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# TAXABILITY OF NON COMPETE FEE ANALYSIS OF SUPREME COURT RULING

SHIV RAJ GUPTA

V.

COMMISSIONER OF INCOME-TAX, DELHI

[2020] 117 taxmann.com 871 (SC)

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# Research Credits

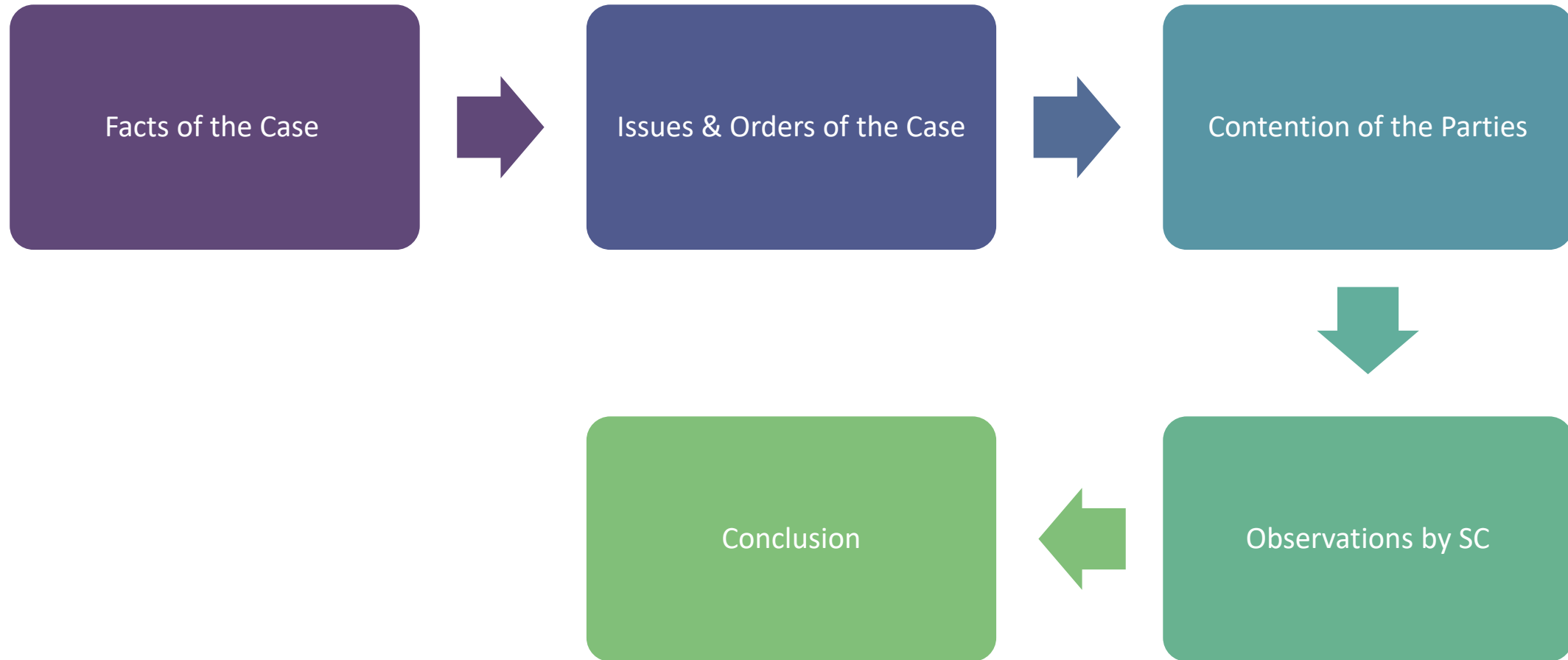
Hepsibah Carolyn J

# Legends used

AO	Assessing Officer
BSE	Bombay Stock Exchange
CBDL	M/s Central Distillery and Breweries Ltd
CG	Capital Gain
CIT (A)	Commissioner of Income Tax (Appeals)
DoC	Deed of Covenant
DSE	Delhi Stock Exchange
FA	Finance Act
FV	Face Value
IMFL	Indian made Foreign Liquor
ITAT	Income Tax Appellate Tribunal

MD	Managing Director
MoU	Memorandum of Understanding
MV	Market Value
NCF	Non-Competent Fee
PGBP	Profits and Gains from Business or Profession
RD	Revenue Department
SC	Supreme Court
SWC	M/s Shaw Wallace Company
SQL	Substantial Question of Law
LAM	Learned Accountant Member
LJM	Learned Judicial Member
TCG	Taxable Capital Gain

# Presentation Schema



# FACTS OF THE CASE

# General Facts

- The present case relates to the **AY 1995-96**,
- The **assessee-appellant** named **Shri Shiv Raj Gupta** is the **chairman and MD of 'CBDL'**,
- It had a unit in Meerut **manufacturing beer and IMFL**.

- The assessee and his family held **1,86,109 equity shares** (57.29%) of CBDL listed in BSE & DSE.

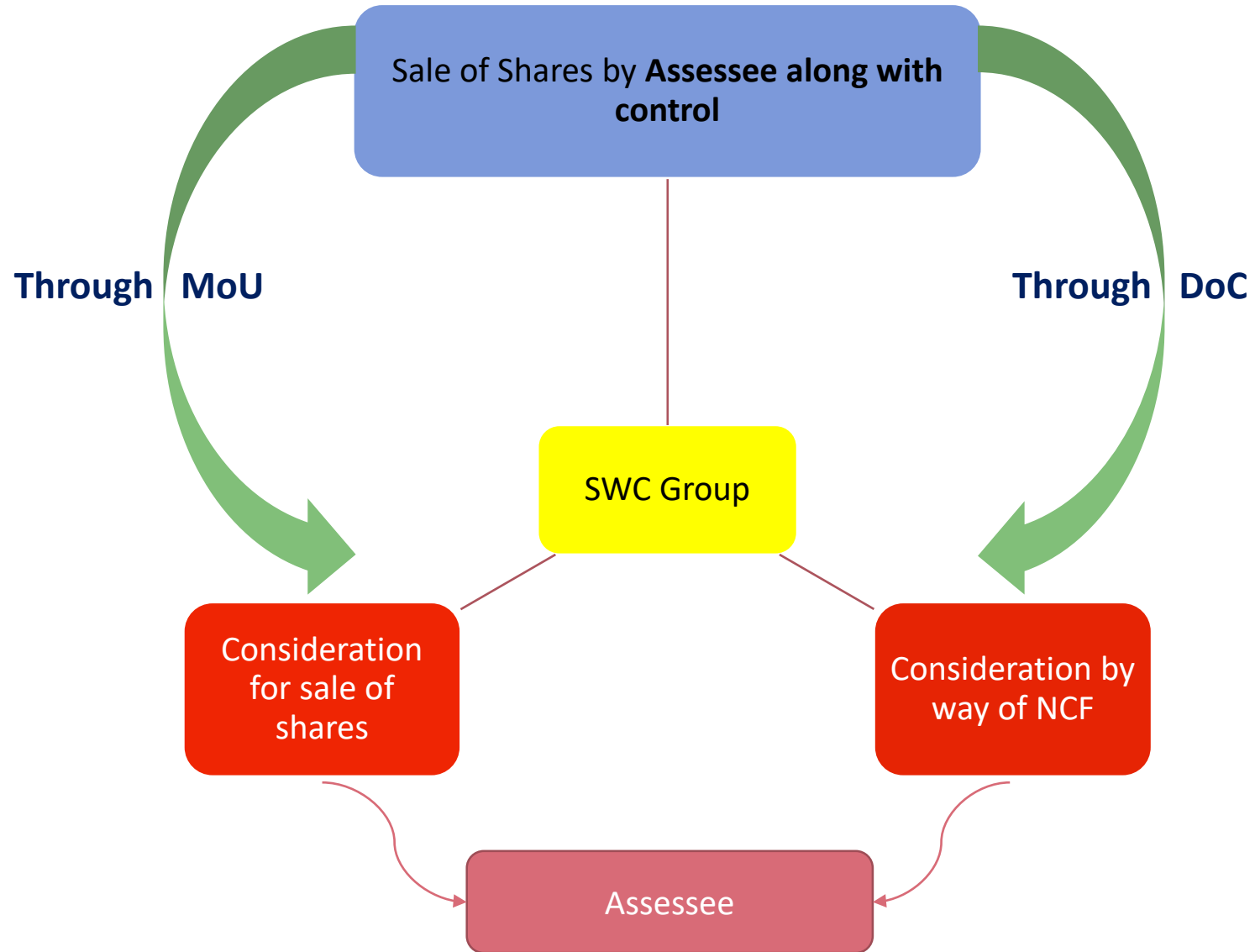
- There was a SC direction stating that the company's manufacturing activity of the **plant at Meerut was suspended**.
- The suspension was effective until a **secondary effluent treatment plant is installed and made operative**
- As a result, **the controlling block of shares were sold at Rs.30 when listed MP was only Rs.3 per share to SWC group**.

# General Facts

- As per MOU, the entire sale consideration of Rs. 55,83,270 was paid by SWC to appellant and family for **irrevocable handing over of possession, management and control** of CBDL.

- **In furtherance of purchase of shares a DOC** was also imposed.
- It was to restrict appellant from carrying directly/indirectly **any manufacturing or marketing activities relating to IMFL/Beer** for **10years from date of handing over.**
- **A Non Compete fee of Rs. 6,60,00,00** was paid for the same.

# Overview







# ISSUES & ORDERS OF THE CASE

# Issue

Whether the **non-compete fee of INR 6.6 Crore** received by the assessee should be treated as receipt of **compensation for termination of management** in CBDL and **taxed u/s 28(ii)(a)**.

## Note

Section 28(ii)(a)- Any compensation received by any person in connection with **termination of his management or modification of terms and conditions** to be taxed under the head PGBP

# Orders by AO & CIT(A)

AO opined that,

i) **No real competition** could be envisaged between a **giant like SWC group** and **loss making dwarf like M/s Maltings** (Owned by assessee)

ii) The **son of appellant was not paid any non-compete fee** despite the fact he **also resigned** from his position as **Joint MD**.

iii) There were **no penalty clause** in DoC

iv) It was held that **DoC was a colorable device** held to evade tax payable u/s 28(ii)(a)

**CIT (A)**

An appeal from AO to CIT was **dismissed**.

# Order by ITAT

**1<sup>st</sup> Member, a LAM** held that,

i) **RD cannot challenge the business perception** of assessee.

ii) **No colorable device** were involved &

iii) **Not taxable** u/s 28(ii)(a)

**2<sup>nd</sup> Member, a LJM,**

Agreed with AO and **decided in favor of RD.**

**3<sup>rd</sup> Member, being again a LJM** emphasized that

i) **Fact that shares of Rs. 3 were sold for Rs. 30, cannot conclude that shares were undervalued.**

ii) **No collusion or sham transaction** existed.

iii) **There existed a 'penalty clause' in the form of letter –Rs. 3Cr to be held as PD by SWC out of RS. 6.6Cr to adjust for losses incurred on breach of terms of MoU.**

In favor of the assessee in 2:1

# Appeal to HC by Revenue



The payment in its real avatar  
**not NCF**

Rs.6.6 Crores paid is **not realistic**  
**without considering the same**  
**along with sale of shares** and  
loss of control

**Taxable as capital gains** as it  
arises from consideration for sale  
of shares and loss of control



# CONTENTIONS OF THE PARTIES

# Contentions of the Revenue Department

1) The amount received by the assessee is in the **nature of sale of shares** as said by HC

**DoC was only a sham transaction in guise to evade tax.**

2) Alternatively it would any time fall under section 28(ii)(a) as was held by AO/ minority judgement of ITAT

# Contentions of the Assessee-Appellant

1  
Only **substantial question of law that is framed** can be answered by the HC.

2  
The decision of LAM and the 3<sup>rd</sup> Member of ITAT, should have been followed by the HC

3  
Only with **introduction of sec 28(va) by FA of 2002 w.e.f 1.4.2003** any sum received on restrictive trade covenant was **taxed for the first time prospectively and not earlier**





# OBSERVATIONS OF SC

# 1. Substantial Question of Law

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An **appeal shall lie to HC** from every order passed by ITAT, if HC is **satisfied that the case involves a SQL.**

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If HC is **satisfied with the SQL**, it shall **formulate that question.**

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Hence, **appeal shall be heard only on question so formulated**

Any other Question other than SQL

Can be heard by HC only after recording reasons and formulating that the question involves SQL

Opportunity of being heard

- Such **notice of the intent has to be given to both parties** and be given an **opportunity to meet the point.**
- **Non-issue** of such notice would make the **appeal illegal and amount to denial of natural justice.**

# Contd

## Grounds of Appeal to HC

Whether the **ITAT has correctly interpreted** the provisions of **sec 28(ii)** of IT Act

Whether **ITAT had rightly held** that **receipt of Rs.6.6crore as NCF was capital nature** not revenue u/s 28(ii)(a) of IT Act

Whether **ITAT failed to distinguish** between nature of capital and nature of revenue w.r.t amount of 6.6crores

Whether **LJM was correct in his recording** of taxability of non-competitive fee u/s 28(ii)(a)

As per the **observations** by SC of decisions held in ***Kshitish Chandra Purkait v. Santosh Kumar Purkait* [1997] 5 SCC 438**  
***Biswanath Ghosh v. Gobinda Ghosh* [2014] 11 SCC 605**

## The judgement of HC was set aside because

SQL raised by HC did not contain any question, **whether NCF can be taxed outside sec 28(ii)(a)**

Neither the **reasons were recorded** nor the **SQL was formulated** before framing that NCF is TCG

## 2. Commercial Expediency

The HC stated that the amount paid is astronomical. But the SC observed the following

*CIT v. Walchand & Co. [1967] 3 SCR 214*  
*J.K. Woollen Mfgr. v. CIT [1976] 103 ITR 66*  
(SC)

In determining the test of commercial expediency reasonableness of the expenditure to be **adjudged from the point of view of businessman** and not the RD.

*Shahzada Nand & Sons v. CIT (CIT [1977] 103 ITR 358 (SC)*  
*CIT v. Dalmia Cement [(2002) 254 ITR 377 (Del)]*

Where **nexus is established between expenditure and purpose of business**, RD cannot decide from the view of assessee how much is **reasonable expenditure having regard to the circumstance**.

Revenue cannot second guess commercial expediency of what parties decide as arm's length

The AO's stance that Maltings ltd is not a threat to giant SWC group is only perception of AO (RD) and not the business reality

Maltings can any time a competitor to SWC with the expertise of assessee.

# Deed not a Sham

The share was sold at Rs. 30 (MV- Rs.3 and FV-Rs.10) higher than MV due to **control premium**

If the sale of **shares was transfer of management, then the compensation of 6.6 crores paid**, in guise of DoC, should have been **paid to the appellant's son & wife being major shareholders.**

**NCF was paid only to appellant given the perception of SWC group that appellant having the attained knowledge and expertise, could start/engage in rival business.**

**SC also held that there were no colorable device involved in having 2 separate agreements for 2 entirely separate and distinct purposes.**

# 3. Taxability of Non-Competent Fee

As was held by court in Gillander's Case (1964) 53 ITR 283 (SC)



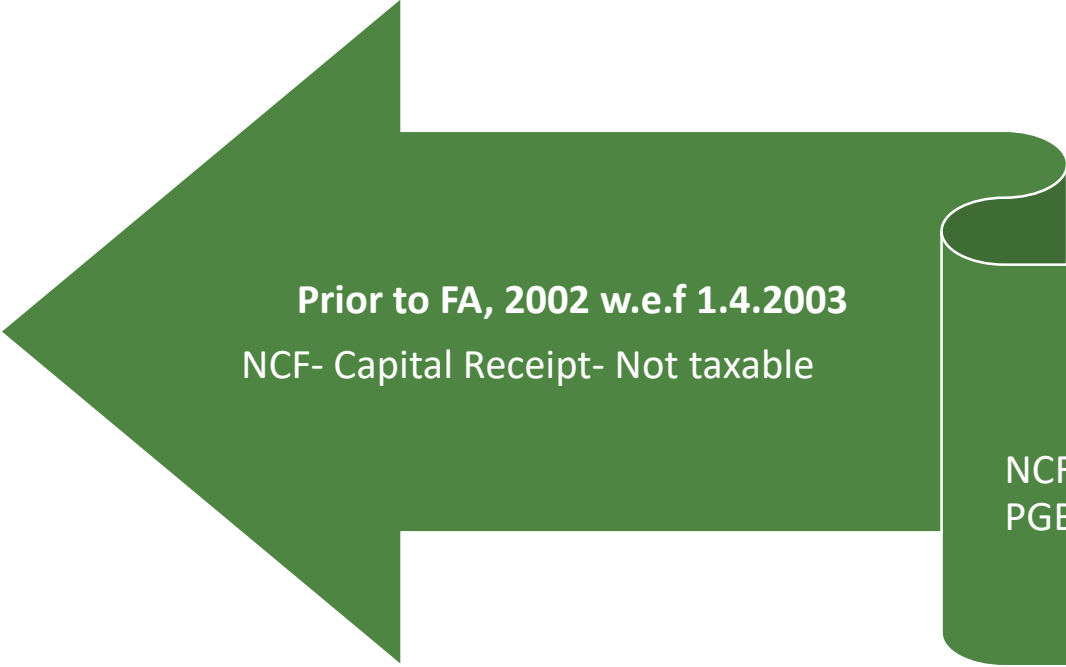
Loss of Source of business-  
Compensation received for  
refraining from carrying on  
business- Non Compete fee- Capital  
Receipt.



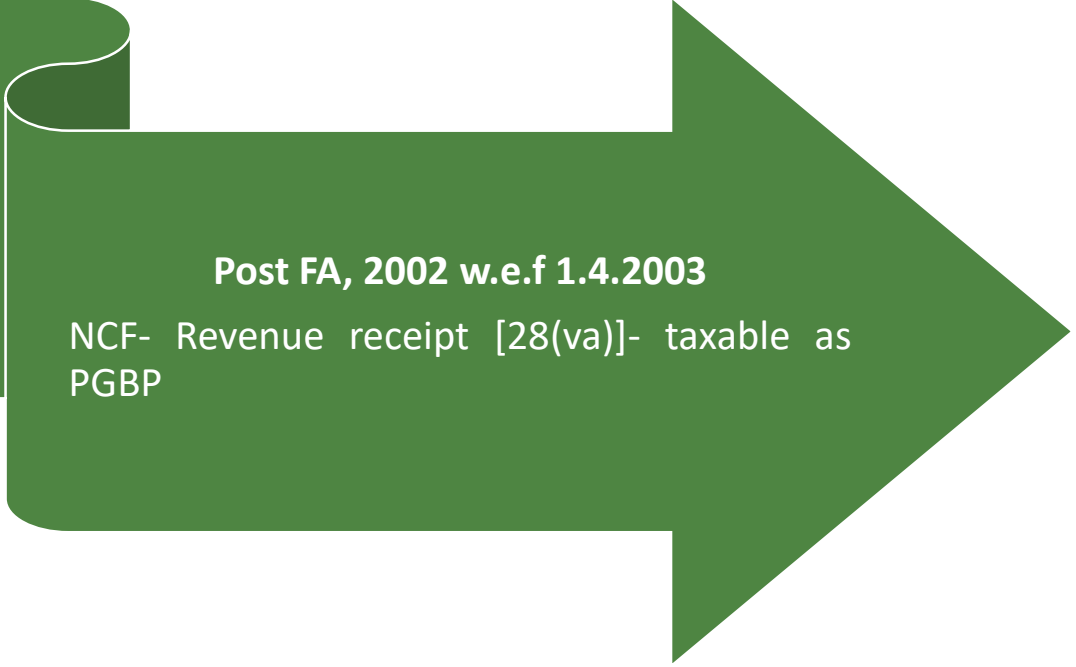
Loss of Agency- Compensation  
received for loss of agency-  
Revenue Receipt- 28(ii)(a)



# Statutory Effect



**Prior to FA, 2002 w.e.f 1.4.2003**  
NCF- Capital Receipt- Not taxable



**Post FA, 2002 w.e.f 1.4.2003**  
NCF- Revenue receipt [28(va)]- taxable as  
PGBP

# CONCLUSION

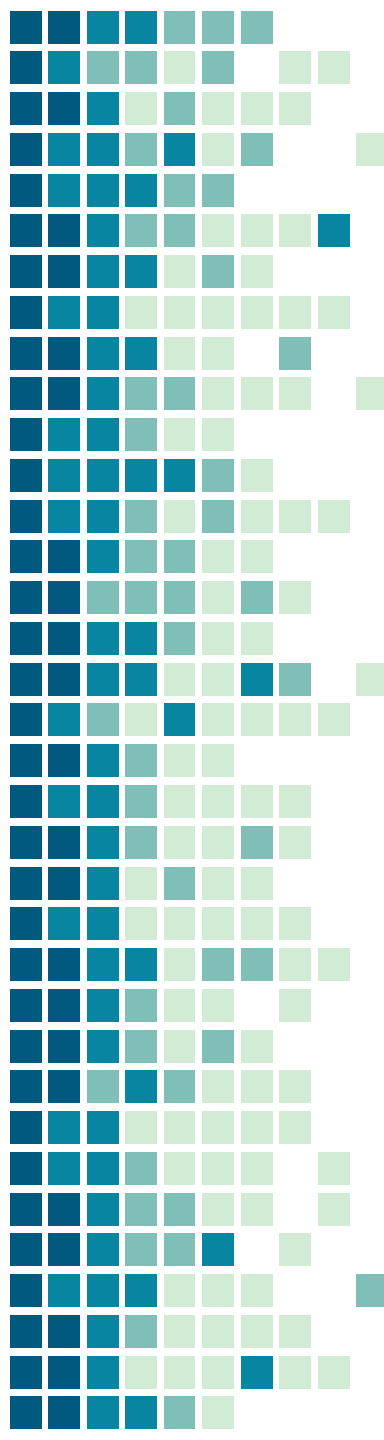


# Conclusion

As per the **observations of SC**, it was held that the NCF of Rs. 6.6 Cr received by assessee from SWC was **not taxable u/s 28(ii)(a)**.

**NCF was exempt as capital receipt.**

HC shall **formulate question being SQL & then pronounce judgement**,  
If HC **wishes to hear appeal on any other SQL not formulated by it**,  
HC may formulate and hear such questions if it is satisfied that case involves such question.



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