Winding Up/Liquidation of the Company under Indian Laws - Understanding the Tax Implications

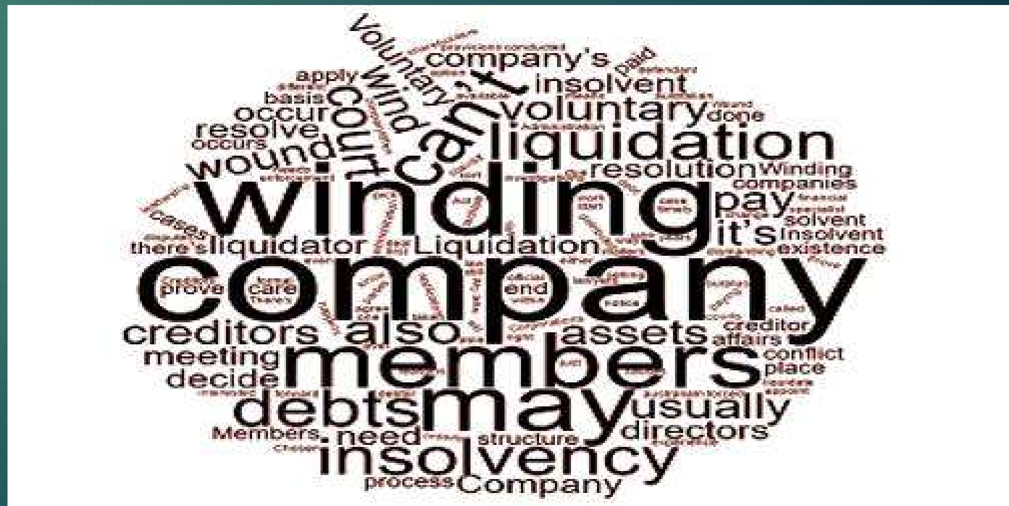
PRESENTED BY: JAIKUMAR VIKAMSEY

Introduction

- What is the difference between *Liquidation - Winding Up* and *Dissolution*?
- How are these events statutorily governed in India?
- What are the tax consequences of these events?

Liquidation - Winding Up and Dissolution

- Process and timing: Which event precedes the other?
- Existence of the entity
- Claim by third party/creditors
- Filing of returns



Insolvency and Bankruptcy Code, 2016 (IBC,2016)

- The ground for winding up 'inability to pay debts' was earlier covered under Section 271 of the Companies Act, 2013. However after the passing of IBC, 2016, the said ground has been omitted from Companies Act, 2013 and is now exclusively covered under IBC, 2016.
- Apart from the inability to pay debts, there is another mode of winding up a company under IBC called "Voluntary Winding Up." Section 59 of IBC, 2016 provides that "A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate voluntary liquidation proceedings under this chapter".

Companies Act, 2013

- Voluntary Winding up
  - Members' Voluntary Winding Up
  - Creditors' Voluntary Winding Up
- 'Compulsory Winding Up' / 'Winding Up by National Company Law Tribunal (NCLT)' and Section 271 of the Companies Act, 2013 has provided 5 grounds for the same
  - Special Resolution (SR) passed by the members for winding up by NCLT;
  - Actions against the sovereignty, integrity of India or security of the State or against public order / decency / morality;
  - Affairs conducted in a fraudulent manner or there is misconduct / misfeasance;
  - Default in filing financial statements or annual returns for 5 consecutive financial years;
  - Other just and equitable ground for winding up.

Tax Consequences

- Nature of income tax liability under IBC – Modification of notices
- waiver or write of loans will be taxable?
  - As waiver of loan is considered as Capital receipt (Now Reversed)
    - JSW Steel Ltd. v. Asstt. CIT [2017] 82 taxmann.com 210 (Mum.-Trib.);
    - Commissioner v. Mahindra & Mahindra Ltd. [2018] 93 taxmann.com 32/255 Taxman 305 (Supreme Court)
- Carry forward and set off of losses
- Conversion of loan in to equity
- Assets distributed to the shareholders of a company on its liquidation shall not be regarded as a transfer by the company
- Deemed dividend implication
- Sale of assets received under the event
- Company in liquidation – section 178
- Directors' Liability – section 179

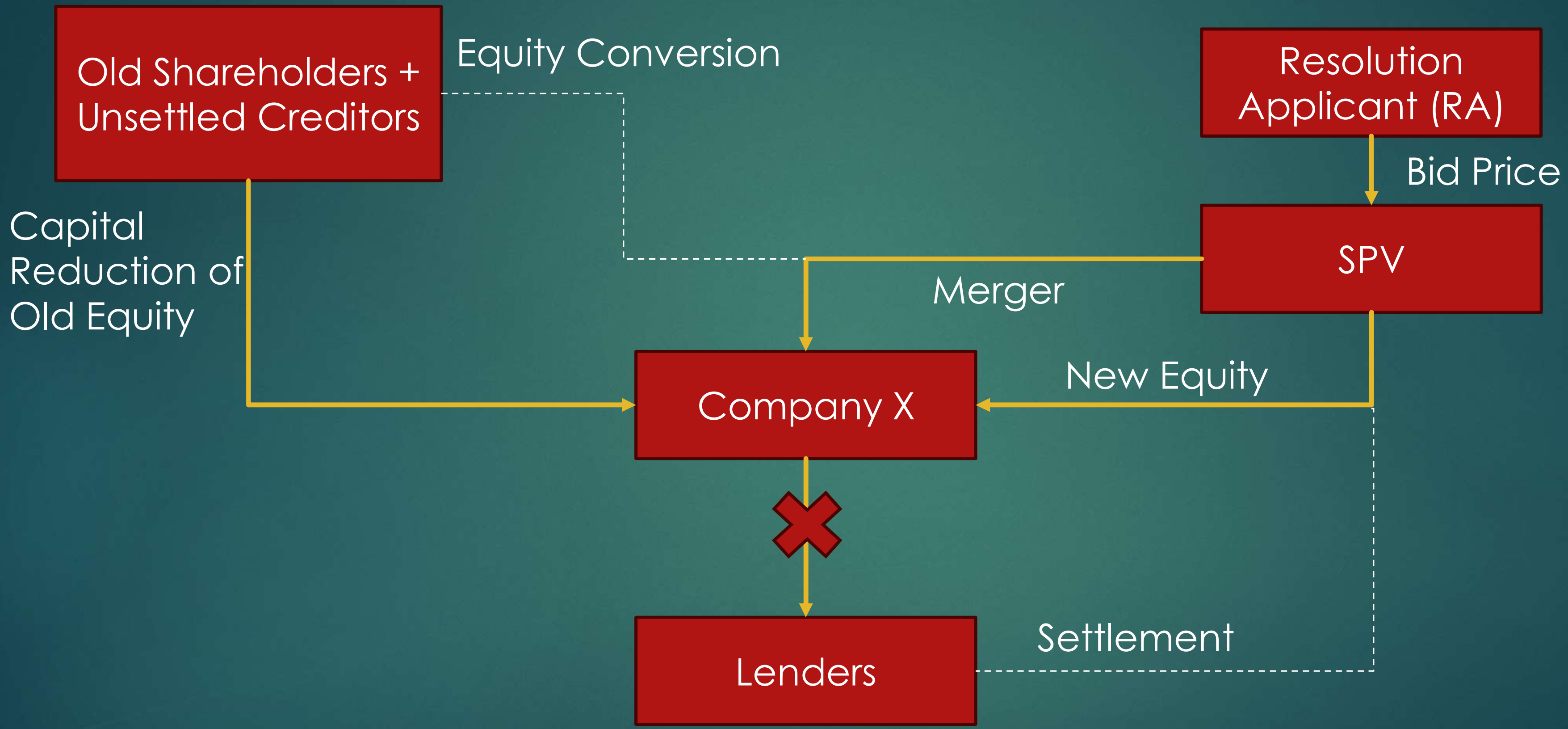
Clean Slate Theory

- 'Clean slate' theory –an applicant taking over an entity undergoing insolvency resolution proceedings should not be saddled with any unexpected claims and should be allowed to commence the business on a 'clean slate' (Section 31 of IBC, 2016)
- The clean slate theory has also been propounded by the Indian courts in several decisions including the Supreme Court's decision in the case of Ghanshyam Mishra & Sons (P.) Ltd., where the court observed that "…the legislative intent behind this is to freeze all the claims so that the resolution applicant starts on a clean slate and is not flung with any surprise claims…".
- The 'clean slate' theory is also recognised internationally.
- The Supreme Court held that government dues would qualify as 'operational debt' and would stand frozen and extinguished if they do not form part of the approved resolution plan. That is, after the approval of the resolution plan under the IBC, no belated claim can be accepted.

Twist in Clean Slate Theory!!

- In 2022 ruling in the case of State Tax Officer v Rainbow Papers Ltd. (Rainbow Papers), the Supreme Court treated the government as a secured creditor. It further held that if the payment of statutory dues in a proportional manner is ignored in a resolution plan, it is bound to be rejected.
- Section 178 (dealing with a company in liquidation) would override the provisions of any other laws except the IBC.
- On a plain and harmonious reading of the ITA and the IBC, it appears that the provisions of the IBC should prevail over that of the ITA. This has been confirmed and upheld in several decisions. Given this, it should be possible to argue against the applicability of the Rainbow Papers ruling to income tax matters.

Comprehensive Case Study



Final Structure - Pros & cons from direct tax perspective

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Company X

QUESTIONS?

Thank You!

Mail: jaikumar.vikamsey@gmail.com