KPMG

Tax Flash News

25 August 2023

Compensation for termination of advertisement and agency sales agreement is allowed as business expenditure. Depreciation is allowed on payment of non-compete fees

Executive summary

The allowability of the compensation paid for the termination of the business agreement and the payment of non-compete fees has been a debatable issue. Normally, the commercial or business expediency of a transaction or the rationale behind the payment is considered for the allowability of such payment as a business expenditure. Recently, the Bombay High Court in the case of Music Broadcast Private Limited[1] (the taxpayer) held that the compensation paid on termination of the agency sales agreement is revenue in nature and allowed as a business expenditure. The payment of non-compete fees was in the nature of capital expenditure. The non-compete fees were covered under 'any other business or commercial rights of similar nature' and therefore entitled for depreciation.

Facts of the case

- The taxpayer, an Indian private limited company, received income from advertising through the intermittent breaks of various programs relaying in its radio station by the name 'Radio City'. For procuring the advertisement from various clients, the taxpayer engaged Star India Private Limited (SIPL).
- In FY 2007-08, due to a dispute, the taxpayer terminated the agreement with SIPL. The taxpayer paid INR 12.60 crore as compensation under the Advertisement and Agency Sales Termination Agreement (ASTA). Further, a sum of INR 19.40 crore under Restrictive Covenant Agreement (RCA) was paid for restricting SIPL for not competing against the taxpayer in a similar business for another 2.5 years.
- The Assessing Officer (AO) disallowed the compensation paid under ASTA and RCA treating the same as capital expenditure.
- The Commissioner of Income-tax (Appeals) [CIT(A)] reversed the findings of the AO and held that:
  - Under ASTA, the taxpayer had not obtained any capital asset that was of enduring nature or any right that did not exist with the taxpayer. The agency commission that the taxpayer was paying to SIPL was an expenditure incurred for earning the advertisement income. Since the taxpayer had paid compensation for the premature termination of the agreement, it was to be treated as revenue expenditure.
  - The compensation paid under RCA was capital in nature. It was an intangible asset, and the taxpayer was entitled to claim depreciation.
- The Tribunal concurred with the view expressed by the CIT(A).

[1] PCIT v. Music Broadcast Private Limited (ITA No. 675 of 2018) – Taxsutra.com

High Court's decision

Payment for premature termination of agreement (ASTA)

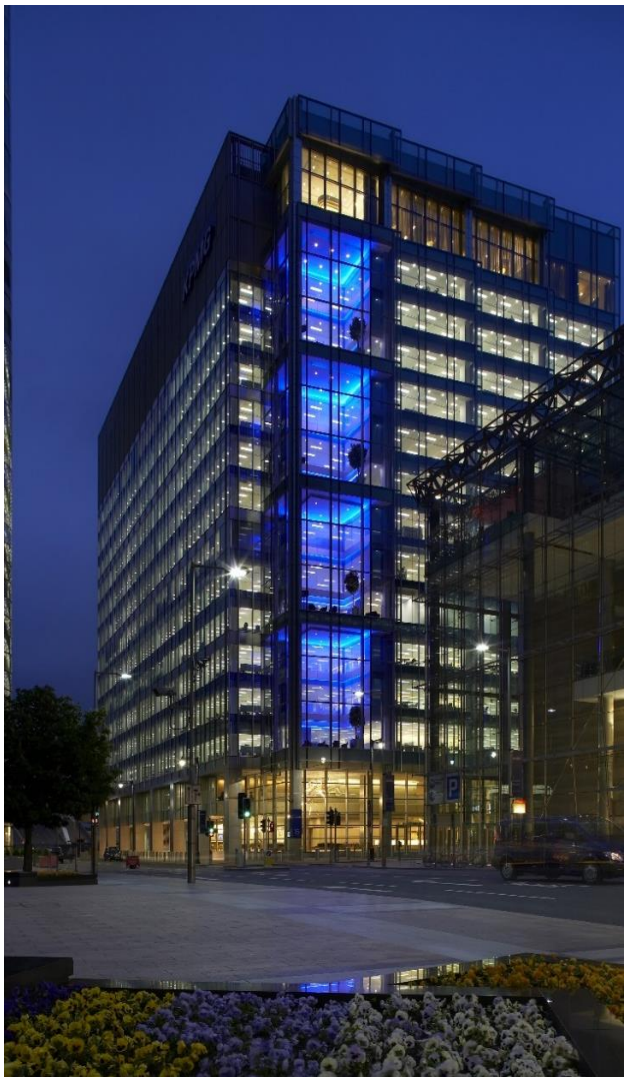
- The Supreme Court in the case of Ashok Leyland Ltd.[2] held that:
  - The payment made for termination of the contract by way of compensation is allowed as a deduction in computing the total income of the taxpayer.
  - When an expenditure was made with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, then only there is a good reason for treating such an expenditure as properly attributable not to revenue but to capital.
  - Where the termination was on business considerations and as a matter of commercial expediency it cannot be stated that by terminating the agreement, the taxpayer acquired any enduring benefit.
  - By terminating the services, the taxpayer not only saved the expenditure that it would have had to incur in the relevant previous year but also for a few more years to come. Therefore, it was not correct to say that by avoiding certain business expenditures, the company has acquired enduring benefits or acquired any income-yielding asset.
- In the present case also, by paying the compensation under ASTA, the taxpayer not only saved the expenditure that it would have had to incur in the relevant previous year but also for a few more years to come. Therefore, the amount paid on account of the termination of agreement to SIPL was to be treated as revenue expenditure.

Payment under Restrictive Covenant Agreement

- The Bombay High Court in the cases of Piramal Glass Ltd.[3] and India Medtronic (P) Ltd.[4] held that the expression 'or any other business or commercial rights of similar nature' used in Explanation 3 to Section 32(1)(ii) is wide enough to include non-compete transactions.
- In the instant case, by paying for non-compete fees under the RCA, the rights acquired by the taxpayer were not only giving it enduring benefits but also protected the taxpayer's business against competition, that too from a person who had closely worked with the taxpayer.
- Therefore, such compensation was capital in nature. It was for an intangible asset and the taxpayer was entitled to claim depreciation.

Our comments

The Bombay High Court has reiterated that the termination of a business agreement, as a matter of commercial expediency, does not result in enduring benefit or the creation of assets and therefore such payment is in the nature of revenue expenditure. With respect to non-compete fees, the important factors to allow depreciation are the right of non-competition and business protection received by the payer against the payment of such fees. The High Court held that such payment is covered under the term 'any other business or commercial rights of similar nature' provided in Explanation 3 to Section 32(1)(ii) and eligible for depreciation.



[2] CIT v. Ashok Leyland Ltd. [1972] 86 ITR 549 (SC)
[3] CIT v. Piramal Glass Ltd. (ITA No.556 of 2017, dated 11 June 2019)
[4] PCIT v. India Medtronic (P) Ltd. (ITA No.1453 of 2017, dated 30 September 2021)

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