High Court holds non-compete agreement as genuine recognising taxpayer's stature and potential in the advertising industry

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In brief

The Delhi High Court (HC) in a recent decision,[1] held that non-compete fee received by the taxpayer (who was working as the president of an advertising agency and was holding 51% shares therein) upon her retirement, was a non-taxable capital receipt. HC also rejected the Revenue's position that payment was in fact a terminal benefit couched as a non-compete fee to escape tax payment.

In detail

Facts

- The taxpayer was working as the President of an advertising agency (company). She also held 51% shares of the said company and 40% of the shares were held by B Inc.
- The taxpayer filed her return of income for the assessment year (AY) 1995-96 declaring an income. During the AY the taxpayer resigned from the company. Upon her retirement, she received the following payments:

  (i) Terminal benefit in the form of gratuity;

  (ii) Consideration for sale of her 51% shareholding in the company; and

  (iii) Consideration towards entering into a non-compete agreement with the company.
- The Tax Officer (TO) considering the non-compete fee as a revenue receipt under section 28(ii) of the Income-tax Act, 1961 (the Act) made an addition of the same to the returned income of the taxpayer.
- The Commissioner of Income-tax Appeals [CIT(A)] and the Income-tax Appellate Tribunal (Tribunal) ruled in favour of the taxpayer, holding the non-compete fee as capital in nature and not chargeable to income-tax.

Issues before the HC

Whether the consideration paid as a non-compete fee to the taxpayer was taxable or not?

Revenue's contention

- The consideration was nothing but a terminal benefit, which was couched as a non-compete fee to escape tax payment. This fact was strengthened on perusal of the taxpayer's clients which included some famous companies.
- The payment of the non-compete fee and the share transactions were "*actually a part of a well-orchestrated plan of breaking up the entire package of terminal benefits received by her.*"
- The non-competition agreement was severely tilted in favour of the taxpayer and was in effect not a "serious" non-competition agreement, as the clauses in the agreement did not impose any restrictions on the

[1] ITA No. 154/ 2005

taxpayer from competing with the company outside India and the laws of England were made applicable to the contract and also the arbitration would be as per International Chamber of Commerce (ICC), Paris.

- The growth of the company after the retirement of the taxpayer showed that there had not been any lag or reduction in its revenues, and thus, the so-called competition from the taxpayer could not have dented the company in any manner.
- Relied on the judgments of the Delhi HC in the case of Shiv Raj Gupta[2] which had relied on the Vodafone judgement and held that any camouflage of terminal benefits as a non-compete fee should have been held to be an "abusive tax avoidance".

Taxpayer's contentions

- The taxpayer contended that taxpayer's goodwill and reputation in the advertising field was unparalleled, and thus, the amount she received as non-compete fee was truly to avoid her taking away the clients of the agency, post her retirement. The amount paid to her was well deserved and the same was not taxable.
- It was settled law as decided in several cases that non-compete fee was not taxable.
- The share transactions could not in any manner be held to be tainted at the instance of the taxpayer, inasmuch as the decision as to who should have been the purchaser of the shares was of the company, and the taxpayer had no role to play in the same.
- The non-competition agreement was entered into with the company itself and was a valid and enforceable agreement in law.
- The decision cited by the revenue authorities was in respect of manufacturing industry, for which a proper manufacturing or sell license was required. In the present case, the taxpayer was fully equipped to start a competing business from the date she retired from the company. She, having been single-handedly responsible for setting up the company in India, commanded a position from which she had the potential to take away not just the clients but even key employees of the company. Thus, the company had rightly paid a non-compete fee to the taxpayer.

High Court's decision

The High Court observed the following:

- In order to determine as to whether the amount paid as a non-compete fee was taxable or not, it was necessary to take a look at the relevant clauses of the non-competition agreement.
- The TO, in the opinion of the Court, did not construe the agreement as a whole. The TO, incorrectly, interpreted few clauses in holding that they actually contradict each other. The TO was clearly wrong in holding that the agreement was structured in a manner to give the taxpayer "adequate loopholes" to bypass the restrictions with the consent of B Inc.
- The TO also appears to have wrongly construed the fact that the payment was received prior to the signing of the agreement, and hence, it was a terminal benefit.
- It was due to the taxpayer's personal efforts that the business of the company had grown and expanded from one office in Delhi to offices in several cities including Mumbai, Bangalore, Calcutta, Chennai and Kathmandu. The money being paid to her as a non-compete fee was not directly related to the remuneration she was receiving from the company. Accordingly, the subsequent conclusion of the TO that the money paid to her was not a non-compete fee but a terminal benefit, was wholly unsustainable.
- From a reading of Clause 1 of the non-compete agreement, it was clear that the company was apprehensive about the retirement of the taxpayer and the effect it could have on their business, and hence, insisted on the obligations contained. This clause was a clear acknowledgement that she did have the potential and stature to take away a substantial number, if not all, of the clients and employees of the company. The non-compete fee paid to her could not, therefore, be termed as a camouflage or a well-orchestrated plan to avoid payment of tax.
- In the present case, the *"real nature of the transaction"* was that it was a non-competition agreement wherein the taxpayer agreed
  - not to be involved in any business in India of advertisement, sale, promotion, public relations, etc., which was competitive with the company; or
  - solicit any client of the company; or

[2] 372 ITR 337 (2015)

  - hire any employee of the company

- The present case was clearly distinguishable from the Shiv Raj Gupta[2] case, in which the decision of this Court was made in the context of the facts of the said case involving a specialised regulated business such as the manufacture and sale of liquor, which required a specific liquor license in each state, manufacturing capability and capital investment, all of which the taxpayer therein did not possess.
- That the non-competition agreement was genuine and the payment made thereunder was indeed a non-compete fee.

The takeaways

- This is a very important decision, as the HC has explained how the essence of the transaction is to be considered while evaluating the characterisation of the payments.
- The HC has made it clear that every case has to be looked at differently and the agreement is always to be read as a whole and not on a standalone basis.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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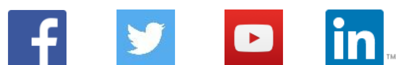

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