

What's New

Tax Insights



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Compensation received on termination of agency, distribution and manufacturing rights agreement is business income – Mumbai bench of the Tribunal

In brief

The Mumbai bench of the Income-tax Appellate Tribunal (Tribunal)¹ has, *inter-alia*, concluded that the compensation received upon termination of an agency, distribution and manufacturing rights agreement is a business income rather than capital gains. The Tribunal has stated that the taxpayer was working as an agent and was able to maintain their livelihood even after the termination of the said agreement. Hence, the compensation is subject to tax under section 28(ii)(c) read with section 28(va)(a) of the Income-tax Act, 1961 (the Act), as business income².

In detail

Facts

- The taxpayer, an Indian pharmaceutical company, entered into an agency, distribution and manufacturing rights agreement (agreement) with a German company. Under the agreement, the taxpayer acquired the right to carry on the business previously undertaken by the German company along with its two subsidiaries.
- In the assessment year (AY) 2005-06, due to a re-organisation and restructuring of the German company, certain specific obligations under the agreement were unilaterally terminated. Consequently, the taxpayer pursued legal action by taking the matter to a United Kingdom (UK) court, which ultimately resulted in an out-of-court settlement. As part of this settlement, the taxpayer received a compensation, which was declared as capital gains, considering it a transfer of the entire business.
- During the assessment proceedings of the relevant AY, the Tax Officer (TO) was of the view that this compensation is taxable under section 28(ii)(c) read with section 28(va)(a) of the Act, contrary to its consideration as capital gains by the taxpayer.

Taxpayer's contentions

- The compensation received is attributed to the transfer or extinguishment or termination of business rights

¹ ITA Nos. 3706/M/2010 & 5091/M/2010

² There were certain other issues that were discussed in the ruling. However, for the sake of brevity, the same have not been covered in this Tax Insights.

under the agreement and should be considered as a capital asset. The taxpayer relies on the Bombay High Court judgment in the case of Tata Services Limited³, which holds that rights under the agreement are considered as capital assets.

- From the settlement, it is evident that the entire business has been transferred. Thus, the compensation is not covered under the purview of sections 28(ii)(c) or 28(va)(a) of the Act⁴. This is because it is not solely for the termination of the agency (it encompasses a termination of not only the agency rights but also the distribution and manufacturing rights), nor does it relate to a non-compete clause.
- The taxpayer also raised an additional ground, contending that the compensation received upon the termination constitutes a capital receipt.

Revenue's contentions

- The compensation received by the taxpayer is an income from the settlement made outside the court in the UK; thus, it is rightly treated as business income. It is further asserted that because the agreement was entered into for conduct of business by the taxpayer, any settlement amount arising from such an agreement constitutes a business income.
- The taxpayer received the sum in question from the German company under a settlement agreement associated with the termination of the agency. Therefore, section 28(ii)(c) read with section 28(va)(a) of the Act has been rightly invoked.
- When the agreement was discontinued *via* the settlement agreement, neither the capital structure nor the trading structure of the taxpayer's business was impacted. On the contrary, after the settlement agreement, the taxpayer's sales increased, and the data for the relevant years can be relied upon for the said purpose.

Tribunal's observations and ruling

- Through a comprehensive interpretation of the various agreement clauses, the Tribunal observed that it is clear that the taxpayer was granted a non-transferable, non-assignable license to manufacture, market, distribute, and sell products owned by the German company.
- The Tribunal also observed that the terms and conditions of the agreement and settlement agreement clearly indicate that the taxpayer operated as an agent for all intents and purposes and also received commission.
- The Tribunal clarified that the provisions outlined in section 28(ii)(c) of the Act are explicit in determining the treatment of compensation received from the termination of any agency business. This has been further elucidated by the new provisions incorporated under section 28(va)(a) of the Act, effective from 1 April 2003. These provisions specifically include within the scope of profit and gains of business 'any sum whatever received or receivable in cash or kind under any agreement for guaranteeing any activity in relation to any business'.
- Reliance is placed on the Madras High Court decision in the case of Indo Foreign Traders (P) Limited⁵ and Supreme Court judgements in the cases of Kettlewell Bullen and Co. Limited⁶, and Chari and Chari Limited⁷. These judgements establish that if a termination of an agency does not adversely affect the profit-making structure of the taxpayer and is executed within the business framework, the receipt from such termination of the agency is considered a revenue receipt.
- Hence, the Tribunal concluded that the TO correctly assessed the compensation received by the taxpayer under the head 'profit and gains' from business and profession as per section 28(ii)(c) read with section 28(va)(a) of the Act.

³ CIT v. Tata Services Limited [1980] 122 ITR 594 (Bom.)

⁴ Section 28(ii)(c) of the Act provides for the treatment of 'compensation received from the termination of any agency business' and section 28(va)(a) of the Act pertains to 'any sum received or receivable in cash or kind under any agreement for guaranteeing any activity in relation to any business'.

⁵ Indo Foreign Traders (P) Limited v. CIT [1987] 166 ITR 308 (Madras)

⁶ Kettlewell Bullen and Co. Limited v. CIT [1964] 53 ITR 261 (SC)

⁷ CIT v. Chari and Chari Limited [1965] 57 ITR 400 (SC)

- Regarding the additional ground raised by the taxpayer, the Tribunal was of the view that in the current facts, there was no loss of livelihood due to the termination of the agreement. Therefore, the compensation received by the taxpayer as a result of the termination agreement is categorised as business income.

The takeaways

This Tribunal ruling reaffirms the position that if the termination of an agency does not adversely affect the profit-making structure of a taxpayer, the receipt from such termination is considered as a revenue receipt. Moreover, the underlying documents such as the agency agreement and settlement agreement play a crucial role in providing the actual nature of transactions or relationship.

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