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Himachal Pradesh High Court treats compensation received by assessee on termination of SPA as 'revenue' receipt chargeable to tax

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Executive Summary

- Himachal Pradesh High Court (HC) in its decision rendered in the case of Avantor Performance Materials India Limited ('assessee') upheld the ITAT order treating compensation received by assessee on termination of Share Purchase Agreement ('SPA') as revenue receipt and not capital receipt.
- Issue under consideration were as follows:
 - Whether amount of compensation received by assessee on termination of SPA is a capital or revenue receipt.
- The High Court observed that assessee knew the conditionality clause from the very beginning and there was no breach by the sellers that resulted in termination of SPA.
- Further, the assessee was pursuing strategic growth through acquisitions and the intent was not to purchase shares but takeover of business for expansion.
- The assessee was conscious that no injury would be caused to his business in the event of SPA not being materialized and its non-execution would in no manner impair its revenue.
- Thus, the High Court observed that the compensation received on cancellation was rightly held taxable as 'revenue' receipt.

Facts

- The assessee is engaged in the business of diagnostic, laboratory solutions and chemical research.
- Sarabhai Zydus Animal Health Limited ('Zydus') was engaged in similar business as that of assessee. The shareholding pattern of Zydus was as follows:
 - 50% held by Cadila Healthcare Ltd ('Cadila' or 'other shareholder')
 - 50% cumulatively by Ambalal Sarabhai Enterprises Ltd, Mautik Exim Ltd, Haryana Containers Ltd and Mr. Kartikeya Sarabhai (collectively referred to as 'sellers')
- During FY 2006-07, assessee entered into a SPA with the sellers to acquire 50% stake in Zydus for a consideration of Rs 72.5 crores out of which Rs 24,81,68,263/- was paid as earnest money by the assessee

- As per the inter se arrangement amongst the shareholders of Zydus, Cadila had a Right of First Refusal ('ROFR'). Accordingly, the SPA had an express clause that in case Cadila invoked its ROFR, the SPA would be terminated by the assessee itself.
- Thereafter, the sellers called upon the assessee to terminate the SPA as Cadila invoked its ROFR and conveyed its intention to purchase sellers shares in Zydus.
- The SPA contemplated consequences of termination of the SPA resulting in payment of interest and penalty by sellers on earnest deposit amount received from the assessee.
- The assessee received an amount of Rs. 2,25,91,587 as compensation from sellers on cancellation of SPA which was disclosed by the assessee in its return of income as a 'capital' receipt.
- Assessing Officer ('AO') disallowed assessee's claim and taxed the same as revenue receipt. On further appeal, CIT(A) and ITAT upheld AO's order. Aggrieved, assessee preferred an appeal before the HC.

Issue before Himachal Pradesh HC

Whether ITAT was correct in holding compensation received on termination of SPA as revenue receipt liable to tax in the hands of the assessee?

Himachal Pradesh HC Ruling

- HC noted that the SPA provided for the consequences of termination and in terms thereof, the assessee received the amounts towards payment of interest and penalty.
- In the instant case, it is the assessee, who had terminated the SPA and not the sellers and as such there was no breach thereof on behalf of the sellers necessitating payment of compensation to the assessee.
- Moreover, the SPA was conditional and subject to approval by Cadila which the assessee knew from the very beginning.
- HC further noted that Zydus was in the similar business as that of the assessee and assessee's intent was not to purchase the shares of Zydus but takeover its business for expansion.

- HC relied on the Supreme Court ruling in the case of *Shri Kamal Behari Lal Singha* wherein it was established that in order to find out whether a receipt is capital or revenue in nature, one has to see it in the hands of the seller.
- HC, inter alia, relied on the Supreme Court ruling in the case of *Kettlewell Bullen and Co. Ltd* wherein it was held that the amount received on cancellation of contract is revenue in nature
 - where a payment is made to compensate a person for cancellation of contract which does not affect the trading structure of his business,
 - nor deprive him of what in substance is his source of income,
 - termination of the contract being a normal incident of the business and
 - such cancellation leaves him free to carry on his trade.
- HC noted that the assessee was conscious that no injury would be caused to his business in the event of SPA not being materialized and its non-execution would in no manner impair its revenue. It is not the case that the assessee's business had come to a halt or impaired the source of income. Thus, the compensation was not on account of injury to any capital assets of the assessee.
- In light of the aforementioned arguments, the HC ruled in favour of the revenue treating the compensation received on termination of SPA as revenue receipt

Comments

The HC has observed that where compensation is received on termination of SPA pursuant to pre-existing conditions which does not impair the contractual party's ability to carry on his trade and termination of the contract is a normal incident of the business, the payment made for such cancellation would be treated as revenue receipt.

Way forward

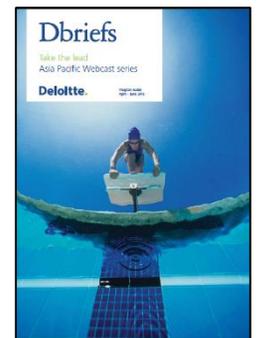
This judgement would render useful while analysing and commenting on termination and compensation clauses forming part of any SPA in relation to M&A transactions.

Source: Avantor Performance Materials India Ltd (formerly known as RFCL Ltd) Vs. CIT [66 taxmann.com 183 (Himachal Pradesh)]

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