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Mergers and Acquisition Alert

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Madras HC attributes part of sales consideration in a brand acquisition transaction towards Non-Compete fees, taxable as business profits

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Executive Summary

- Recently, honorable Madras High Court ('HC') pronounced its ruling in the case of Chemech Laboratories Ltd. ('the assessee') on taxability of Non-Compete fees in case of a brand acquisition transaction
- Based on the facts of the case, the Madras HC attributed partial sales consideration received by the assessee towards the Non-Compete element of the transaction, taxable as business profit u/s 28 (va) of the Act

Background

- The assessee is a pharma company engaged in the business of manufacture and marketing of pharmaceuticals.
- In February, 2003, the assessee entered into the following 3 distinct agreements with Solvay Pharma (I) Ltd. ('SPIL' / 'transferee') for a consideration of INR 60 Million (*payable in 3 installments*):
  - Brand Acquisition Agreement : setting out terms for transfer of business including sale of brands, assignments of trademarks, copy rights, designs
  - Consultancy Agreement : setting out terms and conditions relating to nature and scope of services and remuneration connected therewith
  - Non-Compete Agreement : restricting the assessee to compete with transferee in the business in the territory nor commence / engage in / be interested in / carry on any business similar to the business transferred
- Pertinent to note that, the business transferred by the assessee is highly specialized and exclusive and it involves a cutting-edge technology, which would be inaccessible to the assessee post brand transfer.
- Reference to the Non-Compete agreement was made in the Brand Acquisition agreement stating that the Non-Compete agreement is an integral part of the Brand Acquisition agreement.
- During assessment proceedings, the assessee claimed that entire sales consideration of INR 60 Million was received towards transfer of business under the Brand Acquisition agreement and no part was attributable to Non-Compete fees. Assessing officer ('AO') disagreed and allocated first installment of INR 40 Million towards Non-Compete and taxed it as business income
- On appeal, CIT (A) agreed with AO's contention but noted that both Non-Compete covenant and Brand Acquisition were equally important components in the transfer of an undertaking. Accordingly, he modified the attribution amount towards Non-Compete at INR 30 Million
- On further appeal, ITAT observed that, the restrictive covenant was only incidental to the main transaction of brand acquisition and held that the entire sum of INR 60 million would constitute a capital receipt and no portion of the consideration would be attributable to the negative covenant of Non-Compete.

Issue before the Madras HC

Whether the Tribunal was right in attributing the entire consideration towards sale of brand name, when the contracts in question covered both sale of brand name and Non-Competition agreements?

Madras HC Ruling

- HC noted that the three agreements depict a composite transaction in respect of which the amount of INR 60 Million is paid and thus some part of the consideration would have to be attributed towards the activity of Non-Compete as well
- HC also noted that parties themselves in clause 3.6 of the Non-Compete agreement have agreed that the total consideration of INR 60 million shall include consideration towards the negative covenants as well
- HC further explained that the legislature has made a conscious and clear distinction between the '*positive right*' to carry on a business or the activity of manufacture, production or process, the consideration for the transfer of which would be chargeable under the head 'capital gains' and a '*negative right*' being a covenant against the carrying on of any activity in relation to a business, the consideration for which would be taxable as 'business income'
- HC further stated that ITAT mis-directed itself in addressing the question whether the activity of Non-Compete was incidental, since the Non-Compete agreement itself mentioned that the consideration was inclusive of payment towards the negative covenant
- HC appreciated the fact that the business transferred is a highly specialized and exclusive and re-entry of the assessee in the business would be impossible. However, this fact did not reconcile with the specific clause in the agreement evidencing apparent intention of the parties to attribute some part of the total consideration towards Non-Compete covenants
- Further, HC agreed to the suggestion of the assessee on adopting INR 10 Million as reasonable valuation of Non-Compete covenant

Comments

Depending on the facts of the case, it is critical that the parties determine whether fee / consideration being received is attributable towards a positive right or a negative right as per Section 28 (va) of the Act and accordingly, be cautious while drafting / presenting the terms in the transaction documents

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