Blurred boundaries: Taxing escrowed funds in M&A deals

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Trust and security emerge as cornerstones of every meticulously executed contract. Nowhere is this more conspicuous than in the high-stakes arena of mergers and acquisitions where buyers seek reassurance against potential future claims of liabilities from the seller.

Enter the escrow account — a mechanism epitomising this assurance by housing a portion of the sale proceeds under the oversight of a third party for a period of time. The release of proceeds deposited here hinges upon fulfilment of certain conditions, collectively enshrined in the share purchase agreement (SPA).

Within M&A transactions, one could interestingly juxtapose an escrow account with earn-out arrangements. While the former shields the buyer from potential claims or liabilities, the latter ties a portion of purchase consideration to the attainment of specific business performance goals.

Despite similar fund flow mechanics, the objectives behind such arrangements diverge significantly. Earn-out structures give rise to "deferred consideration" which may be quantified in the year of transfer but crystalises in subsequent years. This has created uncertainty regarding the timing of taxability due to inconsistent jurisprudence and ambiguity in the Income Tax Act.

Similar to earn-out arrangements, navigating the labyrinth of taxation becomes even more convoluted when considering capital gains implications for the seller, where sale consideration is partially parked in an escrow. The challenge lies in discerning whether the consideration stipulated in the SPA falls under the purview of taxation or should be adjusted to reflect actual consideration.

Recent rulings by Delhi Income Tax Appellate Tribunal in the case of *Modi Rubber* has shed some light on this. However, diverse judgments (such as in *Dinesh Vazirani, Carborundum Universal* and *Universal Medicare*) and ambiguous legislative frameworks leave taxpayers and legal practitioners alike grappling with uncertainty regarding timing of taxability.

Revenue authorities assert that taxation under Capital Gains arises when consideration accrues upon transfer of capital asset. Funds deposited in an escrow designated for future claims are deemed as an application of income rather than a reduction in income.

Taxpayers argue that tax liability concerning the escrowed sum should arise only upon its actual receipt on fulfilment of agreed conditions. Given that assessment surfaces post financial year and judicial rulings have been relying heavily on hindsight, this approach leaves taxpayers wondering whether the entire escrowed sum should be included in the consideration or if income tax return filed in the year of transfer could be revised subsequently in the year of actual receipt of escrowed funds.

With the law remaining largely silent on this matter, Courts are tasked with dissecting scenarios on a case-to-case basis, further complicating matters. While judicial precedents have from time-to-time postulated 'hypothetical income' (income which has not accrued) cannot be subject to taxation, a crucial absence persists — the lack of an enabling provision to levy capital gains tax on escrowed funds in the year of actual receipt. Courts frequently rely on specific terms outlined in the SPA to ascertain whether the sale consideration encompasses funds deposited in escrow. SPA, thus, appears substantial in determining the timing of taxation, accentuating the significance of a diligent drafting.

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