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HIGH COURT AFFIRMS REAL INCOME THEORY, RULES THAT THE CONSIDERATION FOR SHARE SALE REDUCED FROM THE ESCROW ACCOUNT CANNOT BE SUBJECT TO CAPITAL GAIN TAX

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The Hon'ble High Court at Bombay (High Court) in the case of *Dinesh Vazirani* (Taxpayer) [Writ Petition No. 2475 of 2015], has held that the consideration for sale of shares by a seller (Taxpayer) which has been deposited in an escrow account but withdrawn by the purchaser towards the liabilities contemplated under the share purchase agreement (SPA), cannot be taxed in the hands of the Taxpayer.

Facts

- The Taxpayer, in this case, was an individual holding shares in WMI Cranes Ltd (Company). During financial year 2010-11, the Taxpayer sold these shares to Konecranes Finance Corporation (Purchaser) under the SPA, as a part of the share sale by all the promoters.

- As per the SPA, the Purchaser was liable to pay a total consideration of INR 155 crores to the promoters, of which INR 125 crores was paid at the time of transfer of the shares and balance INR 30 crores was deposited in an escrow account. With respect to the escrow amount, the SPA provided that such amount shall be released on completion of 2 years provided there is no liability on the promoters towards the specific indemnity obligations envisaged under the SPA.

- The Taxpayer filed his tax return and offered the capital gains on the share sale considering his proportionate share in the total consideration of INR 155 crores (though the amount under escrow account was not received). The tax return was scrutinised by the tax officer and the income as offered to tax by the Taxpayer was accepted.

- Subsequently, certain liabilities arose in the Company to the tune of INR 9.17 crores, towards which the promoters had an indemnification obligation under the SPA. Accordingly, this amount was withdrawn from the escrow account by the Purchaser.

- Consequentially, the Taxpayer filed an application before the Principal Commissioner of Income Tax (PCIT) under Section 264 of the Income Tax Act, 1961 (IT Act) claiming that as the amount of INR 9.17 crores has been withdrawn

from the escrow account, the capital gain for Taxpayer needs to be re-computed by reducing his proportionate share in INR 9.17 crores.

Tax authority objections

The PCIT passed an order rejecting the application of the Taxpayer on the following basis:

- The Taxpayer was entitled to receive his share in the total consideration of INR 155 crores and therefore, the consideration towards meeting contingent liability which may arise subsequent to the transfer cannot be reduced

- For computing the capital gain, only cost of acquisition, cost of improvement and expenditure incurred wholly and exclusively in connection with the transfer can be reduced and hence, there is no scope for reduction of the amount as claimed by the Taxpayer.

- Section 264 of the IT Act allows the PCIT to revise an order passed by the tax officer, which is prejudicial to the interest of the Taxpayer. Thus, the capital gain which has been reported by the Taxpayer himself in his tax return cannot be revised under Section 264 of the IT Act.

- Further, as per Section 240 of the IT Act, if an assessment is annulled, refund cannot be granted for the taxes paid on the income reported in the tax return filed by the Taxpayer.

Aggrieved by the aforesaid order, the Taxpayer filed a writ petition before the High Court.

High Court ruling

The High Court quashed the order passed by the PCIT and directed the tax officer to pass the order recomputing the capital gain (by reducing Taxpayer's proportionate share in the amount withdrawn from the escrow account) and grant refund to the Taxpayer of additional tax paid along with the interest. Some of the key observations by the High Court are as under:

- The amount of INR 9.17 crores was neither accrued nor received by the promoters and was withdrawn from the escrow account. Therefore, such amount cannot form part of the full value of consideration for computing the capital gains.

- The consideration under the SPA was not an absolute amount but subject to certain liabilities as provided under the SPA itself and therefore, the full value of consideration will be the amount ultimately received by the promoters (post reduction of adjustment made towards the liabilities).

- The High Court relied on the landmark decision of Hon'ble Supreme Court in the case of CIT vs Shoorji Vallabhdas and Co [1962] (46 ITR 144) and applied real income principle, to hold that consideration which has neither accrued nor received cannot be brought to tax.

- The High Court held that the Section 264 of the IT Act does not restrict the power of PCIT and can be invoked to amend the assessment order passed by the tax officer and recompute the capital gain, as there cannot be a tax on the income which has neither accrued nor received by the Taxpayer.

- Further, the High Court ruled that the provisions of Section 240 of the IT Act relied on by the PCIT are not applicable in the current facts and if the Taxpayer has paid taxes higher than his actual liability, he is entitled to refund of such excess tax paid.

Comment

This is an important and relevant High Court judgment for M&A transactions. At the outset, the High Court has reaffirmed the important principle that it is an obligation of the tax authorities to levy tax only on the income chargeable under the IT Act and if a higher tax is paid, then it is their duty to compute the correct tax liability and grant refund of the excess tax paid by the taxpayers. This position has also been referred to in the Circular No. 14 (XL-35) dated 11 April 1995 issued by the Central Board of Direct Taxes which states that tax department should assist the taxpayer in claiming the refund due to them.

This is a welcome ruling and would provide much needed clarity on the taxability of the consideration such as escrow amount, earn-outs or holdback, the payment of which is linked to contingences and/or fulfilment of obligations provided under the agreement. In substance, the ruling affirms the principle laid down by the Hon'ble Supreme Court in various rulings including in the case of E. D. Sassoon and Company Ltd [1954] (26 ITR 27) wherein it was held that for an income to be taxed, there should be right to receive the income and liability on the payer to make payment of such income. Nonetheless, the impact of this ruling would need to be determined based on the specific facts of each transaction.

Another key issue that has been a subject matter of debate is the timing of taxability of consideration which is linked to contingences / satisfaction of conditions ie whether such consideration should be taxed in the year of sale of shares or the year of receipt of consideration. While the High Court ruling affirms the position of the Taxpayer wherein capital gain from entire consideration was offered to tax in the year of sale and sought to be recomputed subsequently (on withdrawal of cash from the escrow account), the aspect of timing of taxability has not been dealt with specifically and hence, remains open for further analysis/examination.

Sanjay Sanghvi (Partner) and Rahul Jain (Principal Associate)

For any queries please contact: editors@khaitanco.com

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