

TAX LIENS AND THEIR LEGAL CONSEQUENCES ON BANK-FINANCED ASSETS

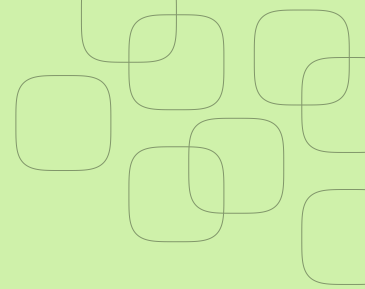
INTRODUCTION

A tax lien is a legal encumbrance imposed by the government on a taxpayer's assets owing to non-payment of tax obligations. It functions as a legal encumbrance that may affix to moveable or immovable property, presenting an obstacle to both transferability and further encumbrance. In India, such liens are often established under the Income Tax Act of 1961, granting tax officials the authority to safeguard the state's financial interests. Although the notion may seem simple, its implications become notably intricate when the asset has been funded by a bank.

This article examines the legal basis of tax liens in India, their effect on secured lending, and the precautions lenders must implement. It also examines the judicial handling of conflicting claims between tax authorities and banks, finally providing practical insights for financial organizations.

LEGAL BASIS OF TAX LIENS IN INDIA

The legal basis for tax liens in India is principally established by Section 281 of the Income Tax Act, 1961. This clause functions as a legal protection for tax authorities, allowing them to prohibit taxpayers from transferring assets in a way that undermines the collection of unpaid tax obligations. According to Section 281(1), any asset transfer by an assessee during ongoing income tax proceedings or after their conclusion, but prior to the full settlement of tax liabilities, is considered void against the claims of tax authorities, unless prior authorization is secured, or the transaction is executed in good faith and for sufficient consideration. This establishes a quasi-lien on the taxpayer's assets, essentially restricting their free transferability until authorized by the Income Tax Department or if the transaction complies with statutory exceptions.



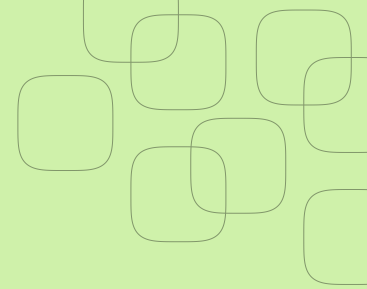
This clause enables tax authorities to indirectly impose a lien on the taxpayer's property by declaring certain transactions legally void. Although it does not explicitly use the word "lien", its legal impact closely mirrors that of a lien by prioritizing the tax department's claims above third-party interests. Moreover, according to the Second Schedule of the Income Tax Act, in conjunction with the Income Tax (Certificate Proceedings) Rules, 1962, tax recovery authorities are endowed with considerable authority to attach, auction, and seize a defaulter's assets for the recovery of outstanding dues. This encompasses both movable and immovable assets, regardless of whether they are mortgaged or pledged—thereby putting secured creditors, such as banks, in a potentially vulnerable situation.

The interaction of Section 281 with other legal frameworks, including the Transfer of Property Act, 1882, and the Companies Act, 2013, is also significant. Secured creditors often depend on the registration of charges and other protective measures to defend their interests; nevertheless, an overriding tax lien under Section 281 may invalidate such protections if the transaction fails to meet the Income Tax Department's stipulations. The failure to get a No Objection Certificate ("**NOC**") from the department may result in issues during asset enforcement or recovery.

The legal ramifications of tax liens on bank-financed properties are significant due to their considerable powers. They not only impact the credit risk evaluation process but also affect the enforceability of the bank's collateral in the event of failure. For lenders, Section 281 is not only a legal reference but a crucial operational issue that must be included into internal loan disbursement procedures and compliance assessments.

EFFECT ON BANKING AND LENDING TRANSACTIONS

Tax liens significantly impact the landscape of banking and lending transactions by introducing an element of uncertainty and potential conflict over asset ownership and claim priority. When banks finance assets—whether through loans backed by mortgages, hypothecation, or pledges—they

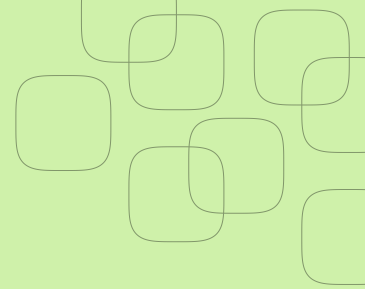


operate under the assumption that their security interest is legally valid, enforceable, and, importantly, enjoys priority over other competing claims. However, when a tax lien exists or arises subsequently under Section 281 of the Income Tax Act, it can threaten the very foundation of this security arrangement. The statutory powers granted to tax authorities allow them to treat certain transfers or encumbrances as void, thereby casting doubt on the enforceability of even duly registered charges created in favour of banks.

The core issue lies in the fact that a tax lien, though not recorded in public registries like CERSAI or ROC, may still hold precedence over a bank's registered security interest if the underlying transaction failed to meet the criteria under Section 281. For example, if a borrower has undisclosed tax arrears and sells or mortgages property to a bank without obtaining prior permission or a NOC from the Income Tax Department, the transaction could be deemed void against the government's claim.

Tax liens are typically "silent" in nature—they are not disclosed unless proactively searched for or unless the borrower chooses to declare them. This puts banks at risk of unknowingly accepting encumbered assets as collateral. The absence of a centralized public record for tax dues or ongoing proceedings compounds this risk, making it harder for lenders to identify red flags during the due diligence stage. Unlike encumbrances registered with ROC or CERSAI, tax claims often come to light only at the time of enforcement, litigation, or regulatory inquiry, placing the lender in a reactionary position.

From a risk management perspective, this creates significant exposure for secured creditors. Not only is there a possibility of losing the asset as a source of recovery, but the presence of tax liens may also impair the borrower's financial profile, increasing the likelihood of default. For large-scale or consortium lending, this can lead to cascading effects on portfolio quality and loan loss provisioning.



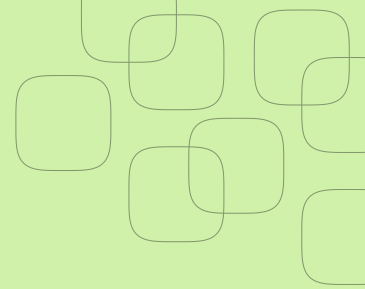
Given these risks, tax liens are no longer a peripheral concern but a central issue in structuring and executing secured lending transactions. Banks must treat them with the same level of scrutiny as they would other statutory liabilities or litigation risks. Understanding their practical effect is critical to adopting preventive strategies and minimizing credit exposure.

DUE DILIGENCE AND COMPLIANCE FOR LENDERS

Lenders are recommended to undertake thorough due diligence and adhere to legislative procedures to protect their security interests, particularly by obtaining a NOC, as mandated by Section 281 of the Income Tax Act. This NOC serves as official verification from the Income Tax Department that there are no outstanding claims against the borrower's assets, or that any current tax obligations would not compromise the bank's charge. In the absence of this clearance, any transaction related to the transfer or establishment of interest in an asset during ongoing tax procedures may be deemed invalid by the tax authorities, thereby jeopardizing the enforceability of the bank's security.

The need for such a safeguard is amplified when managing high-value loans or in case of sale of assets. Banks must guarantee that the borrower fully discloses any active tax disputes, outstanding assessments, or demand notifications. In situations of heightened risk, lenders often include conditions antecedent in loan agreements that require the submission of a NOC as a precondition for disbursement. Furthermore, consistent contact with the Income Tax Department and the use of independent tax due diligence studies have become integral to industry best practices.

In addition to acquiring a NOC, lenders must evaluate the borrower's tax compliance history, examine public records, and include indemnification provisions to safeguard against any future tax liens. These procedures not only reduce legal and financial risks but also bolster the trustworthiness of the lending portfolio.

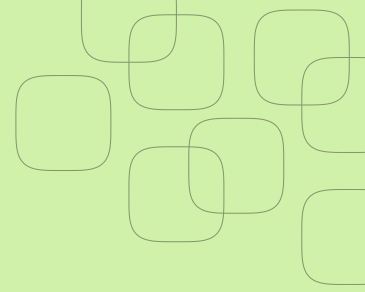


CONFLICT BETWEEN TAX AUTHORITIES AND SECURED CREDITORS

The intersection of tax enforcement and secured lending frequently leads to disputes over the priority of claims, raising a fundamental legal question: who prevails when both tax authorities and banks assert rights over the same asset. Historically, tax authorities have argued that sovereign dues such as taxes take precedence over private claims, including those of secured creditors. However, the legal position in India has evolved through various judicial pronouncements, which have sought to strike a balance between the state's interest in revenue recovery and the rights of lenders holding valid security interests.

In *ICICI Bank Ltd. v. SIDCO Leathers Ltd.* (2006), the Supreme Court held that unless a statutory first charge is created in favour of the government, a secured creditor's charge will have priority over tax dues. This principle was reaffirmed in *Central Bank of India v. State of Kerala* (2009), where the Court clarified that general government dues do not automatically override secured creditors' claims unless explicitly mentioned in the statute. Notably, Section 26E of the SARFAESI Act, 2002 and Section 31B of the Recovery of Debts and Bankruptcy Act, 1993 inserted through later amendments, now grant statutory priority to secured creditors over all other debts, including government dues, provided the security interest is registered.

However, courts have also recognised that banks must act in good faith and follow compliance requirements—particularly those under Section 281—failing which their claims may still be subject to challenge. This underscores the importance of procedural safeguards alongside legal entitlements.



CONCLUSION

The legal and financial ramifications of tax liens on bank-financed properties highlight the need for lenders to engage in proactive risk management. A very successful strategy to alleviate these risks is the prompt verification of a borrower's tax obligations. Recognizing ongoing assessments, concealed tax liabilities, or potential litigation at the initial stage enables lenders and prospective buyers of such assets to evaluate the legal impediments that might influence the enforceability of their security interests.

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