

Tax Hotline

May 12, 2022

WITHDRAWAL OF AMOUNT DEPOSITED IN ESCROW ACCOUNT BY BUYER DEDUCTIBLE FROM SALE CONSIDERATION

- Capital gains are chargeable to tax **only** on the 'real income' earned by an assessee, unless specific provisions provide the contrary. 'Real income' can only be computed after taking into account the real sale consideration;
- Transfer of money by the buyer into an escrow account **does not** automatically mean that it has been received by or accrued to the seller (and thus cannot automatically be included in the FVC for computing capital gains);
- The FVC under section 48 would be the amount arrived at after reducing the liabilities from the purchase price mentioned in the SPA;
- The powers given to the Revenue under Section 264 are not restricted to relieving an assessee only up to the returned income;
- It is the obligation of the Revenue to tax an assessee on the income chargeable to tax under the ITA and if higher income is offered to tax, then it is the duty of the Revenue to compute the correct income and grant the refund of taxes erroneously paid by an assessee

BACKGROUND

The Bombay High Court ("the Court") held amount of consideration for sale of shares deposited by the seller ("Taxpayer") in an escrow account, but subsequently withdrawn by the buyer from such account towards payment of contingent liabilities (i.e., for specific indemnity obligations of the seller as provided for in the SPA) will be allowed to be deducted from the full value of consideration ("FVC") paid to the Taxpayer for computing tax on capital gains under section 45 of the Income-tax Act, 1961 ("the ITA").¹

FACTS

The Taxpayer, along with other promoters of a company ("Target") (holding 100% shares in the company) simultaneously entered into two share purchase agreements ("SPA") to sell 100% shareholding of the Target. The SPAs provided that the consideration payable to the Taxpayer would be in two tranches as under:

- the first tranche will be paid immediately on the transfer of shares, and
- the second tranche will be parked in an escrow account to pay off any contingent liabilities (i.e., indemnification obligations of the Taxpayer, as per the SPA) arising within 2 years of the transaction. If no such liabilities arose within two years of the closing, the amount parked in the escrow account would be released to the Taxpayer.

Accordingly, the Taxpayer filed his income tax return ("ITR") in the year of closing, and disclosed long-term capital gains by taking into account both the tranches of consideration (i.e., including the funds parked in the escrow account). The assessment was selected for scrutiny under section 143(3) of the ITA and the income disclosed by the Taxpayer was accepted as final.

Subsequent to filing of the ITR, certain liabilities (for which specific seller indemnity obligations existed as per the SPA) arose within the stipulated 2-year period, therefore, the consideration payable to the Taxpayer as per the second tranche (which was parked in the escrow account) was reduced to the extent of paying off such liabilities. As a consequence, the tax on capital gains that had already been computed and paid by the assessee, was more than the actual consideration received from the sale of shares of the Target.

The Taxpayer, with this reduction in income receivable from the sale of shares of Targer, filed an application under Section 264 of the ITA and pleaded that the quantum of capital gains computed previously in the ITR must be reduced. This request was refused by the Principal Commissioner of Income-tax ("the Revenue").

The Revenue observed that in the absence of any provision in the ITA which allows for the deduction of contingent liabilities while computing capital gain, no deduction will be permissible. Further, as per section 240 of the ITA, the Revenue contended that once an assessment has been annulled, no refund will be granted on the returned income.

The Taxpayer preferred a Writ Petition before the Court against this order of the Revenue.

RULING BY THE COURT

The Court on appeal set aside the order of the Revenue and held the following:

Research Papers

New Age of Franchising

June 20, 2025

Life Sciences 2025

June 11, 2025

The Tour d'Horizon of Data Law Implications of Digital Twins

May 29, 2025

Research Articles

2025 Watchlist: Life Sciences Sector India

April 04, 2025

Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

Audio

CCI's Deal Value Test

February 22, 2025

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia | NewsX

April 01, 2025

- The amount paid towards the liabilities, was parked in an escrow account, and it was directly paid out of the said escrow account. Therefore, such amount was neither nor accrued to the Taxpayer and the same cannot be taken as FVC in computing capital gains from the transfer of the shares of the Target.
- The Revenue has not understood the true intent and content of the SPA. The purchase price as defined in the SPA was not an absolute amount as the same was subject to certain liabilities which might arise to the promoters on account of certain subsequent events. The FVC for computing capital gains, will be the amount which was ultimately received by the promoters after the adjustments on account of the liabilities from the escrow account as mentioned in the SPA.
- Income or gain is chargeable to tax under the ITA on the basis of the real income earned by an Taxpayer, unless specific provisions provide to the contrary.² The real income (capital gain) can be computed only by taking into account the real sale consideration, i.e., sale consideration after reducing the amount withdrawn from the escrow account.
- If sale consideration specified in the SPA is along with certain liability, then the FVC for purpose of computing capital gains under section 48 of the ITA is the consideration specified in the SPA as reduced by the liability.
- Revenue is erroneous in holding that from the sale consideration only cost of acquisition, cost of improvement and cost of transfer can be reduced, and the subsequent contingent liability does not come within any of the items of the reduction prescribed in the ITA and hence cannot be reduced. The FVC under section 48 would be the amount arrived at after reducing the liabilities from the purchase price mentioned in the SPA. Even if the contingent liability is to be regarded as subsequent event, then also the same ought to be taken into consideration in determining capital gain chargeable under section 45 of the ITA.
- The application made under section 264 within the time limit to revise the returned income is appropriate. Section 264 of the ITA has been introduced to factor in situations wherein income does not arise at all as there can be no tax in absence of income even though in book keeping, an entry is made about hypothetical income which does not materialise. Section 264 of the Act does not restrict the scope of power of Revenue to restrict a relief to a Taxpayer only upto the returned income. It is the obligation of the Revenue to tax an assessee on the income chargeable to tax under the ITA and if higher income is offered to tax, then it is the duty of the Revenue to compute the correct income and grant the refund of taxes erroneously paid by an assessee.
- Reliance by Revenue on section 240 of the ITA is incorrect as circumstance provided in section 240 do not exist in the present case and if the Taxpayer has paid taxes higher than his actual liability, he is entitled to refund of such excess tax paid.

ANALYSIS

The decision by the Court is welcome in context of M&A transactions. The Court has clarified the contours of computing capital gains under section 48 of the ITA and reiterated the real income theory. The Court has clarified that in case where the amounts deposited in the escrow account are subsequently withdrawn by the buyer, the same should not be included in the FVC while computing capital gains.

The usage of escrow accounts to provision for contingent liabilities of the target company or the seller, is quite common across M&A transactions. Taxability of amounts deposited in escrow account (including timing of taxation) has been frequently litigated.

Further, while the Court has elucidated on relief to claim refund by taxpayers on excess payment of taxes even after the filing of income tax returns and the closing of assessments, a number of questions with respect to when contingent or conditional payments should be offered to tax (in the absence of specific provisions) remains unanswered.

Recently, the High Court of Madras in case of *Caborandum Universal Ltd. v. ACIT*³ held that the amount parked in the escrow account will be treated as accrued income and hence will be taxed under section 45 of the ITA. The High Court of Madras while arriving at this conclusion noted that the assessee actually received the full consideration (including the amount deposited in the escrow account) without any deduction of liabilities envisaged under the agreement. To this extent the decision of the Court is in line with the decision by the Madras High Court. In relation to the timing, the Madras High Court held that the entire amount had accrued to the assessee upon execution and thus was subject to tax in the same year itself (despite a certain amount from the consideration having been agreed to be retained in escrow to pay for any exigencies). However, the Madras High Court noting the language in the agreement, further goes on to hold that even if certain payoffs were to be made from the retention money, it will not in any manner alter the full and total consideration received by the assessee. Consequently, it held that even assuming certain payments were made from the amount retained in the escrow account, it would still not in any manner reduce the cost of acquisition.

The key principle noticeable from both rulings is that this determination of taxability of amounts deposited in escrow account needs to be a fact-specific exercise including review of the contours of the agreement, which may grant guidance on whether or not the amount parked in the escrow forms part of the full and final consideration. Therefore, it is important for taxpayers to carefully word the escrow / retention related provisions in the SPA to avoid any future litigation on this account.

Lastly, the Court has also importantly clarified the obligation of the tax authorities to levy tax only on the actual income chargeable under the ITA and if a higher tax is paid, re-emphasised the duty of tax authorities to compute the correct tax liability and grant refund of the excess tax paid by the taxpayers.

– Arijit Ghosh & Ipsita Agarwalla

(We acknowledge and thank Nikunj Maheshwari, Student Nirma University, Ahmedabad for his assistance on this hotline.)

You can direct your queries or comments to the authors

¹ Writ Petition No. 2475 of 2015

² Reliance was placed to the Supreme Court decision in case of CIT vs. Shoorji Vallabhdas Co (1962) 46 ITR 144 (SC)

³ [2021] 130 taxmann.com 133 (Madras).

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.