TAX SPHERE

Compensation received for relinquishment of right to sue is a capital receipt not chargeable to tax

The Madras High Court in its recent ruling[1] overturned the decision of Chennai bench of Tribunal holding that right to sue is a capital receipt and the consideration received by the taxpayer to give such right is in the nature of negative covenant not covered under clause (va) of section 28 of the Act[2] and thus a capital receipt not chargeable to tax.

In facts of the case, the taxpayers (appellants) were jointly holding 23.52% of shares of a Company engaged in the business of human resource management internationally, while 76.33% of the shares were held by a Netherlands based investment company ("investor").

Pursuant to an agreement between the taxpayers and the investor, it was agreed that the investor shall not transfer its shareholding without extending the right of first purchase (ROFP) to the taxpayers. Later on, the taxpayers were informed that the investor attempted to transfer its shares to a third-party vis., Randstad Holdings, Netherlands ("Randstad")

[1] K. Pandiarajan and Smt. Hemalatha vs. ACIT [2026] 489 ITR 142 (Mad.)
[2] Income tax Act, 1961

without granting an ROFP to the taxpayers. Aggrieved thereby, the taxpayers invoked the relevant clause of the agreement and sent a legal notice to the investor threatening to sue for such breach.

In order to avoid legal battle and to settle the dispute, Randstad offered compensation of three million euros to the taxpayers, to be paid in five instalments, the first instalment of one million euros followed by four instalments of 0.5 million euros each. The first payment of one million euros was conditional upon executing of the memorandum of understanding and withdrawing the legal notice by the taxpayers. The compensation of one million euro was claimed by the taxpayers as capital receipt not chargeable to tax.

The tax officer rejected the claim of the taxpayer treating the said compensation as business income in terms of section 28 of the Act.

On appeal of the taxpayer, the Court observed that pursuant to insertion of clause (va) to section 28 of the Act, while the non-compete fee would be taxable as business income, however, the compensation received towards other negative covenants within the sphere of business arrangements is not covered within the purview of that clause.

It was further observed that three judge bench of the Supreme Court in case of Guffic Chem[3] noted that payment received towards a non-compete negative covenant is always treated as a capital receipt and it is only post insertion of clause (va) to section 28, the receipt of non-compete fee was made taxable.

[3] Guffic Chem (P.) Ltd. vs. CIT [2011] 332 ITR 602 (SC)

Relying upon the decision in case of *Oberoi Hotel*,[4] the Court held that facts of the present case where taxpayers were denied ROFP in terms of the agreement between the parties is similar to giving up a right to purchase the property as in the case of Oberoi Hotel which relates to injury inflicted on a capital asset, and giving up a contractual right that results in the loss of a source of income.

It was further observed that the High Courts have consistently held that right to sue constitutes a capital asset. In view thereof, the Court held that the compensation received by the taxpayers towards withdrawing of legal notice/ giving up of right to sue would be treated as capital receipt not chargeable to tax.

[4] Oberoi Hotel Pvt. Ltd. v. CIT[1999] 236 ITR 903 (SC)

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