INSOLVENCY RESOLUTION PROFESSIONAL – JOURNEY AND ACCOUNTING AND TAX ASPECTS

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1. INTRODUCTION

1.1. The introduction of the Insolvency and Bankruptcy Code, 2016 ("Code") ushered in a new era in the distressed asset landscape and was undoubtedly a significant reform. Prior to introduction of the Code, multiple regulations, at times not in congruence, were leading to disputes and defaults thus invariably delaying the entire process. The laws addressing the revival and financial reconstruction were provided for under different Acts. These different laws were implemented in different judicial forums, namely (i) Provincial Insolvency Act, 1920 (ii) Presidential Towns Insolvency Act, 1909 (iii) Winding up provisions of the Companies Act, 1956 (iv) Sick Industrial Companies (Special Provisions) Act, 1985 (v) Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the (vi) Securitisation & Reconstruction of Financial Assets, Enforcement of Security Interests Act, 2002 which often led to delay in achieving the end objective of resolution/ reconstruction.

1.2. The defining aspect of the Code is the strict adherence to timelines, an aspect which was relatively absent in previous legislations. The Code explicitly provides for a 180-day period of resolution of the corporate debtor with an extension of 90 days. The lapse of 180/270 days leads to the compulsory liquidation of the corporate debtor. The Code has ushered in a change from the existing situation of "debtor in possession" to "creditor in control". This overhaul has empowered the creditors to take decisions for the benefit of the corporate debtor and the creditors with relatively less opposition from the promoters or the erstwhile directors of the corporate debtor whose powers have been suspended during the period of moratorium, which lasts during the period of the Corporate Insolvency Resolution Process.

1.3. The Code has given significant headroom to indebted companies reeling under pressure to meet their obligations and has facilitated the lenders to expedite recovery and resolution of stressed assets. The Code stipulates a strict 180-day window (extendable to 270 days) for running and completing the Corporate Insolvency Resolution Process (CIRP). The time-bound nature of the process is a unique feature that provides confidence to the creditors and the appointment of an Independent Resolution Professional to manage the process makes the entire ecosystem of resolution more sacrosanct.

2. IMPORTANCE OF INFORMATION

2.1. As an Interim Resolution Professional/Resolution Professional (IRP/RP), one assumes the management responsibilities of the company since the board of directors of the corporate debtor stands suspended u/s. 17 of the Code.

2.2. While the IRP/RP is entrusted with the duty of managing the company as a going concern during the CIRP and steer it towards a successful resolution, he is required to comply with the provisions of various regulations which govern the company undergoing CIRP.

2.3. As a process, the IRP/RP assumes the control of the company once the CIRP is initiated and takes charge of the books of accounts, financial information and records, assets and operations of the company.

2.4. Various provisions of the Code require the IRP/RP to take on record the financial information relating to the company for present and past time period. For example, section 18 of the Code requires that the IRP on assuming charge of the company has to collect all information relating to the assets, finances and operations of the corporate debtor for determining the financial position of the corporate debtor, including information relating to, *inter alia*, financial and operational payments for the previous two years and list of assets and liabilities as on the initiation date.

2.5. In order to ensure a time-bound and speedy mechanism, due care with appropriate safeguards needs to be incorporated so as to ensure that the scales are balanced with regard to the speed, accuracy and authenticity of the information, accompanied by its legality. In view thereof, the Code has envisaged four pillars of institutional infrastructure. These pillars include a new competitive industry of Information Utilities (IUs), which has probably no parallel in India or abroad. These have been envisioned with a view that they would store authentic and verified financial information such as debt and default, assets and liabilities of corporates, partnerships and individuals. Further, they shall hold a collection of information about all corporate and individual entities at all times. Thus, when the Insolvency Resolution Process would commence under the Code, within less than a day, undisputed and complete information would become available to all stakeholders involved in the process and thus address the source of delay in dissemination of information.[1] However, till date the IU pillar of the IBC has not been optimally developed and is still in its nascent stage

2.6. Further, Regulation 36 of the Code requires the Resolution Professional to prepare and submit an information memorandum including, *inter alia*, the latest financial statements, the audited financial statements of the corporate debtor for the last two financial years and provisional financial statements for the current financial year made up to a date not earlier than 14 days from the date of the application to CIRP.

2.7. Apart from this, the RP while undertaking his duties under the Code requires that all the information pertaining to the accounts of the company is kept up-to-date in order to ensure adequate disclosures with respect to compliances, CIRP costs etc., during the CIRP as and when required by IBBI.

2.8. Regular updating of accounting statements and financial records is also required since the Code provides rights to the Committee of Creditors of the Company to ask the RP for providing them with any particular financial information during the process. Apart from this, the Resolution Professional while dealing with prospective investors is also often required to provide latest financial information which is required by the investors for submission of the resolution plan.

2.9. The IBBI vide Circular dated 3rd January 2018 has directed all Insolvency Professionals to exercise reasonable care and diligence and take all necessary steps to ensure that corporate persons undergoing Insolvency Resolution Process, fast-track Insolvency Resolution Process, liquidation process or voluntary liquidation process under the Insolvency and Bankruptcy Code, 2016 comply with provisions of the applicable laws (Acts, Rules and Regulations, Circulars, Guidelines, Orders, Directions, etc.) during such process. For example, a corporate person undergoing Insolvency Resolution Process, if listed on a stock exchange, needs to comply with every provision of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, unless the provision is specifically exempted by the competent authority or becomes inapplicable by operation of law for the corporate person. This implies that it is the RP's responsibility to ensure that all the financial statements falling during the CIRP are duly prepared and published as required under applicable laws and regulations.

2.10. This aspect regarding compliance of various laws during the CIRP process was also touched upon by the Mumbai NCLT Bench in the case of Roofit Industries, where it noted that companies are governed by various enactments, they have to run in compliance with the laws of this country and it can't be said that companies running under CIRP are free to flout all other laws.

2.11. It is also to be noted that requirements pertaining to their payment of tax or filing of returns during the CIRP would be primarily the responsibility of the IRP/RP.

3. THE CHALLENGE

3.1. More often than not it is observed that the IRP/RP's face challenges in terms of availability of financial information, various legacy non-compliances spilling over into the CIRP period, ongoing tax appeals/litigations, lack of required data to finalise the books of accounts and so on.

3.2. There are instances where it is found that inadequate accounting procedures are followed by a company under CIRP and the company may not have contemporaneous records pertaining to previous periods maintained with it. This usually stems from the fact that there is usually a brain-drain of key executives of the company undergoing CIRP, a possible case of mismanagement in the past resulting in loss of records, loss of data during handover by employees who have left the company, possible IT

1 *BLRC Report*

infrastructure-related issues like server crashes, as also the various existing non-compliances resulting in levy of penalties and interest.

3.3. Thus, the IRP/RP usually finds himself with a myriad of challenges in meeting the ongoing compliances during the CIRP. Although the Code u/s. 19 stipulates that the personnel of the corporate debtor have to extend help to the Interim Resolution Professional in terms of running the process and provide the necessary information, the primary responsibility of compliance remains with the IRP/RP.

3.4. It is possible that the accounts of the company for the year preceding the year in which the CIRP was initiated have not been finalised and published as on the date of CIRP and with the board of directors of the company now suspended, the RP has a task cut for him to ensure the compliance of finalising the accounts. In such circumstances which are usually also caused by lack of necessary co-operation from the previous management of the company and lack of necessary information, the RP finds himself in a challenging situation where he has to completely re-do the financial statements to ensure their correctness and completeness.

3.5. This, in addition to possible non-availability of past records, absence of adequate man-power within the company undergoing CIRP and a legacy of past non-compliances poses a real challenge for the IRP/RP in meeting the ongoing compliance.

3.6. As the auditor of the company is also required to comment regarding the going concern status of the company in its audit report, it becomes very difficult to harmonise the idea of going concern for a company under CIRP to express an opinion.

3.7. The Resolution Professional is also required to carry out a liquidation and fair valuation of the assets of the company under CIRP. This also gives rise to various difficulties in integrating the finding of the valuer appointed by the Resolution Professional which carries out the liquidation and fair valuation within certain assumptions and a framework, with the requirement to restate the financial statements as per the applicable accounting standards for the company undergoing CIRP.

3.8. The matters pertaining to taxation also need to be dealt with caution as there could be several ongoing cases that may result into demands and penalties during the CIRP period. This requires the IRP/RP to understand all the ongoing litigations to ensure that necessary steps are taken to address the same. It is not quite possible to imagine a situation where the bank accounts of the company under CIRP are attached u/s. 226 of the Income Tax Act, 1961 for non-compliances before the CIRP. This leaves the IRP/RP with a challenging situation where on the one hand he is duty-bound to maintain the going concern status of the company, while on the other, the company's bank accounts are frozen affecting its ability to conduct day-to-day operations smoothly.

3.9. This brings to the fore an important aspect of overriding of legislations. Although section 238 of the Code is an over-riding provision, it has been tested on various occasions as to its applicability and operability given the evolving jurisprudence of the Code.

3.10. The problem of inadequate past financial data bears an impact during the ongoing tax assessments as well. The company usually reeling under financial stress finds itself in a difficult position to meet the requirement for paying the appeal deposit or representing before the tax authorities. This, however, does not absolve the RP of any compliances and requires that he has to ensure that appropriate actions, be it appeal or otherwise, are taken.

3.11. Section 80 of the Income Tax Act, 1961 provides that in the event a taxpayer fails to file return in accordance with the provisions of section 139(3) of the Act, the carry-forward losses computed in accordance with the sections specified therein would lapse. The RP often faces some practical predicaments relating to filing of timely income tax returns with inadequate available data, requirement of filing with respect to digital signatures, changing of signatories for filing returns without support from the previous signatories, etc. The direct implication of such non-compliance would be to lose the benefit of carrying forward losses of the year.

3.12. Another set of challenges which may have an implication on compliances is the mandatory applicability of Indian Accounting Standards applicable to certain class of companies. Ind AS 8 deals with Accounting Policies, Changes in Accounting Estimates and Errors. The said standard mandates that any material prior period error is to be set right by restating the financial statements of that year. A tax complication may arise as to whether such error impacting the profit/loss of earlier years would be allowed as an expenditure in the year of resolution or should be claimed for the year when such error occured. Such claim would be possible only if the timeline for revised return permits the same. In a nutshell, the claim in respect of such error may not be available if one were to take the provision of law and jurisprudence on the subject.

3.13. One other aspect of taxation is the claims admission process, wherein the IRP/RP is required to deal with various claims by the tax authorities including claims arising out of ongoing cases or cases under appeal. The law is still evolving on the subject of determining the amount of claim in case of liabilities which are not crystallised on the date of submission of claim or are contingent on the happening/non-happening of certain events in future.

3.14. Like the IBC, another reform that is still in its sapling stages is GST. It is possible that the company under CIRP often does not have adequate resources and manpower to ensure various GST compliances including registration, transition from previous indirect tax regime to GST regime or necessary infrastructure to implement GST.

3.15. A few other aspects that remain to be tested are the possibility of waiver of existing tax demand on approval of a Resolution Plan, tax liability of the period up to the date of approval of Resolution Plan but crystallised afterwards, and waiver of tax liability arising on implementation of the Resolution Plan given that a Resolution Plan may often involve certain write-backs resulting in notional income for the company. The order in the matter of *J.R. Agro Industries Pvt. Limited vs. Swadisht Oils Pvt. Limited, (Company Application No. 59 of 2018 in CP No. (IB) 13/ALD/2017)* may be referred to, wherein a company application was filed before the AA (Allahabad Bench) by the RP u/s. 30(6) of the IBC for approval of the resolution plan as approved by the Committee of Creditors. The AA observed that "we cannot allow exemption of any liability arising in respect of income tax". The NCLT further noted that any statutory liability of the transferor company shall be the liability of the transferee company and since the income tax department was not a party to the proceedings, the resolution plan cannot be approved without giving the department a hearing at this stage. Accordingly, the resolution professional was asked to modify its resolution plan with a direction that the same may be re-submitted after getting the plan approved from the CoC. In this regard, numerous orders of the AA state that a waiver of statutory dues, if any, can only be done by the appropriate authority by moving an appropriate application before the statutory authorities.

3.16. IP is expected to maintain robust documentation during the period he had acted in his role. This would be more relevant because if there are certain challenges post his completion of role, he would be expected to demonstrate that he acted in good faith and with due diligence.

3.17. With the few relaxations and certain decisions of the Hon'ble Supreme Court, it appears that the battle is only half won with the complexities outpacing the challenges faced. The IBC has been a landmark legislation and it will continue to evolve.

3.18. While some of the areas listed above may need more thought and consideration, the issue that IBC deals with is such that there will always be other unforeseen challenges.

4. ACCOUNTING CONSIDERATIONS

4.1. To begin with, when a company is under the Resolution Process, if there is a reporting date and the company has to issue its financial statements, the company will have to consider the following issues:

4.1.1. Going Concern Assessment: Indian Accounting Standard ("Ind AS") 1 *Presentation of Financial Statements*, requires the management to make an assessment of going concern while preparing the financial statements. The company being admitted under the Code is an indicator of accumulated losses and inability to pay its operational and/or its financial creditors. Hence, the management of the company will have to carry out a going concern assessment taking into consideration the stage of the Resolution Process and its future prospects and decide on the accounting treatment accordingly.

In cases where it is likely that the company will be sent under liquidation or it has already been referred for liquidation before the financial statements have been approved for issue, the financial statements cannot be prepared using the going concern assumption. Ind AS 1 does not prescribe the accounting treatment to be followed in case financial statements are to be prepared on a basis other than going concern basis. The management will have to decide on appropriate accounting policies for preparing the accounts depending on the facts and circumstances and provide detailed disclosures for the basis of preparation of the financial statements and judgements made in selecting the accounting policies.

There will be a similar requirement under Accounting Standard ("AS") 1 *Disclosure of Accounting Policies*.

4.1.2. Impairment of Assets: AS 28 / Ind AS 36 *Impairment of Assets* requires the management to test its tangible and intangible assets for impairment in case any indicators are identified. When the company is admitted under a Resolution Process under the Code, it is an indicator for the management to calculate the recoverable amount for its tangible and intangible assets and if it is below the carrying amount, an impairment loss will have to be recognised in the profit and loss.

4.1.3. Additional Disclosures: There may be several claims made by the creditors on the company which may or may not match with the liabilities recognised in the financial statements. Depending on the stage of the Resolution Process, the company will have to provide detailed disclosures about such claims and also give the expected financial effect of the same on the financial statement.

4.2. Once the Resolution Process has been approved, the company under the Code will have to evaluate the following accounting considerations:

4.2.1. Debt restructuring: There are several ways in which the existing debt of the company may be restructured with the lenders as part of the resolution. The accounting will be driven by the terms and conditions of the agreed restructuring. In case of any full or partial waiver of principal or interest amount by the lender, the gain on the reduction of the liability for the company will be recognised in profit and loss as per Ind AS 109 *Financial Instruments*. There are some exceptions to this rule provided under Appendix D to Ind AS 109 which the company may have to evaluate.

In case of novation of the loan to the acquirer or a special purpose vehicle (SPV) formed for the Resolution Process, the company will have to evaluate whether the same will qualify for extinguishment of liability from original lender under Ind AS 109.

Ind AS 109 requires that a substantial modification of the terms of an existing financial liability, or a part of it, should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. A change in lender could significantly alter the future economic risk exposure of the liability and could be regarded as representing a substantial change which would lead to derecognition of the original liability.

In that case, the company will derecognise the existing loan and recognise a new obligation to the acquirer or the SPV at fair value of the loan with the revised term and the difference between the carrying value of the extinguished liability and the fair value of the new loan will have to be recognised in profit and loss.

This credit taken to the profit and loss may have significant implications on the computation of MAT.

4.2.2. Other aspects in the Resolution Process: Depending on the other steps agreed as part of the resolution process, the company may have to account for any additional equity / debt issued to the acquirer. If a part of the business is being demerged, the company may have to evaluate implications under Ind AS 105 non-current assets held for sale and discontinued operations.

4.3. Depending on the structure finalised under the Resolution Process, the acquirer will have to evaluate the following possible accounting implications:

4.3.1. The acquirer will have to apply Ind AS 103 *Business Combinations* and give effect to acquisition accounting at fair values of the net assets acquired depending on the structure agreed – merger, demerger or reverse merger. For the acquisition accounting, the company will also have to undertake purchase price allocation of the net assets. This may entail several accounting complexities as under, depending on the structure of the transaction:

a. Are there any contingent liabilities of the company which need to be fair valued?
b. While comparing the net assets acquired and consideration transferred, normally there should not be a goodwill considering the circumstances in which the transaction has taken place.
c. If there is a merger of the entities, the acquirer to evaluate whether the values to be merged will be those appearing in the standalone financial statements or consolidated financial statements of the acquiree. There is guidance provided pertaining to this in the Ind AS *Transition Facilitation Group* (ITFG) which the company will have to evaluate.
d. Due to fair valuation of assets and liabilities, there will be changes in the book base and the company will have to evaluate the consequent impacts on deferred tax balances.

In case the company is following Indian GAAP, the acquirer will have to evaluate the accounting treatment as per AS 14 *Accounting for Amalgamations,* whether pooling of interest or purchase method will be used to account for the transaction.

4.3.2 Another important consideration is the year in which this acquisition accounting needs to be done. Based on the process under IBC and application of Ind AS 103, the same will be done in the year in which the final approvals for the Resolution Plan have been received from the NCLT. In case such approval is received after the reporting date, but before the financial statements are approved for issue, appropriate disclosures as per Ind AS 10 *Events after the Reporting Date* will have to be given. Even after the Resolution Plan has been implemented, the acquirer and the company will have to be mindful of some of the challenges as mentioned hereunder:

a. In case the company becomes a subsidiary of the acquirer, it will have to include the company's financial statements in its consolidated financial statements.
b. The acquirer will have to harmonise the accounting policies, judgements and estimates of the company with its own policies.
c. The acquirer will also have to evaluate the Internal Controls over Financial Reporting (ICFR) for the company.
d. Finance function readiness will have to be evaluated for quarterly and annual reporting, as applicable and compliance with requirements of Accounting Standards, SEBI requirements and Companies Act.
e. A detailed investor communication will have to be issued to manage the investor expectations.

Thus, it becomes critical for both the acquirer and the company under the IBC to be mindful of the various accounting implications while deciding the overall structure to arrive at an effective resolution to revive the struggling company.

5. TAX CONSIDERATIONS

5.1. Prior to introduction of IBC, the Sick Industrial Companies Act (SICA) was enacted to identify sick and potentially sick companies owning industrial undertakings and for implementation of suitable measures to revive such companies. Section 32 of the SICA provided that the scheme made under the SICA would have overriding effect over other laws in force and basis this provision, it was also possible for a sick company to obtain customised tax concessions with the consent of the income tax department through the BIFR scheme approved under SICA. However, there is no similar provision in the Code. This led to recommendations from the industry bodies and professional chambers for providing tax concessions under the Income Tax Act, 1961 (ITA), for companies undergoing Resolution Process.

In deference to the recommendations and to facilitate the effective implementation of IBC, amendments were made in the ITA vide Finance Act, 2018 (FA 2018) to facilitate the rehabilitation of companies undergoing Insolvency Resolution Process.

The following is a snapshot of the amendments made by FA 2018:

1. Amendment of MAT provisions to provide for deduction of aggregate of brought-forward book losses and unabsorbed depreciation.

Provisions of section 115JB of ITA as they existed prior to amendment by FA 2018 provided for deduction of an amount which is lower than brought-forward loss and unabsorbed depreciation as per books in computing the book profits for MAT purposes. FA 2018 inserted Clause (iih) in Explanation 1 to section 115JB(2) to provide a deduction of **aggregate** of brought-forward losses and unabsorbed depreciation in case of a company against whom an application for insolvency proceedings has been admitted under IBC.

2. Carry forward of losses of IBC companies not to be impacted in case of change in shareholding pursuant to implementation of Resolution Plan.

Section 79 of the ITA provides that carry forward and set-off of losses in a closely-held company shall be allowed only if there is a continuity in the beneficial owner of the shares carrying not less than 51% of the voting power, on the last day of the year or years in which the loss was incurred. Implementation of Resolution Plan under IBC for the revival of the insolvent companies may involve restructuring in the form of mergers, acquisitions, buy-outs, etc., thus resulting in a change in shareholding of the insolvent company. Noting that application of section 79 in such cases may act as a hurdle for the revival of the insolvent companies, FA 2018 amended section 79 to provide that the rigours of section 79 will not apply to change in shareholding resulting from the implementation of the Resolution Plan under IBC[2].

2 *This is subject to affording a reasonable opportunity of being heard to the jurisdictional principal commissioner or commissioner.*

3. Resolution professional authorised to verify the return of income during the Resolution Process.

The return of income filed under the ITA is required to be verified by the managing director/director of the company. Once an application for insolvency resolution has been accepted under IBC, the powers of the board of directors are suspended and the management of the affairs of the company is handed over to the Resolution Professional. Section 140 of ITA was thus amended to authorise the Resolution Professional to verify the return of income filed by the company, in respect of whom an application for corporate insolvency process has been admitted under IBC.

4. Section 178 – In addition, section 178 of ITA dealing with responsibilities of a liquidator was amended by IBC (Section 247 of IBC read with the third schedule) to provide that the provisions of section 178 will apply subject to the other provisions of IBC.

5.2. While the above amendments are welcome, the following are certain aspects that need consideration/ suitable amendments to truly enable the revival of insolvent companies.

1. The insertion of clause (iih) is intended to provide relief to companies undergoing Insolvency Resolution Process by allowing them full set-off of loss and depreciation instead of the lower of the two. However, the interpretation of clause (iih) in conjunction with existing clause (iii) raises number of interpretational issues:

- Which is the first year in the lifecycle of corporate insolvency process in which clause (iih) will become applicable?
- Once clause (iih) becomes applicable, which is the year in which it shall cease to apply? This issue becomes more crucial in cases where the Resolution Process extends beyond the 270 - day period prescribed under IBC due to litigations.
- If the amount of losses and unabsorbed depreciation quantified under clause (iih) remains unutilised, how would such losses and depreciation be carried forward and set off u/s. 115JB? Can both clause (iih) and clause (iii) be applied for a single year?
- A related issue that arises is whether in case of the merger of an IBC company with another company pursuant to a Resolution Plan, the amalgamated company can claim benefit of clause (iih)?

2. MAT relief in respect of sick companies covered under SICA was governed by clause (vii) of of Explanation 1 to section 115JB. Clause (vii) provides that any profits of a sick industrial company for the period beginning from the assessment year in which the company qualifies as a sick industrial company and ending with the assessment year in which the net worth of the company becomes equal to or exceeds the accumulated losses, needs to be reduced from 'book profit'. In other words, profits of a company for the period during which it qualifies as a sick industrial company under the SICA is not to be considered for MAT purposes. Clause (vii) is now redundant with the repeal of SICA.

It is very common for creditors of companies undergoing IBC to take a haircut (waiver). Such waiver when credited to the profit and loss account is likely to have a huge MAT impact for the IBC companies. This acts as a hurdle for the revival of IBC companies. Clause (iih) providing relief to IBC companies is not as wide in scope as clause (vii) and may not be able to relieve the MAT impact of such waiver, especially in case of IBC who have nominal or nil brought-forward losses. Clause (iih) may thus be of no help in revival of such IBC companies.

3. Whether the benefit of exclusion from section 79 applies only to change in shareholding of the IBC company or whether it can apply even to the change in shareholding of subsidiaries of the IBC company?

4. Whether the Resolution Professional who verifies the return of income be visited with the consequences of a principal officer under the Income Tax Act, such as penal consequences for failure in withholding and payment of tax deducted at source (TDS), filing of TDS return, etc.?

6. CONCLUSION

While it is heartening to see that the government is keen to facilitate the implementation of IBC, there are still many aspects as discussed above, which may need policy consideration for the IBC to be effective in its true spirit.

Tax is and continues to be a major factor that will impact and influence various stakeholders in the IBC process. Despite IBC being hailed as an important legislative reform to resolve the burgeoning NPA problem in the Indian economy, if the tax laws are not amended appropriately, it may hinder the growth of the Indian economy. ■