KPMG

Tax Flash News

16 February 2024

A part of sales consideration kept in the escrow account which is unlikely to be received by the seller is to be excluded from the full value of consideration while computing capital gains

Executive Summary

In a recent decision in the case of *Modi Rubber Ltd*[1], the taxpayer sold the shares of a company. A part of the sales consideration was kept in the escrow account for meeting the future liabilities of the company.

The Delhi bench of the Tribunal held that the amount kept in an escrow account (EA) which is unlikely to be received by the taxpayer cannot be said to have been received by, or accrued to, the taxpayer. Such EA amount is not to be included in the full value of consideration for the purposes of computing the capital gains.

The tax officer is entitled to tax such an amount in the year of receipt and may take indemnification from the taxpayer to ensure the taxation.

Facts of the case

- The taxpayer sold the shares of a company (MTCL) to another company (the buyer) for a gross sales consideration of INR1.17 billion.
- Out of the gross sale consideration, a part of the consideration was deposited in an EA.
- The amount in the EA was to be utilised for meeting the MTCL's liability that may arise in the future such as tax liabilities, contingence liabilities.
- The amount in the EA was payable to the taxpayer upon the expiry of the specified years, but only after adjusting the claim arising on account of the abovementioned liabilities.
- The operation of the EA was under the joint instructions of the taxpayer and the buyer. The taxpayer was prevented from appropriating the amount in the EA without the prior approval of the buyer.
- In its tax return, the taxpayer considered the gross sales consideration of INR1.17 billion for the purposes of computing the capital gains arising from the sale of shares.
- However, during the assessment proceedings, the taxpayer pointed out that it has received a part of the amount deposited in the EA and that amount has been offered to tax. However, there were no chances of any further recovery out of the EA as the buyer had made huge claims against the EA. The amount still lying in the EA should fall outside the ambit of the expression 'full value of the consideration received or accruing' for the purposes of computing the capital gains under section 48 of the Income-tax Act, 1961 (the Act).
- The taxpayer submitted a revised computation of capital gain with the sales consideration reduced by the amount lying in the EA.

---

[1] *Modi Rubber Ltd.* v. *DCIT* (ITA No. 6866/Del/2018) (Del) - Source: Taxsutra
Note: The Tribunal also dealt with the issue of Section 14A. However, this flash news only covers the issue of the taxability of the amount kept in the escrow account on the sale of shareholding as a capital gain

- The Revenue rejected the reduction of the sales consideration on the following grounds:
  - The taxability of income depended upon its 'accrual' as a result of the transfer of capital assets and it was immaterial whether or not the taxpayer had actually received the entire sales consideration.
  - There is no provision in the Act to reduce the sales consideration based on an unascertained liability or to defer the taxation of the capital gains to a subsequent year upon the receipt of the amount released from the EA.
  - The Escrow Agreement was entered into subsequent to the share purchase agreement. Such a subsequent event cannot alter the fact of accrual of sale consideration upon entering an arrangement for the transfer of shares.
  - The amount kept in the EA was a clear case of the application of income after its accrual.
  - The fact that some amount was received by the taxpayer out of the EA suggests that the amount in the EA belonged to the taxpayer subject to the indemnification that may occur after the income had already accrued to the taxpayer by virtue of the transfer of the shares.
  - The quantification of deduction to be made from the sum lying in the EA would not postpone the charge of such sum which was deemed to be accrued in the year of transfer.
  - The loss arising in the later year due to the non-realisation can be claimed in those respective years.

Tribunal's decision

- The Tribunal referred to the Bombay High Court in *Dinesh Vaziran*[2] wherein the High Court held that the capital gain was to be computed only on the net amount received from the EA after the adjustments on account of the liabilities. The High Court had observed that:
  - Where the sale consideration was specified in the agreement along with certain liability, then the sales consideration to be considered for computing the capital gains should be after reducing such liability.
  - Even if the contingent liability was a subsequent event, it ought to be taken into consideration.
- The Tribunal observed that the facts of the present case were identical to those in the *Dinesh Vazirani*'s case. In the instant case also, the realisation of the EA amount was contingent upon the fulfilment of the wide-ranging conditions.
- The liabilities against the EA were demonstrated as substantially higher than the amount earmarked in the EA, and the funds were not released to the taxpayer till date.
- The taxability of the amount retained in the EA, which was not received or not likely to be received, was contrary to the provisions of the Act.
- When the events subsequent to the filing of the return of income were factored in, the EA amount could not be regarded as sale consideration accrued to the taxpayer.
- The taxpayer was entitled to claim exclusion of the amount lying in the EA which was not accrued to the taxpayer.
- The Revenue is entitled to tax such amount as capital gain in the year in which it is actually released from the EA. The taxpayer will be under legal obligation to pay taxes on the accrual of such consideration in later years as and when arises.
- The tax officer while giving effect to this order may seek suitable indemnification and other safeguards to ensure taxation of the EA amount, as and when recovered.
- The Tribunal distinguished the Madras High Court's decision in *Carborundum Universal Ltd.*[3] based on the facts of the case. In the *Carborundum* case, the amount deposited in the EA was returned to the taxpayer without any deduction or reduction. The question of the reduction of full value of consideration did not arise. The entire sale consideration including the amount placed in the EA was taxable in the year of transfer itself.

Our comments

The Tribunal dealt with an issue of exclusion of the amount kept in the EA while determining the full value of consideration for the computation of capital gains. Based on specific facts of the case, it was held that the amount in the EA which is unlikely to be received by the taxpayer did not accrue to the taxpayer. Thus, the same was to be excluded while computing the full value of consideration. The Tribunal has followed the Bombay High Court's decision over the Madras High Court's decision. It would be interesting to see how other courts will deal with this matter.

---

[2] *Dinesh Vazirani* v. *Pr.CIT* [2022] 445 ITR 110 (Bom)

[3] *Caborandum Universal Ltd*. v. *ACIT* [2021] 283 Taxman 312 (Mad)

KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
2nd Floor, Block T2 (B Wing),
Lodha Excellus, Apollo Mills Compound, N M
Joshi Marg, Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

---

kpmg.com/in

Follow us on:

kpmg.com/in/socialmedia