IN THE HIGH COURT OF JUDICATURE AT MADRAS

Reserved on : 14.11.2016

Pronounced on: 23.12.2016

Coram:

The Hon'ble Mr.Justice NOOTY.RAMAMOHANA RAO
AND
The Hon'ble Dr.Justice ANITA SUMANTH

TAX CASE APPEAL No.1492 of 2007

Commissioner of Income Tax,
Chennai. .. Appellant

Versus

M/s.Chemech Laboratories Ltd.,
'Chemech House' 5, 10th Sector,
65th Street, K.K.Nagar West,
Chennai 600 078. .. Respondent

Appeal under Section 260A of the Income Tax Act, 1961, against the order of the Income Tax Appellate Tribunal, Madras 'A' Bench dated 01.06.2007 in ITA No.2216/Mds/2006.

For Appellant .. Mrs.Hema Muralikrishnan

For Respondent .. Mr.R.Vijayaraghavan for
M/s.Subbaraya Aiyar

JUDGMENT

(Judgment of this Court was delivered by ANITA SUMANTH, J.)

The Assessee/Respondent in this appeal (CLL) was engaged in the business of manufacture and marketing of pharmaceuticals. It entered into three separate agreements with an entity by the name and style of Solvay Pharma (I) Ltd. (SPIL) dated 06.02.2003 for Brand Acquisition, Consultancy and Non-compete. The parties agreed that the consideration for the transaction shall be a sum of Rs.6

crores. For the assessment year 2003-04, CLL took a stand in its Income Tax Assessment that the amount of Rs.6 crores related solely to the transfer of business under the Brand Acquisition Agreement and no part thereof was attributable to non-compete. The Assessing Authority, however, held that part of the consideration of Rs.6 crores would be attributable to non-compete as well. According to him, the bifurcation could be made on the basis of the instalments set out in the agreement, being upfront payment of Rs.4 crores upon execution of the agreement, Rs.1 crore upon transfer to SPIL of necessary registration under the Drug Laws and Rules and Rs.1 crore upon completion of one year from the date of execution of the agreement. Thus he attributed an amount of Rs.4 crores that, according to him, represented payment towards non-compete and duly brought the same to tax.

2. The Commissioner of Income Tax (Appeals) (CIT(A)) vide order dated 27.02.2006 agreed with the view of the Assessing Officer that part of the cost of Rs.6 crores was attributable to non-compete. He however modified the amount attributing 50% of the total consideration, Rs.3 crores to non-compete, the justification being that non-compete and brand acquisition were equally important components in the transfer of an undertaking. The Assessment was enhanced to this effect.

3. The Assessee filed an Appeal before the Income Tax Appellate Tribunal (ITAT) which reversed the orders of the CIT(A) as well as the assessing authority holding that the entire sum of Rs.6 crores would

only constitute a capital receipt not liable to tax in the year under consideration and that no portion of the consideration would be attributable to the negative covenant of non-compete. The Department is now in appeal before us raising the following Substantial Question of Law:

> '*Whether on the facts and circumstances of the case, the Tribunal was right in attributing the entire consideration to sale of brand name, when the contracts in question covered both sale of brand name and non-competition agreements?'*

4. The scope of the transaction is set out in clause 4 of the preamble to the Brand Acquisition Agreement as follows:

> '*4. CLL intends to sell and SPIL intends to acquire the entire Brands and any and all rights related thereto, past, present and future and whether or not registered, free of all encumbrances, claims, etc, and to this end the Parties wish to enter into an Agreement on the terms and conditions specified herein;'*

5. The parties specified the terms and conditions for the sale of Brands, Assignment of Trade Marks, Copy Rights, Designs etc and interestingly, the Non-compete Agreement dated 06.02.2003 was specifically telescoped and made an integral part of the Brand Acquisition agreement by virtue of clause 4 thereof as follows:

> '*4.Non-compete covenants*
> *SPIL and CLL hereby agree and confirm that the Non-compete agreement executed by and between the parties, forms an integral part of this agreement and the parties further confirm that, save as expressly permitted in writing by SPIL, subsequent to the date of execution of MOU dated December 6, 2002, CLL shall not directly or indirectly retain, use, sell, licence, or in any manner deal with or make available to any person in the Territory, the Brands, or any symbol, monogram, logo, word, device letter, numeral, picture, or combination of any or all of these elements which is, in any manner, confusingly*

similar to the Brands or any registrations in relation thereto.
Without prejudice to the generality of the foregoing, and unless specifically authorized in writing by SPIL, and if so authorized then in the manner and for the period in relation to which such authorization is given, CLL shall not, subsequent to the execution of MOU dated December 6, 2002 do any of the following in relation to the Brands:
4.1 Manufacture
....
4.2 Trade
....
4.3.Marketing
....
4.4. Stocking
....
4.5.Registrations
....
4.6.Research
....
4.7. Assistance
....
4.8.Investment
....
4.9.Usage of Brand name by CLL
...

6. The agreement for consultancy contained various terms and conditions relating to nature and scope of services as well as the remuneration in connection therewith. The non-compete agreement dated 06.02.2003 sets out the agreement of the parties in terms almost similar to the Brand Acquisition agreement as under:

'2.Non-competition
2.1.During the term of this Agreement, CLL shall not compete with SPIL and/or any of its Affiliates in the business in the Territory nor shall it commence, engage in, be interested in or carry on the business or any business similar to that of the business. Provided that, nothing herein shall be construed to restrict CLL's rights to compete in any other commercial activities, not similar to the business.
2.2. CLL also undertakes to SPIL that it will not either on its own or in conjunction with others whether directly or indirectly:-
(i)at any time do or attempt to do anything to disparage or otherwise injure the reputation of the

business or the manner in which the business is conducted,
(ii)do anything which might prejudice the good will of the business. During the Non-Competition Period, CLL agrees that without the prior written consent of SPIL, CLL shall not, on their own behalf or on behalf of any person, entity or group, directly or indirectly;
(i)hire or solicit the employment of (A) any current client or customer of SPIL or (B) any officer, director or employee of SPIL or (ii) solicit the business of any current client or customer of SPIL.

Article 3 details the specific areas of non competition such as Manufacturing, Trade, Stocking, Assistance and Licences.

7. The parties agreed that the consideration in respect of the above transaction shall be payable in the following terms as set out in Article 5 of the Brand Acquisition Agreement as follows:

'*5.Consideration*

5.1.The total consideration payable by SPIL to CLL for the various transactions contemplated herein and agreed to by the parties is Rs.60,000,000/- (Rupees Sixty Million only) which is payable as follows:

a.A sum of Rs.40,000,000/- (Rupees forty million only) payable upon the execution of this agreement, which payment SPIL has made and the receipt of which is hereby acknowledged by CLL.

b.A sum of Rs.10,000,000/- (Rupees Ten Million only) payable upon CLL submitting to SPIL, necessary registrations under the new Drug Laws & Rules, to enable SPIL to import any of the products or the Active Drug Substances in respect of any of the products. SPIL shall pay simple interest at a rate lower of, 7% p.a. and the rate offered by ICICI Bank on deposits placed with the Bank for a tenure of one year, on the said sum of Rs.10,000,000/- from the date of the agreement until the date of registration under the new Drug rules or until February 28, 2003, whichever is earlier.

c.A sum of Rs.10,000,000/- (Rupees Ten Million Only) upon the completion of one year from the date of execution of this agreement. SPIL shall pay simple interest at a rate lower of 7% p.a. and the rate offered by ICICI Bank on deposits sum of Rs.10,000,000/- from the date of the agreement until the end of one year from the agreement.'

8. In this background, the question before us is, whether any part of the consideration of Rs.6 crores would relate, and be attributable to, the activity of non-compete. We don't have to look far for the answer. The parties, in clause No. 3.6 of the non-compete agreement dated 06.02.2003, confirm the reasonableness of the covenants as well as the consideration agreed upon in the following terms:

> '*3.6.Reasonableness*
> *At the instance of SPIL, CLL has agreed to the above and both the parties agree that having regard to the facts and matters aforesaid, the restrictive covenants contained in this Agreement are reasonable and necessary for the protection of the parties, and the parties respectively hereby agree that having regard to such facts and matters, that such restrictive covenants do not work unfairly on either party and* <u>*the consideration for all matters has been agreed after taking all such restrictive covenants into account*</u>*.'*
> *(emphasis supplied)*

9. The three agreements dated 06.02.2003 thus depict a composite transaction in respect of which the amount of Rs.6 crores has been paid. As agreed upon by the parties, some part of the total consideration would thus have to be attributed towards the activity of non-compete as well. The Assessing Officer attributes a sum of Rs.4 crores towards non-compete, modified to Rs.3 crores by the CIT(A) further modified to nil by the Tribunal. The Tribunal finds that the dominant purpose of the transaction was not to formulate a restrictive covenant, which was incidental, but to enforce enjoyment of the rights by exploitation of the brands. Consequently, the submission of the assessee to the effect that the transaction was one of transfer of a *right to carry on any business* falling within the purview of the exclusion in the Proviso to section 28(va) of the Act, stood accepted. We differ with this conclusion.

10. Section 28(va)(a), inserted by Finance Act 2002, w.e.f. 1.4.2002, reads as follows:

> '*(va)any sum, whether received or receivable, in cash or kind, under an agreement for –*
> *(a)not carrying out any activity in relation to any business [or profession] or*
> ……
> *Provided that sub-clause (a) shall not apply to –*
> *(i)any sum, whether received or receivable, in cash or kind, on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on any business [or profession], which is chargeable under the head "Capital gains".*
> ……
> *Inserted by the Finance Act, 2002 with effect from Income Tax Act 2016 effective from the present assessment year that brings to tax any sum received in a non-compete agreement.'*

11. Legislature has thus made a conscious and clear distinction between the <u>positive</u> right to carry on a business or the activity of manufacture, production or process, consideration for the transfer of which would be chargeable under the head 'capital gains' and a <u>negative</u> right, being a covenant against the carrying on of any activity in relation to a business, the consideration for which would be taxable as business income. Thus, post 1.4.2003, consideration received towards a negative covenant, as contra-distinguishable to consideration received towards the transfer of business rights, would be liable to tax as business profits. The question whether the activity of non-compete was incidental or dominant was thus irrelevant, and the Tribunal mis-directed itself in addressing itself to the same. This is particularly so since the parties themselves agree, in Article 3.6

(extracted above) of the Non-compete Agreement, that the total consideration of Rs.6 crores shall include consideration towards the negative covenant as well.

12. We now address the more ticklish question of 'attribution' since the agreements are silent in this regard. The learned counsel for the Assessee, would impress upon us the fact that the business transfered by CLL is highly specialized and exclusive. It involves cutting edge technology wholly inaccessible to CLL in the absence of the brands transferred. The products sold by CLL constitute harmones utilized for infertility treatment under prescription, close monitoring and in controlled conditions. They were:

Brand name	*Generic name*
1.Puregon	*Pure FSH*
2.Nugon	*HMG*
3.Life	*HCG*
4.Adractim	*Dihydrotestesterone Gel*
5.Uterogestan	*Micronised Progesterone*

13. He would explain that only three companies in the World were engaged in the manufacture of the aforesaid biological products viz. *Viz Serono, Switzerland, Organon, Holand and Instituto Massone, Argentina.* The third entity which was under exclusive agreement with CLL now stood transferred to SPIL under the Brand Acquisition Agreement. Thus, according to him, the re-entry of CLL into this market, or for that matter competing in this area, is just wishful thinking and an impossibility. We have however, to reconcile this with the apparent intention of the parties to attribute some amount of the total consideration towards Non-compete as seen from clause 3.6 of the Non-compete Agreement. The learned counsel would, upon

instructions, suggest that a sum of Rs.1 crore might be adopted as a reasonable valuation towards non-compete fee. In the aforesaid facts and circumstances, the sum of Rs.1 crore towards non-compete appears to be proper and would serve the ends of justice.

14. We are conscious of the fact that in attributing an amount of Rs. One crore towards negative covenant, we are substituting yet another value in preference to those already adopted by the lower authorities. However the factual aspects of the matter, as noted by us in paragraph 11 and 12 above have not been taken into consideration, and this, we believe, makes a critical difference. The Substantial Question of Law is answered in favour of the Revenue and against the Assessee and the Tax Case Appeal is disposed of in the above terms. No costs.

[N.R.R.,J] [A.S.M.,J]
23.12.2016

Index: Yes/No
vga/msr

<u>NOOTY. RAMAMOHANA RAO, J</u>

<u>AND</u>

Dr.ANITA SUMANTH,J

vga/msr

PRE DELIVERY JUDGMENT IN
T.C.A.No.1492 of 2007

23.12.2016