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Tax alert: Payment for premature termination of contract is allowable, non-compete fees eligible for depreciation

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The Bombay High Court has held that compensation paid on premature termination of contract is allowable revenue expenditure. Further, the sum paid as non-compete fees is capital in nature; it is an intangible asset eligible for depreciation.

In a nutshell

As a result of the termination of the services, if the taxpayer gets rid of the liability to pay the commission which it is required to pay under the agreement not only during the accounting year but also for a few years more, and where the termination is on business considerations and as a matter of commercial expediency, it cannot be stated that by terminating the agreement, the taxpayer has acquired any enduring benefit or any income yielding asset.

On perusal of the meaning of the categories of specific intangible assets referred to in section 32(1)(ii) of the Income-tax Act, 1961 (ITA) preceding the term 'business or commercial rights of similar nature', intangible assets were not of the same kind and were clearly distinct from one another. The legislature thus did not intend to provide for depreciation only in respect of the specified intangible assets but also to other categories of intangible assets which may not be possible to exhaustively enumerate.

The rights acquired by the taxpayer under non-compete agreement not only gave enduring benefit but also protected the taxpayer's business against competence from a person who had closely worked with the taxpayer in the same business. The expression 'or any other business or commercial rights of similar nature' used in Explanation 3 to section 32(1)(ii) of the ITA, is wide enough to include the present situation.

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Background:

- The taxpayer[1], an Indian company, earns income from advertising through the intermittent breaks of various programs that it relays on its radio station. For procuring the advertisement from various clients, the taxpayer had engaged another Indian company (say A Co).
- During the Financial Year (FY) 2007-08, corresponding to Assessment Year (AY) 2008-09, a dispute arose between A Co and the taxpayer, resulting in termination of the agreement with A Co. While terminating the agreement, the taxpayer paid the following sums and claimed the same as revenue expenditure:
  - Compensation for Advertisement and Agency Sales Termination Agreement (ASTA).
  - Amount under Restrictive Covenant Agreement (RCA) for restricting A Co for not competing against the taxpayer in similar business for another 2.5 years.
- In the course of audit proceedings, the Assessing Officer (AO) disallowed the aforesaid sums treating the same as capital expenditure.
- Aggrieved, the taxpayer filed an appeal and in the course of appeal proceedings, the matter reached before the Bombay High Court (HC).

Relevant provisions in brief:

Relevant extract of Explanation 3 to section 32(1)(ii) of the Income-tax Act, 1961 (ITA)

"Explanation 3.—For the purposes of this sub-section, the expression "assets" shall mean…

… (b) intangible assets, being know-how, patents, copyrights, trademarks, licences, franchises **or any other business or commercial rights of similar nature**, not being goodwill of a business or profession."

Decision of the HC:

The HC noted /observed the following:

Compensation paid for premature termination of the contract

- The Supreme Court (SC) in an earlier ruling[2] had held that a payment made for termination of contract by way of compensation would be an allowable deduction in computing the total income of the taxpayer. The SC in this regard, had observed that:
  - When an expenditure is made with a view to bring into existence an asset or an advantage for the enduring benefit of a trade, there is good reason (in the absence of special circumstances leading to the opposite conclusion) for treating such an expenditure as attributable to not revenue but to capital.
  - As a result of termination of the services, if the taxpayer got rid of the liability to pay the commission which it was required to pay under the agreement not only during the accounting year but also for a few years more, the expenditure thus saved, undoubtedly swelled the profits of the company and where the termination was on business considerations and as a matter of commercial expediency it could not be stated that by terminating the agreement, the taxpayer had acquired any enduring benefit or any income yielding asset.

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[1] PCIT vs Music Broadcast Private Limited [ITA No. 675 of 2018] (Bombay HC)

[2] CIT vs Ashok Leyland Ltd. [1972] 86 ITR 549 (SC)

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In the case under consideration, by making the payment under ASTA, the taxpayer not only saved the expense that it would have incurred in the relevant previous year but also for few more years to come. Therefore, the amount paid on account of termination of the agreement to A Co was revenue expenditure.

Claim of depreciation on non-compete fees

- The Bombay HC in earlier rulings[3] had considered the issue of depreciation claim on non-compete fees paid and observed as follows:
  - The Delhi HC in an earlier ruling[4] had interpreted the meaning of the term 'intangible asset' in the context of section 32(1)(ii) of the ITA. It was observed that on perusal of the meaning of the categories of specific intangible assets referred to in section 32(1)(ii) of the ITA preceding the term 'business or commercial rights of similar nature' intangible assets were not of the same kind and were clearly distinct from one another. The legislature thus did not intend to provide for depreciation only in respect of the specified intangible assets but also to other categories of intangible assets which may not be possible to exhaustively enumerate.
  - The rights acquired by the taxpayer (in that case) under non-compete agreement not only gave enduring benefit but also protected the taxpayer's business against competence from a person who had closely worked with the taxpayer in the same business.
  - The expression "or any other business or commercial rights of similar nature" used in Explanation 3 to section 32(1)(ii) of the ITA was wide enough to include the present situation.

Thus, in the case under consideration, by paying the amount as non-compete fees under the RCA, the rights acquired by the taxpayer was not only giving it enduring benefit but also protected taxpayer's business against competition, that too from a person who had closely worked with the taxpayer. Thus, the sum paid as non-compete fees to A Co was capital in nature, it was an intangible asset eligible for depreciation.

Comments:

Commercial considerations may require, amongst others, pre-mature termination of contracts and / or entering into of non-compete arrangements. Whether amounts paid in relation to the same would qualify as revenue or capital expenditure and whether expenditure qualifying as capital expenditure would be eligible for depreciation, have been subject of litigation.

This ruling has reiterated the following principles:

- As a result of the termination of the services, if the taxpayer gets rid of the liability to pay the commission which it is required to pay under the agreement not only during the accounting year but also for a few years more, and where the termination is on business considerations and as a matter of commercial expediency it cannot be stated that by terminating the agreement, the taxpayer has acquired any enduring benefit or any income yielding asset.
- On perusal of the meaning of the categories of specific intangible assets referred to in section 32(1)(ii) of the ITA preceding the term 'business or commercial rights of similar nature', intangible assets were not of the same kind and were clearly distinct from one another. The legislature thus did not intend to provide for depreciation only in respect of the specified intangible assets but also to other categories of intangible assets which may not be possible to exhaustively enumerate.

[3] PCIT vs Piramal Glass Ltd. [IT Appeal No.556 of 2017] (Bombay HC) and PCIT vs India Medtronic (P) Ltd. [IT Appeal No. 1453 of 2017] (Bombay HC)

[4] AREVA T & D India Ltd. v. DCIT [2012] 20 taxmann.com 29 (Delhi HC)

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- The rights acquired by the taxpayer under non-compete agreement not only gave enduring benefit but also protected the taxpayer's business against competence from a person who had closely worked with the taxpayer in the same business. The expression 'or any other business or commercial rights of similar nature' used in Explanation 3 to section 32(1)(ii) of the ITA, is wide enough to include the present situation.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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