Interplay between GST and IBC: Mutual set off between credits and liabilities

It's quite fateful that both the indirect tax reform and bankruptcy reform occurred around the same time, with the [Corporate] Insolvency & Bankruptcy Code (IBC), setting on motion in May 2016 and GST coming into effect a year later. Both the laws in their respective domain are developing at a rapid speed, with countless judicial development happening day in and day out. Things starts to get very complicated, when the stakeholders found themselves wriggled with both the laws simultaneously. As per Section 238 of the IBC over-rides GST, but only to the extent GST provisions are inconsistent to IBC.

An interesting intertwined topic is **mutual set off of the tax credits and tax liabilities either when the corporate debtor (CD) is either revived or liquidated.** It's not often that CD under CIRP are left with any tax credit (ITC), but for the sake of exploring the various stages of complications, we assume that the CD had ITC to the tune INR 1000 [on date of plan]; unpaid output GST INR 400 [on CIRP date]; and 1% of the outstanding Service tax/ VAT dues of INR 500 were settled at 5 in the plan. In this background, let's devolve if successful resolution applicant (RA) can take any ITC.

Whether set-off is applicable between ITC and output tax

Set off means, the settlement between an insolvent and other person (who is both creditor and debtor to the insolvent) should be on net basis. The concept of set-off arise as a result of statute, principle of equity or by virtue of law. Interestingly, part II of IBC does not have any explicit provision regarding applicability of set off either at either resolution stage or liquidation stage. The claims forms appended to CIRP regulations, provide specific field for set off[1].

The common acceptance is that concept of **set off is applicable at both the liquidation stage as well at the resolution stage, not based on some statutory formula, but on the basis of principle of equity[2].** From this it follows that, even for crown debts, the mutual set off [GST ITC and output GST] should be given effect to. This notion is quite clear in UK after the famous case of **Secretary vs Frid** [2004] 2 AC 506, wherein the UKHL had allowed the state to set off overpaid VAT and employee redundancy payments.

On the other hand, number of Supreme Court judgments[3] have ruled in favour of RA, granting clean slate to the old dues and granting protection to the property acquired under the plan,

[1] Also see Swiss Ribbons para ….

[2] See Official Liquidator vs Lakshmikutty AIR 1981 SC 1483, Pusha Mai Narendera Kumar 1986 (1) WLN 148 (Raj. HC)

[3] See Essar Steel, Manish Kumar vs UOI, Ghanshyam Mishra and Sons

meaning thereby not allowing the debtors of the CD to claim set off. But this call could be aggressive and it might take some time before the air is finally cleared.

Whether abated value of outstanding taxes should be set off

Section 31 of the IBC makes the plan binding on all stakeholders including the CG/ SG for the dues owed to them by CD before the CIRP date. Section 32A in turns provide protection to the RA against the property claimed under the plan against offences occurring prior to CIRP date. A pertinent question could be that even if set off is to be applied, to what extent the debts should be considered for set off. In the example cited above whether the abated claims of service tax/ VAT [495] should be applied against the balance credit [600] available with the RA?

The NCLT in number of earlier cases and Supreme Court in Ghanashyam Mishra's case had declared that the plan is binding on the state and un-settled liability stands extinguished qua the RA. Once the RA is given handover of the properties, it will be against the objectives of IBC to grant anything beyond the settled claim to the state. In GGS Infrastructure , the Bombay adras High Court in the case where the service tax department had recovered more than 6.23 Crore from the CD as against the settled liability of .35 Crore [7.02 Cr * 5%], had held that balance amount of 5.87 Crore should be returned to the RA.

The High Court categorically ruled out the assertion that 5% is additional liability of CD over the unrecovered amount. This case give due credence to the objective of IBC and the same analogy should be applicable over ITC as well, such that if at all set off is to be given effect to, such set off does not extends to 495 in the example above.

Whether set off should be seen at entity level or GSTIN level

Another layer of complication is that GST is multi state tax and practically administered by Central government and all the State governments for their respective state. The cardinal principle of set off is that the debt and credit should be between the same persons[4]. In Frid's case *supra*, the HL had held that since crown is administers both VAT and employee redundancy pay legislation, the inter-se set off should be allowed.

The preliminary question is whether CG and SG be considered as one person if at all, the set off is to be applied? Suppose in the above example, the ITC of 1000 is 100 CGST, 100 SGST and 800 IGST, whereas output tax liability is split between CGST 200 and SGST 200.

[4] Re Morris and Others v Rayners Enterprises Incorporated and Another, Same v Agrichemicals Ltd and Others:

[1] Whether 400 be straight off adjusted from 1000 or [2] whether the formula prescribed under Section 49 of the CGST Act read with Rule 88A of the CGST Rules should be applied? With no clear rules and difficulty in applying Frid's case in Indian context, **it would be preferable to use the second approach and go for set off in terms of procedure prescribed in the GST Law.**

The second layer to the same question is whether set off should be allowed seen on entity level basis or GSTIN level basis? Suppose ITC of 1000 is split into IGST 200 in State A; 500 in State B and 300 in State C, and output GST is split into CGST Nil in State A; CGST 30 in State B and CGST 370 in State C. In that sense, whether the total set off should be restricted to 330 [30 in State B and 300 in State C] or should it still extent to 400 [by setting of unabated 70 set off from excess ITC available in State or State B]? The answer could again be looked at from various angle, **but the safest approach again seems to following Section 49 and Rule 88A in respective state, and therefore allowing set off to the extent of 330 only.**

No protection of post CIRP date defaults

It is also worthwhile that Section 32A protects property of CD from the consequence of offences occurred prior to CIRP date. Conversely, offences occurred after CIRP date should be given full effect to, since these do no lead to inconsistency between IBC and other laws. In the above case, the RA recognizes that out of 1000 ITC, there is violation of 2nd proviso to Section 16 (2) of the CGST Act [180 days payment default] and ITC to the tune of 200 [150 pre CIRP and 50 post CIRP] is covered by such violation.

It may be seen from above that post facto adjustments adds to already complicated ITC situation. Should 150 be deducted from 1000 or not? In the plan the department could not bring out [within available time] that ITC to the extent of 150 is defective. Does this mean 150 defects is cured so long Section 31 makes the plan binding on all the stakeholders? If the analogy of above Supreme Court cases it to be followed, the answer seems to be in affirmative. But from equity stand point, this is absurd.

Further, at first blush it might appear that, if not 150, at least 50 should be set off from 1000 given, the offence has occurred post CIRP date. But again, whether RA gets protection only by virtue of Section 32A or by the implicit of IBC, the RA gets full protection over the properties covered in the plan [re-call that Essar Steel was rendered when Sec 32A was not there]. Plus, this is case is different from the outright nefarious case, where the RA has taken over the CD under his *bona fide*. Therefore there are ample grounds on which even set off of 50 can be contested by the RA.

Conclusion

It is often found that the tax credits are often forfeited by the resolution applicant on the assumed pretext that such credits are not eligible. Another reason for ignoring set off is psychological, such parties find it hard to avail ITC when in the first place they are not accepting claims for output tax liabilities. It is true that the environment relating to tax credits is not clear and the M&A deals by the very nature are complicated, but with proper planning and strategy, IBC offers good window to maximize the tax positions. Hopefully the situation gets clearer, as days unfolds.

Thank You

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