NON-COMPETE FEE AND ITS TAX IMPLICATIONS

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Introduction

Non-Compete Fees are described as, in business jargon, certain contracts have a clause that forbids a person or business from going up against another, particularly a former employer or business partner, without paying a charge. In industry jargon, these costs are referred to as non-compete fees.

In today's business world, non-compete clauses are widely used. Under various regulations, non-compete fees may have a significant impact on how a business operates in general. The impact under these restrictions, particularly under the income-tax laws, should be considered by both the payor and payee of non-compete payments. Although the tax treatment of non-compete fees is sufficiently clear in the recipient's hands, the tax authorities have not yet provided the necessary guidance on how these fees should be treated in the recipient's hands.

Definition

According to Section 2(14), a capital asset is any type of property, whether or not it is related to the appellant's business or profession, with the exception of stock-in-trade and some types of moveable property retained for personal use.

Business goodwill, trade names, brand recognition, the ability to manufacture, produce, or process any item, the ability to practise any trade or profession, tenancy rights, and stage carriage licences are examples of capital assets.

Capital gains must be considered when transferring capital assets, and depending on how long the transferor had the capital asset, profits or gains may be taxed as long-term or short-term capital gains.

Short-term capital gains for corporations are assessed on assets held for less than 36 months, whereas assets maintained for more than 36 months are subject to tax under long term capital gains @ 20%.

The Income Tax Act merely offers examples of capital and business receipts without defining them. The distinction is important when figuring out the non-compete fee's applicable tax rate.
Business income is taxed at a rate of 30% for Indian corporations and at a rate based on the applicable tax slabs for individuals. For separating capital and business receipts, there are no fixed criteria or standards.

In general, courts have ruled that if the appellant has lost their source of income, their compensation must be a capital receipt. The tax authorities should limit their consideration in these situations to taxing non-compete fees as capital gains rather than as business receipts as defined by Section 28(va).

Taxation of Non-Compete Fee

A non-compete agreement that seeks to prevent a former employee, a business vendor, or any other person connected to the business from disclosing information, taking similar employment, etc., is taxed under at least three provisions of the Income Tax Act, 1961 (the IT Act).

According to **Section 17(3)(iii)**, which went into force on April 4, 2002, any money received by an appellant from anyone, whether before beginning employment with them or after ending their job with them, would be subject to taxation as profits in lieu of salary.

According to **Section 28(va)**, which went into effect on April 4, 2003, any payment made in exchange for refraining from engaging in any business or profession-related activity or from disclosing intellectual property rights, technical information, or other information that is likely to help in the production of goods or the provision of services will be taxed unless it is treated as capital gains.

Any compensation or other payment that is due to or received by any person, regardless of name, in connection with the termination of his employment or the modification of the terms and conditions would be taxable as income from other sources, according to **Section 56(2)(xi)**, which was introduced with effect from 1-4-2019. But if such a payment is received or owed by the employer or former employer, it would be taxable as profit in lieu of salary U/s.17(3)(1).

Judicial Inferences

In ***Ramesh D. Tainwala v. ITO, ITAT Mumbai, ITA No. 3853/MUM/2010 (AY 2007-08)***, the appellant promoters of Tainwala Polycontainers Ltd., a business involved in the manufacture and marketing of polyethylene containers, entered into a share purchase agreement for the transfer of their controlling shareholding interest and business operations to Time Packaging Ltd., a different business involved in a related industry. The agreement required the promoters to refrain from directly or indirectly doing any competitive activity for a period of 11 years, and a separate payment of INR 40 million was designated as a non-compete fee. While the AO taxed the non-compete fee as business income in accordance with Section 28(va), the appellant viewed the non-compete charge as a capital receipt and requested a tax exemption.

Before ITAT, the appellant contested AO's decision and argued that the non-compete fee constituted remuneration for giving up a source of income and should be viewed as a capital receipt. Alternately, it was proposed that tax liability, if any, be assessed as capital gains under Section 45 by considering non-compete agreement as a component of share sale. The AO claimed that after 2003, any payment received for refraining from engaging in any business-related activity was subject to taxation as business income under Section 28(va), thereby covering the non-compete fee.

According to ITAT, Section 28(va) addresses whether non-compete payments are taxable, and tax is only calculated as capital gains when any money is received for the transfer of a right to operate a business. According to its clarification, non-compete consideration can either be a capital or revenue receipt, depending on whether the fee is compensation paid with the source of income being intact or paid to sterilise it. In the first scenario, it would be taxable as a business receipt under Section 28(va), whereas in the second, the consideration would be of a capital type, necessitating an assessment under Section 45.

In addition, ITAT noted that despite being a part of the main agreement, the non-compete clause stood alone. Unless it can be proven that the limitation is a necessary component of the transfer, there will be no transfer of the right to operate a business and, as a result, no capital gains. In light of this, ITAT decided that the current case constituted a transfer of shareholding and that a non-compete clause was not a necessary part of that transaction. As a result, Section 28(va) of the tax code applied to the non-compete fee as business income.

Since the stockholders in this judgement are promoters and were genuinely in charge of running the company's business, it differs from the case. The promoters "actually" ran the business as a result, not only had the legal right to. As a result, the non-compete clause included a restriction on carrying out business and taxed under Section 28(va).

According to ITAT Mumbai, ***Sunderraj Srinivasan v. ITO 35(3)(4), ITA/7243/Mum/2016***, ITAT Mumbai, Order dated 13-1-2020, followed ITAT Bangalore in **M.G. Mohan**. In contrast, the High Court of Bombay held in ***Arun Toshniwal, Mumbai v. Deputy Commissioner of Income-tax 1(3), - 2015-TIOL-929-HC-MUM-IT*** that a non-compete fee cannot be a capital receipt because the appellant was receiving compensation for what he would have otherwise been able to earn as a revenue receipt.

The payment of a non-compete fee was a non-taxable capital receipt, as determined in ***Guffic Chem Private Limited v. CIT [2011] 332 ITR 602 (SC)***. Additionally, it was determined in that case that the change to section 28 (va) of the Act, which became effective on 1 April 2003 and made non-compete fees taxable as business income, was amendatory and not clarificatory, and as a result, could not be applied retrospectively to years earlier.

The established rule that economic expediency must be evaluated from the viewpoint of a sensible businessman and not from that of the Revenue has been reiterated by the Supreme Court.

Conclusion

A string of decisions has ruled that the Income-tax Department cannot wade into the murky waters of what constitutes reasonableness of amounts paid and that commercial expediency must be assessed from the perspective of the taxpayer.

There is no one formula that will work in all circumstances because the courts are divided. When deciding on the deal structure, the parties to the transaction must take several factors into account. When deciding whether a non-compete fee should be taxed as business income at a higher rate under Section 28(va), factors such as the nature of the transaction, the parties' contractual intent, the impact on the source of income, and the identity of the person operating the business are important to consider.