An article on An analysis of section 226(3) of the Income Tax Act, 1961

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AN ANALYSIS OF SECTION 226(3) OF THE INCOME TAX ACT, 1961

This is basically an analysis of section 226 of Income Tax Act and a case study.

Section 226 of the Income Tax Act, 1961 ("the Act") comes under Chpt. XVII of the said Act. It deals with the Other Modes of Recovery. For the case study we are more concerned about sub-section (3) of section 226.An analysis of the said sub-section 3 of section 226 reveals as under.

The tax recovery officer or the assessing officer has the right at any point of time or from time to time to issue a notice in writing to any person whose money is due or may become due to the Assessee from whom the tax has to be recovered or to any person who holds the money in trust or otherwise for the said Assessee in default to either pay the amount immediately or forthwith upon the money becoming due or so much money which is sufficient to pay the tax demanded and to be paid to the department.

It is very common for the income tax departments to issue such notices to banks where the assesses have accounts. The major dilemmas which the banks face are as under.

a) The first of the dilemmas which is faced by the Banks is regarding FDs, which is not created by the text of the Section but by the conduct of recovery officer. As far as FDs are concerned, the Section is very clear that once the notice is issued, the Bank holds the money in trust on behalf of the tax recovery officer till maturity, if the said demand continues to be in force till that date. In other words impliedly, as per the Section, the income tax authorities have no right to prematurely close the FD and demand the encashment. *However, in almost all the cases, the tax recovery officer will insist on a premature encashment.*

b) The second of the dilemmas emanate from the exposure of bank to the 'Assesse in default'. Bank may have granted a cash credit facility or other facilities like Term loan, etc. to the said 'Assessee in default' and the same may be secured by either mortgage backed assets or by means of hypothecation of the current assets and or receivables.

On the particular day when the notice is issued, if the account of the 'Assessee in default' is in credit balance, can income tax officer or recovery officer, who has issued the notice come to a conclusion that irrespective of the fact that the 'Assessee in default' has overdrawn or credit balance pertains to the drawings from the CC account, which amount is due to the Bank, will have to be paid

to the income tax authorities or whether the Bank will have the first right to set it off against its outstandings, which in this case is a running account.

c) The last of the dilemmas faced by the Banks is regarding such attachment of current account maintained by the 'Assessee in default' when the borrower (before became 'Assessee in default') has borrowed heavily from the banks and amount is due and payable to the Bank, even though in terms of the said agreement the amount becomes due or the bank's right to call upon the demand arises only upon happening of an 'event of default'.

In such cases, can the Bank take a stand that in view of the fact that the said 'Assessee in default' is indebted to the Bank and therefore, the Banks have first charge and also the banks have a right to set it off against their dues.

The major question in such cases will be whether such attachment notice triggers an 'event of default' automatically, which will enable the banks to recall the amount.

The powers vested with the income tax officers under the Act always enable them to threaten the banks if the banks fail to honour their commitment by stating that the banks will be treated as an Assessee in default and their accounts will be attached.

To answer these questions, we are now coming out with a case study.

Company A is a borrower of the Bank B. However, Company A has been assessed by the income-tax authorities for non-payment of income tax and a huge demand was raised on them. Company went in Appeal against the said demand and an Appeal, at the time of attachment by the income tax authorities, was pending before the Appellate Tribunal. When the matter was before the Appellate Tribunal, the income tax authorities invoked section 226(3) and attached CC bank accounts of the Company A with the Bank B. Company A got an order from the Appellate Tribunal setting aside the said demand and directing the Assessing officer to re-examine the issue and initiate fresh assessment denovo.

The department against the said Order approached High Court u/s 260A of the Income Tax Act stating that there is a question of law involved and therefore, the reference has to be drawn up. The High Court admitted the matter for framing the legal question which had to be answered by the High Court . In the meanwhile, High court stayed operation of the Order of the Tribunal.

The income tax authorities immediately came up with an argument that in view of the stay granted by the Hon'ble High Court, the demand persists and therefore, the recovery has to be made. The banks took a stand that the above view of the department is not correct because the Tribunal has already set aside the demand raised by income tax authorities and therefore, the question of said demand resurrecting itself by virtue of an interim order granted by High court, pending framing of legal question which is to be referred to the High Court for consideration, will not arise.

The banks are of the view that what is stayed by the High Court, pending framing the question, was the order passed by the Tribunal which directed the assessing officer to recompute the tax payment raised by it considering certain issues raised by the assesse before the Tribunal.

The department did not accept the above views of the banks and has threatened to treat the banks as Assessee in default.

The question now we need to consider is whether the view of income tax authorities is legally tenable and also we need to answer the questions raised at the beginning of this article.

In our considered view the stand taken by the department is incorrect and will not stand the test of Law.

We now deal with the other questions raised in the beginning of the article.

The first question to be answered is whether the dues of the income-tax authorities can be considered as crown debts as also whether the same will get priority over any other debts even if the said other debt is created much ahead of the income-tax officer raising a demand or after crystallizing the demand. In this connection, we refer to the following case laws.

Observations of Supreme Court in the case of Dena Bank vs. BhikabhaiPrabhudas Parekh, vide its Judgment dt.25.4.2000 on the Doctrine of Priority Crown Debts assumes a lot of importance.

On 12.4.1972 Dena Bank (hereinafter 'the Bank' for short), who is appellant, filed a suit for recovery of a sum of Rs. 19,27,142.29 paise with future interest and costs against a partnership firm namely, M/s. BhikhabhaiPrabhudas Parekh & Co. and its partners. The suit was based inter alia on a mortgage by

deposit of title deeds made by the partnership firm and its partners on 24.4.1969. The suit sought for enforcement of the mortgage security. During the pendency of the suit some of the defendants expired and their legal representatives were brought on record. Three tenants in the mortgage property were also joined as parties to the suit so as to eliminate the possibility of their causing any hindrance in the enforcement of the charge created by the equitable mortgage of the property in favour of the Bank.

During the pendency of the suit the State of Karnataka tried to attach and sell the mortgaged properties for recovery of sales tax arrears due and payable by the partnership firm, the first defendant. The arrears of sales tax related to the assessment years 1957-58,1966-67 to 1969-70 under the State Act and to the assessment years 1958-59 to 1964-65 and 1967-68 to 1969-70 under the Central Act. There was a court receiver appointed who tried to resist the State's attempt to attach and sale the mortgaged property by preferring objections but he was unsuccessful. It appeared the State of Karnataka itself purchased the property in auction held on 30.4.1976. Upon a prayer made by the Bank the State of Karnataka was impleaded as a defendant in the suit. The Trial Court found all the material plaint averments proved and the Bank entitled to a decree. The charge created on suit properties by mortgage was also held proved. The trial court also held that the State could not have attached and sold the said prope.

The Doctrine of Priority Crown Debts may not apply in respect of debts due to the State if they are contracted by citizens in relation to commercial activities which may be undertaken by the State for achieving socio-economic good. In other words, where welfare State enters into commercial fields which cannot be regarded as an essential and integral part of the basic government functions of the State and seeks to recover debts from its debtors arising out of such commercial activities the applicability of the doctrine of priority shall be open for consideration.....

In Giles v. Grover 1832 131 ER 563 it has been held that the Crown has no precedence over a pledgee of goods. In Bank of Bihar v. State of Bihar and Ors.MANU/SC/0007/1971, the principle has been recognized by this Court holding that the rights of the pawnee who has parted with money in favour of the pawnor on the security of the goods cannot be extinguished even by lawful seized of goods by making money available to other creditors of the pawnor without the claim of the pawnee being first fully satisfied. RashbeharyGhose states in Law of Mortgage (T.L.L., Seventh Edition, p. 3 86) - 'It seems a Government debt in India is not entitled to precedence over a prior secured debt'.....

Observations of National Commission in the case of Union Bank of India vs. Tel Surya Rao, vide its Judgment dt.11.4.1997 on the aspect of 'general lien'

> ……."The general lien of bankers is part of the law merchant as judicially recognized; it connotes the right of a banker to retain the subject matter of the lien until an indebtedness of the customer is paid or discharged. It attaches to all securities deposited with a banker as a banker by a customer, or by a third party on a customer's account, to instruments paid in for collection, and to money held to the account of a customer, unless there is an express or implied contract between the banker and the customer which is inconsistent with the lien. In the case of money, the banker's right is often a right of set-off; it arises only in relation to the customer's money and does not apply to money paid in under a mistake of fact…….
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> ……. Lien is a right of defense and not right of action and therefore, there is no question of bar of limitation coming to the field of exercise of lien. Lien in its primary sense is a right in the banker to retain that which is in his possession belonging to another until certain demands of the person in possession are satisfied. A lien is a right of defense, not a right of action, and consequently can be claimed in respect of a time barred debt. Where a customer deposited its security with a Bank, the Bank is given a general lien over all the securities, except in cases where the deposit was for a larger purpose or where there was an agreement or contract inconsistent with the lien. The banker's lien gives the Bank a right on all the moneys of the constituent in its hand so that they may be transferred to whatever account the Bank chooses, to set-off or liquidate the debt……

We also refer to the two cases mentioned hereinbelow.

1) IN THE SUPREME COURT OF INDIA - CIVIL APPELLATE JURISDICTION - CIVIL APPEAL NO.95 OF 2005 - **Central Bank of India** .. Appellant Vs. **State of Kerala and others** ... Respondents

Whether Section 38C of the Bombay Sales Tax Act, 1959 and Section 26B of the Kerala General Sales Tax Act, 1963 and similar provision contained in other State legislations by which first charge has been created on the property of the dealer or such other person, who is liable to pay sales tax etc., are inconsistent with the provisions contained in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 for recovery of `debt' and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 for enforcement of `security interest' and

whether by virtue of non obstante clauses contained in Section 34(1) of the DRT Act and Section 35 of the Securitisation Act, two Central legislations will have primacy over State legislations. Statutory first charge created in favour of the State under Section 26B of the Kerala Act has primacy over the right of the bank to recover its dues as mentioned in Para 66 viz. reads as the statutory first charge created in favour of the State under Section 26B of the Kerala Act has primacy over the right of the bank to recover its dues.

However, it was made clear that the judgment shall not preclude the banks from realising their dues by taking recourse to other proceedings, as may be permissible under law in terms of Para 67 viz. reads as,"it is made clear that this judgment shall not preclude the banks from realising their dues by taking recourse to other proceedings, as may be permissible under law". The appellant in Civil Appeal No.4174 of 2006 shall be free to avail appropriate remedy for refund of the amount deposited by him in furtherance of the auction conducted by the recovery officer.

In all these cases, save and except the latter, it has been clearly stated that any statutory authorities cannot suo-motto claim priority over any other debts solely because of the fact that the said demand arose out of a statutory liability.

In the case of income-tax, income-tax officer has been given the necessary powers under the said Act, the right to make protective assessment and attach the property or estop the assesse from creating third party interest. Such power per se is to protect the demands in existence or in pipeline (for which process is going on in income tax side)(latter, as per Sec. 281B can be only for limited period). However, having allowed creation of the third party interest, subsequently if a demand is created, the said demand cannot be deemed as to a demand which will take priority over the above charges created in favour of all banks and FIs for borrowings to meet the day to day working of the companies or business of the assessee. This is more so because unless and until the said borrowings are made and capital infused into the business, the said business cannot generate income which can be used / assessed by theincome tax authorities. Therefore, in our view, there has to be a clear distinction where there are borrowings made by the assesse for business purpose and which needs certain charges to be created on theproperties of the business and to generate income which is liable to be assessed. In such cases, the assessment (and the demand pursuant to that) has to be completely out of the purview of the priority of charges vis-à-vis the crown debts or statutory debts inter alia subject to checks and balances to ensure the borrowing for the purpose of conducting the business.

The Banks have a statutory right under the Indian Contract Act u/s 171. This has been reinforced by the court from time to time and we are citing a few of those cases for reference.

VII Bank's statutory rights under the Indian Contract Act

"Sec 171. General lien of bankers, factors, wharfingers, attorneys and policy-brokers

Bankers, factors, wharfingers, attorneys of a High Court and policy-brokers may, in the absence of a contract to the contrary, retain as a security for a general balance of account, any goods bailed to them; but no other persons have a right to retain, as a security for such balance, goods bailed to them, unless there is an express contract to that effect."

Therefore the bank has got statutory rights to recover its dues from the customer's account irrespective of the fact whether there exists a specific clause to that effect or not in the contract
In this regard, the following Judgments clarify and explain the said right.

i) Administrator, Unit Trust of India vs. B M Malani, Date of Judgment dt.11.10.07 by Supreme Court of India (Citation 2007 212 CTR 425)

ii) Dena Bank vs. BhikhabhaiPrabhudas Parekh, Date of Judgment dt.25.4.07 by Supreme Court of India (Citation AIR 2000 SC 3654)

In a latest and recent Judgment dt 5.12.08 of the Supreme Court of India vide Citation SC-2008-1679 in the case of Union of India and Ors vs. SICOM Ltd, the Hon'ble Court held that –

> 11. Generally, the rights of the crown to recover the debt would prevail over the right of a subject. Crown debt means the debts due to the State or the king; debts which a prerogative entitles the Crown to claim priority for before all other creditors. [See Advanced Law Lexicon by P. RamanathaAiyear (3rd Edn.) p. 1147]. Such creditors, however, must be held to mean unsecured creditors. Principle of Crown debt as such pertains to the common law principle. A common law which is a law within the meaning of Article 13 of the Constitution is saved in terms of Article 372 thereof. Those principles of common law, thus, which were existing at the time of coming into force of the Constitution of India are saved by reason of the aforementioned provision. A debt which is secured or which by reason of the provisions of a statute becomes the first charge over the property having regard to the plain meaning of Article

372 of the Constitution of India must be held to prevail over the Crown debt which is an unsecured one. It is trite that when a Parliament or State Legislature makes an enactment, the same would prevail over the common law.

While we do admit that there can be a different view on this issue, in the tussle between the bankers and the statutory authorities to recover the dues from the assesses, the statutory authorities normally wait till the bankers strike to recover their dues to come out with their demand of priority. It is necessary for all concerned to come out with clear unambiguous guidelines on this issue. Today what we see is that the bankers do the kill and when they are about to enjoy their kill, the statutory authorities jump into the fray and claim that they have the first preference to enjoy the kill and Banks should wait till the statutory authorities finish off their hunger.

As regards the case study in question is concerned, the view of income-tax authorities that when theTribunal has set aside any order of the IT Authorities for fresh disposal in accordance with the law, which IT Authorities want to be reconsidered, a stay ordered by the Hon'ble High court on a reference u/s 260A will resurrect the order set aside by the Tribunal is not tenable. Unless and until the entire issue is completely decided either way by the High Court based on the question of law formulated under reference u/s 260A, the effect of stay will be to prevent the assessing officer from taking cognizance of the directions of the Tribunal which has directed for reassessment.So effectively the assessing officer is prevented from conducting the reassessment. However that part of the Tribunal Order which set aside the order of the IT Authorities will remain suspended awaiting the High Court ruling on the question of law.

In fact, under the totality of circumstances, Stay Ordered by High Court has to be taken and construed as "Order of Status Quo" on both the sides. Any other interpretation, certainly the contention of IT Authorities that their Demand Notice gets resurrected, will make the reference u/s 260A and subsequent ruling by High Court as futile exercise as regards the Assesse at the receiving end of IT Authorities, though it was his case that gave raise to proceedings of HC under sec 260A.

If the major issue regarding the priority of debt is not settled, commercial institutions like banks and FIs will always be at a risk and the commercial activity itself can come to a standstill and banks may be hesitant to grant loan because any income tax assessing authority rightly or wrongly can create a fancy demand based on an erroneous interpretation of law and subsequently, while the matter is pending before the Appellate authorities or High Court, can invoke the provisions of Section 226 and its sub-

sections and harass the banks and FIs and completely make them gullible from the position of a secured creditor to that of an unsecured creditor. It is high time that RBI and the Indian Banks' Association take serious note on this issue and discuss these issues at a larger Forum and come out with a clear cut solution which should be a win-win situation for both, the banks as well as statutory authorities.

On the issue of priority of debt, Sec. 529A and 530 of Companies Act, 1956 throw light, which in our view, is based on sound logic. As per the said sections, in the case of winding up of a company, on the proceeds realised, Workers' dues and Secured Creditors' dues rank pari-passu and in priority to any tax dues. The logic is simple – its the efforts of the workers and funds of secured creditors which created the assets of the company which got liquidated. Further Sec. 529A starts with a overriding clause which, in our view, will take precedence over any Tax Authority's claim under Income Tax Act. Its our humble submission that the logic and the sequence of priority that animates distribution of proceeds of a company under winding up should animate in respect of the claims against the company which is not in liquidation also, as there is no logic for different logic.

Our aim in penning this article is not to prevent statutory authorities from getting their rightful and legitimate dues but our intention is to ensure that such claim from the statutory authorities should not be at the cost of Bank or FIs which is lending huge sums solely on the basis of the assets of the Borrower/s being charged to the Banks.

It is also surprising to note that the Act like SARFAESI, which allows the banks without intervention of the court to take possession of the charged properties and dispose it off, has not come out with adequate provisions to address such a dilemma except to state that certain statutory authorities liability namely unpaid dues of workers, etc. shall take precedence over the bankers dues.

"The views expressed herein are that of the writer of the Article and may not represent the views of the organization to which he is affiliated."

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