Non-compete fees re-characterised as consideration for transfer of shares – Vodafone test applied for tax planning v. tax evasion

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In brief

The taxpayer and his family members sold shares of the Central Distillery and Breweries Limited (CDBL) to Shaw Wallace Company Group (SWC) for INR 5.5 million. The taxpayer also contemporaneously entered into a non-compete agreement with SWC with the restrictive covenant that the taxpayer shall not carry on any manufacturing or marketing activities relating to Indian Made Foreign Liquor (IMFL) for 10 years, for a consideration of INR 66 million.

The High Court (HC) held that the consideration for transfer of shares was artificially and deceitfully bifurcated under a sham agreement between a non-compete fee and consideration for transfer of shares. The entire amount received by the taxpayer was held to be for transfer of shares, taxable as capital gains. The HC discussed the distinction between tax mitigation and tax evasion, and between acceptable tax avoidance and abusive tax avoidance; and applied the principle laid down by the Supreme Court (SC) in the Vodafone decision.

In detail

Facts

- The taxpayer[1] was the Chairman-cum-Managing Director of CDBL, a public company listed on the Delhi and Bombay Stock Exchange. It was engaged in the business of manufacturing and sale of IMFL and beer. The taxpayer, along with his family members, i.e., wife, son, daughter-in-law and two daughters, held shares constituting 57.29% of the paid-up equity share capital of CDBL.
- SWC, a giant in liquor business in comparison to CDBL, offered and purchased through its subsidiaries shares held by the taxpayer and his family members in CDBL. The deal for the sale was formalized by an Memorandum of Understanding (MoU) dated 13 April 1994.
- The taxpayer individually held 12% of the paid-up equity share capital of CDBL, and entered into a deed of covenant in his individual capacity with SWC. On 13 April 1944 another MoU was executed between SWC and the taxpayer as an individual with the restrictive covenant that he shall not, directly or indirectly, carry on any manufacturing or marketing activities relating to IMFL for a period of 10 years. As per the MoU the taxpayer received a non-compete fee of INR 66 million which was claimed by the taxpayer not taxable being treated as a capital receipt.
- The tax officer (TO) invoked section 28(ii) of the Income-tax Act, 1961 (the Act) and held that INR 66 million, ostensibly paid as non-compete fee, was nothing but a colourable device, and the tax treatment should not be accepted.

[1] CIT *v.* Shiv Raj Gupta [2014] 52 taxmann.com 425 (Delhi)

The Commissioner of Income-tax (Appeal) upheld the addition made by the TO, but relied on section 28(iv) of the Act for the same.

- The Income-tax Appellate Tribunal (Tribunal) by its order dated 30 May 2001, decided the issue in favour of the taxpayer, relying on the SC decision in the case of Guffic Chem Private Limited[2].

Issue before the HC

Whether the description of the payment as non-compete fee in the MoU dated 13 April 1994 was unquestionable, or could be challenged by the Revenue? If so, when, and in which cases?

HC's decision

The HC held that –

- In view of the discussion and the findings on the true and real nature of the transaction camouflaged as 'non-compete fee', the HC had no hesitation and reservation that the taxpayer had indulged in abusive tax avoidance. The true nature of the transaction was the sale of shares of CDBL in favour of SWC. The consideration of INR 66 million was not a fee paid towards non-compete, and would not be exempt.
- Transfer of majority shareholding would include consideration receivable towards the controlling interest. The price paid by SWC and received by the taxpayer was for purchase of shares, including the controlling interest. The price paid would therefore include the right to control and manage CBDL. Any division or bifurcation would result in the Court or the Revenue splitting the amounts between capital gains and section 28(ii)(a) of the Act.

Tax avoidance v. tax evasion and tax mitigation

- To appreciate the concept of abusive tax avoidance, it was appropriate to first delineate with precision the expressions, "tax mitigation" and "tax evasion", as their boundaries and confines would enable one to draw the lines amongst the four concepts, *viz.*, tax mitigation, tax evasion, acceptable tax avoidance and abusive tax avoidance. Each of these expressions involved an element of tax planning. It would be hard to conceive of a situation where the taxpayer did not indulge in some sort of tax planning, be it tax mitigation, tax evasion, acceptable tax avoidance, or abusive tax avoidance.
- "Tax planning", being common to all situations, could not be the distinguishing feature, but the nature and character of the planning, and its nexus with the transaction, was decisive.
- Tax mitigation, in simple words, referred to a taxpayer taking advantage or benefit of a beneficent provision under the tax code, and complying with its requisites to lower his tax liability.
- If there was no tax avoidance, the question of abusive tax avoidance did not arise, for the latter referred to a particular category of transactions that were unacceptable being pejorative, i.e. sham, colourable device or deceitful, and distinct from tax mitigation. Where the Parliament's intention was contrary and the finding negated the taxpayer's submission, it would be a case of tax avoidance, whether acceptable or abusive being a different matter. Thus, the term, "tax mitigation", was simple, intelligible and unequivocal. It was a positive term, and referred to the taxpayer taking benefit or advantage of a provision which the tax code intended and wanted to confer. Deductions under Chapter VIA, exemptions under sections 10A, 10AA, 10B, etc. of the Act, were all provisions relating to tax mitigation. If a taxpayer benefited or gained advantage by complying with the conditions stipulated therein to reduce his tax liability, it would be a case of tax mitigation.
- It was equally important to distinguish and differentiate between acceptable tax avoidance and abusive tax avoidance. The SC in Raman (A.) & Co.[3], observed that avoidance of tax liability by so arranging commercial affairs that the charge of tax was distributed, was not prohibited. The taxpayer could resort to a device to divert the income before it accrued or arose to him. Effectiveness of the device depended not upon considerations of morality, but on the operation of the Act.
- In clear and categorical terms, this ratio resonated with, and was approved by the SC in Vodafone's case[4]. Thus, the test of 'devoid of business purpose' or 'lack of economic substance' was not accepted and applied in India, as it was too broad and unsatisfactory. The dividing line between acceptable and abusive tax avoidance could not be deduced or inferred from the lowering or elimination of the tax liability. The latter was the consequence and the tax

[2] Guffic Chem Private Limited *v.* CIT [2011] 332 ITR 602 (SC)

[3] CIT *v.* Raman (A.) & Co. [1968] 67 ITR 11 (SC)

[4] Vodafone International Holdings B.V. *v.* Union of India [2012] 341 ITR 1 (SC)

effect. The dividing line as per the ratio in the Vodafone's case[4] was ethically principled and moralistic, as tax avoidance was disapproved when the taxpayer adopts a colourable device, dubiousness and otherwise indulges in a sham arrangement or transaction. For example, in Vodafone's case[4], the taxpayer had several options and therefore, right to choose a particular tax event. As long as the choice was within the framework of law, the TO cannot disturb the tax effect or liability, which was the consequence of the event. The choice of the taxpayer was not abrogated or invalidated.

- Thus when a specific anti-tax avoidance section/ rule was invoked, the court and Tribunal must look at and interpret the relevant provision to decipher whether the chosen tax event covered within the said provision and accordingly the tax consequences would apply.

Conclusion

- In the context of the test applied in the Vodafone case[4], the court opined that when there was one transaction, or a series or combination of transactions intended to operate as such, the courts were entitled to look the real scheme as such or as a whole, even when a particular stage was only an expectation without any contractual force. This did not mean that the transaction, or any step in the transaction, was treated as sham or given a legal effect different from the legal effect intended by the parties. Nor did it imply going behind the transaction or the series of transactions for some supposed underlying substance. It meant looking at the document(s) or the act(s) in the context to which it properly belonged.
- The HC concluded that the current case was a clear case wherein the sale consideration for transfer of shares had been artificially and deceitfully bifurcated under a sham agreement/ document, which was unreal and not a true record of the intention.
- The entire 'non-compete fee' payment had been made to the taxpayer; his family members had not shared any part of the payment. This meant that the taxpayer had chosen the taxable event, i.e., to receive the entire sale consideration in his name; hence he should bear and face the tax consequences. Thus, the entire amount was held to be taxable in the hands of the taxpayer, and would be treated as part of the sale consideration received on transfer of shares in CDBL held by him.

The takeaways

Applying the test laid down in the Vodafone case[4], the Court has gone into substance of the matter to determine true and real nature of the receipt. This is a good example of "judicial GAAR" (GAAR = General Anti-Avoidance Rule).

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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