

Tax Hotline

February 04, 2009

EARN OUTS TAXED AS SALARY! NEW CHALLENGES IN M&A STRUCTURING...

The Madras High Court (“**High Court**”) recently delivered an interesting ruling¹ in a writ petition filed under Article 226 of the Constitution of India, challenging the ruling of the Authority of Advance Ruling (“**AAR**”) *In Re: Anurag Jain*².

FACTS OF THE CASE

Anurag Jain (“**Petitioner**”) and four others were the shareholders in M/s Vision Healthsource India Private Limited (“**VHIPL**”), a private limited company, engaged in the business of medical billing. VHIPL and all its shareholders entered into an agreement (“**SPA**”) to transfer its entire business and share capital in favor of M/s Perot Systems Investments BV (Netherlands) and M/s Perot Systems BV (Netherlands) (“**Perot**”). Further an Associate Employment Agreement (“**AEA**”) was entered into, wherein the Petitioner had agreed to enter into an employment relationship with VHIPL. The total consideration for the SPA was to be received by the Petitioner in 2 forms:

1. A consideration of US\$ 2.3 million, which was payable at the time of transfer (“**Upfront Payment**”)
2. The balance consideration would consist of payments, dependent on Earnings Before Interest, Tax and Depreciation Allowance earned from the business so transferred (“**EBITDA**”) and would be made in first year, second year and third year after the Upfront Payment, up to a maximum of 7 million US \$. (“**Contingent Payment**”)

On the basis of these facts the Petitioner had sought an advance ruling to determine the characterization of consideration received in the form of Upfront and Contingent Payment.

RULING OF THE AAR

Section 45 of the Income Tax Act, 1961 (“**ITA**”) provides that where there is a profit and gains from the transfer of a capital asset, income tax shall be payable in the year in which transfer takes place. Thus when the consideration for such a transfer is not ascertainable, as on the date of transfer, due to it being contingent on future events there appears to an ambiguity as to the amount of income tax payable. The AAR in its ruling after having considered the above proposition sought to segregate the Upfront Payment and Contingent Payment by holding the former being in nature of capital gains and the latter in nature of salary.

As regards the taxability of the Upfront Payment, the AAR held that the entire sum of \$ 2.3 million would be liable to be subject to capital gains tax and same would have to be paid in the year in which the transfer of business of VHIPL was effected.

In respect of the taxability of the Contingent Payments, the AAR read the AEA as part of the SPA due to the specific reference in the AEA to the SPA. More particularly, the AAR was of the view that the Contingent Payment paid under SPA should be considered as incentive remuneration for achieving the target of EBITDA. Therefore the Contingent Payment falls within the purview of “*salary*” under section 17(1)(iv) of the Income Tax Act, 1961, viz., “*any fees, commission, perquisites or profits in lieu of or in addition to any salary or wages*”. In light of the same, the AAR held that the Contingent Payment was in nature of profit in lieu or addition to salary and thus taxable under Section 17 of the ITA as salary income and not capital gains.

RULING OF THE HIGH COURT

The High Court reiterated the well established proposition³ that under article 226 of the Constitution the jurisdiction of the High Court is restricted to merely testing the legality of the procedure followed and not the validity of the order. Further the courts under judicial review are merely concerned with decision making and not the decision itself.

On the basis of the said settled principle, the High Court refused to venture into the merits of the order of the AAR. Further the High Court observed that as long as the procedure followed by the AAR was appropriate, even if it the AAR has erred in reading the AEA as part of the SPA, the High Court cannot under Article 226 venture into determining the correctness of the ruling. However, since in the present case the procedure followed by the High Court was never in dispute, the High Court dismissed the writ petition.

ANALYSIS

It must be borne in mind that in the present case due to the existence of AEA, the Contingent Payment was characterized as salary. However on account of the High Court not going into the merits of the AAR ruling questions on the taxation of earn outs remains unanswered. Also it must be pointed out that the AAR ruling has not taken into consideration the non existence of an employer-employee relationship between the Perot (acquirer) and the Petitioner, which is an important pre requisite for characterization of income as salary.

Further, the issue with respect to taxation of earn outs still remains ambiguous since Section 45 provides for taxation in the year of transfer and does not contain provisions for taxation of contingent payments. This could also result in

Research Papers

New Age of Franchising

June 20, 2025

Life Sciences 2025

June 11, 2025

The Tour d'Horizon of Data Law Implications of Digital Twins

May 29, 2025

Research Articles

2025 Watchlist: Life Sciences Sector India

April 04, 2025

Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

Audio

CCI's Deal Value Test

February 22, 2025

Securities Market Regulator's Continued Quest Against “Unfiltered” Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia | NewsX

April 01, 2025

potential issues with respect to levy of interest by tax authorities in the event the income is declared in the year of receipt. Also in the case of an acquirer, issues relating to deduction of tax at source may also arise in the light of this judgment.

The decision of the High Court in the above case is definitely a disappointment for the many M&A deals that entail earn-out payments, which in most cases is clearly a mechanism for discharging consideration for the acquisition. This is especially when the future of the target company would depend significantly on the intellectual capital that had helped build it in the first instance.

- Harshal Shah, Rajesh Simhan & Parul Jain

You can direct your queries or comments to the authors

-
1. Anurag Jain v. Authority for Advance Ruling and Another, (2009) 308 ITR 302
 2. (2005) 277 ITR 1 (AAR)
 3. R. B. Shreeram Durga Prasad and Fatehchand Nursing Das v. Settlement Commission (1989) 176 ITR 169 (SC)
-

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.