

### **NON-COMPETE FEE, WHY SO TAXING?**

In a recent decision of far-reaching financial implications, the Delhi High Court in *Sharp Business System Vs. CIT* (on November 05, 2012) has ruled that non-compete fee paid is capital expenditure and cannot be claimed as a deduction under the head business expenditure. Further, the court also held that non-compete rights cannot be treated as intangible assets, and hence no claim of depreciation is permissible.

Sharp Business System ("Sharp") is a company involved in the business of importing, marketing and selling of electronic office products and equipments in India. Sharp is a joint venture between M/s. Sharp Corporation, Japan and L&T Ltd. ("L&T"). Sharp had paid INR 3 Crores to L&T as consideration for L&T agreeing to a non-compete for a period of seven years. Sharp treated the non-compete fee paid as revenue expenditure.

The Assessing Officer disallowed the deduction. Sharp's appeals to the Commissioner of Income Tax (Appeals) and the Income Tax Appellate Tribunal were rejected. Sharp then appealed to the Delhi High Court. The Delhi High Court, following the decision of the Madras High Court in **Blaze and Central (P) Ltd. Vs. CIT**, held that any amount paid towards fighting competition or warding off competition is capital expenditure and not revenue expenditure. Hence non-compete fee cannot be treated as expenses deductible from income as a business expenditure. The Court also held that since the arrangement between Sharp and L&T is for a period of seven years and that Sharp would obtain a commercial advantage over this period, the amount paid as non-compete fees is capital in nature.

Sharp also contended that the non-compete rights should be treated as an intangible asset, and that therefore depreciation should be allowed on the same. The High Court rejected the contention on the ground that the rights are enforceable only against L&T, and not against the world at large. The Court held that only such rights that may be exercised against the world at large can be brought within the ambit of the term "intellectual property" as used in Section 32 of the Income Tax Act, 1961. The Court also held that the non-compete rights are not alienable (transferable), unlike other intangible assets such as copyright, patent and trademarks. Consequently depreciation also cannot be claimed on non-compete fees.

**INDUSLAW QUICK VIEW:** The decision indicates that the payment of a non-compete fee results in the acquisition of an asset. Per the decision, the asset being the non-compete right is however not an intangible asset as understood for tax purposes. Hence, there is no tax advantage to be gained by way of a depreciation benefit on non-compete fees. With the loss of the advantage both on the revenue and capital fronts, one wonders whether payment of non-compete fees will remain as a significant aspect of transaction structures.

From the perspective of the person who agrees to the non-compete, the question as to the taxable nature of the non-compete fees received could become relevant. If the non-compete is an asset could a person receiving non-compete fees claim the sale of a capital asset, and therefore pay tax on the same as a capital gain? However, could the revenue argue that non-compete while an asset is not a capital asset under the provisions of the income tax act? Alternatively, could the revenue authorities argue that the non-compete came into creation with the agreement, and therefore the recipient still receives other income and not a capital gain? Further, if a non-compete is treated as a capital asset, the calculation as to the gains from the sale become relevant. Valuing the asset (non-compete) and the gains thereof could pose interesting challenges. If the view taken is that the receipt of non-compete fees leads to capital gain, from the perspective of the recipient this would reduce his tax liability. Therefore, the non-compete fee could become an advantage in the hands of the person receiving the non-compete fees. Perhaps non-compete fees may remain relevant after all, but the decision does raise further challenging questions, that are in need of answers.



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