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Bombay High Court decides deferred consideration dependent on a contingency does not accrue unless the contingency has occurred and is not liable to capital gains tax in year of transfer of capital asset

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Executive Summary

- The Hon'ble Bombay High Court ('HC') recently pronounced its ruling in the case of Mrs. Hemal Raju Shete ('the Assessee') with respect to taxability of deferred consideration on sale of shares.
- The HC held that the amounts to be received as contingent consideration under the agreement dated 25th January 2006 (Agreement) could not be subjected to tax in the year in which transfer took place since the same has not accrued in that year.
- It further noted that the test of accrual is whether there is a right to receive the amount, though later, and whether such right is legally enforceable. In the present case, the Assessee has not, pursuant to the Agreement, obtained a right to receive the amount or any specified part thereof in that year and accordingly dismissed the revenue's appeal.

Facts

- Pursuant to the Agreement, the Assessee transferred its holding in Unisol Infraservices Ltd. (Unisol) to Radha Krishna Hospitality Services (RKHS) during assessment year 2006-07. The Agreement provided for (i) a fixed amount of initial consideration to be received immediately on completion; and (ii) a deferred consideration to be received over a period of four years dependent upon profits made by Unisol in each of the years. The deferred consideration was to be worked out based on a formula and the total consideration was capped at a particular amount in the Agreement.
- While filing the tax return for assessment year 2006-07, the Assessee offered the initial consideration only to tax as capital gains.
- The Assessing Officer, on perusal of the Agreement, was of the view that the entire consideration including the deferred consideration is taxable in the year of transfer of shares itself. On appeal, the Commissioner of Income-Tax (Appeals) ['CIT(A)'] observed that working of the formula did not guarantee that this amount or for that matter any amount would be received by the Assessee and this was evident from the immediate succeeding assessment year (i.e. assessment year 2007-08) when no amount was received as deferred consideration.

- On further appeal by revenue, the Tribunal upheld the findings of the CIT(A) and held that there is no certainty of receiving any amount as deferred consideration. The Tribunal further held that what amount has to be brought to tax is the amount which has been received and/or accrued to the Assessee and not any notional or hypothetical income. In the given situation, maximum cap in the Agreement cannot be equated with sale consideration or full value of consideration since the maximum cap is neither received nor accrued to the Assessee in the subject assessment year.

Issue before Bombay HC

Whether the Tribunal was justified in holding that the deferred consideration is not taxable in the year of transfer of capital asset as it had not accrued to the Assessee?

Bombay HC Ruling

- The HC observed that the formula prescribed in the Agreement makes it clear that the deferred consideration to be received by the Assessee in four years would be dependent upon the profits made by Unisol in each of the years. Thus, no right to claim any particular amount gets vested in the hands of Assessee in the subject assessment year.
- Relying on the principles laid down by Supreme Court in its various rulings¹ in respect of accrual of income, the HC held that test of accrual is whether there is a right to receive the amount, though later, and whether such right is legally enforceable. The amount which could be received as deferred consideration is dependent/contingent upon certain events and therefore it cannot be said to have accrued to the Assessee.
- It was brought to the notice of HC by the Assessee that for the subsequent assessment years (except for assessment year 2007-08 for which there was no deferred consideration on application of formula), the Assessee has offered to tax the amounts which have been

¹ Morvi Industries Ltd v CIT (1971) 82 ITR 835
E.D. Sassoon & Co. Ltd. v CIT (1954) 26 ITR 27
Commissioner of Income Tax v M/s Shoorji Vallabdas and Co (1962) 46 ITR 144
K. P. Varghese v Income Tax Officer, Ernakulam & Anr 181 ITR 597

received on the application of formula provided in the Agreement.

- Accordingly, the HC upheld the decision of Tribunal and held that the amounts to be received as deferred consideration under the Agreement could not be subjected to tax in the year in which transfer took place as the same has not accrued in that year.

Comments

This ruling provides major relief for the taxpayers executing agreement for transfer of capital assets for a contingent consideration dependent on occurrence of certain future events. The tax authorities generally seek to tax such contingent consideration in the year of transfer itself even though the taxpayer have not received such contingent consideration in that year. There are practical difficulties also in determination of deferred consideration which is contingent on happening of future events.

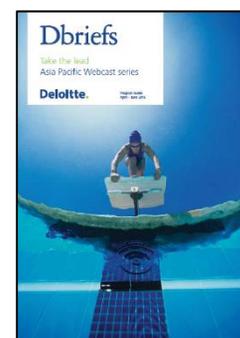
It is interesting to note a contrary ruling of Delhi HC² where Delhi HC had held that merely because the agreement provides for payment of remaining consideration upon happening of certain events in the future, it cannot be said that the income had not accrued in the year of transfer. Furthermore, as there was no condition in the agreement suggesting that even if the entire consideration or part of it was not paid, the title to the shares will revert to the seller, the entire sum receivable on the transfer of shares would be chargeable to tax in the year of transfer. This ruling of Delhi HC has not been discussed by the Bombay HC in its ruling.

Source: CIT v. Mrs Hemal Raju Shete [ITA No. 2348 of 2013 (Bombay)]

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² Ajay Guliya v. ACIT [2012] 24 taxmann.com 276 (Delhi)

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