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* **HIGH COURT OF DELHI : NEW DELHI**

\+ **ITA No. 611 of 2007**

Judgment reserved on: January 10, 2008

% Judgment delivered on: March 20, 2008

Rohitasava Chand
B-19, Defence Colony
New Delhi-110024. …Appellant
Through Mr. B. Gupta with Mr. R.K. Chaufla, Advocates

Versus

Commissioner of Income Tax
New Delhi. …Respondent
Through Ms. Prem Lata Bansal, Advocate

Coram:

HON'BLE MR. JUSTICE MADAN B. LOKUR
HON'BLE MR. JUSTICE V.B. GUPTA

1. Whether the Reporters of local papers may be allowed to see the judgment? Yes
2. To be referred to Reporter or not? Yes
3. Whether the judgment should be reported in the Digest? Yes

MADAN B. LOKUR, J.

The Assessee is aggrieved by an order dated 19th January, 2007 passed by the Income Tax Appellate Tribunal, Delhi Bench 'B' in ITA No.4713 (Del)/2003 relevant for the assessment year 2000-2001.

2. After hearing learned counsel for the parties, we admit this appeal and frame the following substantial question of law for consideration:

> "Whether the Income Tax Appellate Tribunal was correct in law in holding that the non-compete fee received by the Assessee in terms of the agreement dated 4th December, 1997 was a capital receipt in the hands of the Assessee?"

Filing of paper books is dispensed with.

3. The Assessee was a shareholder and a Director in a company called IIS Infotech Ltd. He entered into two agreements dated 4th December, 1997 with F.I. Group Plc, U.K. (hereinafter referred to as the 'foreign company'). By one agreement, the Assessee agreed to sell all his shares in IIS Infotech Ltd. and by the other agreement, the Assessee agreed that till 31st May, 1999 he would not take up any business activity relating to software development in all the seven companies/organizations in which he was a director, major shareholder or a member since his expertise in the matter may adversely affect the business of the foreign company. For convenience, the second agreement is referred to as the "non-compete agreement".

4. The relevant terms of the non-compete agreement are as follows:

> "2.1 Save in relation to a potential breach of Article (b) as otherwise disclosed to the Covenantee and accepted by the Covenantee in writing from time to time provided however such acceptance shall not be unreasonably withheld by the Covenantee, the Covenantor shall not for the period up to May 31, 1999 directly or indirectly, either alone or jointly with or on behalf of any person, firm, company or entity and whether on his own account or as principal, partner, shareholder (unless such shareholding is less than 10% of the issued share capital of the company concerned and is held by way of bona fide investment only), director, employee, consultant or in any other capacity whatsoever:
>
> (a) solicit or interfere with or endeavor in the Relevant Territory to entice away from the Covenantee Group any person, firm, company or entity who was a client or customer of the Covenantee Group in relation to the Relevant Business in the months (12) prior to the Completion Date or becomes a client or customer of the Covenantee Group in relation to the Relevant Business prior to May 31, 1999;
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> (b) be concerned with the supply of services or products in the Relevant Territory to any person, firm, company or entity which is or was a client or customer of the Covenantee Group in relation to the Relevant Business in the months (12) prior to the Completion Date or becomes a client or customer of the Covenantee Group in relation to the Relevant Business prior to May 31, 1999 where such services or products are identical or similar to or in competition with those services or products supplied by the Covenantee Group;
>
> (c) solicit or interfere with or endeavor in the Relevant Territory to entice away from the Covenantee Group any person, firm, company or entity who is was a supplier of services or goods to the Covenantee Group in relation to the Relevant Business in the months (12) prior to the Completion

Date or becomes a supplier of services or goods to the Covenantee Group in relation to the Relevant Business prior to May 31, 1999;

(d) offer to employ or engage or solicit the employment or engagement of any person who, at the time of, or immediately prior to the date of, making an order to employ or engage or solicitation, was an employee of the Covenantee Group, provided that nothing contained herein shall prevent the Covenantor from making an offer to employ or engage his personal staff such as secretary, personal assistant or driver;

(e) save as consistent with the provisions of any agreement entered into with the Company, represent himself as being in any way connected with or interested in the business of the Covenantee Group;"

5. In terms of the non-compete agreement, the Assessee was required to be paid an amount of Rs.1,07,36,570/- as the first installment and a sum of Rs.1,26,25,940/- as the second installment towards non-compete fees. The Assessee received the first installment of Rs.1,07,36,570/- in the period relevant to the assessment year 1998-99. According to the Assessing Officer, this was a capital receipt as stated by the Assessee in his return.

6. When the Assessee received the second installment of Rs.1,26,25,940/- in the previous year relevant to the assessment year

2000-2001 he relinquished the office of Director of IIS Infotech Ltd. and also transferred all his shares in IIS Infotech Ltd. to the foreign company.

7. In respect of the assessment year 2000-2001, the Assessee again claimed the receipt as a capital receipt and this was accepted by the Assessing Officer. Later on, however, the Assessing Officer initiated re-assessment proceedings by issuing a notice to the Assessee under Section 148 of the Income Tax Act, 1961 (for short the Act).

8. In the reassessment order, the Assessing Officer did not accept the contention of the Assessee that the second installment received by him was a capital receipt. The following facts (as mentioned in the order of the Tribunal) were taken into consideration by the Assessing Officer in coming to this conclusion:

(i) The Assessee was not carrying on the business of software and, thus, there was no question of putting any embargo on him from carrying on software business by paying him non-compete fees;

(ii) There was no loss to the Assessee for which he was required to be compensated in any manner;

(iii) The Assessee was not doing any business in the line of computer software, it was only his employer that was doing

this business, and

(iv) The question whether a particular receipt is capital or revenue in nature is largely a question of fact.

9. Feeling aggrieved, the Assessee preferred an appeal before the Commissioner of Income Tax (Appeals) [CIT (A)]. With regard to reopening of the assessment, the CIT (A) came to the conclusion that the assessment order had been validly reopened and that the principles of res judicata would not apply to the facts of the case. On merits, the CIT (A) set aside the assessment order and came to the conclusion that since the non-compete agreement was valid only for 1½ years and that too in some limited jurisdictions, it was not really in the nature of a non-compete agreement. He was of the view that the main reason behind signing the non-compete agreement was not to put restrictions on the Assessee but to compensate him and he, therefore, held that the amount received by the Assessee towards the second installment was in fact a capital receipt.

10. In the appeal filed by the Revenue, the Tribunal agreed with the view expressed by CIT (A) on the question of reopening the assessment. Feeling aggrieved, the Assessee has preferred this appeal

before us under Section 260-A of the Act. On 10th July, 2007, we heard learned counsel for the Appellant but were not inclined to issue notice on the correctness of the assessment being reopened.

11. On the merits of the case, the Tribunal was of the view that the second installment received by the Assessee represented a revenue receipt in his hands. We are required to consider only the correctness of this conclusion arrived at by the Tribunal.

12. At the outset, it needs to be appreciated that the Assessee was a Director and an employee in IIS Infotech Ltd. It is true that he was also a shareholder but he transferred all his shares in favour of the foreign company by an agreement other than the non-compete agreement. In terms of the non-compete agreement, the prohibition in respect of the Assessee was with regard to software development and that pertained to his activity in IIS Infotech Ltd. and the six other companies in which he was a director or a shareholder or a member.

13. According to the Tribunal, there was no increase in the profit making apparatus of the Assessee. Indeed, the Assessee did not own

any profit making apparatus. He was not carrying on any business on his own but was merely an employee of IIS Infotech Ltd. In regard to this company, the Assessee had resigned as its Director and transferred his shares to the foreign company and, therefore, had nothing further to do with IIS Infotech Ltd. In so far as the other six organizations are concerned, it appears that the Assessee had agreed not to carry on his activity of software development in these companies also in which he was a director, shareholder or member. In essence, therefore, the non-compete agreement was consideration paid to the Assessee for loss of his office as a Director and shareholder of IIS Infotech Ltd. leaving him free to carry out his other employment but without being involved in software development. Payment for loss of office was held by the Tribunal to be a revenue receipt and not a capital receipt.

14. In our opinion, the Tribunal has approached the issue from an incorrect legal standpoint and a narrow interpretation of the non-compete agreement. As such, a substantial question of law arises for consideration.

15. Among the first few cases on the subject of a restrictive

covenant or a non-compete agreement is the decision of the Supreme Court in ***Commissioner of Income Tax v. Best & Co. (Pvt). Ltd., [1966] 60 ITR 11***. In that case, the assessee was paid, as a result of a restrictive covenant, some compensation to refrain from selling or accepting any business which would compete with the business of the covenantor. The question was whether the compensation received for the non-compete agreement is a revenue receipt. The Supreme Court observed as follows:

> "The next question is whether that part of the compensation attributable to the restrictive covenant is a capital receipt or a revenue receipt.
>
> The House of Lords in Beak (H.M. Inspector of Taxes) v. Robson ([1942] 25 T.C. 33.), had to consider, whether compensation paid for a restrictive covenant was a capital receipt or a revenue receipt. Under a service agreement the respondent therein covenanted in consideration of the payment to him of sterling pounds 7,000 on the execution of the agreement, that if the agreement were determined by notice given by him or by his breach of its provisions, he would not compete directly or indirectly with the company within a radius of fifty miles of its place of business until the five years had expired. The House of Lords held that the said amount was a payment for giving up a right wholly unconnected with his office and operative only after he ceased to hold that office and, therefore, it was not taxable under Schedule E of the Income-tax Acts.
>
> This Court in ***Gillanders Arbuthnot and Co. Ltd. v. Commissioner of Income-tax, Calcutta [1964] 53 ITR 283*** accepted the said principle and held that the compensation paid for agreeing to refrain from carrying on competitive

> business in the commodities in respect of the agency terminated or for loss of goodwill was prima facie of the nature of a capital receipt.
>
> In the present case, the covenant was an independent obligation undertaken by the assessee not to compete with the new agents in the same field for a specified period. It came into operation only after the agency was terminated. It was wholly unconnected with the assessee's agency termination. We, therefore, hold that that part of the compensation attributable to the restrictive covenant was a capital receipt and hence not assessable to tax."

16. In ***Commissioner of Income Tax v. Saraswathi Publicities, [1981] 132 ITR 207*** the question was the nature of compensation received under an agreement to refrain from carrying on competitive business. One of the findings in ***Saraswathi*** was that no business was taken over or acquired of the assessee. On this basis, the Madras High Court considered the law applicable to restrictive covenants and receipts in connection therewith. After discussing the law laid down in ***Best & Co.*** and ***Gillanders Arbuthnot*** it was held by the Madras High Court that the compensation paid was a capital receipt and not liable to income tax. This is how the Madras High Court dealt with the two decisions:

> After considering the agreement in the case in ***CIT v. Best and Co. (P.) Ltd.***, the Supreme Court held that the compensation agreed to be paid was not only in lieu of the giving up of the agency but also for the assessee accepting a

> restrictive covenant for a specified period. As far as the loss of agency was concerned, it was only a normal trading loss and the income received on that account was only a revenue receipt. But, with reference to the loss on account of the restrictive covenant, after referring to the decision in ***Gillanders Arbuthnot and Co. Ltd. v. CIT*** the Supreme Court reiterated that the restrictive covenant was an independent obligation undertaken by the assessee not to compete with the new agent in the same field and that part of the compensation attributable to the restrictive covenant was a capital receipt, not assessable to tax. As to how the compensation was to be apportioned was left to be determined by the assessing authorities."

17. The Madras High Court noted that the cases decided by the Supreme Court fell into two categories: the first category consisting of those cases where there is a mere loss of a trading agency of a company which has a number of such agencies while the second category refers to those cases where the receipt is not for the loss of an agency but for certain restrictive covenants preventing the assessee from carrying on business to that extent. On the facts of the case, it was held that ***Saraswathi Publicities*** fell in the second category and the amounts received by it amounted to a capital receipt.

18. In ***Commissioner of Income Tax v. Late G.D. Naidu, [1987] 165 ITR 63*** payment was received pursuant to a restrictive covenant and

the question was whether it was a revenue receipt. The Madras High court followed its earlier view and held that compensation received in respect of a restrictive covenant is not taxable as it is a capital receipt.

19. In ***Commissioner of Income Tax v. Saroj Kumar Poddar, [2005] 279 ITR 573***, the assessee had acquired considerable knowledge and expertise in the field of manufacture of shaving blades and other products with special reference to the manufacturing process, sources of raw materials and the marketing of the products of Gillette. On 18th January, 1996, Gillette entered into a non-compete agreement with the assessee wherein the facts relating to the expertise of the assessee were mentioned and thereafter the assessee undertook, on receipt of consideration of Rs.18 million, that he would not engage himself in any business relating to the manufacturing, marketing or distribution of razors, razor blade, shaving systems or shaving preparations.

20. On these facts, the question before the Calcutta High Court was whether the payment under the non-compete agreement is a colourable device to earn some income since the assessee did not sell any assets. After considering the case law, the Calcutta High Court

came to the conclusion that the non-compete agreement entered into between the assessee and Gillette resulted in a payment to the assessee which was in the nature of the capital receipt.

21. In ***Commissioner of Income Tax v. A.S. Wardekar, [2006] 283 ITR 432***, the assessee received a sum of Rs.1.75 crores for entering into a restrictive covenant of not entering into a competing business with the United Breweries Group for a period of five years. Referring to and relying upon ***Saroj Kumar Poddar***, the question was answered in favour of the assessee by holding that the amount received by the assessee for entering into a restrictive covenant of not entering into a competitive business was a receipt by the assessee of a capital nature and thus not liable to tax.

22. On the other hand, in ***Tam Tam Pedda Guruva Reddy v. Joint Commissioner of Income Tax, [2007] 291 ITR 44***, the question before the Karnataka High Court related to an agreement whereby the assessee agreed not to compete with Tam Tam Pedda Guruva Reddy Constructions (P) Ltd. within the local limits of Turuvekere, Tumkur and Kunigal for a period of five years. In consideration of this

covenant, the assessee was paid a sum of Rs.8 lakhs by way of compensation. The Karnataka High Court referred to ***Saraswathi Publicities*** and ***A.S. Wardekar*** but concluded, on the facts of the case, that the amount received was not a capital receipt but a revenue receipt.

23. The various decisions that we have referred to above show that the law is quite well settled that where an amount is received by way of compensation under a restrictive covenant or under a non-compete agreement, it would amount to a capital receipt in the hands of the recipient but a lot would depend on the agreement entered into between the parties. This being the position, it is necessary to take note of the relevant clauses of the agreement that we are concerned with.

24. There is no doubt that the non-compete agreement incorporates a restrictive covenant on the right of the Assessee to carry on his activity of development of software. It may not alter the structure of his activity, in the sense that he could carry on the same activity in an organization in which he had a small stake, but it certainly impairs the carrying on of his activity. To that extent it is a loss of a source of income for him and it is of an enduring nature, as contrasted with a

transitory or ephemeral loss. During the currency of the non-compete agreement, the Assessee was restrained from soliciting, interfering, engaging in or endeavouring to carry on any activity, including supply or services or goods concerning software development. The non-compete agreement was independent of the first agreement whereby the Assessee agreed to transfer his shares to the foreign company. Under the circumstances, looking to the case law on the subject and the terms of the non-compete agreement, particularly the restrictive covenant, it is difficult to agree with the view taken by the Tribunal. The receipt in the hands of the Assessee was certainly a capital receipt in as much as it dented his profit making capabilities.

25. In so far as the question of consistency is concerned, this was agitated before us by learned counsel for the Assessee on the basis that in the assessment year 1998-99 the receipt of non-compete fee was held to be a capital receipt by the Assessing Officer and, therefore, in the assessment year 2000-2001, the Assessing Officer ought to have been consistent and ought to have held the receipt to be a capital receipt. We find that for the assessment year 2000-2001, a notice under Section 148 of the Act was issued to the Assessee and the re-assessment order was

passed on 21st February, 2003. The reopening of the assessment proceedings has been upheld both by CIT (A) as well as by the Tribunal. Even we have not issued any notice on the grievance made by the Assessee in this regard. The reopening having been held to be valid, the question of consistency would not arise because if this argument were to be accepted, then it would mean that the reopening was erroneous. We cannot do something indirectly if it cannot be done directly. We are, therefore, not in agreement with learned counsel for the Assessee that the rule of consistency would be applicable to the facts of this case.

26. Consequently, the substantial question of law is answered in the negative, in favour of the Assessee and against the Revenue. The appeal is disposed of.

MADAN B. LOKUR, J

V.B. GUPTA, J

March 20, 2008
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Certified that the corrected copy of the judgment has been transmitted in the main Server.