

# Taxability of Deferred Consideration

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## In brief

The Bombay High Court has held that accrual of any capital gains on consideration which is receivable in future, and contingent upon a prospective event, cannot be chargeable to tax in the initial year of transfer of capital asset.

## In detail

### Facts

The taxpayer<sup>1</sup> and other shareholders had transferred 100% shares in a company for an initial consideration of INR 27 million received immediately on closing. Further, deferred consideration upto a maximum of INR 173 million, to be computed on the basis of earnings of the company for each of subsequent four years, was receivable by the taxpayer and other shareholders.

Accordingly, the taxpayer offered capital gains computed on the basis of her share of initial consideration received, while the tax officer (TO) sought to tax the gain based on her share in entire consideration, i.e., INR 200 million. On appeal, the Commissioner of Income-tax (Appeal) [CIT(A)] and the Income-tax Appellate Tribunal (Tribunal) ruled in the taxpayer's favour and deleted the TO's addition. The Revenue thereafter filed an appeal to the High Court (HC).

### Issue before the High Court

Could the capital gain based on the entire consideration, including deferred consideration that is contingent upon future profitability of the company be taxed in the initial year in which the capital asset, being shares in the company, was transferred?

### CIT(A)'s and Tribunal's rulings

The formula prescribing the determination of deferred consideration was dependent upon the profits derived by the company whose shares were transferred. The formula could lead to, and had, in fact, in the subsequent year, led to a situation where no amount was received by the taxpayer.

The Tribunal, upholding the CIT(A)'s decision, held that there was no certainty of receipt of any amount in future since the same was contingent upon an uncertain event. Therefore, capital gain, computed on deferred consideration, being notional or hypothetical, could not be

taxed in the initial year of transfer.

### Revenue's contentions

The transfer of capital asset would be liable to capital gains tax under section 45(1) of the Income-tax Act, 1961 (the Act), which was not dependent on the receipt of consideration, unlike under section 45(1A) and section 45(5) of the Act. Accordingly, the Revenue contended that the TO was justified in taxing the capital gain based on the total sum of INR 200 million in the initial assessment year itself.

### High Court's ruling

The HC observed that formula prescribed in the agreement made it clear that the deferred consideration was dependent on profits to be made by the company in future. Thus, in absence of profits of the company, no consideration would be receivable by the taxpayer; thereby the deferred consideration was not an assured consideration and could not be said to have accrued.

<sup>1</sup> [2016] 68 taxmann.com 319 (Bombay)

The HC observed that if the taxpayer acquired a right to receive such income, then income could be said to be accrued to him, even if the same was received at a later date on being ascertained. Since the amount had neither been received nor had it accrued to the taxpayer, on account of the consideration being contingent upon future profits of the company, it could not be said that any right to receive such income had accrued to the taxpayer in the initial year. The Revenue's contention that the impugned order was seeking to tax the amount on receipt basis was, therefore, not correct.

### ***The takeaways***

This is a welcome ruling of the Bombay HC, since the view that only the consideration that has accrued/ been received in the year of transfer is chargeable to capital gains tax, has been affirmed. Therefore, in various transactions involving deferred consideration, (*viz.*, earn out deals) where the consideration is contingent upon occurrence of certain future events/ formula and is not ascertainable in the initial year of transfer, the entire estimated consideration would not be taxable in the year of transfer of asset.

However, this ruling does not answer the question whether the consideration is taxable on receipt basis, i.e., as and when the deferred consideration is received in future.

### ***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact:

#### ***Tax & Regulatory Services – Mergers and Acquisitions***

Gautam Mehra, *Mumbai*  
+91-22 6689 1154  
[gautam.mehra@in.pwc.com](mailto:gautam.mehra@in.pwc.com)

Hiten Kotak, *Mumbai*  
+91-22 6689 1288  
[hiten.kotak@in.pwc.com](mailto:hiten.kotak@in.pwc.com)

## Our Offices

### Ahmedabad

1701, 17th Floor, Shapath V,  
Opp. Karnavati Club,  
S G Highway,  
Ahmedabad, Gujarat 380051  
+91-79 3091 7000

### Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th  
Floor, Road No. 10, Banjara Hills,  
Hyderabad – 500034,  
Andhra Pradesh  
Phone +91-40 44246000

### Gurgaon

Building No. 10, Tower - C  
17th & 18th Floor,  
DLF Cyber City, Gurgaon  
Haryana -122002  
+91-124 330 6000

### Bangalore

6th Floor  
Millenia Tower 'D'  
1 & 2, Murphy Road, Ulsoor,  
Bangalore 560 008  
Phone +91-80 4079 7000

### Kolkata

56 & 57, Block DN.  
Ground Floor, A- Wing  
Sector - V, Salt Lake  
Kolkata - 700 091, West Bengal  
+91-033 2357 9101/  
4400 1111

### Pune

7th Floor, Tower A - Wing 1,  
Business Bay, Airport Road,  
Yerwada, Pune – 411 006  
+91-20 4100 4444

### Chennai

8th Floor  
Prestige Palladium Bayan  
129-140 Greams Road  
Chennai 600 006  
+91 44 4228 5000

### Mumbai

PwC House  
Plot No. 18A,  
Guru Nanak Road (Station Road),  
Bandra (West), Mumbai - 400 050  
+91-22 6689 1000

### For more information

Contact us at  
[pwctr.knowledgemanagement@in.pwc.com](mailto:pwctr.knowledgemanagement@in.pwc.com)

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