

## M&A Hotline

August 16, 2013

### AMOUNTS IN ESCROW CANNOT BE APPROPRIATED BY TAX AUTHORITIES

Recently, the Delhi High Court ("**Court**"), in the case of AAA Portfolios Pvt. Ltd. v. DCIT<sup>1</sup> held that funds lying in an escrow account cannot be appropriated by the tax authorities as recovery of taxes in connection with a taxpayer's liability, when such funds are not held by the escrow agent on behalf of the taxpayer, or owed by the third party to the taxpayer.

### BACKGROUND

The petitioners, AAA Portfolio Pvt. Ltd., Big Apple Clothing Pvt. Ltd. ("**Petitioners**") and other shareholders (collectively referred to as "**Sellers**") held shares in Escorts Heart Institute & Research Centre Ltd. ("**Target**"). The Sellers entered into a Share Purchase Agreement ("**SPA**") for the sale of their shares in the Target, which constituted 90% of the total shareholding in the Target, to Fortis Health Care Ltd. ("**Purchaser**"). Apart from the SPA, the Sellers, Purchaser and the escrow agent also entered into a separate an escrow agreement ("**Escrow Agreement**") which recorded the obligations of the escrow agent towards the release of the total consideration.

As per the key terms of the SPA and Escrow Agreement,

1. The Purchaser deposited the total consideration representing the purchase price of the shares of the Target with the escrow agent;
2. The Sellers deposited certain documents with the escrow agent to effectuate the sale of shares;
3. After completion of the above steps, a part of the consideration was disbursed to the Sellers except for the Petitioners;
4. The balance consideration represented the income tax liability of the Target that was being contested. This amount was to be withheld until final adjudication of the tax dispute. This tax dispute was related to the conversion of the Target from a charitable society into a company which resulted in the discontinuation of tax benefits enjoyed earlier;
5. Upon final adjudication, if the income tax liability exceeded the withheld amount, no amount would be released to Petitioner and the money will be refunded to Purchaser;
6. In the event the liability was less than the withheld amount, then an amount equivalent to the actual income tax liability will be refunded to Purchaser, and the balance would be released to Petitioner.

### PROCEEDINGS AT LOWER TAX AUTHORITIES

The tax department issued notices to the escrow agent for remitting the moneys to the tax department that was held on behalf of the Petitioner for recovery of the contested income tax liability. In response to these notices, the escrow agent furnished an affidavit stating that no part of the said amount in the escrow account is owed to the Petitioner by the escrow agent or is held on behalf of the Petitioner. The tax department failed to take this into consideration and ultimately the assessing officer passed an unfavorable order against the Petitioner. Pursuant to the order the tax department issued a notice to the escrow agent for remitting the money and the escrow agent paid the said amount in compliance of the notice. The instant writ petition is filed against this order of the assessing officer.

### ISSUES

The Court, in its judgment considered the following two questions;

1. Whether, in the instant case, the escrow agent could be compelled to remit the escrow funds?
2. Whether the escrow agent held any amount in the escrow account on behalf of the Petitioner?

### JUDGMENT

*Whether, in the instant case, the escrow agent could be compelled to remit the escrow funds?*

**Nature of garnishee proceedings:** The Court explained that proceedings under section 226(3) are in the nature of garnishee proceedings whereby a garnishee is called upon to directly pay a debt to the creditor of a person to whom the garnishee is indebted. Further, under this section the tax department exercises special powers that enables it to appropriate funds held by the a third party on behalf of the taxpayer, or owed by the third party to the taxpayer. However, an important limitation is that these powers can only be exercised by the tax department as garnisher in cases where a third party admits to owing money to or holding money on behalf of the taxpayer. Thus, no powers are available when the debtor disputes his liability to pay the taxpayer. To reach this conclusion, reliance was placed on

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the decision of the Calcutta High Court in *Shaw Wallace and Co. v. UOI*<sup>2</sup> which affirms this view.

*Garnishee proceedings under the Civil Procedure Code ("CPC")*: The Court also discussed the provisions of the CPC, in particular, Order 21 Rule 46 which deals with garnishee proceedings. The Court was of the view that even under the CPC, a court cannot issue a garnishee order against a debtor of the judgment debtor who disputes his indebtedness unless such issue is adjudicated and struck down. The Court went on to state that the ITA, unlike the CPC, does not provide powers to the tax department to adjudicate over the issue on indebtedness. This is clear from the language used in section 226(3)(vi).

In the present case, the escrow agent has furnished an affidavit affirming that it does not hold any amount on behalf of the Petitioner in the escrow account, or owes any such amount to the Petitioner. Based on this reasoning, the Court concluded that the tax department has no power to call upon the escrow agent to remit such amounts lying in the escrow account.

#### *Whether the Bank held moneys on behalf of the Petitioner?*

The Court perused through the relevant provisions of the Escrow Agreement and the SPA. It noted that neither of the agreements provide for any contingency that allowed the funds to be remitted to the taxpayer or the tax department. The main purpose of withholding an amount under the Escrow Agreement was to indemnify the Purchaser against any adverse effect on the valuation of the shares of the Target that may arise due to the contested income tax liability. Thus, the Court held that the Escrow Agreement never provided that the funds could be transferred to the Target.

Further, the Court also stressed on the fact that the Target is a separate legal entity from its shareholders. In light of this reasoning, the Court was of the view that the consideration paid for the sale of the Target's shares is not an asset of the Target on which the Target can exercise its rights. Thus, the amount in the escrow cannot be said to be available to the Target to meet its tax liability.

### ANALYSIS

This judgment brings to the forefront, tax risks associated with transactions such as share transfers, share subscriptions; mergers etc. where parties generally enter into escrow arrangements.

The instant case demonstrates a scenario wherein the tax authorities have tried to use garnishee proceedings to recover moneys lying in an escrow account, in which the taxpayer does not have any interest per se. In this respect, the Court has rightly pointed out that tax department cannot extend garnishee proceedings to the debtor of the taxpayer unless such a debt actually exists and the debtor confirms the same.

While the instant case was decided in the favor of the taxpayer, the consequences could be different in different factual scenarios. For example, in a situation where one of the parties entering into the escrow arrangement has an existing tax liability and certain portion of the money is supposed to be paid back to the taxpayer upon happening of a certain contingent event, the tax authorities can still proceed against the escrow agent since here he "*holds money on behalf of the taxpayer*". The instant case may not apply to such a scenario. Thus, one must put in place safeguards to ensure that investors are not negatively prejudiced. A successful attempt by the tax department could put an investor in a disadvantageous position, especially since he is unconcerned with a previous tax liability of the company. Thus, while drafting agreements it becomes important for parties to factor in the possibility of garnishee proceedings being instituted against the escrow agent.

In this case, the Court has also highlighted the limitations of the powers of the tax department in tax recovery by garnishee proceedings. However, it is important to keep in mind that a statement by the garnishee disputing the tax demand does not prevent the tax department from proceeding against the garnishee. In the event that the tax department proves that the garnishee has made a false statement, he could be held personally liable for the tax amount in question<sup>3</sup>. This is an important consideration that banks must bear in mind while acting as escrow agents.

Historically, the tax department has used garnishee proceedings to attach bank accounts or fixed deposits of taxpayers. But, the instant case throws light on an innovative technique that the tax department has applied for recovery of taxes. Although it may not have worked in this case, tax risks of this nature may still exist in different factual scenarios.

- Shipra Padhi and Alap Yadav

You can direct your queries or comments to the authors

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<sup>1</sup> W.P.(C) No.1272/2013

<sup>2</sup> (2003) 262 ITR 528 (Cal.)

<sup>3</sup> Beharilal Ramcharan vs Income-Tax Officer, Special Circle 'B' Ward, Kanpur and Anr. AIR1981SC1585

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