END OF AMBIGUITY: PAYMENT TOWARDS NON-COMPETE FEE, A REVENUE EXPENDITURE

The Supreme Court vide recent judgment in a batch of appeals, lead matter being *Sharp Business System vs. CIT*[1], has delivered a landmark/ significant ruling, wherein the core question for Court's consideration was, (a) whether payment of non-compete fee to ward off business competition is 'revenue' or 'capital' expenditure; (b) if the same is termed as capital expenditure, whether depreciation as "intangible asset" under section 32(1)(ii) of the Act[2] is allowable?

The titular appeal was concerned with a payment of Rs.3 crores made by the Taxpayer to its Joint Venture partner, L&T, to abstain from competing in certain specific products for 7 years. The Taxpayer claimed payment of non-compete fee as revenue expenditure in terms of section 37(1) and in the alternative, claimed that if it is termed as capital expenditure, then, depreciation should be allowed under section 32(1)(ii) of the Act.

The lower authorities and also the Hon'ble Delhi High Court, however, rejected both the alternative claims, thereby resulting it to be a sunk cost to the Taxpayer. The High Court disagreeing with the contentions of the Assessee, held the payment to be capital expenditure and also denied depreciation under section 32 of the Act by stating that non-compete fee is not an intangible asset. The Court held that non-compete results in right in *personam* only against payee and not a right in *rem* and for an asset to be intangible, it has to be right in *rem*.

As regards the cases arising out of Hon'ble Madras and Bombay High Courts, the respective assessees treated non-compete fee as capital expenditure and claimed depreciation under section 32(1)(ii) of the Act. This contention found favour with the said High Courts, against which Revenue was in appeal before the Apex Court.

The Apex Court took note of the tests laid down by the British and the Indian Constitutional Courts, for determining the nature of expenditure, viz., (a) enduring benefit in the capital field; (b) fixed vs. circulating capital; and (c) accretion to profit making apparatus. The Apex Court, while opining on the issue reiterated the oft quoted conundrum set out in Alembic Chemical[3], *"In the infinite variety of situational diversities in which the concept of what is capital expenditure and what is revenue expenditure arises, it is well nigh impossible to formulate any general rule, even in the generality of cases, sufficiently accurate and reasonably comprehensive, to draw any clear line of demarcation."*

Applying the fundamental tests laid down in Empire Jute[4], Alembic Chemical and others to the payment made towards non-compete, the Hon'ble Supreme Court held that such payments cannot be considered to be for acquisition of any capital asset or towards bringing into existence a new profit earning apparatus. The Court, analysing the fundamental character of such payment, held the non-compete fees to be revenue expenditure, and observed as under:

(i) **Purpose** of non-compete is to give head start to the business or for protecting the business;

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[1] Civil Appeal No. 4072 of 2014
[2] Income Tax Act, 1961
[3] Alembic Chemical Works Co. Ltd. vs. CIT [1989] 177 ITR 377 (SC)
[4] Empire Jute Co. Ltd. v. CIT [1980] 124 ITR 1 (SC)

(ii) Non-compete fee only **seeks to protect or enhance the profitability** of the business, thereby facilitating the carrying on of the business more efficiently;

(iii) Such payment neither results in **creation of any new asset nor accretion to the profit earning apparatus**;

(iv) **Length of time** over which the enduring advantage may enure to the payer is **not determinative** of the nature of expenditure;

(v) The non-compete compensation from the standpoint of the payer of such compensation is in anticipation that absence of a competition from the other party may secure a benefit to the party paying the compensation. However, there is **no certainty that such benefit would accrue**;

(vi) Such payment **does not create a monopoly**, as there is no complete elimination of competition.

Since, the payment of non-compete fee was held to be revenue expenditure, the Court did not venture into the issue of allowability of depreciation, as the same was rendered redundant.

Pertinently, the appeals wherein the assessees themselves treated non-compete fee as capital expenditure, were also remanded back to respective Income Tax Appellate Tribunal to be heard afresh in accordance with ratio of the judgment and liberty has been granted by the Court to the assessees to even raise additional grounds, if required, to claim the expenditure as revenue.

In other appeals forming part of this batch, on the issue of disallowance of interest on borrowed funds advanced to subsidiary companies under Section 36(1)(iii) of the Act, the Court held in favour of the Taxpayers by reaffirming the principle of "Commercial Expediency", following the landmark precedent in *S.A. Builders*[5].

VA Comments

This landmark judgment has reiterated that the test of enduring benefit is not of universal application and does not automatically classify an expenditure as revenue or capital unless the enduring benefit is attributable to capital. The Court, considering the nature of non-compete fee, has applied the test of accretion to profit making apparatus and held that such a payment does not create any new asset, nor augment the profit-making apparatus of a Taxpayer. More importantly, the Court held that such payment only seeks to enhance profitability and hence revenue expenditure irrespective of the length of non-compete. This conclusion is important since basis the facts of Coal Shipment, the Courts, in certain cases, decided the issue of revenue vs. capital based on the tenure of the non-compete.

[5] [2007] 288 ITR 1 (SC)

As a way forward, Taxpayers shall have to re-evaluate and re-strategize it's claim in line with the principle laid by the Supreme Court depending upon the stage where the issue is pending in litigation. Cases where the appeal/ issue is not presently pending/ alive before any forum shall have to be evaluated taking into consideration the entire factual situation. The specific direction of the Hon'ble Apex Court in remanding all cases, including cases where the Taxpayer itself did not claim the expense as revenue deduction, to the lower authority to be redecided in line with principle laid down by the Court, is clearly indicative of the intent of the Court in ensuring that the Taxpayers are allowed its legitimate claim of deduction.

It is important to note that while deciding the issue of allowability of interest expenditure under section 36(1)(iii) the Court has reaffirmed the principle of *"commercial expedience"*, as laid down in SA Builders. This will also have a significant bearing on the reconsideration of SA Builders which is pending consideration before a Three judge bench of Supreme Court.

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