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Direct Tax

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# Article

## Taxation of non-compete fee received from former employer - The argument of capital receipt

By **Sumitha Krishnan**

### *Introduction:*

The income head 'salaries' covers exhaustively, 'payments' made between persons in the capacity of employer and employee. The terms 'Salaries', 'Perquisites' and 'Profits in lieu of salary' are defined under Section 17 of the Income Tax Act, 1961 ('the Act'). Of the items that Section 17 of the Act covers, profits in lieu of salary is of special interest for the purposes of this Article.

At present, (after amendment *vide* Finance Act, 2001) the definition of the term 'profits in lieu of Salary' under Section 17 of the Act is so wide that it is capable of covering any payments made between the employer and employee (including payments received from the former or prospective employer). Through this Article the author attempts to analyze, taxability of the receipt pursuant to a contract entered into (not forming part of employment contract) by a person from former employer towards non-compete fee or other restrictive covenants' few months or years after he was terminated from the rolls of employment.

### *Income chargeable under the head 'Salaries':*

Income tax is a tax on 'income'. The term 'income' is defined under Section 2 (24). Clause (iii) of Section 2 (24) includes "the value of any perquisite or profit in lieu of Salary taxable under Clauses (2) and (3) of Section 17" as income. Clause (3) defines the term 'profit in lieu of Salary' in the following words:

"profits in lieu of salary" includes—

*(i) the amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the termination of his employment or the modification of the terms and conditions relating thereto;*

*(ii) any payment (other than any payment referred to in clause (10), clause (10A), clause (10B), clause (11), clause (12), clause (13) or clause (13A) of section 10), due to or received by an assessee from an employer or a former employer or from a provident or other fund, to the extent to which it does not consist of contributions by the assessee or interest on such contributions or any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.*

*(iii) any amount due to or received, whether in lump sum or otherwise, by any assessee from any person—*

*(A) before his joining any employment with that person; or*

*(B) after cessation of his employment with that person.*

It is a settled principle that only revenue receipts are taxable under the Act, while capital receipts are exempted unless specifically mentioned in the Act. Payment received by an employee as compensation for loss of employment before the Amendment to Section 7 *vide* Finance Act, 1955 of the 1922 Act, was held to be a 'capital receipt' by the Apex Court in the case of *Commissioner of Income Tax* v. *E.D. Sheppard* [1963] 48 ITR 237 (SC)] and various other decisions. To overcome this, the income Tax Act,1922 was amended to include even payments received as compensation for loss within the ambit of Section 7. In the same way, to understand if 'payment received by an employee from former employer towards non-compete fee or other restrictive covenants are liable to be taxed under Act', it is first necessary to understand the nature and scope of the receipt in the hands of the employee, i.e. whether it is a capital receipt or revenue receipt.

In *Kettlewall Bullen and Co.* [(1964) 53 ITR 261], the Hon'ble Apex Court laid down the following broad principle in determining whether a payment is in the nature of capital or revenue receipt "*Where on a consideration of the circumstances, payment is made to compensate a person for cancellation of a contract which does not affect the trading structure of his business, nor deprive him of what in substance is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade (freed from the contract terminated), the receipt is revenue: Where by the cancellation of an agency the trading structure of the assessee is impaired, or such cancellation results in loss of what may be regarded as the source of the assessee's income, the payment made to compensate for cancellation of the agency agreement is normally a capital receipt*".

The Hon'ble Apex Court in the case of *Commissioner of Income Tax* v. *Best and Company (Private) Limited* [AIR 1966 SC 1325] held that compensation received to refrain from selling or accepting any agency for explosives or other commodities competitive with those covered by the agency agreement now being terminated in the assessment year 1951-52 & 1952-53 as 'capital receipt' and therefore not assessable to tax under the head Salaries.

The Delhi High Court recently in the case of *CIT* v. *Pritam Das Narang* (2015) 61 taxmann.com 332 (Delhi) held as follows "*The words 'from any person' occurring in section 17(3)(iii) have to be read together with the following words in sub-clause (A): 'before his joining any employment with that person'. In other words, section 17(3)(iii)(A) presupposes the existence of an employment, i.e., a relationship of employee and employer between the assessee and the person who makes the payment of 'any amount' in terms of section 17(3)(iii). Likewise, section 17(3)(iii)(B) also presupposes the existence of the relationship of employer and employee between the person who makes the payment of the amount and the assessee. It envisages the amount being received by the assessee 'after cessation of his employment'. Therefore, the words in section 17(3)(iii) cannot be read disjunctively to overlook the essential facet of the provision, viz., the existence of 'employment', i.e., a relationship of employer and employee between the person who makes the payment of the amount and the assessee*". Similar interpretation was assigned in the case of *ITO* v. *Kuwait Airways corporation* (2017) 78 taxmann.com 187 (Mumbai Tribunal).

Relying on the above proposition, the Bangalore Tribunal in the case of *MG. Mohan Kumar* v. *DCIT* (2016) 73 taxmann.com (Bangalore Tribunal) held as under *"For assessment year 2007-08 amount received by assessee after cessation of employment for not sharing knowledge and secrets of trade of ex-employer to competitors would be capital receipt and could not be taxed as profit in lieu of salary under section 17(3)(iii)"*

The author is of the view that interpretation of Section 17 must be confined to cover only such payments as have some connection with employment. Further, considering the above decisions, the payment received by Mr. X should not be covered under the head 'income chargeable under the head Salaries' even though Clause (iii) to sub-section (3) to Section 17 is comprehensive enough and that payments that are due to or received by the employee for the past services rendered or compensation received on termination of employment till the notice period of the employee, is only eligible to be taxed under this head.

### *Transfer of a Capital asset:*

Section 12B of the 1922 Act and the present Section 45 states that "profits and gains arising from transfer of a capital asset effected in the previous year shall be chargeable to income-tax under the head "capital gains" and shall be deemed to be the income of the previous year in which the transfer took place.

Section 2 (47) defines transfer in relation to capital asset includes *"(i) the sale, exchange or relinquishment of the asset or (ii) the extinguishment of any rights therein or (iii) the compulsory acquisition thereof under any law or (iv) ….(iva)….(v)…(vi)……".*

Section 2 (4A) of the 1922 Act defined the term 'capital asset' in a similar way as it stands today. Section 2 (14) of the Act defines the term 'Capital asset' to mean (a) a property of any kind held by an assessee, whether or not connected with his business or profession (b) any securities held by a foreign institutional investor which has invested in such securities in accordance with the regulations made under the Securities Exchange Board of India Act, 1992 but does not include…………".

Applying the above provisions, in the case of *Commissioner of Income tax, Punjab* v. *Prabhu Dayal (Decd. By Legal representatives)* [1971] 82 ITR 804 (SC) the Hon'ble Apex court held that *"the assessee possibly by some fortuitous circumstances discovered kankar in some places in the Jind State. This circumstance gave him an opportunity to bring about an engagement between the State of Jind and Shanti Prasad Jain and when Shanti Prasad Jain transferred his right to a new company, in the formation of which that assessee had a hand, he was promised certain yearly commission on net profits earned by the company. None of these activities of the assessee can be considered as a business activity but yet he did acquire an income yielding asset as a result of his activities. But the compromise decree destroyed that asset and in its place he was given Rs. 70,000 as compensation. This payment was neither in respect of the services rendered in the past nor towards the accumulated commission due to him. It was paid as compensation to him because he gave up his right to get commission in future to which he was entitled under the agreement. It was a price paid for surrendering a valuable right which, in our opinion, was a capital asset. Therefore, that receipt must be considered as a capital receipt".*

As rightly pointed out by the Hon'ble Apex Court in the decision of *Prabhu dayal* (supra), right to join any office of employment could be considered as capital asset as the definition under Section 2(14) is wider to include anything under its ambit and 'extinguishment of such right' for a consideration would amount to transfer as per Section 2 (47).

However, there is lack of clarity on the aspect of method of ascertaining cost of acquisition (as it is extinguishment of inherent right of a person) for the purpose of computation of profits or gains under this head and therefore, as per the decision of the *Commissioner of Income Tax* v. *B.C. Srinivasa Shetty* [(1981) AIR (SC) 972] one may say that computation mechanism fails and therefore not purported to be covered under Section 45.

***Profits and gains of business or profession:***

An analysis under this head may not be required, as it is evident that Mr. X is not a person in the business of 'entering into agreement to not compete or other restrictive covenants'.

In this regard, however, it is interesting to note that, Section 28 which deals with income taxable under the head 'profits and gains of business of profession", in sub-section (ii) Clause (va) includes "any sum whether received or receivable, in cash or in kind, under an agreement for-

(a) Not carrying out any activity in relation to any business; or

(b) Not sharing any know-how, patent, copyright, trade-mark, license, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services.

A clause such as the one available under the head "income chargeable under the head profits and gains of business or profession" is not explicitly present in Section 17 of the Act. Clause (ii) to Section 17(3) appears to be very wide however its interpretation has to be confined to cover only such payments as have some connection with employment, as held in *Lachhman Das* v. *CIT* 124 ITR 706 (Del). As regards clause (i) of the said Section, the same can apply only if the compensation is either at or in connection with termination/medication of employment. The expression 'in connection with something' means intrinsically related to that thing as held in *V.A. Vasumathi* v. *CIT* 123 ITR 94(Ker). In this decision, the court accepted the argument that the phrase is wide enough to cover transactions occurring either prior to or after the event with which they otherwise have a connection. This decision was followed in *Stumpp Schuele* v. *CIT* 190 ITR 152. The author is of the view that the payment of non-compete fee arises from an agreement entered into for that and does not necessarily arise on account of termination of employment.

As already stated the payment can be better described as a capital receipt and for a capital receipt to be taxable under the Act it must be specifically mentioned in the Act, otherwise it is understood that the same is not subject to taxation.

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# Circular

## Assessees to be intimated about variation in income as per TDS returns

Finance Act 2016 inserted sub-clause (vi) in Section 143 (1)(a), in terms of which the total income will be computed after addition of income appearing in Form 26AS, Form 16 or Form 16A which has not been included in computing the total income in the return. As per CBDT Circular No.1/2018 dated 10-1-2018, the revenue authorities have been instructed to initiate an awareness process and a formal intimation before the addition is made. The assessee will receive intimation of variation in the return *vis-à-vis* the information available the three Forms (mentioned above) and the assesse will have to furnish his response within 30 days failing which the proposed adjustment shall be made to the returned income. If the assesse agrees with the adjustment, he must file a revised return and where he does not agree with the adjustment, he must file a reconciliation statement.

# Ratio Decidendi

## Write off of obsolete stock which is not liable to be replaced by AE is not an international transaction

The assessee, as per the resolution passed by the company effected a write off of obsolete stock and destroyed the same. The revenue authorities contended that the assessee was eligible for replacement of goods with manufacturing defects etc., for a period of two years in terms of the agreement with its Associated Enterprise (AE) and the write off without any reimbursement by the AE reflected that the purchase price had been high. Thus, the authorities sought to determine the ALP of the goods and effect a TP adjustment. The ITAT, however, held that the agreement to replace certain goods for manufacturing defects or compliance issues at time of importation was not an omnibus clause to replace even non-defective goods and there was no relation between the write off and purchase price of goods. The decision to write off was not in terms of any arrangement or agreement with the foreign AE. Hence, the ingredients for an international transaction were not satisfied. [*Safilo India P Ltd* v. *DCIT*, ITA 588/Mum/2015, ITAT order dated 12-1-2018]

## Salary and tax borne by same person albeit indirectly : Tax component is to be taxed as salary in hands of recipient

The Kerala State Electricity Board ('KSEB') entered into a contract of consultancy with SNC - Shawinigan Inc. Canada, for carrying out a project in the site of KSEB. As per the terms of an agreement, entered into between the KSEB and the consultant, the liability to pay the salary, of the employees (petitioners) deputed by the consultant to the project site, was of the consultant itself. However, the income tax component had to be satisfied by the KSEB. The tax component was reported as income from other sources by the petitioners where as the department was of the view that it was taxable under the head salary as per Section 195A and accordingly raised a demand for balance tax.

The petitioners contended that Section 195A is to be applied only when tax is paid by the same person by whom salary is payable and in the instant case salary was payable by the consultant and tax was paid by KSEB. As per the agreement it was clear that there was no master-servant relationship between the KSEB and the consultant. However, the High Court, relying on the definition of "salary" as given in *Commissioner of Income Tax* v. *C.W. Steel* – 1972 (86) ITR 817, ruled that KSEB was indirectly paying the salary of these employees, as part of the consultancy charges. Thus, as per the rule in Section 195A, both the salary as well as the tax on that salary were payable by the same person. Hence, the tax component would be taxable under the head salary and not income from other sources. [*Horace Dansereau* v. *ACIT*, [2017] 88 taxmann.com 228 (Kerala)]

## Section 45(3) applies to transfer of assets as capital contribution and not Section 50C

The assessee transferred an immovable property as its capital contribution to a Limited Liability

Partnership. The transfer was recorded in the books of the partnership at a value lower than the value determined by stamp valuation authorities. The assessee, in accordance with section 45(3) of the Act, computed capital gains by taking the amount recorded in the books as the full value of consideration. The AO contended that section 50C of the Act overrides section 45(3) and as per the provisions of section 50C, the value assessed by the stamp duty authority will be the full value of consideration as it is more than the consideration amount received. The Tribunal accepted the argument of the assessee that section 45(3) is a special provision of transfer between partnership firm and partners and in such circumstances, a deemed full value of consideration shall be considered for computation of capital gain as per which the amount recorded in the books of account of the firm shall be taken as full value of consideration. The Tribunal referred to the case of *CIT* vs. *Moon Mills Ltd.*, (1966) 59 ITR 574 to show that since the Act itself provides for deeming consideration to be adopted for section 48 of the Act, another deeming fiction provided by way of section 50C cannot be extended to compute deemed full value of consideration as a result of transfer of capital asset. [*Amartara Pvt Ltd* v. *DCIT*, TS-612-ITAT-2017]

## Section 50C may apply in preference over Section 45(3) on transfer of assets as capital contribution

In a given case the contribution of immovable properties as capital in firm may be a colourable device to avoid execution of registration documents for transfer of land and thereby avoid levy of capital gains tax on stamp duty valuation necessitated on account of registration. In such a case if the route of partnership firm is used for tax avoidance and the transaction of capital contribution is a sham for avoiding capital gains then the provisions of Section 50C may be invoked. The Court also held that registration is required under Section 17 of The Registration Act 1908 for capital contribution of immovables. [Note: The case pertained to AY 2004-05 when the provisions of Section 50C could be invoked only on actual registration of documents] [*CIT* v. *Carlton Hotel (P) Ltd*., ITA 31 of 2009 - [2017] 88 Taxmann.com 257 (All)]

## Lease rental paid as upfront fee in advance is revenue expenditure

Under the agreement to operate, manage and develop the Delhi airport, the assesse paid an upfront fee of Rs. 150 crores and was to pay lease rental of Rs. 100 per year and an annual fee as a percentage of gross revenue from operations. The revenue authorities argued that by paying the lump sum fee which the assessee said was payment of lease rental in advance, the assesse had acquired the license to carry on business for 30 years in the airport premises and hence an enduring benefit accrued to the assesse. The Assessing Officer had allowed deduction of 1/30$^{th}$ of the amount for the relevant year. The ITAT held that lump sum payment of 'upfront fee' such that the annual lease rental of subsequent years was fixed at a nominal fee of Rs. 100 per year would be revenue expenditure and not capital expenditure or deferred revenue expenditure. The ITAT agreed with the contention of the assesse that the lump sum payment of lease rental cannot have different character from the lease rental paid. It also relied on various judicial precedents to hold that the Income Tax Act does not provide for deferred revenue expenditure and the decision upholding deferred revenue expenditure based on matching concept had been given in a situation when the assessee sought to apply the same. [*ACIT* v. *Delhi International Airport* , ITA 4202/ Del/2013 , ITAT Order dated 14-12-2017]

## Corporate guarantee to fulfil shareholder obligations is not an international transaction

Reasoning that a corporate guarantee which is extended without collecting any fee from the AE might have an 'influence' over profits, incomes, losses or asset but not 'impact' the ITAT held that the corporate guarantee did not fall within the ambit of international transaction as per Section 92B. The assessee relied on the ruling of a coordinate Bench in *Tega Industries Ltd. Vs DCIT (ITA No.1912/Kol/2012* and argued that its expectation from provision of guarantee was not the fee but fulfilling its obligations as shareholder. The revenue authorities were of the view that the assese which had guaranteed the loans of its overseas subsidiary should have been compensated adequately for the service rendered by it. However, the ITAT agreed with the argument of the assese that the guarantee was extended only to fulfil obligation as a shareholder and to protect its interest and not as a service to another enterprise. [*DCIT* v. *EIH Limited*, ITA 153/Kol/2016, ITAT Order dated 12-1-2018]

## Medical research centre not engaged in processing or manufacture of goods is not an industrial undertaking for purposes of Section 72A

At issue was the denial of carry forward of depreciation and accumulated loss of the research centre engaged in establishing developing, leasing, managing, operating and running of medical service centers such as nursing care homes, hospitals, polyclinics which was amalgamated with the assessee. The ITAT agreed with the contention of the revenue authorities that the amalgamating entity as not an industrial undertaking as per Section 72A(7)(aa) since it was not engaged in manufacture or processing of goods nor was it in the businesses specified therein. The ITAT did not find force in the assessee's argument that the laboratories were engaged in processing because it was only an ancillary activity. Thus, following the judgement of Madras High Court in *ACIT Vs. Apollo Hospitals Enterprises Ltd, 171* TAXMAN 397, the ITAT held that brought forward loss and depreciation of the amalgamating entity could not be carried forward. [*Healthcare Global Enterprises Ltd* v. *JCIT*, ITA No. 1900/Bang/2016, ITAT Order dated 15-12-2017]

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