

Non-compete fees allowable as revenue expenditure – Supreme Court Ruling

The issue whether non-compete fees should be treated as revenue expenditure or capital expenditure has always been litigative, with divergent views taken by various High Courts. The Delhi High Court in the case of *Sharp Business System v CIT*¹ has held that, non-compete fees paid to restrain a competitor or a potential competitor from operating in same business segment, constituted a capital expenditure but did not result in a depreciable intangible asset under Sec. 32(1)(ii) of the Act.

In a batch of appeals before the Hon'ble Supreme Court (SC)², comprising of the aforesaid Delhi High Court decision and contrary decisions of other High Courts³, the SC has reversed the decision of Delhi Court to hold that non-compete fees is allowable as revenue expenditure u/s. 37(1) of the Act. As regards the remaining appeals, the matters are remanded back to the respective ITATs and all appeals/ cross-appeals filed, are directed to be revived by allowing assessee to take additional ground(s) to be heard afresh having regard to the ratio laid down in this judgment.

Facts

1. The assessee is a joint venture of M/s Sharp Corporation, Japan (Sharp) and M/s Larsen and Toubro (L&T). It is engaged in business of importing, marketing and selling electronic office products and equipment in India.
2. During the assessment year, the assessee paid non-compete fees to L&T with the agreed condition that L&T shall not engage in or assist any competing business in India for seven years. The assessee claimed this payment as a deductible revenue expenditure u/s. 37(1) of the Act.
3. In the course of appellate proceedings, an alternative ground was placed by the assessee that if the non-compete fee was treated as capital expenditure, then the benefit of depreciation should be given u/s. 32(1)(ii) of the Act. CIT(A) and ITAT affirmed the decision of Assessing Officer.
4. The assessee filed appeal before Delhi High Court wherein the Court held that, while non-compete fees is capital expenditure, it does not result in a depreciable intangible asset. The Court observed that the non-compete right was not a "business or commercial right" within the meaning of Section 32(1)(ii) of the Act.

¹ 254 CTR 233

² [2025] 181 taxmann.com 657 (SC)

³ Arising from judgments of Pentasoft Technologies Ltd [Madras HC] and Piramal Glass Ltd [Bom HC]

5. The other connected appeals arose from judgements of Madras HC and Bombay High Court wherein such non-compete fees was held as an intangible asset eligible for depreciation allowance u/s. 32(1)(ii).

Contentions by Sharp Business System (Assessee) – Non-compete fees is a revenue expenditure

1. Non-compete fee is an allowable revenue expenditure u/s. 37(1) since all conditions under the section are met viz;
 - the expenditure is incurred wholly and exclusively for business,
 - it is not personal in nature and;
 - it is not covered by Sec. 30 to 36 of the Act.
2. Payment of non-compete fee was not made to eliminate competition or create a monopoly but only to run the business more efficiently and profitably. Accordingly, it did not result in asset creation.
3. The benefit arising from restriction of a competitor or potential competitor in business is of an enduring nature, but not in the capital field since fixed assets are not affected.
4. Reliance was placed on Supreme Court's decision of Empire Jute Co. Ltd.⁴ and Madras Auto Service (P) Ltd⁵ to contend that an expenditure incurred for carrying on the business more efficiently or profitably without addition to the profit earning apparatus should be allowable as revenue expenditure.

⁴ 124 ITR 1 (SC)

⁵ 233 ITR 468 (SC)

5. The assessee further relied on Coal Shipments (P) Ltd to assert that – it is the **nature of benefit**⁶ arising from an expenditure which is relevant to determine its treatment as capital or revenue, regardless of whether the benefit is enduring or not.

Alternative Argument

6. The assessee placed an alternative argument that, if the payment is construed to be a capital expenditure, depreciation should be allowed u/s. 32(1)(ii).

In this regard, to support its interpretation of 'intangible asset' u/s. 32(1)(ii), the assessee relied on Techno Shares & Stocks Ltd. v. CIT⁷ [SC] wherein it was held that, membership card of BSE is in nature of license to trade and hence a depreciable intangible asset u/s. 32.

Contentions by Piramal Glass Ltd. (Assessee) – Non compete fees are depreciable intangible assets

1. Sec. 32(1)(ii) of the Act provides for depreciation on intangible assets owned and used for the purpose of business and profession. As per explanation 3 (b) to Sec. 32(1), the definition of intangible assets can be dissected into 2 categories- (i) intellectual property rights like know-how, patents, copyrights, trademarks, licenses, franchises (specific category); (ii) 'any other business or commercial rights of similar nature' (general category).

⁶ Bold and underlined for emphasis

⁷ 327 ITR 323 (SC)

Applying the principle of *ejusdem generis*⁸, non-compete rights emanating from commercial arrangements fall under the general category, which is similar to the specific category of intangible assets. In the present case, the common element to be considered for *ejusdem generis* is that both categories of intangible assets are species of the same genus – 'intangible assets', without further distinction on nature of rights conferred by such intangible assets.

2. The distinction of rights as rights in rem⁹ and rights in personam¹⁰ brought out by Delhi High Court is irrelevant for allowability of depreciation claims as the specific category of intangible assets confer both such rights under relevant statutes.
3. Classification of rights into positive and negative rights is not relevant for allowability of depreciation claim as a negative covenant (non-compete), gives a positive commercial advantage to the payer, enabling business expansion.

Further, the legislature inserted Sec. 28(va) by Finance Act 2002 to tax non-compete receipts without distinguishing such receipts into positive or negative rights.

4. Depreciation should apply even if the asset is "passively used" i.e. enforcing the right by restraining

competitors in the same business segment.

Revenue's Contentions

1. Payment of non-compete fee is a capital expenditure, not allowable u/s. 37(1) since it creates an enduring advantage.
2. Non-compete fees results in an intangible asset however it is not eligible for depreciation.
3. The expression 'any other business or commercial rights of similar nature' does not constitute a separate category. It is to be read along with the preceding specific category of intangible assets which are distinct class of positive rights capable of being used or put to use. Accordingly, non-compete fees being negative rights are not covered by the expression 'any other business or commercial rights of similar nature'.
4. Only positive rights can be owned and/or used unlike negative covenants which exist but are incapable of being owned and/or used, whether actively or passively. Consequently, the test of 'ownership' and 'useability' is not met by the assessee.

⁸ Rule of statutory interpretation – where general words follow specific words, the general words are interpreted to include only things similar to the specific ones listed.

⁹ Legal right enforceable against the entire world

¹⁰ Legal right enforceable only against a specific individual or group, not against the world

Issue before Supreme Court

1. Core issue – Whether non-compete fee paid by the assessee is a revenue expenditure or capital expenditure?
2. Corollary question to core issue – If the expenditure is construed to be capital in nature, whether it is entitled to depreciation under Section 32(1)(ii) of the Act?

Supreme Court Ruling

On the aspect of nature and character of non-compete fee, the Apex Court held that such payment did not result in creation of new asset. It only sought to protect or enhance the profitability of the business. The enduring advantage, if any, by restricting a competitor in business, was not in the capital field. Accordingly, SC concurred with the contentions of the assessee that non-compete fees paid to restrain competition in same business segment is a revenue expenditure u/s. 37(1) of the Act.

Further, the Court made a detailed analysis of its own decisions on the issue and observed as under -

1. Expenses for running business efficiently are revenue, while those altering its structure are capital.
2. Expenses resulting in enduring benefits can be revenue in nature if they are incurred only to facilitate business operations, enhance profitability without adding to profit-making apparatus.
3. 'Once-for-all' payments and enduring benefits are not conclusive tests to

determine nature of expenditure as revenue or capital. The commercial reality and purpose of expenditure must be considered.

4. Payments made to avoid competition, where monopoly is not created are revenue in nature.

Our Comments**Impact of the decision**

1. Supreme Court has taken a simplistic view of the matter and held that any non-compete fees would be allowable as revenue expenditure and not caveated based on years of non-compete.
2. For cases where from Year 1, assessee claimed depreciation on non-compete fee, as an intangible asset, the matter has been restored back to Tribunal, to allow fresh ground to be taken for claiming the non-compete fees as revenue expenditure. This will lead to undoing depreciation claim in all subsequent years.

By allowing the expenditure, it may result into business loss, which has 8 years finite time limit for carry forward, instead of unabsorbed depreciation, which would have allowed infinite time limit and also allowed set off against income from any head, except salaries, in subsequent years.

3. Separately, in one connected SLP, it reaffirmed principle of S.A. Builders¹¹ on allowability of interest on borrowed funds based on commercial expediency.

¹¹ 288 ITR 1 [SC]

Disclaimer:

This document is intended to provide certain general information and should not be construed as professional advice. It should neither be regarded as comprehensive nor sufficient for the purposes of decision making. The firm does not take any responsibility for accuracy of the document nor undertakes any legal liability for any of the contents in this document. Without prior permission of the firm, this document may not be quoted in whole or in part or otherwise.