Globeview Advisors LLP

Contingent & Deferred Consideration

Welcome to another edition of *Beyond Headlines,* in this edition, we explore the **tax implications of contingent and deferred consideration in a divestment transaction**.

In line with the latest Artificial Intelligence (AI) trends, we've also experimented with a podcast version of this newsletter using NotebookLM by Google. The NotebookLM created this podcast within a minute. It can be sharper but is still impressive!

Podcast Here!

Globeview updates

Last month, our team was engaged in several exciting assignments, including:

- Termination of the **joint venture** and treatment of compensation among parties.
- Structuring **transfer of interest in a Limited Liability Partnership** held by an Indian company to a third-party buyer.
- Tax implications on US movie producer's arrangement on a **cinematographic film** with Indian distributor.
- Conceptualizing **set-up of a subsidiary in the UAE** for an Indian company, including identifying appropriate designated zone.
- Tax rules for **residential property investment** against share sale gain.

Contingent and Deferred Consideration

Contingent and **deferred consideration** mechanisms are widely used in transactions for various commercial reasons.

- **Contingent consideration** is tied to achieving specific performance milestones (e.g., revenue, profit, or employment continuity).
- **Deferred consideration** refers to payment made at a later date after the transaction closes. The amount in such cases is decided upfront and its receipt by seller is certain.

Taxing the entire consideration (incl. contingent and / or deferred portion) in the year of closing can result in tax outflow before actual receipt of funds. In case of contingent consideration, if the performance conditions are not met, the consideration may never be received – posing a significant challenge for sellers.

Contingent consideration taxable when right to receive established

In a recent ruling[1], Mumbai tribunal decided in favour of taxpayer (Huntsman Investments). The tribunal ruled that under the Share Purchase Agreement, the right to receive consideration was contingent on meeting certain future targets. Since the seller shareholder had no enforceable right to the consideration in the year of closing of the deal, the gain was held as not taxable in that year. The gains were taxable in the year in which a right to receive consideration was established.

In a case[2], money was placed in an escrow bank account and was to be released to the seller only once conditions were met. The court in such case as well have ruled in favor of the taxpayer.

However, in a case[3] court has ruled against the taxpayer, reasoning that the transfer was conclusive in the initial year, regardless of whether the contingent consideration was paid or not in subsequent years.

Deferred consideration

On the other hand, if a consideration amount is agreed upfront without any contingencies and only the timing of the payment is deferred to later years, the deferred component would be taxed in the year of closing. For taxing capital gains, cash basis is not relevant.

Additional aspects

While the above precedents provide some clarity, there are other nuances that can arise depending on the terms agreed upon between the parties:

- If conditions are linked solely to employment, does it resemble salary rather than capital gains? This distinction matters, as long-term capital gains are taxed at 15%, while salary may be taxed at 39% for individuals.
- What if consideration is decided upfront, but funds are held in escrow as part of an indemnity arrangement?

- If a deduction for investment in residential property is claimed in the year of closing, can it also be claimed in subsequent years when deferred or contingent consideration is received?

The outcome in these cases depends heavily on the terms of the agreement between the parties.

Regulatory complexities

When a non-resident purchases shares from an Indian resident, FEMA regulations allow for deferred consideration up to 25% of the total transaction value and for a maximum period of 18 months from the date of the transfer agreement. These provisions also apply to Foreign owned and controlled Indian companies (i.e. non-residents holding more than 50% of equity instruments).

[1] [2024] 166 taxmann.com 63
[2] [2020] 185 ITD 250
[3] [2012] 209 Taxman 295

Recently, our founder, Mr. Ameya Kunte conducted two insightful sessions on Employee Stock Option Plans and Share Appreciation Rights. Hosted by Venture Center, these sessions were attended by founders, professionals and academicians. You can watch the recordings here:

- **Part I:** Introduction to share based payments
- **Part II:** Strategies and best practices

We look forward to bringing you more updates in our next edition. Until then, feel free to reach out to us at contact@globeviewadvisors.com for any discussions.

About Globeview Advisors LLP

An Indian boutique consulting firm focused on tax centric business advisory services. We adopt solution-oriented, pragmatic, agile & time bound approach in delivering professional services. With a strong team with relevant experience, we have expertise and network to co-ordinate and deliver global projects. Read more about Globeview and our service offerings at our website.

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