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# TAX FLASH NEWS

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## The non-compete fee is not taxable because it is in the nature of capital receipt and it was not a camouflage to avoid payment of tax

### Background

Recently, the Delhi High Court in the case of Mrs. Tara Sinha[1] (the taxpayer) held that the non-compete fee received by the taxpayer is in the nature of capital receipt. The taxpayer enjoyed stature in the advertising industry and vide non-compete agreement, she agreed not to compete in India with the company.

The High Court observed that in order to determine as to whether the amount paid as a non-compete fee is taxable or not, it is necessary to look at the relevant clauses of the non-compete agreement. The AO did not construe the agreement as a whole and incorrectly, interprets clauses of the agreement. The reason to leave the taxpayer was that the company wanted to drop the taxpayer's name in order to have a competitive advantage in India. The non-compete fee was not directly related to the remuneration of the taxpayer which was received from the agency. Therefore, the non-compete fee paid to the taxpayer cannot be termed as camouflage or a well-orchestrated plan to avoid payment of tax.

### Facts of the case

- The taxpayer is an Individual and was working as a President of Tara Sinha McCann Erickson Pvt. Ltd. (TSME), an advertising agency. The taxpayer held 51 per cent shares of the said company and McCann Erickson Worldwide Inc. (MEW) held 40 per cent of the shares of TSME. The remaining 9 per cent shares were held by Associated Corporate Consultants Pvt. Ltd.
- During the Assessment Year (AY) 1995-96, the taxpayer filed her return of income declaring an income of INR1.27 million. During the AY, the taxpayer resigned from TSME. Upon her retirement, the taxpayer received payments of terminal benefit in the form of gratuity, INR3.5 million for the sale of her 51 per cent shareholding in TSME to Gyan Marketing Associates Pvt. Ltd. and INR31.53 million towards entering into a non-compete agreement with MEW.
- The Assessing Officer (AO) made an addition of INR31.53 million to the returned income of the taxpayer treating the non-compete fees as a revenue receipt in nature.
- The Commissioner of Income-tax (Appeals) [CIT(A)] deleted the addition made by the AO and held that the payment of compensation in lieu of the non-compete agreement by the taxpayer was a capital receipt and not chargeable to income tax. The Tribunal held that the amount received was a capital receipt not liable to tax.

### High Court's decision

- In order to determine as to whether the amount paid as a non-compete fee is taxable or not, it is necessary to take a look at the relevant clauses of the non-competition agreement.

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[1] CIT v. Mrs. Tara Sinha (ITA No. 154/2005) – Taxsutra.com

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- Relying on clauses of the agreement, the AO held that the true intention of MEW is not to enforce any of the restrictions. The AO did not construe the agreement as a whole. The AO, incorrectly, interprets clauses of the agreement in holding that they actually contradict each other. The AO was wrong in holding that the agreement was structured in a manner so as to give the taxpayer 'adequate loopholes' to bypass the restrictions with the 'consent of MEW'. The AO termed the agreement as being non-serious and wrongly construed the fact that the payment was received prior to the signing of the agreement and hence it is nothing but a terminal benefit.

- The taxpayer had explained that it was due to her personal efforts that the business of the company had grown and expanded from one office in Delhi to offices in several cities including Mumbai, Bangalore, Calcutta, Chennai, and Kathmandu. The reason to leave TSME was that MEW wanted to drop her name from TSME in order to have a competitive advantage in India. The money being paid to the taxpayer as a non-compete fee was not directly related to the remuneration she was receiving from TSME.

- Accordingly, the subsequent conclusion of the AO that the money paid to the taxpayer was not a non-compete fee but a terminal benefit is wholly unsustainable. From the record, it is clear that TSME was a brain child of the taxpayer.

- From a reading of the clauses of the agreement, it is clear that MEW was apprehensive about her retirement and the effect it could have on their business and hence insisted on the obligations contained. On reference to the clauses of the agreement, it is a clear acknowledgement that the taxpayer did have the potential and stature to take away a substantial number, if not all, of the clients and the employees of TSME. The non-compete fee paid to her cannot, therefore, be termed as camouflage or a well-orchestrated plan to avoid payment of tax.

- The clients of the taxpayer, at the time when she retired from TSME, did include some of the most well-known Indian and multinational companies. The non-compete agreement is a genuine agreement, and the same would be governed by the laws of England. Any disputes would be referred to ICC Paris, cannot be termed as a devious method not to seek enforcement, inasmuch as, such clauses appear regularly in several contracts involving international companies.

- Certain specific clauses in the agreement are standard severability clauses which appear in most contracts that have multiple obligations cast on the parties. Even if one obligation is held to be illegal or void, other clauses and obligations would be enforceable. These clauses cannot by any stretch of the imagination, be held to be a ruse to not enforce the agreement.

- Similar issue had arisen as far back as in 1942 before the House of Lords in Beak v. Robson[2]. It was held that the amount of GBP7000 paid to Mr. Robson for agreeing not to engage in a competing business within 50 miles of Newcastle-upon-Tyne without the company's consent, was held to be not taxable. The House of Lords held that the test is to establish the 'real nature of transaction'.

- In the present case, the *`real nature of the transaction'* is that it is a non-competition agreement wherein the taxpayer agreed not to be involved in any business in India of advertisement, sale, promotion, public relations, etc., which is competitive with MEW or solicit any client of MEW or hire any employee of MEW.

- The taxpayer enjoyed a stature in the advertising industry and the non-competition agreement, by which she agreed not to compete in India with MEW, was clearly not a sham. She is now 82 years of age and considering that the tax department's appeal challenges concurrent findings of the CIT(A) and Tribunal, did not find any cause to interfere.

- In the case of Khanna and Annadhanam[3], the Delhi High Court followed the decision of the Supreme Court in Kettlewell Bullen and Company Ltd.[4] and held that any payment made which represents compensation for the loss of the source of income would be capital in nature and that it would not be taxable.

- In the case of Guffic Chemical Pvt. Ltd.[5], the Supreme Court held that the non-compete fee of INR50 lakh received by Ranbaxy was a capital receipt. Similar was the view of the Delhi High Court in Rohitasava Chand[6], which dealt with the payment of a non-compete fee to the taxpayer which included a transaction for sale of shares. A similar view was also held by the Calcutta High Court in Saroj Kumar Poddar[7] and the Madras High Court in Saraswati Publicity[8].

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[2] Beak v. Robson (1943) 11 ITR Suppl. 23
[3] Khanna and Annadhanam v. CIT [2013] 351 ITR 110 (Del)
[4] Kettlewell Bullen and Company Ltd. v. CIT [1964] 53 ITR 261 (SC)
[5] Guffic Chemical Pvt. Ltd. v. CIT [1987] 32 ITR 602 (SC)
[6] Rohitasava Chand v. CIT [2008] 306 ITR 242 (Del)
[7] CIT v. Saroj Kumar Poddar [2005] 279 ITR 573 (Cal)
[8] CIT v. Saraswati Publicity [1981] 132 ITR 207 (Mad)

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- The present case is clearly distinguishable from the decision of the Delhi High Court in the case of Shiv Raj Gupta[9] wherein the taxpayer was involved in a specialised regulated business like manufacture and sale of liquor which requires a specific liquor license in each state, manufacturing capability and capital investment, all of which the taxpayer therein did not possess.

- In the facts of the present case, the High Court following the decisions of Guffic Chemical Pvt. Ltd, Khanna and Annadhanam and Rohitasava Chand held that the non-compete agreement is genuine and the payment made thereunder is indeed a non-compete fee.

## Our comments

The issue with respect to taxability of non-compete fees and the characterisation of such fees as capital or revenue has been a matter of debate before the Courts.

The Finance Act, 2002 amended Section 28 with effect from 1 April 2003 to tax the non-compete fees as business income. The proviso to Section 28(va)(a) provides for an exception to cases where such receipts are taxable as capital gain.

On one hand, various Courts/Tribunal[10] have held that compensation received towards negative covenant of non-compete agreement is a capital receipt and not taxable under the Act. However, these cases were prior to 1 April 2003. On the other hand, various Courts/Tribunal[11] have held that payments on account of the non-compete fee were taxable under Section 28(va)(a) as business income and not under the head 'capital gains'. The Mumbai Tribunal in the case of Anurag Toshniwal has clarified that post amendment in Section 28 with the insertion of clause (va), the non-compete fee received by the taxpayer is liable to be taxed under the head 'Profits and gains of business or profession'.

On the terms of the agreement, the Madras High Court in the case of Ambadi Enterprises Ltd.[12] observed that one test for ascertaining as to whether what was received was a capital receipt or a revenue receipt is to find out whether the taxpayer had snapped its link with the profit making apparatus that had been transferred. When the entire trained manpower and customer network were handed over to the other party to the agreement, the payment received by virtue thereof is to be treated as capital receipt since the taxpayer which had a well-developed large scale organisation and marketing network, had given up the enjoyment of good profits that it had in all these years till the date of termination of the agreement.

In the present case, the Delhi High Court held that the non-compete fees received by the taxpayer is in the nature of capital receipt since it represents compensation for the loss of a source of income. The High Court observed that in order to determine as to whether the amount paid as a non-compete fee is taxable or not, it is necessary to look at the relevant clauses of the non-compete agreement.

[9] CIT v. Shiv Raj Gupta [2015] 372 ITR 337 (Del)
[10] Sapthagiri Distilleries Ltd [2015] 229 Taxman 487 (SC), CIT v. TTK Healthcare Ltd [2016] 70 taxmann.com 263 (Mad), CIT v. Real Image (P.) Ltd [2012] 359 ITR 606 (Mad), ACIT v. Ashok Mehra [2009] 27 SOT 15 (Del)
[11] Ramesh D. Tainwala v. ITO [2011] 15 taxmann.com 181 (Mum), Anurag Toshniwal v. DCIT [2013] 56 SOT 62 (Mum)
[12] CIT v. Ambadi Enterprises Ltd. [2004] 267 ITR 702 (Mad)

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