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## Compensation for takeover of key employees on contract cancellation is a capital receipt

### In brief

In a recent ruling in the case of **3i Infotech Limited**<sup>1</sup>, the Mumbai Bench of the Income-tax Appellate Tribunal (Tribunal) held that, following the cancellation of a service contract, the takeover of key employees from the entity that had been providing contract services by the entity that had been receiving them led to the loss of a source of income for the former; accordingly, compensation received for this loss would be a capital receipt.

### Facts

- 3i Infotech Limited (the taxpayer) was providing back-office support services to ICICI Bank Limited (the customer) in respect of its retail lending business, which comprised housing loans, auto loans, and credit cards, among others (RFCO activities).
- For providing such services, the taxpayer had put in place certain resources, including:
  - a) office space,
  - b) software,
  - c) IT infrastructure,
  - d) manpower with technical, managerial and other skills.

<sup>1</sup> 3i Infotech Ltd. v. ACIT [TS-417-ITAT-2013(Mum)]

- With a view to exercise direct control over RFCO activities and to reduce costs, the customer decided to carry out these activities in-house in 2002. Consequently, the customer proposed to employ some of the taxpayer's senior personnel who had been handling RFCO activities. Further, the taxpayer and the customer agreed to cancel their agreement for those services.
- The customer agreed to pay a sum of INR 15 crores to the taxpayer as compensation for the loss of business and future earnings and the transfer of knowledge, subject to confirmation through valuation of the taxpayer's RFCO business by two independent agencies.
- The taxpayer treated the receipt of INR 15 crore as a capital receipt on the ground that such compensation was towards the loss of a source of income that affected the taxpayer's ability to make a profit.
- The Assessing Officer (AO) disallowed the taxpayer's claim, but on appeal by the taxpayer, the Commissioner of Income-tax (Appeals) (CIT(A)) accepted the taxpayer's arguments rebutting the AO's contentions.
- The CIT(A) allowed the taxpayer's appeal and ruled that the compensation received by the taxpayer was a capital receipt.
- The CIT(A) relied on a number of judgements of the Supreme Court, particularly the case of *Oberoi Hotels Pvt. Ltd.*<sup>2</sup>, in support of this decision.
- The Indian tax authorities appealed against the CIT(A)'s decision.

### Issue before the Tribunal

- Was the compensation received by the taxpayer from the customer a capital receipt?

### Revenue's contentions

- There was no transfer of any asset or business expertise or IPR

<sup>2</sup> Oberoi Hotels Private Ltd v. CIT [1999] 236 ITR 903 (SC)

- There was no clause in the agreement which restrained or restricted the taxpayer from continuing RFCO activities. The taxpayer was free to carry on such activities, if it so desired
- Where payment was made as compensation for cancellation of a contract which did not affect the structure of the taxpayer's business and did not deprive the taxpayer of a source of income, then cancellation was a normal incidence of business, and thus, the receipt should be classified as a revenue receipt
- The taxpayer had continued RFCO activities in subsequent periods, and so there had been no loss of business or a source of income to the taxpayer on account of the cancellation of the service contract and the takeover of the taxpayer's key employees. Reliance in this regard was placed on the annual reports of the taxpayer wherein income from such activities continued into subsequent periods.
- There was no transfer of assets by the taxpayer as the taxpayer's assets never decreased. Again, reliance in this regard was placed on the taxpayer's annual reports of the taxpayer.
- The termination of a contract was a normal incidence in business and if a cancellation left the taxpayer free to carry on such activities, then any compensation received in respect thereof would be a revenue receipt. Reliance in this regard was placed on the decision of the Supreme Court in the case of *Kettlewell Bullen and Co. Ltd.*<sup>3</sup>.
- The CIT(A) therefore had erred in concluding that the compensation received by the taxpayer was in respect of loss of business or a source of income.

### Taxpayer's contentions

- The taxpayer was engaged in the services business, which was largely driven by employees. Accordingly, takeover of the taxpayer's key employees by the

<sup>3</sup> Kettlewell Bullen and Co. Ltd. v. CIT [1964] 53 ITR 261 (SC)

customer was tantamount to a transfer of assets by the taxpayer to the customer.

- The taxpayer countered the Indian tax authority's contentions by relying upon the same decisions i.e. *Kettlewell Bullen and Co. Ltd.*<sup>3</sup> and *Oberoi Hotels Pvt. Ltd.*<sup>2</sup>, wherein it was held by the Indian Supreme Court that compensation was a capital receipt even if the taxpayer had ceased activities or business with one entity, but continued similar activities or business with other entities.
- The taxpayer was not providing RFCO services to any other customer, and takeover of the taxpayer's key employees by the customer made it unfeasible for the taxpayer to carry out these activities.

### **Tribunal ruling**

- While RFCO activities carried on for the customer had once been provided by the taxpayer, cancellation of the service contract with the customer and takeover of the taxpayer's key employees by the customer led to the loss of a source of income for the taxpayer.
- The compensation received by the taxpayer had been determined on the basis of this loss.

- As held by the Supreme Court in the case of *Kettlewell Bullen and Co. Ltd.*<sup>3</sup>, what was relevant was whether the taxpayer had lost one of its sources of income. It was irrelevant whether the taxpayer continued similar activities with other customers.
- In the present case, the taxpayer lost its source of income with respect to the RFCO activities it had provided for the customer. The taxpayer had never rendered RFCO services to any other person or entity, and this fact was not contradicted by the Indian tax authorities.
- Accordingly, the Tribunal held that cancellation of the service contract with the customer and takeover of the taxpayer's key employees by the customer led to loss of a source of income for the taxpayer, and therefore, the compensation received from the customer was a capital receipt.

### **Conclusion**

The decision follows the well-settled principle that compensation received in lieu of loss of a source of income is a capital receipt. In transactions involving transfer of business or cancellation of contracts, it is important to demonstrate the intention and substance of the compensation arrangement so as to enable appropriate tax positions being taken.

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