Compensation for non-competition in business and its tax implications

[Published in 102 Taxman (Mag) p.33 (Part-2)]

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In a free market economy, competition plays a vital role in commerce, trade and industry. While healthy competition is a sine qua non of growth and development of business in such an economy, unbridled, unfair and cut-throat competition can also ruin a businessman. It may happen that a person occupying a senior post a business organization is in possession of certain valuable trade secrets of that organization. When such a person retires from the service of that organization, he becomes a potential source of direct or indirect competition and it is becoming increasingly common now that to ward off or reduce the chances of such competition, the employer enters into a covenant with the retiring or retired employee whereby that employee agrees not to disclose or utilize information in his possession resulting in any competitive business activity against the employer. The employer also agrees to pay a lump sum amount as compensation to the retiring / retired employee for the restriction imposed on the latter. In this article, the author discusses the tax-treatment of such compensatory payment and concludes that it is not taxable in the hands of the recipient either as income or capital receipt or as casual receipt and that, in the hands of the employer, it would be deductible as revenue expenditure – **EDITOR**

1. Introduction

We are presently living in a society where global trade is getting an all-round boost. Indian economy has almost become a free market economy. In a free market economic scenario, market forces play a very vital and important role. For a businessman, competition is one of the most important market forces. He is always on the look out for ways and means to reduce competition. He would, therefore, not mind providing monetary incentives to a prospective competitor in order to reduce competition in business.

2. Restrictive covenants to reduce chances of competition

With the rapid pace of industrialization, technology transfers have become quite common. It is in this background that protection of technical know-how, etc., assumes a lot of importance for the survival of an organization. Therefore, secrecy with respect to the same has to be maintained. It is for this reason that when a senior employee / director of a company retires or resigns, he may become a likely source of competition with the business of the company. Therefore, employers have started worrying about the adverse impact likely to be created on their business through the exploitation of the knowledge, experience and expertise of their senior employees / directors after cessation of their employment. In order to ward-off competition from such employees / directors, employers have started entering into non-competition agreements with such employees / directors, after their retirement. Such agreements are in the form of restrictive covenants wherein a lump sum compensation is paid to such employees / directors, in lieu of non-competition in business and non-disclosure of secret information, etc., on their part.

As already stated, whenever a senior executive of a big company is about to retire, the company starts thinking of restricting his future activities in such a manner that such activities do not have any adverse impact on the business of the company and for this purpose, a restrictive covenant known by various names, is entered into with such ex-employee. The heading of such a covenant may be in the likeness of "*confidentiality and non-competition agreement*". Such an ex-employee is normally restricted from (a) disclosing to any person any confidential and valuable information provided to him for the benefit of the company, (b) divulging the secrets regarding the business of the company, and (c) serving as a director or being engaged as a consultant or otherwise, in any company, firm, etc., that competes with the business of the company. Such agreements are normally for a duration of five years. But sometimes the period of such agreements may vary from 3 to 10 years. The *quid pro quo* for the aforesaid restrictions on the ex-employee is normally in the form of a lump sum compensation paid to him.

With the increase in incidence of payments of such compensation, the income-tax authorities are called upon to decide the nature of the aforesaid compensation in the hands of the ex-employee as well as the employer, that is, the recipient and the payer. The purpose of this article is to deal with the issue as to whether the aforesaid compensation is taxable in the hands of the ex-employee and secondly, whether the same is allowable as a revenue expenditure in the hands of his former employer, under the provisions of the Income-Tax Act, 1961.

3. Tax treatment of the compensatory payment in the hands of the ex-employee

The issue before us is to decide whether the lump sum compensation paid to the ex-employee in view of the aforesaid restrictive covenant, is liable to tax under the provisions of the Act.

As far as the case of an ex-employee is concerned, such payment in his hands cannot be taxed either as "*salary*" or "*perquisite*" because such agreement is entered into only after the retirement of the employee from service. The Department has, in the past, tried to bring to tax the aforesaid compensation as "*profits in lieu of salary*" under the provisions of section 17(3) of the Act.

On the face of it, such lump sum compensation cannot be said to be profit from his employment. It is not a remuneration, reward or a return for his services, by any stretch of imagination. The aforesaid payment is received not for doing anything but for not doing certain things.

In order to appreciate the real character of the aforesaid receipt, one has to look into certain legal and factual aspects thereof. The same are dealt with as follows :

(a) *The aforesaid compensation is a capital receipt in the hands of the recipient.*

In this connection a reference may be made to the decisions of the Apex Court in the cases of *Gillanders Arbuthnot & Co. Ltd. v. CIT [1964] 53 ITR 283* and *CIT v. Best & Co. (P) Ltd. [1966] 60 ITR 11*. In the first case, the relevant part of the head-note is as follows :

"*Compensation paid for agreeing to refrain from carrying on competitive business in the commodities in respect of the agency terminated, or for loss of goodwill, is prima facie of the nature of a capital receipt* " (p.283)

In the second case reported in 60 ITR, the assessee undertook to refrain from selling or accepting any agency in explosives, competitive with those covered by the agency agreements terminated. The relevant part of the head-note is as follows :

" (i) *that the compensation agreed to be paid was not only in lieu of the loss of the agency but also for the respondent accepting a restrictive covenant for a specified period;*

(ii) that the restrictive covenant was an independent obligation which came into operation only when the agency was terminated and the part of the compensation which was attributable to the restrictive covenant was a capital receipt and, hence, not taxable." (p.12)

The Madras High Court has also dealt with the same issue in the cases of *CIT v. G.D. Naidu [1987] 165 ITR 63 /[1980] 24 Taxman 255* and *CIT v. Saraswathi Publicities [1981] 132 ITR 207*. In the first case, the assessee and his son were partners in a number of firms carrying on bus-plying business. All those firms were taken over by new partners. Payments were made to the assessee and his son for not carrying on bus-plying business for five years. It was held by the High Court that the amounts received by the assessee and his son were not liable to tax either as income or capital gains. In the second case, compensation was paid to the assessee for agreeing to refrain from carrying on competitive business. it was held that as the receipt was referable to the restrictive covenant, it was a capital receipt not liable to income-tax.

In view of the aforesaid decisions of the Supreme Court and the Madras High Court, the aforesaid compensation would be a capital receipt in the hands of the recipient, *which is not liable to tax either as income or capital gains.*

(b) *The aforesaid amount is not "profit in lieu of salary" on the ground that it is neither an amount earned or paid for services rendered; nor a payment related to employment*.

There are the decisions of various High Courts holding that the aforesaid compensation is not "*profit in lieu of salary*", as the same is not an amount earned or paid for services rendered.

The first such case is *CIT v. Ajit Kumar Bose [1987] 165 ITR 90 / [1986] 26 Taxman 510 (Cal.)* The relevant part of the head-note is as follows :

"*….The payment made by the employer was ex-gratia and totally voluntary and was not compensation which implied some sort of obligation to pay. Therefore, the amount received by the employee was not profit in lieu of salary within the meaning of section 17(3) and was not taxable as income*" (p.90)

The second such case is *CIT v. Jamini Mohan Kar [1989] 176 ITR 127 (Cal.).* The relevant part of the head-note is as follows :

"*….The payment of Rs.36,326 made by the employer was ex gratia and totally voluntary and was not compensation which implied some sort of obligation to pay. Therefore, the amount of Rs.36,326 received by the employee was not profit in lieu of salary within the meaning of section 17(3) of the Income-Tax Act, 1961, and, as such, was not taxable as income.*" (p.127)

The next such case is *Lachhman Das v. CIT [1980] 124 ITR 706 / 3 Taxman 560 (Delhi).* The relevant part of the head-note is as follows :

"*Any payment, merely because it is made by an employer to an employee, will not fall within section 17(3)(ii). The section cannot include those payments which are made not* *on account of the master-servant relationship but on account of personal consideration or for reasons unconnected with the employment. The reference in section 17(3)(ii) to the various clauses of section 10 is only clarificatory and does not imply that any other payment which is made by an employer to an employee on personal consideration or to the services rendered by the employee; would become "profit in lieu of salary" within the meaning of section 17(3)(ii)*". (p.706)

There is yet another case on the issue, viz*., CIT v. J. Visalakshi [1994] 206 ITR 531 (Mad).* It was, *inter alia*, held in this case that as the amount received by the assessee was not earned or paid for services rendered, it cannot be income liable to tax and it will only be a capital receipt.

Besides, as per the decision of the Supreme Court in the case of *CIT v. E.D. Sheppard [1963] 48 ITR 237*, if the object of such payment is unrelated to the relation between the employer and the employee, it would not be "*profit received in lieu of salary*".

The aforesaid view is also supported by the decision of the House of Lords in the case of *Beak (Inspector of Taxes) v. Robson [1943] 11 ITR (Suppl.) 23.* It has been held by their Lordships in the aforesaid case that lump sum payment made after termination of service for restraining the employee from competing in the same business, is not profit arising from office or employment.

(c) *The aforesaid lump sum compensation is not taxable as per direct decisions of the Bombay High Court and the ITAT.*

In an important decision in the case of *R.N. Agrawala v. CIT [1960] 38 ITR 67*, the Bombay High Court has held that compensation for not accepting an employment detrimental to the employer's interest for a specified period is not taxable in the hands of the employee. The relevant part of the head-note is reproduced as follows :

"*…The assessee gave up all claims against the company whatsoever and undertook for a period of one year not to engage himself on his own account or on behalf of others, within a specified area any profession or business which might be detrimental to the interest of the company. The question was whether the sum of Rs. one lakh received by the assessee was taxable* :

Held, that as the assessee's employment was terminated, the payment made to him of his own account or on behalf of others, within a specified area on any profession or business which might be detrimental to the interest of the company. The question was whether the sum of Rs. one lakh received by the assessee was taxable.

Held that as the assessee's employment was terminated, the payment made to him was not under the terms of the agreement of employment, but was made as compensation for termination of employment, and not withstanding the fact that the assessee was being compensated for loss of employment and was also giving up all his claims against the company and binding himself to a covenant not to accept employment which may be detrimental to the interest of the company in a certain area, the payment was in the nature of capital and was not assessable in the hands of the assessee." (p.67)

The Tribunal, Mumbai Bench, in the case of *M.N. Karani v. Asstt.CIT [1998] 64 ITD 119*, has held that payment made against a restrictive covenant was a capital receipt, as the amount received by the assessee could not be said to be profit from his employment either in the form of remuneration, reward or return for his services.

Similarly the Madras Bench of the Tribunal, in the case of *K.S.S. Mani v. ITO [1995] 54 ITD 76*, has held that such a lump sum amount received by an ex-director of a company, for not undertaking any employment or activity which could b prejudicial to the interests of the company for a period of three years, was to be treated as capital received and was not assessable as profit in lieu of salary.

In the light of the aforesaid decisions, the amount of lump sum compensation, received by an ex-employee from his employer in lieu of a restrictive covenant entered into between them; cannot be construed to be of revenue nature or a "*profit in lieu of salary*" under section 17(3) of the Act. Therefore, the same would not be liable to tax under the provisions of the Income-Tax Act, 1961.

(d) *The aforesaid compensation cannot be brought to tax even within the term "casual and non-recurring receipt" as contemplated under section 10(3) of the Income-Tax Act.*

An attempt may be made by the income-tax authorities to tax the aforesaid compensation in the guise of "*casual and non-recurring receipt*". However, the same is not taxable as a casual and non-recurring receipt also. The reasons for this view are as follows :

First of all, the provisions of section 10(3) should be understood in the correct perspective. Section 10 of the Act lays down certain categories of income which do not form part of the "*total income*" of a person. The heading of section 10 is "*Incomes not included in the total income*". Thus, it is very clear that under the provisions of section 10 certain types of income enumerated therein, are not to be included in the total income of a person. As per section 10(3), a casual and non-recurring receipt not exceeding Rs.5,000 will not be taxed. It does not follow therefrom that any capital receipt over and above Rs. 5,000 will have to be taxed. If a person receives Rs.25,000 by way of legacy, the amount cannot be brought to tax on the ground that it is casual and non-recurring receipt above Rs.5,000. Section 10 is not a charging section. It merely specifically excludes certain types of income from the ambit of "*total income*" as defined under the Act. Thus, if a receipt does not have the character of income, it cannot be brought to tax within the term "*casual and non-recurring receipt*" under section 10(3) of the Income-Tax Act.

The aforesaid view is supported by the decision of the Calcutta High Court in the case of *B.K. Roy (P) Ltd. v CIT [1995] 211 ITR 500*, obsn: pages 504 and 505. It has been held in this case that an amount not assessable as capital gains cannot be charged as a casual and non-recurring receipt. The High Court has dissented from the view taken by the Allahabad High Court in the case of *CIT v. Gulabchand [1996] 192 ITR 495*. The Madras High Court in the case of *CIT v. Seshasayee Bros. (P) Ltd. [1996] 222 ITR 818 / 89 Taxman 13* also supports the aforesaid view. In this case the assessee, engaged in agency business, entered into an agreement to sell land and its super-structure for which the vendee paid the first instalment of Rs.20,000 as earnest money. However, because of the default on the vendee's part, the said amount was forfeited by the assessee. The Assessing Officer brought the said amount to tax as business income, but the Commissioner (Appeals) deleted the addition on the basis of the view that the receipt did not bear the character of income, profits or gains. The Tribunal upheld the order of the Commissioner (Appeals). On a reference by the department, the Tribunal, *inter alia,* referred the following question for the opinion of the Madras High Court.

"*Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that the sum of Rs.20,000 could not at all be considered as income to bring it within the term "casual receipt" falling under section 10(3) of the Income-Tax Act*? (p.820)"

After careful consideration of all the relevant case-laws cited before it, the High Court answered the aforesaid question in the affirmative and against the department. The High Court, in effect, held that the amount of earnest money forfeited by the assessee could not, at all, be considered income to bring it within the term "*casual receipt*" falling under section 10(3). Thus, the High Court has held that if the character of a receipt is not that of income, it could not be brought within the term "*casual receipt*" as contemplated in section 10(3).

A decision of the Pune Bench of the Tribunal in the case of *Fattechand Rajmal Jain v. IAC [1997] 60 ITD 47*, also supports the aforesaid view, as the lump sum compensation received by the ex-employee is neither accidental nor gratuitous and, therefore, it could not become a casual and non-recurring income / receipt.

In the light of the aforesaid discussion, the lump sum compensation, cannot be brought to tax even in the guise of "casual and non-recurring receipt".

4. Tax-treatment of whether the aforesaid lump sum compensation in the hands of the employer / payer : is it expenditure of revenue nature ?

In order to decide the aforesaid issue, we have to refer to a very important decision of the Supreme Court, viz. that in the case of *Devidas Vithaldas & Co. v. CIT [1972] 84 ITR 277*. The relevant observations of their Lordships are found at p.285 of the Report. The same are reproduced as follows :

> "*…Payment to ward off competition would constitute capital expenditure, provided the object is to derive an advantage by eliminating the competition over some length of time but such result would not follow if there is no certainty of duration for such an advantage and the same could be put an end to at any time. Thus, what the extent of durability or permanence should be depend on the facts of each case*."

From the aforesaid observations it can be easily understood that payments to ward off competition would constitute capital expenditure provided the object is to derive an advantage of enduring nature.

In this context it is important to note that a restrictive covenant cannot bring into existence an advantage of enduring nature. The decision of the Madras High Court in the case of *G.D. Naidu (supra)* presents the aforesaid issue in the right perspective. In this case, the assessee and his son were partners in certain firms carrying on transport business. Then new partners took over the business of all the firms in stages and by the year 1964 all the firms were composed of entirely new partners. Certain payments were made by the newly constituted firms to the assessee and his son for not carrying on business similar to that of the firms for a period of five years. The relevant part of the head-note is as follows :

> "*So far as the cash compensation paid by the new partners referable to the assets and goodwill of the firm was concerned, the cash took the place of the assets of the partnership and the compensation paid for restrictive covenant not to carry on similar business for a period of five years was in the nature of the separate transaction unconnected with the business of the assets of the partnership. The Tribunal was right in its view that the total compensation paid by the firms to the old partners was for (a) the share in the assets, (b) the share of the goodwill, and (c) for the restrictive covenant and that the part of the amount referable to the acquisition of the share in the assets and the share of the goodwill would be on capital account as it was in the nature of an initial outgoing and the payment towards the restrictive covenant was on revenue account and it would not amount to an acquisition of an advantage of an enduring nature. The Tribunal was also right in its view that the amount received by the recipients was not liable to tax either as income or capital gains…..*" (p. 64)

While coming to the aforesaid conclusion, the High Court considered two decisions concerning the issue involved. The first decision is the decision in the case of *CIT v. Jalan Trading Co. (P) Ltd. [1985] 155 ITR 536 / 23 Taxman 1 (SC).* The relevant observations of their Lordships regarding the aforesaid decision of the Supreme Court in the case of *G.D. Naidu (supra).* The same are reproduced as follows :

> "*….We are unable to see how this decision is in any way helpful to learned counsel for the revenue for contending that there was any acquisition of any benefit in the present case. Further, as seen from the facts in this case, the right to carry on the business of sole-selling agency was acquired by the assessee-firm on a long-term basis and was also subject to renewal agreement. On the other hand, in the present case, the restrictive covenant is operative only for a period of five years. it may be also mentioned that in the present case, it is not a new business of the assessee, though the new partners have come in for the first time…..*" (p. 76)

The other decision is of the same High Court in the case of *Blaze & Central (P) Ltd. v. CIT [1979] 120 ITR 33 / 1 Taxman 546 (Mad.)* The relevant observations of their Lordships regarding the aforesaid decision in G.*D.Naidu's case (supra)* are as follows :

"*….It may be seen from the facts of that case that that case also related to an acquisition of an existing competitive business, whereas in our case it is only a restrictive covenant. No separate business of the old partners was acquired or any competition was eliminated by such acquisition. Since there is no acquisition of any business by payment of the amount referable to the restrictive covenant and there is no benefit of an enduring nature being acquired, we are in entire agreement with the Tribunal that the payment can only be treated as a revenue outgoing and not capital in nature….*" (p. 77)

There is a recent decision of the Madhya Pradesh High Court on this issue in the case of *Grover Soap (P) Ltd. v. CIT [1996] 221 ITR 299.* In this case, the assessee company became one of the partners of the firm N with effect from August 1 / 1976. The said firm originally had two partners J and J.C. The company by virtue of its becoming a partner in the said firm became entitled to a one-third share in the firm. Before the assessee joined the partnership, the partners on July 31, 1976 created a goodwill of the firm to the extent of Rs.2,10,000 and the two partners credited their capital account with Rs.1,05,000, respectively. The said firm was dissolved on December, 31, 1976.and as a consequence, the assets and the liabilities of the erstwhile firm along with the business, vested with the assessee-company. In the dissolution-deed it was specifically stated that the partners J and J.C. shall be paid Rs.10 per ton each on the soap manufactured by the continuing partner provided that the minimum payment to each of the retiring partners would not be less than Rs.1,000 per month. This was in lieu of their undertaking not to carry on a similar business for a period of 15 years under similar trade name. The Hon. High Court following the decision of the Supreme Court in the case of *Devidas Vithaldas & Co. (supra)*, held that the expenditure incurred to ward off compensation for 15 years was capital expenditure.

It may easily be seen from the aforesaid case before the M.P. High Court that the assessee therein obtained an enduring benefit by taking over an existing business which provided the assessee a long-term advantage or an advantage of enduring nature. Thus, the ratio of the aforesaid decision of the Madhya Pradesh High Court cannot be applicable to a case where lump sum compensation has been paid in lieu of a restrictive covenant.

In the light of the aforesaid decisions, the compensation paid in lieu of the restrictive covenant is to be treated as on revenue account, as it does not amount to an acquisition of an advantage of enduring nature. As a corollary, the aforesaid amount of lump sum compensation paid towards a restrictive covenant would be expenditure of revenue nature.

5. Conclusion

In the light of the aforesaid discussion it may be safely concluded that :

(i) the aforesaid amount of lump sum compensation is not liable to tax under the Act in the hands of the recipient, viz. the ex-employee, either as income, capital gains or casual and non-recurring receipt; and

(ii) the aforesaid lump sum compensation would be allowable as a deduction on revenue account in the case of the payer, viz. the former employer.

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