COMPENSATION FOR NON-COMPETITION IN BUSINESS AND ITS TAX-IMPLICATIONS

Compensation paid by an employer to an ex-employee for non-competition in business is a capital receipt in the hands of the employee and revenue expenditure in the hands of the employer under the Provisions of the Income-tax Act 1961.

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We are presently living in a Society where global trade is getting all round boost. Indian economy has almost become a free market economy. In a free market economic scenario, market forces play very vital and important role. For a businessman, competition is one of the important market forces. He is always on the look-out of 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.

With rapid pace of industrialisation, technology transfers have become quite common. It is in this background that protection of technical know-how etc. assumes lot of importance for the survival of an organisation. 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, even the 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, the 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 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 some times 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 a lump sum compensation paid to him.

With the increase in incidence of payments of such compensation, the IT 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 scope of this Article is to deal with the issue 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.

2. Treatment of the aforesaid 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 IT 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 IT Department has, in the past, tried to bring to tax the aforesaid compensation as "profits in lieu of salary" under the provisions of S.17(3) of the IT Act.

On the face of it such lump sum compensation cannot be said to be a profit from his employment. It is not a remuneration, reward or 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 in respect 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 A. and Co. Ltd. Vs CIT, 53 ITR p.283 and CIT Vs Best & Co. P. Ltd., 60 ITR p.11. In the first case reported in 53 ITR 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."

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. "

The Madras High Court has also dealt with the same issue in the case of CIT Vs Late G.D.Naidu and Others, 165 ITR p.63 and CIT Vs. Saraswathi Publicities, 132 ITR p.207. In the first case the assessee and his son were partners in a number of firms carrying on bus-plying business. All such firms were taken over by entirely 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 Hon. 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 reported in 132 ITR 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 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 a "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 decisions of various High Courts holding that the aforesaid compensation is not a "profit in lieu of salary", as the same is not an amount earned or paid for services rendered.

The first such case is CIT Vs A.K. Bose, 165 ITR p.90 (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 if 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."

The second such case is CIT Vs J. M. Kar, 176 ITR p.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."

The next such case is Lachhman Das Vs CIT, 124 ITR p.706(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 S.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 S.17(3)(ii) to the various clauses of S.10 is only clarificatory and does not imply that any other payment which is made by an employer to an employee on personal consideration and without any reference to the terms of employment or to the services rendered by the employee; would become "profit in lieu of salary" within the meaning of S.17(3)(ii)."

There is yet another case on the issue, viz CIT Vs. J.Visalakshi,, 206 ITR p.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 an 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 Vs E.D.Sheppard, 48 ITR p.237(SC), 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) Vs Robson, 11 ITR (Suppl.) p.23(HL). 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.Agarwala Vs CIT, 38 ITR p.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, in 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.**"

The ITAT Mumbai Bench in the case of M.N Karani Vs ACIT, 64 ITD p.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 ITAT, in the case of K.S.S. Mani Vs ITO, 54 ITD p.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 be prejudicial to the interests of the company, for a period of three years, was to be treated as capital receipt 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; could not be construed to be of revenue nature or a "profit in lieu of salary" U/s 17(3) of the IT Act. Therefore, the same would not be liable to tax under the provisions of the IT Act 1961.

3. **The aforesaid compensation can not be brought to tax even within the term "casual and non-recurring receipt" as contemplated U/s 10(3) of the IT Act.**

An attempt may be made by the IT 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 S.10(3) should be understood in the correct perspective. S.10 of the IT Act, lays down certain categories of income which do not form part of "total income" of a person. The heading of S.10 is "Incomes not included in the total income". Thus it is very clear that under the provisions of S.10 certain types of income enumerated therein, are not to be included in the total income of a person. As per S.10(3) a casual and non-recurring receipt not exceeding Rs.5000, will not be taxed. It does not follow therefrom that any capital receipt over and above Rs.5000 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.5000. S.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 could not be brought to tax within the term "casual and non - recurring receipt" U/s 10(3) of the IT Act.

The aforesaid view is supported by the decision of Calcutta High Court in the case of B.K.Roy (P) Ltd. Vs CIT, 211 ITR p..500, obsn. P.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 Hon. High Court has dissented from the view taken by the Allahabad High Court in the case of CIT Vs Gulabchand, 192 ITR p.495. The Madras High court in the case of CIT Vs Seshasayee Bros. (P) Ltd., 222 ITR p.818, 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 AO brought the said amount to tax as business income, but the CIT(A) deleted the addition on the basis of the view that the receipt did not bear the character of income, profits or gains. The ITAT upheld the order of the CIT(A). On a reference by the IT 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 U/s 10(3) of the IT Act?

After careful consideration of all the relevant case-law cited before it the Hon. 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 as **income** to bring it within the term 'casual receipt' falling U/s 10(3) of the IT Act. 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 10(3) of the IT Act.

A decision of Pune Bench of the ITAT in the case of Fattechand Rajmal Jain Vs IAC, 60 ITD p.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. **Whether the aforesaid lump-sum compensation, is an expenditure of revenue nature in the hands of the payer/employer.**

In order to decide the aforesaid issue we may have to look into certain case-law which are relevant to the issue. There is a very important decision of the Supreme Court on this issue in the case of Devidas Vithaldas and Co. Vs CIT, 84 ITR p.277. The relevant observations of their Lordships are on 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 of eliminating the competition over some length of time but such result would not follow if there is no certainty of duration for such advantage and the same could be put an end to at any time. Thus, what the extent of durability or permanence should be, depends 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. In this respect the decision of the Madras High Court in the case of CIT Vs Late G.D.Naidu and Others, 165 ITR p.63; 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 composed firms to the assessee and his son for not carrying on a 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 or the assets of the partnership. The Tribunal was right in its view that the total compensation 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**."

While coming to the aforesaid conclusion the Hon. High Court has considered two decisions concerning the issue involved. The first decision is CIT Vs. Jalan Trading Co. (P) Ltd, 155 ITR p.536(SC). The relevant observations of their Lordships regarding the aforesaid decision of the Supreme Court in 155 ITR, are on p.76 of the report. 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 the 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."

The other decision is of the same High Court in the case of Blaze and Central (P) Ltd Vs CIT, 120 ITR p.33 (Mad). The relevant observations of their Lordships regarding the aforesaid decision in 120 ITR are on p.77 of the report. The same are reproduced 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 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."

There is recent decision of MP High Court on this issue in the case of Grover Soap (P) Ltd. Vs CIT, 221 ITR p.299 (MP). In this case the assessee company became one of the partners of the firm N w.e.f from 1.8.'76. 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 31.7.'76 created goodwill of the firm to the extent of

.2,10,000 and the two partners credited their capital account with Rs.1,05,000 respectively. The said firm was dissolved on 31.12.'76 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 continuing partner provided that the minimum payment to each of the retiring partners would not be less than Rs.1000 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. Vs CIT, 84 ITR p.277(SC), held that the expenditure incurred to ward-off competition for 15 years was a 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 M.P. 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 conclusion the aforesaid amount of lump-sum compensation paid towards a restrictive covenant would be an 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 IT 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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