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DIRECT TAX ALERT

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The Supreme Court holds that payment for non-compete fee is allowable as revenue expenditure

The Supreme Court holds that payment for non-compete fee is allowable as revenue expenditure

The Hon'ble Supreme Court[1] holds, in the given facts, that payment for non-compete fee is allowable as revenue expenditure under Section 37(1) of the Income-tax Act, 1961 ("the Act"), as it enables the taxpayer to operate the business more efficiently and profitably. Further such payment neither results in creation of any new asset nor accretion to the profit earning apparatus of the payer. The Court affirms that the length of time over which the enduring advantage may enure to the payer is not determinative of the nature of expenditure, as long as the enduring benefit cannot be said to be in the capital field.

Background

- Sharp Business System (India) Pvt Ltd ("the taxpayer") is engaged in the business of importing, marketing and selling electronic office products and equipment's in India.

- During assessment year ("AY") 2001-02, the taxpayer paid INR 3 crores to L&T (taxpayers' JV partner) as consideration for not setting up or assisting in the setting up of or undertaking any business of the taxpayer in India for 7 years and claimed the same as revenue expenditure in the return.

- Assessing Officer ("AO") treated the same as capital expenditure by holding that such expenditure had brought into existence an advantage of enduring nature.

- The CIT(A) and Income Tax Appellate Tribunal ("ITAT") also decided against the taxpayer. Additionally, the ITAT held that non-compete fees do not result in a depreciable intangible asset, as a right arising out of such an agreement would not constitute a commercial right falling within the ambit of intangible assets under Section 32(1)(ii) of the Act.

- The Delhi High Court while dismissing the taxpayer's appeal held that the non-compete fee could not be claimed as revenue expenditure as it was clearly a capital expenditure. Further, the High Court held that the right acquired by the taxpayer was a right *in personam* only against L&T and not a right in *rem*. The right has to necessarily result in an intangible asset against the entire world to qualify for depreciation.

- The taxpayer preferred the appeal before the Hon'ble Supreme Court[1]). Batch of civil appeals[2] were tagged with this appeal.

Issues under consideration

- Whether the non-compete fee paid by the taxpayer is allowable as a revenue expenditure?

- If non-compete fee is considered to be an expenditure of capital nature, whether the same is entitled to depreciation under Section 32(1)(ii) of the Act?

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[1] *Sharp Business System (Civil Appeal No. 4072 Of 2014)*
[2] *DCIT v. M/s. Pentamedia Graphics Ltd. (Civil Appeal No. 15048 of 2025); PCIT v. Piramal Glass Ltd. (Civil Appeal No. 15049 of 2025); CIT v. M/s. Pentasoft Technologies Ltd. (Civil Appeal No. 15050 of 2025); DCIT v. M/s. Pentasoft Technologies Ltd. (Civil Appeal No. 15051 of 2025)*

Taxpayer's contentions

Revenue v. Capital expenditure

- Expenditure was made wholly and exclusively for the purposes of its business and for establishing and enlarging the business of the taxpayer.

- The Supreme Court in its earlier decision [3] laid down the principle that the test of enduring benefit is not universally applicable, and that the mere creation of an enduring benefit is not conclusive of capital expenditure if it only facilitates carrying on the business more profitably and efficiently.

- The payment of non-compete fee only seeks to protect and enhance the business and profitability of the taxpayer and does not create a new capital asset or any accretion to the business apparatus. The enduring benefit is due to the restriction of a competitor in business, and therefore, not in the capital field.

- The period or length of time over which the enduring advantage may spread over is not determinative of the nature of expenditure[4].

- The payments made to eliminate competition may be capital in nature[5], however, these are distinguishable as, in the present case, there is neither elimination of competition nor creation of any monopoly in the business of electronic products.

Claim of depreciation on intangible assets

- If the expenditure is considered as a capital expenditure, the same is eligible for depreciation under Section 32(1)(ii) of the Act

- The expression *'any other business or commercial rights of similar nature'* refers to intangible assets and not the species of intangible assets, such as, know-how, patents, copyrights, trademarks, licences and franchises.

- For the principle of ejusdem generis to be followed, a commonality is required, however amongst intangible assets listed in section 32(1)(ii), the commonality is neither positive rights or negative rights nor rights in rem or rights in personam.

- The Act does not distinguish between rights in rem and in personam for the allowability of depreciation. Under the specific Acts, certain rights can be in rem and certain in personam. Hence, the allowability of depreciation would not depend on nature of right being rights in *rem* or in *personam*.

- The scope of expression 'any other business or commercial rights of similar nature' cannot be restricted to carve-out negative rights.

- Classifying rights as purely positive or negative may lead to absurd results, as rights can be partly positive and partly negative. Further, Section 28(va) of the Act does not provide any distinction between positive or negative rights.

- The right acquired pursuant to payment of non-compete fee is a positive right as it enables to expand business because of reduced competition. Thus, such right would be capital asset under the Act and entitled for depreciation.

- The assets must be "owned" and "used" for the purpose of business or profession to be eligible for depreciation. In case of intangible asset, a physical or active user test cannot be satisfied as compared to tangible asset. Therefore, a passive use or latent use would also satisfy the condition of the same being 'used'.

- In case of a non-compete covenant, the user is using such a covenant the day he enters into the agreement for keeping the rivals out of the same business, thereby earning better profits.

[3] *Empire Jute Company Limited v. CIT (1980) 124 ITR* 1 (SC)
[4] *CIT v. Madras Auto Services (P) Limited (1998) 233 ITR 468 (SC); CIT v. Coal Shipments (P) Limited (1971) 82 ITR 902 (SC)*
[5] *CIT v. Coal Shipments (P) Limited (1971) 82 ITR 902 (SC), Assam Bengal Cement Company Ltd v. CIT (1955) 27 ITR 34 (SC)*

Revenue's contentions

- The payment of non-compete fee constitutes capital expenditure as the same have been incurred for acquiring an enduring benefit. In support of this, reliance was placed on various decisions.[6]

- The principles of statutory interpretation and *ejusdem generis*[7], must be applied in this case. The legislative intent was to read the expression 'any other business or commercial rights of similar nature' along with the preceding categories.

- The Delhi High Court[8] observed that the common underlying feature of all the intangible assets is that they are positive rights.

- The only right acquired by the taxpayer is to seek legal remedies upon breach of contract, with no ownership or use of any intangible asset akin to the specified items.

- Hence, only positive rights can be owned and/or used whereas negative covenants only exist but cannot be used. The Act does not envisage allowance of depreciation on rights/assets that are not inherently capable of being put to use for the purpose of business.

- The expression 'any other business or commercial rights of similar nature' must be read as being limited to positive rights specified by the preceding words i.e. know-how, patents, copyrights, trademarks, licenses and franchises which are capable of being owned and put to use.

Ruling of the Supreme Court

- The Supreme Court referred to various judicial precedents which lay down tests to ascertain the nature of expenditure.

- In the case of Assam Bengal Cement Company Ltd.[9], the Supreme Court had held that if the expense is not for the purpose of bringing into existence any asset or advantage of enduring nature but for running the business with a view to produce profits, it is revenue expenditure.

- The Supreme Court in the case of Coal Shipments Pvt. Ltd.[10], had held that the non-compete fee was a temporary arrangement to carry on trade more profitably, not yielding an enduring benefit. The enduring benefit should not be transitory and ephemeral so that it can be terminated at any time at the will of the parties. Further, it was concluded that the payments were made in the course of trading activities with no relation to capital assets, hence were to be revenue expenditure.

- In the case of Empire Jute Company Ltd[11] it was held that the nature of advantage in a commercial sense should be considered for the determination of nature of expenditure (revenue or capital). Expenditure that merely improves business efficiency or profitability without affecting fixed capital is revenue in nature, even if the benefit endures. An expense integral to the profit-earning process, and not for acquiring a permanent asset or right, is revenue in nature.

- In Alembic Chemical Works Co. Ltd.[12], it was observed that the idea of 'once for all' payment and 'enduring benefit' require flexibility and not rigidity. There is no single criteria to determine as to whether a particular expense is capital or revenue. The purpose and intended object of the expense is relevant. It was held that the expense, being for the better conduct and improvement of the existing business, constituted revenue expenditure.

- In case of Madras Auto Services (P) Ltd.[13] the entire capital cost of construction on a leasehold premises

[6] *Empire Jute Co. Ltd v. CIT (1980) 124 ITR 1 (SC); Guffic Chem (P.) Ltd. v. CIT (2011) 332 ITR 602 (SC); CIT v. Bharti Hexacom Ltd. (2023) 458 ITR 593 (SC); Pitney Bowes India (P) Ltd. v. CIT 2011 SCC OnLine Del 5114 (Del HC)*
[7] *Siddeshwari Cotton Mills (P) Ltd. v. UOI (1989) 2 SCC 458 (SC); CIT v. McDowell & Co. Ltd. (2009) 314 ITR 167 (SC)*
[8] *CIT v. Hindustan Coca Cola Beverages (P) Ltd. (2011) 331 ITR 192 (Del HC)*
[9] (1955) 27 ITR 34 (SC)
[10] (1971) 82 ITR 902 (SC)
[11] (1980) 124 ITR 1 (SC)
[12] [1989] 177 ITR 377 (SC)
[13] (1998) 233 ITR 468 (SC)

was held to be a revenue expenditure as the assessee made substantial savings in monthly rent for a period of 39 years by expending these amounts.

- In a non-compete compensation, there is no certainty that benefit will accrue to the taxpayer. The taxpayer may still not achieve the desired results. The expenditure was essentially to keep a potential competitor out of the same business. Such payment made by the taxpayer did not create a monopoly over the business of the taxpayer.

- Non-compete fees only protect or enhance the profitability of the business, thereby facilitating the carrying on of the business more efficiently and profitably.

- The Supreme Court observed that by payment of non-compete fees, taxpayer had not acquired any business and there is no addition to the profit-earning apparatus of the payer. The enduring advantage, if any, by restricting a competitor in a business is not in capital field.

- Where the enduring advantage is not in the capital field and only facilitates more efficient and profitable business operations, leaving the fixed assets untouched, the payment is an allowable business expenditure, regardless of the period of benefit.

- The payment of non-compete fee by the taxpayer is an allowable revenue expenditure under Section 37(1) of the Act.

- For other cases, tagged along with this appeal, the matter has been remanded back to the ITAT where appeals are to be heard afresh with a direction to apply the principles laid down in this decision.

Issue 2 – Interest on borrowed capital

- The Supreme Court also dealt with the issue of allowability of interest on borrowed capital in the case of PCIT v. Piramal Glass Ltd[14].

- The taxpayer in the current case claimed deduction for interest on:
  - Borrowed funds used to invest in a subsidiary company.
  - Borrowed funds used to provide interest-free loans/advance to a sister concern and its directors.

- The aforesaid claim of deduction was disallowed by the AO stating that deduction of interest on money borrowed shall not be allowed against shares acquired for acquiring controlling interest in a Company and should be allowed only if money is borrowed for earning profits.

- AO held that borrowed funds were used for non-business purposes as it was provided to sister concern or directors

- The CIT(A) upheld the order of the AO. The ITAT held that, since the investment was made in a sister concern engaged in the same line of business and was driven by commercial expediency, no disallowance was warranted under the Act[15].

Ruling of the Supreme Court

- The Supreme Court relied on its own decision in the case of SA Builders and held that the investment made was for commercial expediency since it was for acquiring controlling interest in a subsidiary. In relation to the advances made to sister concern and its directors, the Supreme Court held that the same would also be covered by the principle of commercial expediency.

- The claim of interest on borrowed funds used for investment in a subsidiary and for providing interest-free loan to sister concern and its directors was allowed as deduction under Section 36(1)(iii) of the Act.

[14] *PCIT v. Piramal Glass Ltd [SLP(C) No. 719/2020]*

[15] *SA Builders Ltd. v. CIT 288 ITR 1 (SC)*

DHRUVA INSIGHT

The Supreme Court has addressed the long-standing controversy surrounding the tax treatment of non-compete fees and based on the facts of the case held that such payments are revenue in nature, being incurred to protect or enhance the profitability of the business. In doing so, the Court reaffirmed the settled principle that the duration for which an advantage endures is not, by itself, determinative of the capital or revenue character of the expenditure. Having held the non-compete payment to be allowable as revenue expenditure, the Supreme Court observed that the question of its eligibility for depreciation does not arise.

Interestingly, Supreme court has dealt with the facts of only one case and remanded the matter back to the ITAT in the other tagged matters where appeals are to be heard afresh with a direction to apply the principles laid down in this decision. Interestingly, in the other tagged matters the non compete fees were paid in conjunction with acquisition of businesses.

A key observation of the Court is that by payment of non-compete fee, in the facts of the case, the taxpayer had not acquired any new business and there was no addition to the profit making apparatus. Further, there was no complete elimination of competition. It remains to be seen in which factual scenarios the ITAT may characterise non-compete payments as capital in nature and what distinguishing factors may guide such conclusions. It will be interesting to observe whether non-compete fees paid at the time of acquisition of a business are viewed differently from standalone non-compete payments made by entities already carrying on the business.

In cases where non-compete fees are held to be capital in nature, the further question of whether such fees constitute an intangible asset eligible for depreciation was not taken up by the Supreme Court. This question would arise for consideration once the ITAT decide the tagged matters remanded back, potentially resulting in the issue once again reaching to the Supreme Court.

On the issue of allowability of interest expenditure where borrowed funds were used to acquire a controlling interest in an associate concern and to advance funds to directors and sister concerns, the Supreme Court relied on its decision in the case of *S.A. Builders Ltd. v. CIT*, which is founded on the principle of commercial expediency. It would be interesting to see whether the test of commercial expediency will be reaffirmed or recalibrated once the petitions seeking reconsideration of this principle will be brought before the Supreme Court.

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