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Supreme Court holds that payment of non-compete fee is a revenue expenditure and upholds deduction of interest on funds borrowed for acquiring controlling stake in subsidiary

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Issue 1: Deductibility of non-compete fees

The Hon'ble Supreme Court (SC) delivered a common judgement in a batch of five appeals concerning the tax treatment of payment of non-compete fees in Sharp Business Systems v CIT, 2025 SCC OnLine SC 2892. In one set of appeals, relating to payment of non-compete fees by Sharp Business System (Taxpayer) to M/s. Larsen and Toubro Limited (L&T) as a standalone arrangement, the Hon'ble SC held that such payments were allowable as revenue expenditure under Section 37(1) of the Income-tax Act, 1961 (IT Act), reversing the Delhi High Court's judgement which held that such expenses were capital in nature. The SC observed that, despite any enduring benefit, the payments did not result in the acquisition of a capital asset.

The other appeals pertained to Pentasoft Technologies Ltd where it paid non-compete fees to Pentamedia Graphics at the time of acquisition of its software division; and Piramal Glass Ltd where it paid non-compete fees to Nicholas Piramal at the time of acquisition of its glass division. In these cases, the Madras High Court and Bombay High Court respectively held that by payment of non-compete fees, the taxpayer acquired a commercial right to carry on the business without competing business from the counterparty and treated it as capital expenditure and allowed depreciation on the non-compete fee. The Hon'ble SC has remanded these matters back to the respective benches of the Income-tax Appellate Tribunal (ITAT) for reconsideration in light of its judgment.

Background

Section 37 of the IT Act allows deduction of any expenditure (which is not otherwise provided in specified provisions of IT Act) provided such expenditure (i) is incurred wholly and exclusively for taxpayer's business (ii) is not **capital in nature** or personal in nature or otherwise prohibited/impermissible under the IT Act. Further, Section 32(1)(ii) of the IT Act allows deduction for depreciation on intangible assets which includes know-how, patents, copyrights, trademarks, licenses, franchises or **any other business or commercial rights of similar nature**.

Facts of the case

- The Taxpayer was incorporated as a joint venture of M/s. Sharp Corporation, Japan and L&T, and engaged in the business of importing, marketing and selling electronic office products and equipments in India. L&T was in the business of developing, manufacturing, marketing, distributing and selling, amongst other things, electronic equipments in India and had a well-established country-wide sales network.

- During the assessment year (AY) 2001-02, the Taxpayer paid a sum of INR 3 crores (Non-Compete Fees) to L&T in lieu of L&T agreeing not to set up, undertake, or assist in setting up or undertaking any business in India for sale, marketing and trading of electronic office products for 7 years.

- The Non-Compete Fees was treated as a deferred revenue expenditure and written off in Taxpayer's books over a period of 7 years. From income-tax perspective, the entire Non-Compete Fees was claimed as deduction in AY 2001-02 on the ground the amount paid facilitated its business and did not enhance or alter the fixed capital and ought to be treated as revenue expenditure.

- The tax officer rejected the Taxpayer's claim and held that the non-compete arrangement resulted in an enduring benefit and, accordingly, treated the Non-Compete Fees as capital expenditure. The Commissioner of Income-tax (Appeals), the ITAT as well as the Delhi High Court upheld the tax officer's order and both ITAT and Delhi High Court also rejected the alternate ground of the taxpayer for claim for depreciation.

- Aggrieved by the order of Delhi High Court, the Taxpayer filed an appeal before the Hon'ble SC.

SC Ruling

The SC ruled in favour of the Taxpayer and held that the payment of a non-compete fee is a revenue expenditure under Section 37(1) of the IT Act for the following reasons:

- *Expenditure for the purpose of business:* Non-compete fee seeks to protect or enhance the profitability of the business, thereby facilitating the carrying on of the business more efficiently and profitably.

- *No creation of asset*: Payment was made to L&T only to ensure that the taxpayer operated the business more efficiently and profitably. Such payment made to L&T cannot, therefore, be considered to be for acquisition of any capital asset or towards bringing into existence a new profit earning apparatus.

- *Length of time not determinative of the nature of expenditure:* The SC held that the length of time over which the benefit will endure to the payer is not the determinative factor of the nature of such expenditure. The real test is whether such enduring benefit is capital in nature. In the present case, the taxpayer has only received the benefit of carrying on the business more efficiently and profitably, leaving the fixed assets untouched.

As the SC concluded that Non-Compete Fees were in the nature of revenue expenditure, it did not adjudicate on the issue of allowability of depreciation on Non-Compete Fees and remanded the other batch of appeals to ITAT to reconsider those appeals.

Comments

This ruling has reaffirmed the well-established principle that the duration for which an enduring benefit may accrue to the taxpayer is not, by itself, determinative of the nature of expenditure. The SC placed special emphasis on the form of the transaction and the purpose of payment of the non-compete fees while deciding on the revenue nature of the payment. However, it would be important to see how the related appeals pan out in the coming years where payment of a non-compete fee was bundled along with M&A transactions (such as share acquisitions or business acquisitions). Accordingly, taxpayers should carefully consider the drafting of these documents and evaluate the applicability of this ruling to their structures, including satisfaction of anti-abuse provisions under the IT Act.

Issue 2: Interest deductibility in a leveraged acquisition

In the appeal of Piramal Glass, the Hon'ble SC also examined the issue of allowability of interest expenditure incurred towards borrowings used to acquire a strategic stake in an overseas subsidiary engaged in the similar line of business.

Background

Section 36(1)(iii) of the IT Act allows deduction of interest incurred on borrowings used for business or profession, except where such borrowings are used towards acquisition of a capital asset which is not yet put to use.

Facts of the case

Piramal Glass Limited (PGL) invested INR 258.7 Mn in its subsidiary, Ceylon Glass Company Ltd out of interest bearing funds. PGL claimed interest on such borrowings as a deduction as per section 36(1)(iii) of the IT Act on the ground that it was an acquisition of a controlling stake in a subsidiary which is in a similar of business. The Assessing Officer as well as the Commissioner of Income Tax (Appeals) denied the claim of PGL; however, the ITAT and the Bombay High Court allowed the claim of PGL.

SC Ruling

The SC upheld the order of the Bombay High Court and allowed the claim of PGL for deduction of interest on funds borrowed and used for acquiring controlling stake in a subsidiary, relying on the principle of commercial expediency laid down by the SC in SA Builders [1987] 288 ITR 1.

Comments

In leveraged buyouts, it is common for an investor to use third party borrowings to make a strategic acquisition; Despite the landmark SC ruling in SA Builders, there was ambiguity on the allowability of interest expenditure incurred for these borrowings. This ruling will hopefully reduce the tax disputes on this issue.

- *Vinita Krishnan (Executive Director), Avin Jain (Principal Associate) and Pal Jain (Associate)*

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