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

\+ **ITA 542/2005**

Reserved on : 16th November, 2017
Date of decision : 27th November, 2017

M/S. GKN DRIVELINE INDIA LTD. ..... Appellant

Through: Mr. V. P. Gupta and Mr. Anunav Kumar, Advocates.

Versus

COMMISSIONER OF INCOME TAX ..... Respondent

Through: Mr. Asheesh Jain, Senior Standing Counsel with Mr. Shahrukh Ejaz, Advocate.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MS. JUSTICE PRATHIBA M. SINGH

JUDGMENT

Prathiba M. Singh J.,

This appeal under Section 260A of the Income Tax Act, 1961 (Act, for short) arises out of order dated 26th October, 2004 passed by the Income Tax Appellate Tribunal (for short 'ITAT') in ITA No.1281/Del/1999.

2. On 14th December, 2005, the appeal was admitted and the following questions of law were framed.

> *"1. Whether the ITAT was right in holding that payment of Rs.70 lakhs made by the appellant on*

account of non-competition for a period of five years was in the nature of capital expenditure?

2. Whether the ITAT was right in holding that the interest income earned by the appellant on deposits in banks towards margin money is not income derived for industrial undertaking?"

3. The short question that arises in the present appeal is as to whether the amount of Rs.70 lakhs paid by the Appellant/Assessee (hereinafter referred as 'Assessee') to M/s. Shriram Mobiles Limited (hereinafter referred as 'SML') is a non-compete fee and whether the Assessee is entitled to deduction on the ground that it is a revenue expenditure.

Brief Background

4. The Assessee claims to be the Indian Arm of the GKN group based in Germany and engaged in the manufacture and sale of front wheel drive axle assembly for vehicles. It is the Assessee's case that some of its customers during the relevant period included companies such as Maruti Udyog Limited and Bajaj Tempo. According to the Assessee, it was the market leader in manufacturing of these products.

5. The Assessee was in the process of expanding its manufacturing capacity and since demand for axles was increasing and new models of cars were coming into the market, it entered into an agreement dated 16th February 1995, for purchase of assets and liabilities of a newly set up factory, established by a company named Shriram Mobiles Limited in Madras. According to the

Assessee, the consideration in the said agreement was in two parts - first Rs.1.30 Crores towards the net asset value and secondly Rs.70 lakhs paid on account of non-compete clause.

6. The Assessee filed its return of income on 30th November, 1995. One of the issues raised during the course of assessment was in relation to the nature of the payment of Rs.70 lakhs. The Assessing Officer (*hereinafter 'AO'*) after discussing the case law, held that the Assessee obtained an advantage of an enduring nature and hence the expenditure is in the nature of capital expenditure. The AO held that the intention of the Assessee was to keep competitors out of the market thereby increasing sales, the said amount could not be held to be revenue expenditure as it derived long term benefit.

7. The Assessee approached the Commissioner of Income Tax (Appeals) [*hereinafter 'CIT(A)']* who held that since the non-competition period was for a short term of five years the expenditure is revenue in nature. The CIT (A) relied upon ***CIT v. G.D. Naidu [1987] 165 ITR 63*** *(hereinafter 'G.D. Naidu')* of the Madras High Court and gave relief to the Assessee to the tune of Rs.70 lakhs.

8. The ITAT vide order dated 26th October, 2004 reversed the order of the CIT(A) and restored the finding of the AO. The reasoning of the ITAT was that the Assessee was the only manufacturer in India for front wheel drive axle assembly for vehicles and being the sole manufacturer, it acquired an enduring

benefit. Thus, according to the ITAT, the expenditure was capital in nature as the Assessee eliminated its only competitor after acquiring the factory, thereby perpetuating its exclusivity in the market.

Submission of the Appellant/Assessee

9. Mr. V. P. Gupta, learned counsel appearing on behalf of the Assessee submits that the ITAT has erred in holding that the expenditure is capital in nature, inasmuch as it is the settled legal position that a non-compete fee paid for a short term of five years is a revenue expenditure. Mr. Gupta took us through various clauses in the agreement as also the annual report of the Assessee to demonstrate that the Assessee was the market leader and the sole manufacturer of these products. In fact, the factory of SML had not yet commenced manufacturing and there was no serious threat to the market leadership position of the Assessee and hence the non-compete fee was a revenue expenditure incurred by the Assessee. Mr. Gupta specifically relied upon the judgment of this Court in ***CIT v. Eicher Ltd.[2008] 302 ITR 249 (Del)*** *(hereinafter 'Eicher Ltd.')* wherein a Division Bench of this Court held that a non-compete fee is in the nature of business/revenue expenditure. It was further submitted that the SLP against this judgment was also dismissed.

Submissions of the Revenue

10. Mr. Asheesh Jain, learned Senior Standing Counsel appearing for the Revenue, heavily relied upon the judgment of this

Court in ***Sharp Business System v. Commissioner of Income Tax [2012] 254 CTR 233 (Delhi)*** *(hereinafter 'Sharp Business System')* to submit that a non-compete fee for a period of seven years was held to be a capital expenditure and not a revenue expenditure. He submitted that the Assessee obtained a benefit of an enduring nature by ensuring that competition was eliminated at the inception itself.

Agreement dated 16th February 1995

11. Before embarking upon and deciding the question of law framed in this case, it is important to discuss the nature of the agreement entered into between the Assessee and SML. In fact, the clauses in the agreement tell a different tale.

12. It is surprising to note that none of the authorities beginning from the AO to the ITAT have referred to the clauses of the agreement which would have made the decision on the question quite easy, inasmuch as, the nature of the rights and obligations as captured in the agreement would enable one to come to the conclusion as to whether the expenditure is capital or revenue in nature. A few relevant clauses of the agreement are set out herein below:

> *"3.1 The consideration payable by ITL to SML shall consist of:*
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> *I. Rs 1,30,00,000 (Rupees one crore and thirty lakhs only) being Net Asset Value, i.e. difference of the value of assets and value of the liabilities as per Schedule No. 5 subject to adjustment as hereinafter provided.*

II. A further sum of Rs. 70,00,000/- (Rupees Seventy lakhs only) for obligations and covenants set out in this Agreement.

4. Payment Schedule: ITL shall pay consideration as set out in Article 3.1 above as follows:

4.1 On or after the Completion Date by issue of 100,000 (One lac) equity shares of ITL at such premium and on such terms and conditions as may be approved by ITL shareholders at a general meeting, SEBI and other relevant Government authorities, if any. These shares will be forwarded to ICICI at the request of SML.

4.2 Balance of the consideration as reduced by adjustment pursuant to Article III and payment' under 4.1 above shall be paid In cash on or after the completion date. This amount shall be deposited in an Escrow Account with ICICI Banking Corporation, Madras at the request of SML and shall be payable to SML subject to a no objection certificate form ICICI, Madras and IFCI, Madras.

6.1 SML shall indemnify ITL and hold ITL harmless from and against any damages, deficiencies, losses, costs, liabilities and expenses (including legal fees and disbursements) and in particular, but without prejudice to the generality of the foregoing, from and against any depletion or diminution of the assets resulting directly and indirectly from or arising out of any breach of any of the representation, warranties and undertakings made or given by SML.

8.1 SML agrees and undertakes to obtain within 45 days or within such further period as may be mutually agreed upon by the parties in writing, all necessary approvals/sanction form Income Tax Authorities as may be required.

10.1 (a) On and after the execution of this Agreement neither party shall directly or indirectly disclose or divulge to any third party the terms of this

Agreement or any previous communication either oral or written between the parties hereto with respect to the subject matter hereof or any Confidential Information as defined in sub-article (b) below except with prior written consent of other party or to comply with law or guidelines issued by any regulatory authority.

(b) For the purpose of sub-article (a) the expression "Confidential Information" shall mean information relating to the products, services, business, personnel or commercial activities of the other party or its affiliates including but not restricted to formulas, compilations, programs, devices, concepts, inventions (whether or not patentable), designs, methods, technique, marketing and commercial strategies, process, data concepts, customer, client and contact lists and know - how, unique combinations of separate items which individually may or may not be confidential, which information is not generally known to the public and either derives economic value, actual or such that the other party or its affiliates has a legitimate interest in maintaining its secrecy. All documents will be considered CONFIDENTIAL INFORMATION whether or not marked with any proprietary notice or legend when the disclosure takes place.

11. It is hereby expressly declared that SML shall not for a period of five years from the Appointed Date directly or indirectly manufacture, market or distribute constant velocity joints or any other product or products that may be of a competitive nature.

14. SML shall within a period not exceeding 45 days from the Effective Date or within such further period as may be mutually agreed upon between the parties in writing (time being of the essence in this behalf) obtain all necessary sanctions and approvals

necessary or required to comply with the terms of this agreement."

The agreement has the following Schedules:

Schedule -1: Lists all the fixed assets of SML as on 1st April, 1994.

Schedule -2: Gives the value of current assets as on 1stApril, 1994.

Schedule -3: Gives the institutional liabilities as on 1st April, 1994.

Schedule -4: Enumerates the current liabilities and provisions as on 1st April, 1994.

Schedule-5: Depicts the calculation of net asset value as on 1st April, 1994. The same is set out below:

NET ASSET VALUE AS ON 01/04/1994

	Rs. lakhs
Fixed Assets (Schedule 1)	459.13
Current Assets (Schedule 2)	30.76
Total Assets (A)	489.89
Institutional Liabilities	341.78
(Schedule 3)	18.14
Current Liabilities (Schedule 4)	
Total Liabilities (B)	359.92
Net Assets (A-B)	129.97
Say	130 lakhs

13. A perusal of the agreement clearly points to the fact that while the consideration of Rs.1.30 Crores was towards the net value of assets as per Schedule 5, the payment of Rs.70 lakhs is ***"for obligations and covenants"*** which include the following:

- Warranty and representations – Clause 5.1
- Indemnification of SML – Clause 6.1
- Prompt execution of documents for effective transfer of marketable title in all the assets – Clause 7.1
- Obtaining approvals from the financial institutions confirming the release of charge on the assets – Clause 7.2
- Approval from the income tax authorities – Clause 8.1
- Maintenance of confidentiality including confidential information relating to the product services, business commercial activities, formulas, compilations, programs, devices, concepts, inventions, designs, methods, techniques, marketing and commercial strategies, client and contact lists and customers list etc. – Clause 10.1 (A) & (B)
- Non-compete clause – Clause 11
- Obligation of SML to obtain all necessary sanctions and approvals required for compliance of the agreement - Cl. 14

14. The above clauses of the agreement go to show that the amount of Rs.70 lakhs is not merely payment towards the non-compete clause but also towards various other obligations which were imposed upon SML and had a direct bearing on the final execution and implementation of the agreement. To argue that the entire consideration was towards the non-compete fee would

therefore be an incorrect statement, inasmuch as the clauses of the agreement do not reflect so. The emphasis in the agreement is towards the takeover of the assets of SML, and it was to ensure that the agreement bears fruition that the consideration of Rs.70 lakhs has been apportioned for various obligations and covenants imposed on SML.

15. Under these circumstances, the question that is to be decided is whether the expenditure of Rs.70 lakhs incurred is of capital or revenue in nature. The consideration of Rs.70 lakhs is clearly towards ensuring that there is no impediment in the smooth transfer of SML's factory to the Asssessee. It should be complete and final. From the facts placed before the Court, there really did not appear to be any serious threat whatsoever in order for the Assessee to pay the non-compete fee to SML which had not even commenced its manufacturing. From the nature of the transaction, it is clear that the acquisition of SML's unit in Madras was, as submitted by learned counsel for the Assessee, for expansion purposes. It was to expand and increase production by acquiring a new undertaking. The entire business with capital assets was acquired. The payment was bifurcated into two parts, Rs.130 lakhs towards net assets and Rs.70 lakhs for other obligations and recitals. The payment was towards all the obligations and covenants imposed upon SML, i.e., obtaining permissions from financial institutions, obtaining approvals from governmental authorities, income tax authorities, indemnity towards other losses, if any, and maintenance of

confidentiality about the agreement as also all the intellectual property and other data and information. This goes to show that the said payment was clearly for an enduring benefit and not just towards the non-compete obligation.

16. Even the non-compete obligations in clause 11 appear to be illusory in nature and restricted to '*constant velocity joints or any other competitive products*'. Clearly, the same is of limited nature and there was also no obligation of non-compete imposed upon the promoter directors of SML. In fact, as stated during the course of arguments, the managing director of SML became the corporate director of the Madras Division of the Assessee. Thus, the non-compete clause and the consideration of Rs.70 lakhs are not completely and exclusively inter-linked. The payment of Rs.70 lakhs, which is a substantial sum, i.e., more than half of the consideration paid for the net assets of the unit itself, was for a multitude of obligations and covenants which were fastened upon SML and not only towards the non-compete obligations.

17. Insofar the authorities cited are concerned, including ***Eicher Ltd (supra)*** and ***Sharp Business System (supra)***, it is clear that neither of the cases are comparable on facts to the present case, in terms of the nature of consideration or the non-compete clause. In ***Eicher Ltd (supra)*** the employee, with whom the non-compete agreement was executed, was a person who possessed specialized knowledge of the technology as also specialized knowledge

relating to two wheelers. The Court in ***Eicher Ltd (supra)*** held as under:

> *"12. It is quite clear from the above that to decide whether an expenditure of this nature is a capital expenditure or not would depend on the facts of the case. However, it is necessary to know whether the advantage derived by the prayer is of an enduring nature, and for this one of the considerations is the length of time for which the non-compete agreement would operate although that is not decisive. While the length of time for which competition is eliminated may not strictly be decisive in all cases, yet, at the same time, it should not be so brief as to virtually be transitory."*

In the facts of the said case, this Court came to the conclusion that the Assessee did not acquire any capital asset by making the payment of the non-compete fee. It merely eliminated competition in the two wheeler business for a while. ***Eicher Ltd (supra)*** clearly holds that if the advantage is of an enduring nature, then it could be a capital expenditure.

18. The test laid down by the Supreme Court in ***Empire Jute Co. Ltd Vs. CIT [1980] 124 ITR 1 (SC)***, to determine as to whether a particular expenditure is capital or revenue in nature is also applied in ***Eicher Ltd (supra)*** as also ***Sharp Business System (supra).*** It is clear that the consideration of Rs.70 lakhs was not expressly towards the non-compete obligation, but towards smoothening the process of acquisition of the asset, i.e., the unit of SML in Madras. Approvals that were required from the financial institutions, income tax authorities and other governmental authorities were

towards the finalisation and closure of the acquisition process. Other covenants and obligations imposed upon SML, i.e., warranties, confidentiality, etc., added value to the asset being acquired. There is no doubt that in the facts of the present case, the payment of Rs.70 lakhs is a capital expenditure and hence the question of law is answered in favour of the Revenue and against the Assessee.

19. The appeal is dismissed with no orders as to costs.

PRATHIBA M. SINGH, J

SANJIV KHANNA, J

NOVEMBER 27, 2017
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