K.R.RAMAMANI MEMORIAL NATIONAL TAXATION MOOT PROBLEM 2023-24

The Income Tax Department filed a SLP before the Hon'ble Supreme Court of India against the order of the Hon'ble Madras High Court passed in ***M/s. Vulcan TV Pvt. Ltd.vs CIT in TCA 1774 of 2005 for the AY 2000-01***. Leave was granted by the Hon'ble SC and the case is posted for final hearing to deal only with the following legal question raised:

"Whether on the facts and in the circumstances of the case, the High Court is right in law in holding that the consideration paid by the company to its Director for the non-competing covenant is an allowable deduction in computing the income?"

Annexure: Impugned HC Order. Note: There is no dispute on wording, facts of Agreement and this is only on a question of law not facts.

IN THE HIGH COURT OF JUDICATURE AT MADRAS
DATED : 26.06.2018
Tax Case (Appeal) No.1774 of 2005

M/s.Vulcan TV Pvt. Ltd.... Appellant
vs
Commissioner of Income Tax... Respondent

Tax Case (Appeal) filed under Section 260A of the Income-tax Act, 1961 against the order passed by the Income-tax Appellate Tribunal (ITAT), Chennai, "D" Bench, dated 03.01.2005 in I.T.A.No.4443/Mds/2004 for the **assessment year 2000-01**.

For Appellant :Mr.Vikram Vijayaraghavan, Senior Advocate
For Respondent: Mr.AzizAlam, Senior Standing Counsel

Judgment:
1. The above appeal has been admitted on the following substantial questions of law:- *"Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal is right in law in holding that the consideration paid by the appellant company to Mr.VV for the non-competing covenant is not an allowable deduction in computing the income?"*

Facts are as follows: The appellant is a company registered under the Companies Act and engaged in the business of television broadcasting, formed in the year 1991. The company was managed by one of the Directors, Mr.VV and he was also the Chairman of the company, managing all the affairs of the company till April, 1999. Mr.VV had 50% shareholding and the balance was held by a Non-Resident Indian ("NRI"). The NRI and VV decided to part ways and an agreement was reached between them by which Mr.VV agreed to sell 50% of his shareholding to the NRI or his nominees and to renounce his management of the company. As a part of the said agreement, Mr.VV, agreed not to compete with the business of the assessee company for a period of five years for which the company agreed to pay him a sum of Rs.7 crores during the previous year relevant to the assessment year 2000-01. This amount was paid to Mr.VV in respect of a non-compete covenant, which was claimed as a business expenditure in computing the income (in the income tax return) for the same year.

2. The Assessing Officer, by order dated 31.03.2003, disallowed the claim and computed the assessee's income stating that the payment is of capital nature and is not allowable under S.37(1) of the Income Tax Act, 1961. The Assessing Officer held that the decision of the Hon'ble Supreme Court in the case of ***CIT vs. Coal Shipments Pvt. Ltd., (1971) 82 ITR 902*** was not applicable to the facts of the case and distinguished the said decision on the ground that the compensation paid therein was paid for an uncertain period, whereas in the assessee's case, the restrictive covenant was restricted for a period of five years. The decision of this Court in the case of ***Commissioner of Income Tax vs. Late G.D.Naidu and Others (1987) 168 ITR 63*** and the decision of the Hon'ble Supreme Court of India in ***Empire Jute Co. Ltd. vs. Commissioner***

of Income Tax (1980) 124 ITR 1, which were relied on by the assessee were held to be inapplicable to the facts of the case.

3. As against the order of the Assessing Officer, the appellant preferred appeal before the CIT(A) contending that the assessee has not secured any enduring benefit pursuant to the payment made to Mr.VV in consideration of the restrictive covenant. The CIT(A) confirmed the conclusion of the Assessing Officer holding that expenses having been incurred in respect of an agreement for a period of five years, the expenditure should be deemed to be capital. Against the order of the CIT(A), the appellant preferred appeal before the ITAT and reiterated the contentions raised before the Assessing Officer and CIT(A). The Tribunal rejected the assessee's case holding that the payment made to Mr.VV was expended to ward off competition in the field of the assessee's business and therefore, the stand taken by the Revenue has to be accepted and held that the assessee derived an enduring benefit in its business.

4. The learned Senior Counsel for the appellant referred to the following decisions:-
(i) Firstly, the decision in the case of Empire Jute Co. Ltd., (supra) and submitted that the expenditure incurred by the appellant for the purpose of removing a restriction with a view to increase its profit was revenue in nature and allowable as a deduction and upon payment of the non-compete fee, no new asset was created. As it was part of the cost of operating the profit earning apparatus and was clearly in the nature of revenue expenditure.
(ii) Relying on *G.D.Naidu* (supra), it was emphasised that it was also a case where similar non-compete agreement was subject matter of issue and the restrictive covenant was also for a period of five years and the Hon'ble Division Bench held that payment towards such restrictive covenant was on revenue account and it would not amount to any acquisition of an advantage of an enduring nature.
(iii) The decision in the case of ***Carborandum Universal Ltd. vs. Joint Commissioner of Income-tax (2012) 26 taxmann.com 268*** was relied on and it was submitted that the Hon'ble Division Bench of this Court took into consideration all the decisions on the point including the decision in the case of ***Chelpark Co. Ltd. vs. CIT (1991) 191 ITR 249*** and held that the assessee therein entered into a non-compete agreement with one U.Mohanrao for a period of five years and paid a sum of Rs.50,00,000/- as a non-compete fee and claimed the same as revenue expenditure and such payment was in respect of performing of business of the assessee and those expenditure was revenue account and not on capital account.
(iv) Reliance was also placed on the decision of Delhi High Court in the case of ***CIT vs. Eicher Ltd. (2008) 302 ITR 249 (Delhi)*** and it is pointed out that in the said case though the period for which the restrictive covenant was to operate was neither permanent nor ephemeral yet the payment was held to be revenue in character. This decision of the Delhi High Court was confirmed by the Hon'ble Supreme Court in ***CIT vs. Eicher Limited (SC) 312 ITR 333.***

5.The learned Senior Counsel further submitted that the other High Courts in the Country have also taken a similar view, and cited the following decisions.
(i) CIT vs. Messrs. Piggot Chapman & Co. (Cal.) (1949) 17 ITR 317;
(ii) CIT vs. Lahoty Brothers Ltd. (Cal.) (1951) 19 ITR 425;
(iii) Champion Engineering Works Ltd. vs. CIT tax (Bombay) 81 ITR 273;

(iv) CIT vs. Bowrisankara Steam Ferry Co. (A.P.) (1973) 87 ITR 650; and
(v) CIT vs. Andhra Fuels (P.) Ltd. (A.P.) (2016) 70 taxmann.com 271.

6.The learned Senior Counsel also placed reliance on the recent decision of this Court in the case of ***M/s.Hatsun Agro Products Ltd., vs. JCIT T.C.A.1173 of 2005 dated 10.04.2017***, in which the Hon'ble Division Bench, after taking note of the decisions in ***Alembic Chemical Works Co. Ltd. vs. CIT 177 ITR 377***, *Chelpark Company Limited (supra), Carborandum Universal Limited (supra) and Empire Jute Ltd. (Supra)* held that payments made towards restrictive covenant are revenue in nature. Thus, it is the submission of the learned Senior Counsel for the appellant that the payment made to Mr.VV has to be allowed as a revenue expenditure and the question has to be answered in favour of the assessee.

7.The learned Standing Counsel for the Department submitted that the non-compete was part and parcel of the share transfer agreement and hence nothing but a capital expenditure . Further, he pointed out that assessee in the books of accounts has amortised the payment for a period of five years and thus they themselves effectively treated it as capital expenditure.

8.The learned Standing Counsel referred to the following decisions:-
(i) Neel Kamal Talkies vs. CIT [1973] 87 ITR 691 (Allahabad);
(ii) Blaze & Central (P.) Ltd. vs. CIT [1979] 1 Taxman 546 (Madras)
(iii) CIT vs. Hindustan Pilkington Glass Works 139 ITR 581 (Cal.)
(iv) Pitney Bowes India (P.) Ltd. vs. CIT 254 CTR 38 (Delhi);
(v) Sharp Business System vs. CIT-III 254 CTR 233 (Delhi); and
(vi) M/s.Tamil Nadu Magnesite Ltd. vs ACIT in T.CA Nos.907,908/2007 dated 05.06.2018.

9. By referring to the decision in *Neel Kamal Talkies (supra),* it is submitted that the agreement entered into between the assessee and the firm was one which had the effect of eliminating competition, so far as the assessee was concerned and under it, the said firm was prohibited from exhibiting any films at its Talkies for a period of five years, which was held to be capital expenditure.

10. It is submitted in *Blaze & Central (P.) Ltd. (supra),* the agreement entered into by the assessee-company with one B does not indicate that the film shots are subject matter of bargain and in substance and effect, the agreement involved a transfer of the B's business to the assessee-company for a consideration of Rs.1,50,000/- and it cannot be said that the said sum was paid for acquiring the stock-in-trade, as the assessee-company has not only warded off the business rivalry, but also acquired the business of the rival for a period of nine years in a specified area. Referring to the said decision, it is emphasised that when amount is paid to ward off business rivalries, it has to be treated in the capital field.

11. The decision in the case of *Hindustan Pilkington Glass Works (supra)* was referred to, to support the submission that payment made to eliminate competition was to prevent a person from producing products manufactured by the assessee for five years under an agreement, which was treated as capital in nature.

12. The decision in *Pitney Bowes India (P.) Ltd. (supra)* was cited to state that when the assessee itself has treated the expenditure as capital in the books of accounts, it cannot be treated to be revenue in nature.

13. Reliance was mainly and heavily placed on *Sharp Business System (supra),* wherein the non-compete fee paid by the assessee to its erstwhile partner as consideration for not setting up any business of selling, marketing and trade of electronic office products for a period of seven years amounted to capital expenditure and thus, the same was not allowable under Section 37(1) of the Income Tax Act, 1961.
On the above submissions, the learned Standing Counsel sought for rejecting the appeal.

14. In reply, learned Senior Counsel, submitted that the decision of the Delhi High Court in the case of *Sharp Business System (supra)* does not lay down the correct legal position. Though in paragraph 9 of the said judgment, the Court had referred to the decision in Empire Jute Co. Ltd. (supra) and the decision in Alembic Chemical Works Co. Ltd. (supra), but had applied the wrong test and held that the expenditure was capital in nature. Further, it is submitted that though the Court referred to the decision in G.D.Naidu (supra), while discussing the various decisions on the point, did not discuss about the decision laid down in G.D.Naidu, which is subsequent to the decision in Blaze & Central (P.) Ltd. (supra), which judgment was distinguished in G.D.Naidu.

15. It was further submitted that the assessee has not capitalised the expenditure in his account, but has treated the same as deferred Revenue expenditure for a period of five years. Further, it is submitted that the method of accounting is totally irrelevant, and to support this argument, the learned Standing Counsel referred to the decision in the case of ***Taparia Tools Ltd. vs Joint Commissioner of Income-tax [2015] 55 taxmann.com 361 (SC).*** Thus, the learned counsel concluded by submitting that on account of the payment of the non-compete fee, the company does not acquire any business, the profit making apparatus remains the same and the assessee used to run the business remains the same and there is no new business or new source of income and therefore, the expenditure has to be treated as revenue.

16. After elaborately hearing the learned counsels for the parties and carefully perusing the materials placed on record, we are in agreement with the submissions made by the learned Senior Counsel for the assessee. We support such conclusion with the following reasons:-

17. The Revenue would contend that the agreement is part of a share purchase agreement and must be treated as capital. However this argument does not hold water; merely because it was part of the share purchase agreement does not mean it immediately partakes the nature of shares. The principles established by the Supreme Court in the case of *Continental Construction Ltd. vs. CIT (2002-TIOL-661-SC-IT),* if followed, would bind us to apportion the amount paid towards various services and accordingly the amount paid towards use of non-compete should considered separately and tested as revenue or capital. Further regardless of being in the same agreement, the fact is the non-compete is paid towards restricting the Director, being an individual, from going ahead and competing or joining with competition

against the payer. Thus we are unable to pursue ourselves with the argument of the learned counsel of the Department. Further the Revenue would contend that assessee has amortised the payment and spread over the same for a period of five years and thus, the assessee having treated the same in the books of accounts as a capital expenditure, have to be bound over by the same and cannot take a different stand. It is pointed out that the Tribunal, while accepting that the facts are not in dispute, has specifically pointed out that the expenditure is laid out and expended for the purpose of business. Further, the assessee has explained that they have not capitalised the said expenditure in their accounts, but as deferred revenue expenditure for a period of 5 years.

18. Thus, the question would be as to whether the manner in which the accounts of an assessee are maintained could impact the assessment under the provisions of the Act. This question was answered by the Apex Court in *Taparia Tools Ltd. (supra),* pointing out that the Court has repeatedly held that the entries in the books of accounts are not determinative or conclusive and the matter is to be examined on the touchstone of the provisions contained in the Act. Therefore, this argument advanced by the Revenue does not merit acceptance.

19. The next contention advanced by the Revenue was based upon the decisions in *Neel Kamal Talkies (supra), Blaze & Central (P.) Ltd. (supra), Commissioner of Income-tax (supra), Pitney Bowes India (P.) Ltd. (supra) and Sharp Business System (supra).*

20. As far as *Neel Kamal Talkies (supra)* is concerned, this decision was rendered prior to *Empire Jute Co. Ltd. (supra),* which has laid down principle and broadened the field of interpretation to ascertain the real nature of the advantage, which the taxpayer would derive. Therefore, we are of the view that after the decision in the case of Empire Jute Co. Ltd., the Revenue would be precluded by referring to the decision in *Neel Kamal Talkies (supra).* So far as Blaze & Central (P.) Ltd. is concerned, this decision was distinguished in *G.D.Naidu*. At this juncture, it would be relevant to take note of the findings rendered by the Division Bench in *G.D.Naidu*, which read as follows:-

"26..... It may be also mentioned that in the present case, it is not a new business of the assessee, though the new partners have come in for the first time. The old business of the outgoing partners was being carried on by the new partners and we have already pointed out that even the Income-tax Officer has registered the firm under the Income-tax Act for the subsequent years also.

27. In Blaze and Central (P.) Ltd. v. CIT, the facts were these. The assessee which was carrying on business of arranging exhibition of advertisement and film shorts in licensed public cinema theatres in the four Southern States of Madras, Andhra, Kerala and Mysore, entered into an agreement with one Saraswathi Publicities who was also carrying on similar business on behalf of two companies in the four States. Under the said agreement, Saraswathi Publicities agreed to part with its business in the four States for period of 9 years in consideration of the assessee paying a sum of Rs. 1,50,000. This court held that the assessee had taken over the business carried on by Saraswathi Publicities for a consideration of Rs. 1,50,000 though it was for a period of 9 years. It was further held that the assessee not only derived an advantage by

eliminating competition and also acquired a business which generated income. It is in those circumstances, this court held that the sum of Rs. 1,50,000 paid by the assessee was capital in nature and was not allowable as a revenue expenditure. It may be seen from the facts of that case that that case also related to an acquisition of an existing competitive business, whereas in our case it is only a restrictive covenant. No separate business of the old partners was acquired or any competition was eliminated by such acquisition. Since there is no acquisition of any business by payment of the amount referable to the restrictive covenant and there is no benefit of an enduring nature being acquired, we are in entire agreement with the Tribunal that the payment can only be treated as a revenue outgoing and not capital in nature. These findings will answer questions Nos. 6, 7, 8 and 9 and all those questions are answered in favour of the assessee and against the Revenue." Therefore, reliance placed on the decision in Blaze & Central (P.) Ltd. (supra) does not merit
acceptance.

21. Similarly, the decision in the case of Hindustan Pilkington Glass Works (supra) was prior to G.D.Naidu, which decision of the Division Bench has laid down principle, that too, in a case, which is more or less identical to that of the case of the assessee.

22. So far as the decision in *Pitney Bowes India (P.) Ltd. (supra)* is concerned, we find that the decision was rendered on a concession made by the learned counsels on either side. This is evident from paragraphs 10 & 13 of the judgment, wherein both the assessee as well as the Revenue treated the expenditure as capital expenditure. Thus, the said decision does not render any support to the stand taken by the Revenue.

23. So far as the decision in *Sharp Business System(supra)* is concerned, which is the main bulwark of Revenue's argument, in para 5 of the judgment, it has referred to the decision of this Court in G.D.Naidu. The discussion is in para 9 and the conclusion is in para 10.

24. In paragraph 9 of the judgment, the Court has not discussed the decision of G.D.Naidu, though it has referred to it in paragraph 5 of the judgment. This is pointed out because, the Court has discussed the decision in *Blaze & Central (P.) Ltd. (supra),* which was distinguished in G.D.Naidu. We find that in paragraph 9 of the judgment, the Court after referring to *Empire Jute Co. Ltd. (supra)* and *Alembic Chemical Works Co. Ltd. (supra),* has pointed out that the single test, that is, whether the payment results in an enduring benefit cannot be conclusive in a decision as to whether an expenditure qualifies as one falling or in the capital field and that the decisions have emphasized the need to shift from a narrower field to a broader one, to ascertain the real nature of the advantage, which the taxpayer would derive.

25. Thus, the test to be applied following *Empire Jute (supra)* is to see as to whether it added to the capital of the assessee, whether a new asset was created and whether there was an addition or expansion of the profit making apparatus of the assessee and whether the assessee acquired source of profit or income when such investment was made. However, the Court in our respectful view, applied the test, which does not flow from the test laid down in *Empire Jute*

(supra) by observing that the test is one of ascertaining whether from commercial angle and the advantage results in a capital field or it is the expenditure falls legitimately within revenue field.

26. Ultimately, the Court held that the arrangement for a period of 7 years is an enduring benefit. This in our respectful view, does not fulfill the test laid down by *Empire Jute Co. Ltd. (supra)* and in fact, the Court itself had pointed out that is not the conclusive test to determine whether expenditure is in capital field or revenue. Thus, for above reasons, we are not in respectful agreement with reasoning given by the Division Bench in *Sharp Business System (supra).*

27. In *Carborandum Universal Limited*, one of the questions framed for consideration was whether the Tribunal was right in holding that non-compete fee paid to Shri U.Mohan Rao was capital expenditure, without appreciating that such expenditure has not resulted in an enduring benefit. To be noted that in the said case there were three agreements entered into with the said U.Mohan Rao all pertaining to non-compete and that there were different sets of parties. The expenditure so incurred was held to be revenue and the decision applies with full force to the assessee's case.

28. In the case of *Hindustan Pilkington Glass Works (supra)*, the Division Bench referred to the decision in *Empire Jute Co. Ltd (supra)* and pointed out that the test of enduring benefit could not be applied blindly with regard to the facts and circumstances that arise in the given case. It was pointed out that the conclusion of the Tribunal that the payment has enduring benefit and is capital in nature does not take into account the commercial benefit raised by the company and that the Tribunal appears to have guided solely by an earlier decision rendered by it in the case of Asianet (the case on hand).

29. Further, it was pointed out that the advantage of restraining individuals from engaging any competition is in the field of facilitating its own business and rendering much more profit in the capital field. In the said case, the Directors, to whom the non-compete fee was paid was with a view to remain with the company. While analyzing this factual aspect, the Division Bench pointed out that though there was no actual or limited threat of the Directors so far they are ties with their company or starting a new venture always remains and prudence dictates that the company protects itself as against such a probability. Thus, the payment made as non-compete fee to the directors was held to constitute revenue expenditure in the hands of the assessee.

30. In *Tamilnadu Magnesite Ltd., (supra),* we had decided somewhat similar issue and applied the decision of the Hon'ble SC in Empire Jute Co. Ltd. (supra) and held in favour of the Assessee.

31. Even as the doctrine of enduring benefit is on the wane, in determining whether an expenditure is a capital expenditure or not, the point at hand can still be tested on this aspect. The point here is whether the non-compete compensation paid is to be termed as a capital expenditure.

32. The governance for non-compete is traceable to Section 27 of Indian Contract Act, 1872:

“27. Agreements in restraint of trade, void. Every agreement, by which any one is restrained from exercising a lawful profession, trade or business or any kind, is to that extent void.

Exception 1.Saving of agreement not to carry on business of which goodwill is sold

One who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided that such limits appear to the Court reasonable, regard being had to the nature of the business.”

33. Any contractual term that imposes restraint on a contracting party from engaging in any business for a reasonable term must be backed by consideration. Therefore, the non-compete compensation is but a consideration paid to the party who is kept out of competing business during the term of the contract.

34. The non-compete compensation, from standpoint of the payee of such compensation, is so paid in anticipation that absence of a competition from the other party to the contract may secure a benefit to the party paying the compensation. There is no certainty that such benefit would accrue.

35. In other words, in spite of the fact that a competitor is kept out of the competition, one may still suffer loss. If it were to be a capital expenditure whether or not, an assessee makes a business profit, the character and value of the capital assets will, subject to depreciation, remain unaltered.

36. Thus, the facts clearly disclose that on account of the payment of non-compete fee, the assessee has not acquired any new business, profit making apparatus has remained the same, the assets used to run the business remained the same and there is no new business or no new source of income, which accrue to the assessee on account of the payment of non-compete fee.

Accordingly, the substantial question of law is answered in favour of the assessee and against the Revenue.