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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

RESERVED ON: 10.09.2012
PRONOUNCED ON: 05.11.2012

\+ **ITA 492/2012 & C.M. APPL. 14836/2012**

SHARP BUSINESS SYSTEM ..... Appellant
Through: Sh. Ajay Vohra, Ms. Kavita Jha and Sh. Somnath Shukla, Advocates.

versus

THE COMMISSIONER OF INCOME TAX-III ..... Respondent
Through: Ms. Suruchi Aggarwal, Sr. Standing Counsel.

CORAM:
MR. JUSTICE S. RAVINDRA BHAT
MR. JUSTICE R.V. EASWAR

MR. JUSTICE S.RAVINDRA BHAT

% The following questions of law were framed for consideration by the Court:

"1. Whether on the facts and in the circumstances of the case the Tribunal erred in holding that non-compete fee paid aggregating to Rs.3,00,00,000/- was not allowable revenue deduction.?

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2. Whether on the facts and in the circumstances of the case, the Tribunal erred in holding that the non-compete fee paid was in the nature of initial outlay and thus capital expenditure?

3. Without prejudice, whether on the facts and in the circumstances of the case, the Tribunal erred in denying depreciation on the non-compete fee paid, consistent with the finding that the same represented expenditure of capital nature?

4. Whether on the facts and in the circumstances of the case, the conclusion arrived at by the Tribunal is such that no reasonable person correctly informed of the position of law would come to?"

2. The appellant, a company which used to import, market and sell electronic office products and equipment in India, at the relevant time, was incorporated on 29.02.2000, as a joint-venture of M/s. Sharp Corporation, Japan, and L&T Ltd. During the year under consideration, the appellant paid Rs. 3 crores to L&T as consideration for the latter not setting-up or undertaking or assisting in the setting-up or undertaking any business in India, of selling, marketing and trade of electronic office products for seven years. This amount was treated as deferred revenue expenditure in the assessee's books of accounts and written-off over corresponding period of seven years. For Assessment Year 2001-02, in the return filed, assessee claimed entire sum as Revenue deduction. The assessee contended, during the proceedings that the amount paid facilitated its business and did not enhance or alter the fixed capital and ought to be treated as revenue expenditure. The AO, however, disallowed the deduction on account of non-compete fee, by order dated 19.03.2004, as according to him, it

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conferred a capital advantage of enduring value. The assessee's appeal was rejected by the CIT (Appeal) by order dated 02.09.2004. The CIT (Appeal) also rejected the alternative contention of the assessee, that the payment was for the further purposes of business and, therefore, the assessee could not claim depreciation.

3. Being aggrieved, the assessee appealed to the Tribunal. The Tribunal rejected the claim that the non-competing fee of Rs. 3 crores which was the subject matter of the appeal constituted revenue expenditure and that its treatment as such was justified. The reasoning of the Tribunal is as follows:

> *"The period of 7 years is quite long during which any new company can establish its reputation and a reasonable market share would have been acquired. Therefore, the payment made by the assessee to L and T Ltd. is not to increase the profitability, but to establish itself in the market and acquire market share. By keeping away L and T Ltd. from the same business, the assessee had visualized to acquire a good market share. The contention of the assessee that after a period of 7 years, L and T Ltd. would have entered in the same trade and, therefore, the expenditure should be treated as revenue in nature, we are not in agreement with thus arguments of the assessee. The payment has been made to ward off the competition for a period of 7 years during which any company could have set up its products and reputation in the market. Therefore, the expenditure cannot be treated to have been incurred in revenue field.*
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> *XXXXXX XXXXXX XXXXXX*
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> *In the case of assessee the payment of Rs.3 crores to L and T Ltd. has been made at the start of business of joint venture. Therefore, assessee's case will fall under the first test laid down*

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in CIT v. J.K. Synthetics Ltd. (supra) which describes that if expenditure is made for initial outlay or for the extension of business or a substantial replacement of equipment then it will fall under the capital expenditure.

(emphasis supplied)"

4. The Tribunal further rejected the appellant's claim for depreciation. It is submitted on behalf of the appellant/assessee that the Tribunal and the appellate Commissioner fell into error in holding that the amount of Rs.3 crores is non-competing fee, which constituted capital expenditure. In this regard, reliance was placed upon the judgment reported as *Empire Jute Co. Ltd. v. CIT* 124 ITR 1 (SC). It was submitted that even if expenditure is incurred for obtaining some advantage that may be enduring, nevertheless, be on the revenue account. It was emphasized by the assessee that not every advantage of enduring nature acquired by an assessee would result in a capital expenditure and that the material consideration is the nature of advantage as viewed in a commercial sense. Thus, mere facilitation of the trading operations of an assessee or its enabling management and conduct of its business so as to carry on more efficiently or more profitably, leaving the fixed capital untouched, would not amount to revenue expenditure. Learned counsel also relied upon the decision in *Alembic Chemical Works Co. Ltd. v. CIT, Gujarat* 177 ITR 377 (SC). The appellant's counsel placed heavy reliance on the judgment *CIT v. Madras Auto Service (P) Ltd.* 233 ITR 468 (SC) and submitted that the mere length of time during which an advantage is conferred as a result of the expenditure is not a determinative factor and that in these circumstances what the Court should really see is whether in the

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commercial sense, the expenditure is capital or revenue. Learned counsel relied upon the decision of the Bombay High Court in *CIT v. Excel Industries Ltd.* 122 ITR 995 (Bom); *Hindustan Times Ltd. v. CIT* 1980 (122) ITR 977 and *CIT v. Saw Pipes Limited* 208 CTR 476 (Del). The appellant next relied upon the decision of the Supreme Court in *CIT v. Coal Shipments P. Ltd.* 82 ITR 902 (SC) where it was held as follows:

> *"There are some other tests like those of fixed capital and circulating capital for determining the nature of the expenditure. An item of disbursement can be regarded as capital expenditure when it is referable to fixed capital. It is revenue when it can be attributed to circulating capital. It is not the case of any party that this test of fixed and circulating capital can be invoked in this case nor has reference been made to some of the other tests. The case which has been set up on behalf of the revenue is that, as the object of making the payments in question was to eliminate competition of a rival exporter, the benefit which enured to the respondent was of an enduring nature and, as such, the payment should be treated as capital expenditure. We find ourselves unable to accede to this contention because we find that the arrangement between the respondent and M/s. H.V. Low & Co. Ltd. was not for any fixed term but could be terminated at any time at the volition of any of the parties. Although an enduring benefit need not be of an ever-lasting character, it should not, at the same time, be so transitory and ephemeral that it can be terminated at any time at the volition of any of the parties. Any other view would have the effect of rending the word "enduring" to be meaningless. No cogent ground or valid reason has been given to us in support of the contention that, even though the benefit from the arrangement to the respondent may not be of a permanent or enduring nature, the payments made in pursuance of that arrangement would still be capital expenditure."*

5. It was also submitted that besides this consideration, another

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important factor which the Court should take into account is whether the expenditure results in capital asset. Special reliance was placed upon the decision of the Madras High Court in *CIT v. Late G.D. Naidu & Ors.* (1987) 165 ITR 63 (Mad) where the payments were made by the firm to the assessee for not carrying or competing with it for term-basis for five years. The High Court had there held that the expenditure was in the nature of revenue expenditure and no business had been acquired by payment of the amount. It was contended that likewise, in the present case, the non-competing fee in consideration of L&T not entering into the same business activity for a period of seven years. This did not create any capital asset and that expenditure merely facilitated the mere efficiency, profitability and conduct of the assessee's business; it was, therefore, deductible under Section 37(1).

6. It was next argued in the alternative that the Tribunal fell into error in concluding that the right to trade freely in the market is not an asset and does not qualify for depreciation under Section 32. Special reliance was placed on Section 32(1)(ii) which enables depreciation in respect of know-how, patent, copyright, trademark, licences, franchises or any other business or commercial rights of similar nature being intangible assets owned – wholly or partly by the assessee and used for the purpose of business. Learned counsel emphasized that once the Tribunal concluded that the assessee had acquired an advantage in the capital field, denial of depreciation under Section 32(1) amounted to inconsistent approach and clear error of law. Reliance was placed on the decision of the Supreme Court in *Techno Shares & Stocks Ltd. v. CIT* 2010 (327) ITR 323 (SC). The Supreme Court had ruled in that case that holding a membership card of the Bombay Stock

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Exchange amounted to acquiring an intangible asset which qualified for depreciation under Section 32(1)(ii). By parity, submitted counsel, the right acquired by the assessee, for itself, after payment of the non-competing fee was akin to license or other similar rights in which depreciation had to be given. Reliance was also placed upon the ruling in *CIT v. Hindustan Coco Cola Beverages P. Ltd. v. CIT* 2011 331 ITR 192 (Del) where it was held that intangible advantages or assets in the form of know-how, trade-style, goodwill etc. were depreciable assets.

7. In response, learned counsel for the Revenue contended that in order to determine whether a non-competing fee is an expenditure that confers capital advantage, one of the important considerations has to be whether the advantage is short-term or enures for a sufficiently long period. In this regard, particular emphasis was placed upon the decision in *Coal Shipments P. Ltd. (supra)* to the effect that a transient or a ephemeral benefit would not amount to a capital expenditure. Built on this, learned counsel emphasized that the assessee's own stand was that the non-competing fee was paid to stay-off competition by its erstwhile partner L&T for seven years. From a common sense or commercial angle, there can be no doubt that such payment did not merely facilitate conduct of business but in fact ensured that the assessee's market position and customer base was not threatened by competition from its erstwhile partner. This undoubtedly amounted to capital expenditure and had to be treated as such. Learned counsel relied upon the ruling in *Shankar Trading Tea Ltd. v. CIT (ITA No. 53/2000, decided on 09.07.2012).* Reliance was also placed upon the decision in *CIT v. Eicher Limited* 2008 (302) ITR 249.

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8. It was argued next that the question of permissibility of depreciation does not arise at all in this case because the business or commercial rights of similar nature referred to in Section 32(1)(ii) cannot be said to arise overnight on account of payment of non-competing fee. In any event, submitted counsel, the payment did not result in any intangible asset akin to patent or intellectual property right. Therefore, in view of the decision of this Court in *Hindustan Coco Cola Beverages P. Ltd.(supra)*, the non-competing agreement did not create asset or intangible nature or kind which qualified for depreciation.

9. It can be gathered from the previous discussion that the assessee claimed deduction, as revenue expenditure, the sum of Rs.3 crores, paid by it to L&T, towards non-competing fee. The agreement between the assessee and L&T by which the latter was not to compete with the assessee, was to subsist for seven years. This Court is conscious of the fact that the ruling in *Empire Jute Co.Ltd. (supra)* and *Alembic Chemical Works Co. Ltd. (supra)* have emphasized that a single test, i.e. whether the payment results in an enduring benefit cannot be conclusive in a decision as to whether an expenditure qualifies as one falling or in the capital field. Those decisions have emphasized the need to shift from an narrower field to a broader one, to ascertain the real nature of the advantage which a tax-payer would derive. The test now well-settled is one of ascertaining whether from the commercial angle, the advantage results in a capital field or does the expenditure fall legitimately within the revenue field. The decisions such as *Madras Auto Service (P) Ltd. (supra)* have no doubt emphasized that the length or duration of the benefit accruing to the assessee may at times be irrelevant. In that case, the Court was concerned with the duration of the

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lease. At the same time, even while accepting the contentions of the assessee, the Supreme Court had cautioned that if an advantage accrues in a short span of time or is "epheramal", it cannot be considered a capital benefit qualifying as a capital expenditure. Necessarily, therefore, the Court has to adopt a fact-based approach and apply settled proposition. In the present case, the advantage which the assessee/appellant derived on account of its agreement with L&T was that the latter, a previous joint-venture partner to the extent of 26% was kept put out of the market for a period of 7 years. In this context, the decision in *Blaze and Central (P) Ltd. v. CIT* 1979 (120) ITR 33, the decision of the Madras High Court is instructive. The assessee had entered into an agreement with one *Saraswati Publicities* by which the latter agreed to part with its business of film exhibition shots and not to compete with the assessee in business within a specified territory for nine years. The Supreme Court's decision in *Coal Shipments P. Ltd. (supra)* was relied upon and the High Court ruled that the assessee warded off business rivalry for nine years and also acquired business in a specified area and, therefore, the acquisition of business that generated income or the expenditure led out for fighting competition had to be treated as capital. The observations in *Eicher Limited (supra)* no doubt favour the assessee; however, this Court notices that the judgment recorded also noticed that "*it is not clear how long the restrictive covenants was to last but it was neither permanent or epheramal. In that sense, the advantage was not of an enuring nature.*" This Court in another decision, *Pitney Bowes India (P) Ltd. v. CIT* 204 Taxman 333 (Del) held that the expenditure of Rs. 5,94 crores made an non-competing fees for a limited period of 5 years to a distributor not to enter into agreements with other concerns, paid at the time of acquisition of

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business from its erstwhile manager as acting concern, requiring the previous management not to enter into identical business. The Court had held that the deduction towards non-competing fee could not be allowed as it conferred a capital advantage.

10. In the present case, the appellant is a joint-venture between M/s. Sharp & L&T. Apparently, the agreement entered into with the L&T in view of the changed relationship ensures that the latter does not enter into the same business. Although it is contended that the advantage is only by way of facilitation of the appellant's business and ensuring greater efficiency as well as profitability, on the other side, what can be seen is that the arrangement is to endure for a substantial period, i.e. 7 years. Coupled with the fact that the L&T has its own presence in consumer goods sector and would be, if it chooses – able to put up an effective competition for business engaged in by the assessee, there is no doubt that the amount is to ensure a certain position in the market by keeping-out L&T. Applying the test indicated in the *Empire Jute Co. Ltd.(supra)*, *Alembic Chemical Works Co. Ltd. (supra)* and *Coal Shipments P. Ltd. (supra),* this Court is the opinion that the deduction cannot be claimed as a revenue expenditure; it clearly falls within the capital field. The first two questions are, therefore, answered against the assessee and in favour of the Revenue.

Q. Nos. 2 and 3 *In Tangible Asset –*

11. This question arose as a direct sequel to the appellant's alternative submission that if the expenditure is treated as a conferring capital advantage, necessarily they are depreciable. The appellant claims for depreciation of "know-how", "patents", "copyrights", "trademarks", "licenses", "franchises" or other business or commercial rights of similar

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nature being intangible assets acquired on or after 1st day of April 1998. Arguing by analogy, learned counsel for the appellant relied upon the judgment of the Supreme Court in *Techno Shares & Stocks Ltd. (supra)* where the issue was whether the contention of the assessee that it could claim depreciation on the Bombay Stock Exchange Membership Card held by it on the plea that it was a license or "business or commercial right of similar nature" was upheld. The appellant also relied upon the decision of this Court in *Hindustan Coco Cola Beverages P. Ltd. (supra)* and the judgement of the Kerala High Court in *B. Ravindran Pillai v. CIT* 332 ITR 531 (Ker). As would be evident from Section 32(1)(ii), depreciation can be allowed in respect of intangible assets. Parliament has spelt-out the nature of such assets by express reference to 'know-how', 'patents', 'copyrights', 'trademarks', 'licenses' and 'franchises'. So far as patents, copyrights, trademarks, licenses and franchises are concerned, though they are intangible assets, the law recognizes through various enactments that specific intellectual property rights flow from them. Licenses are derivative and often are the means of conferring such intellectual property rights. The enjoyment of such intellectual property right implies exclusion of others, who do not own or have license to such rights from using them in any manner whatsoever. Similarly, in the matter of franchises and know-how, the primary brand or intellectual process owner owns the exclusive right to produce, retail and distribute the products and the advantages flowing from such brand or intellectual process owner, but for the grant of such know-how rights or franchises. In other words, out of these species of intellectual property like rights or advantages lead to the definitive assertion of a right *in rem.* The decisions of this Court in *Hindustan Coco Cola Beverages P. Ltd.*

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(supra) and that of the Kerala High Court in *B. Ravindran Pillai (supra)* underlined that goodwill is also a species of depreciable right which can claim the benefit of Section 32. Those decisions were based on the ruling of the Supreme Court in *CIT v. B.C. Srinivasa Setty* 1981 (128) ITR 294 (SC) and subsequent cases which have ruled that goodwill is a depreciable capital asset. So far as the decisions in *Techno Shares & Stocks Ltd. (supra)* is concerned, the Supreme Court clearly limited its holding that the right to membership of Stock Exchange is in the nature of "any other business or commercial right" which was an intangible asset as is evident from the following observations:

> *"Before concluding we wish to clarify that our present judgment is strictly confined to the right to membership conferred upon the membership under the BSE Membership Card during the relevant assessment years. We hold that the said right to membership is "business or commercial activity" which gives a non-defaulting continuing membership and right to access Exchange and to participate therein and in that sense it is a license or akin to a license, in terms of Section 32(1)(ii)......."*

12. It is, therefore, apparent that the ruling in *Techno Shares & Stocks Ltd. (supra)* was concerned with an extremely limited controversy, i.e. depreciability of stock exchange membership. This Court observes that such nature was held to be akin to a license because it enable the member, for the duration of the membership, to access the Stock Exchange. Undoubtedly, it conferred a business advantage and was an asset which and was clearly an intangible asset. The question here, however, is whether a non-compete right of the kind acquired by the assessee against L&T for seven years amounts to a depreciable intangible asset. As discussed earlier, each of the species of

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rights spelt-out in Section 32(1)(ii), i.e. know-how, patent, copyright, trademark, license or franchise as or any other right of a similar kind which confers a business or commercial or any other business or commercial right of similar nature has to be "intangible asset". The nature of these rights mentioned clearly spell-out an element of exclusivity which enures to the assessee as a sequel to the ownership. In other words, but for the ownership of the intellectual property or know-how or license or franchise, it would be unable to either access the advantage or assert the right and the nature of the right mentioned or spelt-out in the provision as against the world at large or in legal parlance "*in rem".* However, in the case of a non-competition agreement or covenant, the advantage is a restricted one, in point of time. It does not necessarily – and not in the facts of this case, confer any exclusive right to carry-on the primary business activity. The right can be asserted in the present instance only against L&T and in a sense, the right *"in personam"*. Indeed, the 7 years period spelt-out by the non-competing covenant brings the advantage within the public policy embedded in Section 27 of the Contract Act, which enjoins *a contract in restraint of trade would otherwise be void*. Another way of looking at the issue is whether such rights can be treated or transferred – a proposition fully supported by the controlling object clause, i.e. intangible asset. Every species of right spelt-out expressly by the Statute – i.e. of the intellectual property right and other advantages such as know-how, franchise, license etc. and even those considered by the Courts, such as goodwill can be said to be alienable. Such is not the case with an agreement not to compete which is purely personal. As a consequence, it is held that the contentions of the assessee are without merit; this question too is answered against the appellant and in favour of the

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Revenue.

13. For the above reasons, this Court is of the opinion that the words "similar business or commercial rights" have to necessarily result in an intangible asset against the entire world which can be asserted as such to qualify for depreciation under Section 32(1)(ii) of the Act.

14. In view of the above discussion, the Court is of the opinion that the appeal is meritless and has to fail. It is accordingly dismissed.

S. RAVINDRA BHAT
(JUDGE)

R.V. EASWAR
(JUDGE)

NOVEMBER 05, 2012

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