framework, being fragmented, gave rise to forum shopping, and placed greater emphasis on secured financial creditors (FCs),[103] thus leading to a lack of focus on the socio-economic impact of insolvency proceedings. The BLRC tasked with preparing the Indian insolvency resolution framework[104] referred to the UNCITRAL Legislative Guide on Insolvency and suggested that insolvency proceedings should be the least cost imposed on society.[105] The underlying philosophy behind the IBC broadly aligns with a communitarian vision of insolvency.[106]

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[96] The Income Tax Act 1961, https://incometaxindia.gov.in/pages/acts/income-tax-act.aspx.

[97] Central Goods and Services Tax Act 2017, https://www.indiacode.nic.in/handle/123456789/15689.

[98] Insolvency and Bankruptcy Code 2016, https://www.indiacode.nic.in/handle/123456789/2154?sam_handle=123456789/1362.

[99] Taxes & Government Revenue, World Bank,https://www.worldbank.org/en/topic/taxes-and-government-revenue, (June 12, 2024).

[100] IMF, *How Can an Excessive Volume of Tax Disputes Be Dealt With?,* https://www.imf.org/external/np/leg/tlaw/2013/eng/tdisputes.pdf, (June 24, 2024).

[101] Tax Department Sets Strict Targets to Resolve Appeals: Sources, CNBCTV18, https://www.cnbctv18.com/finance/tax-department-sets-strict-targets-to-resolve-appeals-sources-18368031.htm, (Feb. 9, 2024).

[102] *Id.*, Dhirendra Kumar, *Budget 2024: Govt to Withdraw Outstanding Disputed Tax Demand to de-Clog Recover,* Mint, https://www.livemint.com/budget/news/budget-2024-govt-to-withdraw-outstanding-disputed-tax-demand-to-de-clog-recovery-11706774550860.html, (Feb. 9, 2024).

[103] Rajeswari Sengupta, Anjali Sharma and Susan Thomas, *Evolution of the Insolvency Framework for Non-Financial Firms in India,* http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf, (May 8, 2024); Aparna Ravi, The Indian Insolvency Regime in Practice-An Analysis of Insolvency and Debt Recovery Proceedings, http://igidr.ac.in/newspdf/publication/WP-2015-027.pdf, (May 8, 2024).

[104] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, *supra note* 29.

[105] *Id.*

[106] Shekar and Guru, *supra note* 64.

The BLRC noted that the following primary objectives were to be met by the new insolvency framework[107] –

1. Low time to resolution
2. Low loss in recovery
3. High levels of debt financing across a variety of debt instruments

The IBC was enacted to promote business reorganisation and retain corporate entities' value as a going concern to promote growth and efficiency in the market.[108]

The overall objective of the IBC was to create information symmetry between creditors and debtors to enable creditor wealth maximisation. It aimed to assess the viability of the business to enable resolving the entity while maintaining it as a going concern.[109] These are also the modern goals and objectives of insolvency law. The IBC is reflective of the value-based theory espoused by Korobkin and Warren. This is evidenced in the BLRC Report, which expounds the principles that the IBC:

> These principles are derived from three core features that most well developed bankruptcy and insolvency resolution regimes share: a linear process that both creditors and debtors follow when insolvency is triggered; a collective mechanism for resolving insolvency within a framework of equity and fairness to all stakeholders to preserve economic value in the process; a time-bound process either ends in keeping the firm as a going enterprise or liquidates and distributes the assets to the various stakeholders. These features are common across widespread differences in structure and content, present either through statutory provisions or their implementation in practice.[110]

Constitutional Perspective of Taxation

In India, after independence, the right of the state to tax its citizens emerged from the Constitution of India. Article 366 (28) of the Constitution of India defines taxation as follows –

> "taxation" includes the imposition of any tax or impost, whether general or local or special, and "tax" shall be construed accordingly [111]

The Supreme Court has held that the right to tax exists as a sovereign right of the state. The court held –

> The power to levy taxes has been recognised as an essential attribute of sovereignty. The power to tax is a necessary incident of sovereign authority (imperium) but not an incident of proprietary rights (dominium). ..... The assertion of authority to collect a duty or tax is in the realm of the sovereign authority, but not a proprietary right. [112]

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[107] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, *supra note* 29.
[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] The Constitution of India 1950, Article 366(28).
[112] Thressiamma Jacob v. Dept of Mining & Geology 2013 9 SCC 725 (Supreme Court of India).

Taxation, therefore, while being an extension of the sovereign right of the state, is not an extension by the government into the proprietary rights of persons or corporations. While tax is understood as a means to raise revenue to meet the state's expenditure, courts have held that today, taxation also exists to achieve certain fiscal and social objectives.[113] It is important to note that despite taxation being a state sovereign right, any tax levied has to conform with all other provisions of the Constitution of India.[114]

Against this backdrop, the *compensatory tax theory* emerged in India through the court's interpretation of Part XIII of the Indian Constitution, which regulates trade and commerce. Article 301 of Part XIII states –

> 301. Freedom of trade, commerce and intercourse. —Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.[115]

The Supreme Court, in one instance, was tasked with interpreting whether taxation statutes would be ultra vires of Article 301due to the resultant restriction on trade and commerce.[116] In *Automobile (Rajasthan) Transport Ltd. v. State of Rajasthan,*[117] the court was tasked with determining the validity of the Rajasthan Motor Vehicles Taxation Act of 1951. While analysing whether the said legislation and imposition of tax was a restriction on trade and commerce, the court held that the Act was valid and carved out an exception under Article 301 that would exempt compensatory taxes. The court expounded the scope of taxes being compensatory as follows -

> It seems to us that a working test for deciding whether a tax is compensatory or not is to enquire whether the trades people are having the use of certain facilities for the better conduct of their business and paying not patently much more than what is required for providing the facilities. It would be impossible to judge the compensatory nature of a tax by a meticulous test, and in the nature of things that cannot be done.[118]

If a court determined that a particular tax levied was compensatory, it could not be said to be *ultra vires* of the Constitution of India. In this case, the court noted that the tax does not restrict trade but instead facilitates the maintenance and provision of roads, which was a constitutionally sound law.[119] The compensatory tax theory was widened and held that "some link between the tax and facilities extended to such dealers directly or indirectly" would be sufficient for a taxing statute to be exempt from scrutiny under Article 301.[120] The broad interpretation of the compensatory tax theory led to difficulties distinguishing taxes from fees, which traditionally had a quid pro quo relationship wherein payment was made for particular services rendered.[121] Over time, the broad interpretation of the compensatory tax theory was gradually narrowed through a series of judicial decisions.[122]

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[113] Elel Hotels & Investments Ltd v. Union of India1989 3 SCC 698 (Supreme Court of India).
[114] Karthik Sundaram, Tax, Constitution, and the Supreme Court Analysing the Evolution of Taxation Law in India (Oakbridge Publishing Private Limited 2019).
[115] The Constitution of India, Article 301.
[116] Atiabari Tea Co v. the State of Assam1961 1 SCR 809 (Supreme Court of India).
[117] Automobile (Rajasthan) Transport Ltd v State of Rajasthan 1962 SCC OnLine SC 21 (Supreme Court of India).
[118] *Id.*
[119] *Id.*
[120] Bhagatram Rajeevkumar v. CST 1995 Supp 1 SCC 673 (Supreme Court of India).
[121] Neha Pathakji, *Slippery Slopes of Compensatory Tax and Fee* (2014) 56 Journal of the Indian Law Institute 78.
[122] *Id.*

In 2017, the Supreme Court in *Jindal Stainless Ltd. (2) v. State of Haryana*[123] held that the compensatory tax theory was not rooted in constitutional jurisprudence and, as a result, was no longer a good law. The court reasoned that categorising taxes as compensatory effectively obliterates the difference between a fee and a tax.[124] The court relied on Thomas M Cooley's definition of tax as "a compulsory exaction of money for general public good".[125] The court held that since all taxes are collected with the broader objective of serving a public purpose, then all taxes would effectively be compensatory when looked at broadly.[126] The court, while analysing whether taxes could be construed as affecting the freedom of trade, held –

> Taxes simpliciter are not within the contemplation of Part XIII of the Constitution of India. The word 'Free' used in Article 301 does not mean "free from taxation"[127]

The court, therefore, effectively held that a non-discriminatory tax could not be construed as a restrictive or violative of the rights to free trade enshrined under Part XIII of the Constitution of India. The evolving jurisprudence has done away with the compensatory theory of taxation and reaffirmed taxation's traditional notions and underpinnings as a sovereign function to serve the public good.[128] To understand how the constitutional notions of taxation are at a crossroads with the IBC, we look at the objectives of the IBC that were sought to be achieved at the time of drafting.

Friction between Taxation and Insolvency Objectives

The friction between taxation and insolvency laws is most apparent in insolvency proceedings wherein claims/debts owed to the tax authorities often become points of contention during the resolution process. While courts have attempted to interpret these statutes harmoniously, we see a continued discordant judicial interpretation.[129] In the past few years, there have been several cases that have looked at the nature of income tax dues, i. e. whether it is operational or financial debt,[130] the priority of tax dues within the waterfall mechanism under the IBC,[131] the taxation of loan/interest waivers during the restructuring of the company

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[123] Jindal Stainless Ltd v. State of Haryana, 2017 12 SCC 1 (Supreme Court of India).
[124] *Id.*
[125] *Id.*
[126] Sundaram, *supra note* 114.
[127] Jindal Stainless Ltd. v. State of Haryana, *supra note* 123.
[128] Sundaram, *supra note* 114.
[129] In the interpretation of certain aspects of taxation dues within the insolvency resolution process, there have been discordant notes wherein judges have attempted to limit the precedential value of prior judgement to harmoniously balance the interests of all stakeholders involved. An example of this can be seen in the Supreme court's judgements on the issue of priority of tax debts in insolvency resolution. In *State Tax Officer v. Rainbow Papers Ltd,* (2022 SCC OnLine SC 1162), the court held that the State would be treated as a financial creditor in respect of dues that were pending under the Gujarat Value Added Tax Act of 2003. Subsequently, in Paschimanchal Vidyut Vitran Nigam Ltd. v. Rarman Ispat Private Limited & Ors (2023 SCC OnLine SC 842), the court without overruling the judgement in Rainbow held that the judgement was passed without considering the waterfall mechanism established under the IBC and limited the use of the case to its specific facts and circumstances.
[130] Ghanashyam Mishra and Sons Private v. Edelweiss Asset Reconstruction Company Pvt Ltd 2021 SCC Online SC 313 (Supreme Court of India). (Supreme Court, India).
[131] State Tax Officer v. Rainbow Papers Ltd, 2022 SCC OnLine SC 1162 (Supreme Court of India); Paschimanchal Vidyut Vitran Nigam Ltd v. Rarman Ispat Private Limited & Ors 2023 SCC On Line SC 842 (Supreme Court of India).

through resolution plans passed by the Committee of Creditors, recovery of customs dues after moratorium etc.[132]

The priority of these claims and the friction between these legislations can be viewed through the lens of the Constitution of India, which grants the right to tax, and the underlying objectives sought to be achieved by the IBC and insolvency law in general. Given that the IBC is being modelled with a communitarian vision, the question remains how these theoretical frameworks operate within the Indian legal framework. Although the communitarian theory of insolvency accounts for the competing interests of both consensual and non-consensual creditors and broader society,[133] the priority ascribed to these interests under the communitarian theory and taxation theory varies and leads to tension.

The core objective of taxation is to raise revenue for an array of purposes. Principally, the existence of a priority in taxation dues is consistent with meeting the fiscal adequacy objectives of tax law.[134] The argument favouring the same is that tax revenue is ultimately used to serve the community's interests. Therefore, a communitarian vision of insolvency must enable taxation dues to be recovered before other secured and unsecured debts owed to various creditors.[135] The prioritisation of tax debt was expounded in *Dena Bank v. Bhikhabhai Prabhudas Parekh & Co*[136]–

> The principle of priority of government debts is founded on the rule of necessity and of public policy. The basic justification for the claim for priority of State debts rests on the well-recognised principle that the State is entitled to raise money by taxation because unless adequate revenue is received by the State, it would not be able to function as a sovereign Government at all.....
>
> the arrears of tax due to the State can claim priority over private debts and that this rule of common law amounts to law in force in the territory of British India at the relevant time within the meaning of Article 372(1) of the Constitution of India and therefore continues to be in force thereafter. On the very principle on which the rule is founded, the priority would be available only to such debts as are incurred by the subjects of the Crown by reference to the State's sovereign power of compulsory exaction.

Therefore, it is argued that the priority of tax dues over the creditor's interests during insolvency is but an extension of the state's sovereignty and fulfils the community interest as

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[132] Vinod Kothari, Sikha Bansal and Vinod Kothari, *Income Tax Issues in Insolvency, Insolvent Liquidation and Voluntary Liquidation,* https://vinodkothari.com/wp-content/uploads/2023/04/Income-tax-issues-in-insolvency-insolvent-liquidation_final-1.pdf; Prachi Bhardwaj, *IBC Prevails over Customs Act Once Moratorium Is Imposed; CBIC Has Limited Jurisdiction, Cannot Initiate Recovery of Dues: Supreme Court,* SCC Times,https://www.scconline.com/blog/post/2022/08/29/ibc-prevails-over-customs-once-moratoriumimposed-cbic-has-limited-jurisdiction-supreme-court-legal-updates-research-news/, (June 24, 2024).

[133] Villios, *supra note* 3.

[134] *Id.*

[135] *Id.*

[136] The present case was a recovery suit filed by Dena Bank for recovery of monies granted to a partnership firm in a mortgage agreement by deposit of title deeds. The suit sought enforcement of the mortgage security. During this time, the State of Karnataka sought to recover sales tax from the partnership firm arrears. One of the issues the Court was tasked with ascertaining was whether recovery of tax by the State would have priority over the Banks right to recover against mortgaged property. See Dena Bank v Bhikhabhai Prabhudas Parekh & Co 2000 5 SCC 694 (Supreme Court of India).

well. However, neither the BLRC nor the Financial Sector Legislative Reforms Commission have adopted this view.[137] While the issue of priority of tax debt has always been analysed from the lens of the state's sovereignty, if we analyse the same from the lens of compensatory tax theory, there would be considerable inconsistencies. An argument favouring priority under the compensatory tax would be that since they have availed specific benefits for which the tax is due, they would have to be treated as unsecured creditors. The compensatory tax theory examines whether "some link between the tax and facilities extended to such dealers directly or indirectly"[138] exists. If we substitute the same notion of compensatory taxation while ascribing priority, there would not be any positive link between ascribing priority to the state in insolvency proceedings and meeting the broader objectives of reorganisation/revival of the corporate entity. Therefore, theoretically, the issue of priority would be in greater flux if the compensatory tax theory continued to subsist as opposed to a claim of priority under the right of state sovereignty.

The claim for a priority as an extension of the state's sovereignty has also been criticised. The criticism of tax priority over the debts of other creditors is twofold. First, it is argued that the state could focus on the administration of tax regimes to ensure better compliance in the short-medium term. The Committee on Financial Sector Reforms elucidates this –

> The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors.[139]

It is argued that by focusing on tax administration, they could limit the loss to their revenue base without placing an additional burden on financially distressed companies at the time of insolvency resolution.[140] The second criticism is that an increased priority of tax dues could lead stakeholders who are required to revive the distressed company to be less motivated to pursue reorganisation.[141] In 1999, the IMF, while analysing the best manner to conduct orderly insolvency resolution, argued that tax priority in insolvency may have some unintended consequences that diverge from the basic tenets and principles that govern a modern taxation system -

> The second category relates to tax claims of the government. This latter privilege has been justified on the grounds that giving the government priority with respect to tax claims can be beneficial to the rehabilitation process in that it gives the tax authorities an incentive to delay the collection of taxes from a troubled company. However, the creation of such incentives can in fact be counterproductive. Not only does failure to collect taxes compromise the uniform enforcement of the tax laws, but it also constitutes a form of state subsidy and, thereby, undermines the disciplinary forces that an effective insolvency law is designed to support.[142]

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[137] Interim Report of The Bankruptcy Law Reform Committee (Bankruptcy Law Reforms Committee 2015), https://msme.gov.in/sites/default/files/Interim_Report_BLRC.pdf, (Feb. 18, 2024); 'Report of the Financial Sector Legislative Reforms Commission, Volume I: Analysis and Recommendations' (Financial Sector Legislative Reforms Commission, 2013), https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf, (Feb. 18, 2024).

[138] Bhagatram Rajeevkumar v. CST, *supra note* 120.

[139] A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, Planning Commission, Government of India,(SAGE Publications 2009); Report of the Financial Sector Legislative Reforms Commission, Volume I: Analysis and Recommendations, *supra note* 138.

[140] Villios, *supra note* 3.

[141] Interim Report of The Bankruptcy Law Reform Committee, *supra note* 137; Villios, *supra note* 3.

Therefore, while the communitarian vision of insolvency aims to include several other stakeholders, such inclusion under the theory cannot compromise economic efficiency.[143] Thus, the theoretical and principled underpinnings of insolvency and tax legislation inherently have tension, reflected in the legislative frameworks and judicial decisions. This can only be resolved by states determining the trade-offs between some of the objectives of these legislations in the context of the broader interest of the community. The wider interest of the community is the underlying principle that commonly runs below a communitarian vision of insolvency law and modern taxation systems. From this perspective, any broader policy-based solution may be generated to resolve the tension between taxation and insolvency laws.

CONCLUSION

The intersection of insolvency and taxation law is a considerable source of tension in India and worldwide. This is evidenced by multiple countries having varied and continuously evolving stances on treating tax dues within insolvency resolution processes. The Raghuram Rajan Committee described the treatment of various stakeholders in an insolvency resolution process as "a compromise between political and economic considerations."[144] This description summarises the tension between insolvency and taxation statutes. The tension exists not merely due to conflicting provisions but at a deeper and more foundational level at their theoretical intersection. As evidenced in the creditor's bargain theory, the contractarian perspective of insolvency law provides little to no flexibility in treating tax dues and little opportunity to resolve this tension.

On the other hand, a communitarian vision of insolvency that has been increasingly adopted in several countries provides a degree of flexibility by providing some standing to non-consensual creditors such as tax authorities. From the Indian perspective, the constitutionally granted sovereign right of taxation also experiences considerable divergence when applied in insolvency resolution. Creating a consistent and efficient manner to treat tax dues in insolvency proceedings is vital to fulfilling the principles and ideals of both modern taxation and insolvency systems. A better understanding of the fundamental nature of these two essential fields of law is essential to achieve this.

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[142] International Monetary Fund, *Orderly and Effective Insolvency Procedures, Orderly and Effective Insolvency Procedures* (International Monetary Fund 1999), https://www.elibrary.imf.org/display/book/9781557758200/9781557758200.xml, (Feb. 18,2024).

[143] Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay* (1994) 72 Washington University Law Review 1031.

[144] A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, *supra note* 139.