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[2021] 128 taxmann.com 353 (Article)

M&A - Taxing Earn-out Consideration

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In structuring a M&A transaction, the element of purchase price that is contingent on the performance of the acquired business, over a specified time period following the closing, is often termed as Earn-out consideration. Earn-outs are intended to bridge the valuation gap between an optimistic seller and a sceptical buyer. It provides an opportunity for a post deal true-up and validation of the headline price based on actual performance of the business that gets acquired.

While the Exchange Control regulations permit deferral upto 25% of purchase consideration for a maximum period of 18 months[1], the nature and timing of tax treatment of the consideration paid as Earn-out is somewhat vexed. On a high level, it may be argued that the earn-out is directly linked to transfer of shares in the deal and even though the quantum is contingent upon future performance of the business being acquired, it could result into capital gains. While this sounds logical, what happens in a case where the exiting promoters are also employed in the business post sell-out? Does the earn-out then partake the character of income towards employee-shareholder's services (Salaries)? In all of this, the timing of taxing such consideration is also a critical factor. These are some pertinent issues that we have discussed in this note.

Earn-out Consideration - Whether taxed as Salary or Capital Gain?

Where inherent element of employment exists and it can be demonstrated that services have been rendered under an employer-employee arrangement, the earn-out may be attributed to the employment, specifically in case of directors/key managerial employees and thus taxed as salary instead of capital gains. On the other hand, where the earn-out is receivable, on equal terms, by a significant group of sellers, where some are non-employees (*e.g*. third-party investors) and/or individuals who were employees but who ceased to be employees following the transaction, it may be viewed as a consideration attributable to sale of shares and thus, subjected to capital gains tax. That said, there is limited clarity on the subject and the Courts have given divergent views.

In the case of Anurag Jain[2], the assessee and four other shareholders had entered into an agreement to transfer business and shareholding in favour of an overseas buyer. The sale consideration comprised of a fixed part and also a contingent portion, payable over three years subject to maintaining EBITDA above a specified threshold. Alongside, a non-compete agreement and an employment agreement was signed which entitled him to receive a portion of purchase price in respect of his ownership interest over five years besides an employment for five years as the CEO of company. In this case, the Madras High Court held that where the earn-out component to be paid in future was linked only to the performance of the manager (*i.e.,* real nexus with the employment agreement) and not directly linked to the performance of the acquired business, the contingent payment would be 'profits in lieu of or in addition to salary' under section 17 of the Income-tax Act, 1961.

In another notable ruling, the Authority for Advance Rulings[3] ('AAR') held that the consideration payable on deferred basis (as per agreed formula), where the deferred payment is a part of the total purchase price, entire purchase price will be subject to taxation of capital gains under section 45[4]of the Act.

Clearly, divergent views have emerged, and one needs to view the facts of each case, including critical terms of the Share Purchase Agreement ('SPA'), to ascertain the appropriate head to tax the earn-out consideration.

Timing of Taxation of Consideration

By definition, income includes capital gains chargeable under section 45 of the Act arising from the transfer of a capital asset. The term 'capital asset' is broadly defined in section 2(14)[5] to include property of any kind held by an assessee, whether or not connected with his business or profession.

It is settled position in law that capital gain arises upon transfer and not necessarily at the time when consideration is received by the transferor or the date of the agreement to transfer, although section 48[6] links the computation of capital gains to the full value of the consideration, received or accruing as a result of the transfer of capital asset. Again, section 50D[7]allows adoption of Fair Market Value ('FMV') to arrive at capital gains accruing from the transfer of capital assets, even when the actual consideration is not ascertainable or cannot be determined.

A combined reading of these provisions indicate that entire consideration is taken into account in arriving at the capital gains. Thus, the issue that arises is whether a contingent consideration, that is dependent on the happening or not happening of a future event, will be considered in computing capital gains in the year of actual transfer or when such receipt actually accrues to the transferor?

In Hemal Shete[8], the assessee and other co-owners sold shares in an Indian company at aggregate consideration capped at Rs. 20 crore of which Rs. 2.70 crores was payable initially and the balance on deferred basis over 4 years in accordance with a stipulated formula linked to profit generation in future years. Based on this arrangement, the Assessing Officer ('AO') took a view that since the entire consideration was determined at the point of transfer, it should be taxed in the year of transfer. On this, the Bombay High Court held that the deferred consideration, which was dependent on future profits made by company in each of those years, does not vest a right to claim (title or ownership) such amounts in hands of the assessee in the year of transfer. Thus, the balance consideration cannot be taxed in the year of transfer.

On a similar issue, the Delhi High Court in Ajay Gulia[9] has taken a contrary view. The assessee divested his shareholding in an Indian company through a SPA wherein, out of the aggregate purchase consideration,

the assessee received substantial portion upfront and balance over three succeeding years subject to fulfilment of specific conditions. The AO held that the entire sales consideration accruing to the assessee was taxed as capital gain in the year of transfer. On appeal, the Delhi High Court upheld the findings of the AO and held that entire income by way of capital gains is chargeable to tax in the year in which transfer took place. It was stated that as per section 45(1), full consideration includes the deferred consideration in the contract, whether accrued in the year of transfer or not.

To summarise, determining the taxable head of earn-out consideration and timing of taxation, depends upon specific case facts, terms and modalities of paying Earn-out consideration between the seller and buyer, etc. Having said that, based on judicial precedents, the following factors emerge as critical

(*a*) Whether the seller is an employee of the company holding a key managerial position. If so, what is the contribution to the success and profits of the company?

(*b*) Is the earn-out contingent upon the seller's continued employment?

(*c*) Is the earn-out contingent upon the seller achieving certain targets/milestones or providing certain services to the company or is it contingent upon the future performance of the company itself?

(*d*) Whether the earn-out payments are proportionate to the selling shareholder's equity in the company and whether the total payments made to the seller when viewed together, represent a reasonable price?

(*e*) What are the conditions of receiving earn-out for the other selling shareholders?

(*f*) Whether the earn-out consideration is determinable in the year of transfer or it is dependent on future events?

Conclusion

Clearly, taxing earn-out consideration is a vexed issue and a definite position can only be taken keeping in view the facts and circumstances of each case. However, in case the Earn-out is not known on the date of transfer, the onus is on the taxpayer to demonstrate that the Earn-out did not accrue and clearly, was not even determinable at the point of transfer of the capital asset. Importantly, the facts of the case should be distinguished with a situation where the part payment of consideration is known but held under escrow, to be paid upon fulfilment of specific conditions. In case of escrow transfers, the amount of consideration is clearly known, determinable. The title of the monies kept in escrow is with the seller and thus, taxability can be said to arise on the point of transfer of capital asset. Most of these elements can inherent in the SPA thus it would be worthwhile to examine the terms in detail specifically, those relating to payment and determination of earn-outs in case of a potential dispute between parties. If the title in Earn-out consideration does not automatically passes over to the seller, that itself provides a compelling argument to defer taxability on account of such consideration. Thus, to arrive at a conclusive view, thrust should be on the terms of settling the consideration, arrangement and modalities of the business acquisition and criteria linked to deferred payments as earn-out consideration.

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1.Notification No. FEMA.368/2016-RB

2.*Anurag Jain* v. *Authority for Advance Ruling* [2009] 183 Taxman 383/308 ITR 302 (Mad.)

3.*Moody's Analytics, Inc.,* USA In re [2012] 24 taxmann.com 41/209 Taxman 404/348 ITR 205 (AAR - New Delhi)

4. S.45, Income-tax Act, 1961.

5. S.2(14), Income-tax Act, 1961.

6. S.48, Income-tax Act, 1961.

7. S.50D, Income-tax Act, 1961.

8. CIT v. *Hemal Raju Shete* [2016] 68 taxmann.com 319/239 Taxman 176 (Bom.)

9.*Ajay Guliya* v. *Asstt. CIT* [2012] 24 taxmann.com 276/209 Taxman 295 (Delhi)