# Taxation of Non-compete Fee

## 1. Introduction

Taxability of non-compete fee has been a bone of contention in several acquisitions. Prior to 2003, the Income-Tax Act ("**Act**") did not provide for taxing of non-compete fee, and it was judicially established that any compensation received owing to a negative or restrictive non-compete covenant was a "capital receipt", and thus, tax exempt.[1] Interestingly, till date, the Act does not define capital receipt. However, in 2003, clause (va) was added to Section 28 of the Act. It provides that any sum, whether received or receivable in cash or kind under an agreement for not carrying out any activity in relation to business or profession shall be treated as profit or gain from business or profession, thereby, being taxable as "business receipt" at applicable rates. Further, S. 28(va) does not apply to any receipt for transfer of the right to manufacture, produce or process any article, or right to carry on any business that otherwise is taxable as "capital gains" (which is a capital receipt) under the Act. Accordingly, non-compete fee has been either taxed as capital gains or business income post 2003.

The change has impacted the manner in which share or business acquisition deals are structured in India to arrive at an optimal arrangement that has minimal tax liability for the parties. This newsletter provides an overview of the underlying concepts, and aims at analyzing the approach followed by Income-Tax department and courts while taxing non-compete fee post 2003.

## 2. Applicable provisions

In addition to Section 28(va), the following concepts and principles under the Act are relevant for understanding taxation of non-compete fee:

- *Capital asset is defined* under Section 2(14) as property of any kind whether or not connected with assessee's business or profession, except stock-in-trade, and certain kinds of movable property held for personal use.
- *Capital assets include* business goodwill, trade-mark, brand name, right to manufacture, produce or process any article, right to carry on any business or profession, tenancy rights, and stage carriage permits.[2]
- Consideration for *transfer of capital assets is subject to capital gains,* and depending on the period of holding of the capital asset by the transferor, profits or gain can be taxed as long-term or short-term capital gains.[3]
- If capital asset is held for less than 36 months, short-term capital gains @ 30% for corporates is levied, while assets held for more than 36 months are taxed with long-term capital gains @ 20%.
- The Act does not define and only provides illustrations of *capital and business receipt*. The distinction is relevant for determining the applicable tax rate on non-compete fee.

[1] Capital receipt is different from capital gains computed under Section 45 of the Income-Tax Act, as the former is generally tax exempt, and the later is more often than not subject to tax payment

[2] Section 55(2)(ii) of the Act

[3] Section 45 of the Act

**Disclaimer** – This e-newsline is for information purposes and should not be construed as legal advice. © PSA

- For (i) Indian companies, business income is taxed @30%, and (ii) individuals, tax rate will be calculated as per applicable slabs.
- There are *no set tests or parameters for demarcating capital and business receipts*.
- Generally, *courts have observed that the compensation shall be capital receipt if the assessee has lost the source of income*.
- In such cases, *the tax authorities should limit their analysis to tax non-compete fee as capital gains and not as business receipt* under Section 28(va).

## 3. Approach of Income-Tax department and Judiciary

The transacting parties prefer to compute their tax liability as long-term capital gains for lower tax rate @20% and absence of any legal requirement for the acquirer to withhold tax at source. Nevertheless, courts have to analyze all the foregoing provisions at #2 above for determining the tax liability. While this exercise may appear simple, interpretation of the abovementioned principles has resulted in conflicting decisions on taxation of non-compete fee in share or business acquisition transactions. Each case has been determined on specific facts. In the following paragraphs, some select cases are analyzed to provide an insight on the varied approaches.

### 3.1 Transfer of entire business

3.1.1 In *CIT v. Chemech Laboratories Ltd*,[4] the assessee company was engaged in the business of manufacturing and marketing pharmaceuticals. It transferred its business (comprising of brand, permits under drugs law, technology, etc.) to the transferee company under 3 distinct agreements (brand acquisition, consultancy and non-compete), and for a cumulative consideration of INR 60 million (USD 854,760).[5] The non-compete agreement was specifically made an integral part of the brand acquisition agreement. Further, the parties expressly acknowledged that the restrictive non-compete covenants were reasonable, essential for protecting parties' interest, and the total consideration factored compensation thereof. However, no specific value was identified as non-compete fee. During tax assessment, the assessee allocated the entire consideration towards transfer of the business as capital asset, thereby computing tax as capital gains. To the contrary, the assessing officer (**AO**) bifurcated the total consideration and treated INR 40 million (USD 569,760) as non-compete fee, levying higher tax on it as business receipt under S. 28(v). The assessee challenged AO's computation before the Income-Tax Appellate Tribunal (**ITAT**). ITAT adjudicated in the assessee's favour and observed that the entire consideration arose from business transfer which must be taxed as capital gains. Further, ITAT held that the "dominant purpose" of the agreements was to transfer the business, and non-compete was incidental to such key purpose.

3.1.2 Against ITAT's decision, the Income-Tax department went in appeal to the Madras High Court. The court relied on the contractual clauses (as discussed above) to decipher parties' intent. It observed that the parties intended to factor non-compete consideration towards the total payment, and it was irrelevant to determine the main purpose of the contract. Based on such contractual intent, the court overruled ITAT's decision and partially allowed department's claim. The high court determined INR 10 million as a reasonable non-compete fee and ordered the assesse to pay tax on it as business receipt under Section 28(va).

[4] Decision of Madras High Court in tax case appeal No. 1492 of 2007 decided on December 23, 2016

[5] USD 1 = about INR 70

**Disclaimer** – This e-newsline is for information purposes and should not be construed as legal advice. © PSA

3.1.3 *Inference*: If parties to an acquisition transaction intend to factor non-compete fee towards total consideration, AO can determine some proportion towards such fee and levy higher tax under Section. 28(va). In such cases, the nature of transaction is irrelevant for adjudication.

### 3.2 Transfer of specific assets or business divisions

3.2.1 In *Commissioner of Income-Tax v. Mediworld Publications Pvt. Ltd*,[6] the assessee company entered into a specified assets transfer agreement with CMP Media India Private Limited for sale of all rights, titles, and interests in specified assets (such as periodicals, products, IPR, goodwill, customer database, records, etc.) of its healthcare journals and communications business at a cumulative consideration of INR 38 million (USD 541,272). Pursuant to this, assessee agreed to non-compete obligations and relinquished its right to carry on any business involving, or relating to, or competing with the transferred specified assets for 6 years. The assessee had a separate clinical trial business division, which was not covered under the transaction. Additionally, there was no specific contractual clause that suggested parties' intent to allocate any part of the consideration towards non-compete obligation. The assessee filed returns with long-term capital gains @20% on the entire consideration. However, AO imposed higher tax on the entire consideration as business receipts, premised on the rationale that assessee (i) had merely surrendered his right to the business of publishing healthcare journals amounting to compensation for not carrying on a business activity under Section 28(va), and (ii) there was no transfer of the whole business. The assessee challenged AO's determination before ITAT, which ruled in assessee's favour. ITAT held that the transaction in effect was transfer of whole healthcare journal and communications business and liable to long-term capital gains tax.

3.2.2 The department went in appeal to the Delhi High Court. The court observed that under the agreement, intangible assets such as trademark, copyright, goodwill were sold to the transferee, which are expressly recognised as capital assets, the consideration was primarily received for transfer of the assets and liabilities, and was not solely for non-compete obligations. Further, it observed that it was wrong to hold that the assessee had given up only his right to carry on business of publishing healthcare journals and communication, and that same was merely a part of the agreements. Accordingly, the court ruled in favor of the assessee and ordered taxation of the entire consideration as capital gains.

3.2.3 *Inference:* Parties' intent and the overall nature of transaction is important to determine whether non-compete fee has to be separately calculated and taxed. If no such inference is possible from the contract, restrictive covenant refraining the assessee from carrying on competing business cannot be taxed as business receipt under Section 28(va), and the entire consideration is liable for capital gains taxation.

### 3.3 Transfer of non-controlling shares

3.3.1 In *Mrs. Hami Aspi Balsara v. the ACIT*,[7] the assessee executed a share purchase agreement to transfer her shareholding in 3 companies to Dabur India Limited. The share purchase price was mutually determined by the parties, and the agreement prohibited the assessee from carrying on similar business in India for 5 years from completion of the transaction. It was specifically

[6] 2011 VAD (Delhi) 362
[7] MANU/IU/0114/2009

acknowledged that the purchase price was sufficient consideration for the non-compete obligation and no bifurcation was provided. At the time of tax computation, the assessee calculated her tax liability as capital gains on transfer of shares, but AO revised the filings to add tax on non-compete fee under Section 28(va). Since the agreement was silent on non-compete fee, AO calculated non-compete fee to be the difference in book value of shares and consideration paid, resulting in a higher tax liability. Such computation was challenged on the ground that basis of computing non-compete fee was unreasonable and against share valuation principles, since about 80% of the share consideration was treated as non-compete fee.

3.3.2 The assesse appealed to ITAT which rejected AO's tax determination. ITAT upheld assessee's contentions and observed that the assessee *per se* had no obligation to identify separate non-compete fee and pay tax on it as business income. ITAT also explained the scenario where non-compete arrangements will be taxed as business income under Section 28(va) *versus* where they will be considered as capital gains and charged under Section 45. In cases where capital asset is in the nature of assessee's right to carry on business, then non-compete consideration will be liable for capital gains. However, where the non-compete relates to an assessee who is actually carrying on the business and does not merely have a right, the tax shall be charged as business income. Applying these principles, ITAT observed that the assessee was merely a shareholder and was not actually carrying on the concerned business, which was carried on by the respective companies where she held shares. Thus, there was only transfer of the right and there was no tax incidence under Section 28(va).

3.3.3 *Inference:* This decision pertains to a shareholder who did not control operations of the company. To this extent, it is distinguishable from the principles applied in cases at #3.1 and 3.2 above, where the assessee was the company that actually carried on the business or owned the assets transferred. However, ITAT has completely disregarded intent of the transferor shareholder that non-compete fee was factored in the consideration, which was taken into account in cases at #3.1 and 3.2 above. In any event, based on this ruling, it emerges that while determining tax liability of non-compete consideration, it is important to analyze if the non-compete is on the assessee who is carrying any business or on one who has merely a "right" to carry on any business. Where non-compete is on the former, tax will be imposed as business income, while in case of later, it will be imposed as capital gains.

## 3.4 Transfer of controlling shares

3.4.1 In *Ramesh D. Tainwala v. ITO*,[8] the assessee promoters of Tainwala Polycontainers Ltd., a company engaged in manufacture and marketing of polyethylene containers, entered into a share purchase agreement for transferring their controlling shareholding interest and operations of the company to Time Packaging Ltd., another company engaged in similar business. The agreement obligated the promoters to not engage in any competing business, directly or indirectly for 11 years and a separate consideration of INR 40 million was allocated as non-compete fee. The assessee considered the non-compete fee as a capital receipt and sought tax exemption, while the AO taxed the non-compete fee as business income under Section 28(va).

3.4.2 The assessee challenged AO's determination before ITAT and contended that non-compete fee was compensation for giving up a source of income and must be considered as capital

[8] TS-594-ITAT-2011 (Mum)

receipt. In the alternative, it was submitted that tax liability, if any, should be imposed as capital gains under Section 45 by treating non-compete fee as part of sale of shares. The AO submitted that post 2003, any receipt for not carrying out any activity in relation to any business was taxable as business income under Section 28(va), and the non-compete fee was squarely covered.

3.4.3 ITAT observed that Section 28(va) deals with taxability of non-compete fees, and only when any sum is received for transfer of a right to carry on any business, tax is calculated as capital gains. It clarified that non-compete consideration can either be a capital or revenue receipt, depending on whether such fee is compensation paid with the source of income remaining intact or paid for sterilisation thereof. In the first case, it would be taxed as business receipt covered under Section 28(va), while in the second scenario, the consideration will be capital in nature and the assessment has to be under Section 45. But if there is no transfer of right to carry on business, and the restriction is on the person who actually carries on the business, capital gains cannot be applied. Further, ITAT observed that the non-compete obligation was standalone despite its inclusion in the main agreement, and unless it is substantiated that the restriction is part and parcel of the transfer, there is no transfer of right to carry on business, and consequently, no capital gains. Accordingly, ITAT ruled that the present case involved a transfer of shareholding and non-compete was not integral to such transaction. Thus, the non-compete fee was taxable as business income under Section 28(va).

3.4.4 *Inference*: This judgment differs from the case at #3.3 as the shareholders here are promoters, and were actually responsible for carrying company's business. Thus, the promoters "actually" carried on the business and did not merely have a right to do so. Accordingly, the non-compete consideration was for restriction on carrying business and taxed under Section 28 (va).

## 4. Analysis and Conclusion

As described above, courts are divided and there is no single formula that will fit all cases. Transacting parties have to factor a variety of considerations while finalizing the deal structure. Nature of transaction, parties' contractual intent, impact on source of income, and identity of the person who carries on the business are relevant for determining whether non-compete fee should be taxed as business income at a higher rate under Section 28(va). Further, where parties have specifically acknowledged that acquisition consideration includes non-compete fee, or where there is a standalone non-compete obligation with promoters and directors, courts are likely to order separate tax assessment for non-compete fee under Section 28(va). Furthermore, if there is only a transfer of right to carry on business by the transferor recipient and the recipient is not a promoter shareholder, tax is likely to be levied as capital gains under Section 45, but where the transfer is restriction on the person actually carrying on the business, tax is imposed as business income.

While these indications are pertinent for determining optimal deal structure, they are not conclusive and the Income-Tax department has almost always attempted to bifurcate the transaction consideration towards non-compete fee. The uncertainty makes it critical that parties determine and agree upon a specific non-compete fee upfront, to avoid unreasonable bifurcation and resultant tax liability.

**Author**
**Arya Tripathy**

**Disclaimer** – This e-newsline is for information purposes and should not be construed as legal advice. © PSA