Sharing insights

News Alert
3 August, 2012

pwc

Consideration on sale of shares chargeable to tax in the year of transfer, notwithstanding that a part of the consideration is deferred

In Brief

In a recent decision in the case of Ajay Guliya[1] (the assessee), the Delhi High Court (the Court) has held that chargeability on transfer of shares cannot be deferred merely because the share purchase agreement (SPA) provides for a deferral of part of the consideration. As per section 45 of the Income-tax Act, 1961 (the Act) read with section 48 of the Act, income accrues in the year in which 'transfer' takes place, even if the remaining consideration is payable upon happening of certain events in future.

Facts

- The assessee sold his shares in Orion Dialog Pvt. Ltd. (Orion) to Essar Investments Ltd. through an SPA.
- As per the SPA, the assessee received only the partial consideration upfront and the remaining consideration was receivable over a period of two years subject to the fulfilment of certain conditions by Orion.
- The assessee computed the capital gains by taking the upfront payment received as sales consideration and offered the same to tax.

[1] Ajay Guliya *v.* ACIT [TS-520-HC-2012 (Del)]

- The assessing officer (AO), however, computed the capital gains on the entire consideration (i.e. upfront as well as deferred payment) as per the SPA.

- The Commissioner of Income-tax (Appeal) (CIT(A)) decided in favour of the assessee on the ground that the part of the consideration that was payable in future did not constitute income for the relevant assessment year (AY) as the assessee would be entitled to it only on the fulfilment of certain conditions, which cannot be asserted.

Issue

- Where only a part of the consideration was determinable and the remaining amount depends upon the fulfilment of certain conditions, whether the entire sale consideration would be charged to tax in the year of transfer?

Assessee's contentions

- Section 48 of the Act provides that capital gains should be computed by the deducting cost of acquisition and improvement from the full value of consideration (FVC) received or accruing. Therefore, the consideration must accrue on the transfer of a capital asset.

- Relying on the decisions of the Supreme Court in the case of Ashokbhai Chimanbhai[2], the Calcutta High Court in the case of Bharat Petroleum[3] and the Authority for Advance Rulings (AAR) in the case of Anurag Jain[4], it was contended that a sum is said to accrue only when the legal right to receive it had come into existence.

- In this case, the deferred consideration was receivable only upon Orion's performance in the future. Therefore, it could never be said to have 'arisen' or 'accrued' immediately in the year of transfer of shares.

- [5]Relying on the decision of the Supreme Court in the case of B.C. Srinivasa Setty[6], the assessee contended that in order to arrive at the true nature of the transaction, the provisions of section 45 of the Act cannot be read in isolation from section 48 of the Act. As per section 45 of the Act, in the current situation, the transfer had taken place in the relevant AY. However, the FVC as per section 48 of the Act had arisen only to the extent of the part consideration received, as the remaining consideration was contingent on the performance of Orion.

Tribunal ruling

The Income-tax Appellate Tribunal (the Tribunal) set aside the order of the CIT(A) and held the following:

- As per section 45 of the Act, profits and gains arising from the transfer of a capital asset shall be deemed to be the income of the previous year in which the transfer took place.

- There was no doubt that the transfer of shares had taken place during the relevant AY.

- As per section 48 of the Act, read with section 45 of the Act, all sums accruing or received in connection with the transfer of assets were liable to be taxed in the year in which the transfer took place.

[2] CIT *v.* Ashokbhai Chimanbhai [1965] 56 ITR 42 (SC)
[3] CIT *v.* Bharat Petroleum Corporation Ltd [1993] 202 ITR 492 (Cal)
[4] Anurag Jain *In re* [2005] 227 ITR 1

[5] This is an additional contention raised before the Delhi High Court
[6] CIT *v.* B.C. Srinivasa Setty [1981] 128 ITR 294 (SC)

- Distinguishing the cases of Ashokbhai Chimanbhai (above) and Bharat Petroleum (above), the Tribunal made the following observations:
  - Due to the fiction contained in section 45 of the Act, irrespective of the fact that income will accrue over a period of different years, income would be chargeable to tax in the year in which the transfer took place.
- Distinguishing the decision of the AAR in the case of Anurag Jain (above), the Tribunal held the following:
  - In the aforementioned case, payment of deferred sale consideration was interlinked with the performance of the assessee, whereas in this case the payment of deferred consideration was dependent on the performance of Orion. Further, there was no provision regarding the cancellation of the agreement in case Orion fails to achieve its targets.
- As the above transfer was not specifically covered by any exemption to section 45 of the Act, the entire consideration would be chargeable to tax in the year of transfer.

Delhi High Court ruling

- The Tribunal ruling was based on the fact that the capital asset was transferred on the date on which the assessee executed the SPA.
- There was no condition in the SPA stating that if the entire consideration or any part thereof was not paid, the title to the share will revert back to the seller.
- The mere fact that the appellant adopted a mechanism in the SPA that allowed the transferee to defer payments would not affect the chargeability when shares are transferred.
- As per B.C. Srinivasa Setty (above), in order to arrive at the chargeability to tax, both the sections, viz., sections 45 and 48 of the Act, have to be 'looked into and read' together. Section 45 of the Act is the charging section and acquires primacy, whereas section 48 of the Act merely provides a computation mechanism.
- Thus, the Court held that merely because the agreement provides for the payment of the remaining consideration upon the 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.

Similar ruling by the Mumbai Tribunal in the case of Indira Shete[7]

In a recent case, the Mumbai Tribunal had taken a similar view, holding that the sale consideration (on share transfer) contingent upon subsequent year's profitability would be taxable in the year of transfer itself.

- The assessee sold shares in a company for a consideration payable in two tranches—one upfront and the second based on a certain formula linked with profitability of the company over a period of different years. However, the aggregate of the upfront and the deferred consideration was capped at a maximum of Rs. x.
- The assessee computed the capital gains by taking the upfront consideration as FVC, while the AO computed the capital gains by taking Rs. x as FVC.

[7] ITO *v.* Indira R Shete [TS-562-ITAT-2012 (Mum)]

- The assessee argued before the CIT(A) that Rs. x was the maximum amount that can be received as consideration but was not the final consideration (as the actual consideration may also be lower than Rs. x, as it depends upon future events) and except for the initial consideration, no part of the deferred consideration was actually accrued or received during the relevant AY, to which the CIT(A) had also agreed.

- The Mumbai Tribunal held that as per section 45 of the Act, any gain arising from the transfer of a capital asset shall be deemed to be the income of the previous year in which the transfer took place irrespective of its actual receipt, as the right to receive the total consideration had already accrued to the assessee and any contrary view will frustrate the legislative intent.

- Further, relying on the Madras High Court's decision in the case of T.V Sundaram Iyengar and Sons Ltd.[8], it was held that if in the subsequent years, the entire consideration is not actually received the same would be treated as a capital loss arising in the year when the money became irrecoverable.

Conclusion

Both the Delhi High Court and the Mumbai Tribunal interpreting section 45 of the Act had held that income accrues in the year in which the transfer takes place, irrespective of the fact that a part of the consideration was contingent upon happening of certain future events.

The above rulings may cause hardship to taxpayers who would end up paying tax upfront on the entire sale consideration at the initial stage itself, even though a part or a major part of the consideration was deferred over several years. Furthermore, there may be issues relating to claiming of exemption under section 54 of the Act. Though there were some favourable judgments on similar situations in relation to reinvestment in capital gains bonds, taxpayers may face hardship if they seek to reinvest the gains to claim exemption under sections 54 or 54F of the Act.

8 T.V Sundaram Iyengar & Sons ltd*v.* CIT [1959] 37 ITR 26 (Chennai)

Our Offices

For private circulation only

Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	**Bangalore** 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	**Bhubaneswar** IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	**Chennai** PwC Center, 2nd Floor 32, Khader Nawaz Khan Road Nungambakkam Chennai 600 006 Phone +91-44 4228 5000	**Hyderabad** #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata South City Pinnacle, 4th Floor, Plot – XI/1, Block EP, Sector V Salt Lake Electronic Complex Bidhan Nagar Kolkata 700 091 Phone +91-33 4404 6000 / 44048225	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com