

**THE HON'BLE SRI JUSTICE C.V. NAGARJUNA REDDY
AND
THE HON'BLE SRI JUSTICE T. AMARNATH GOUD**

I.T.T.A. Nos.159 and 160 of 2005

DATED:05-01-2018

Between:

V.C. Nannapaneni ... Appellant

And

Commissioner of Income Tax
Hyderabad-2
Ayakar Bhavan, Basheer Bagh
Hyderabad ... Respondent

COUNSEL FOR THE APPELLANT: Mr. K. Vasant Kumar

COUNSEL FOR THE RESPONDENT: Ms. K. Mamata

THE COURT MADE THE FOLLOWING:

COMMON JUDGMENT:

(per the Hon'ble Sri Justice C.V. Nagarjuna Reddy)

These two appeals by the assessee of income tax raise identical issues. They arise out of a common order of Income Tax Appellate Tribunal, Hyderabad Bench "B" in ITA Nos.642 and 782/Hyd/2002. ITA No.642/Hyd/2002 pertains to the assessment year 1998-99 and ITA No.782/Hyd/2002 pertains to the assessment year 1999-2000. Except that the issues pertain to different assessment years and the parties with whom non-competition agreements entered into are different, all other aspects are common in both these cases.

2. The facts giving rise to these appeals are briefly stated hereunder. The appellant is an individual earning income from salary and other sources. He is the Chairman and Managing Director of a pharmaceutical company, by name, Natco Pharma Ltd. He is an assessee to income tax on the file of the Assistant Commissioner of Income Tax, Circle-II, Hyderabad, with Permanent Account/G.I.R. No.N-707/ABEPN 6301 L. The appellant filed his returns of income for the assessment year 1998-99 on 31.10.1998 and for the assessment year 1999-2000 on 29.9.1999. For the assessment year 1998-99 he declared loss of Rs.1,91,209/- and for the next assessment year he declared loss of Rs.5,21,560/-. The returns of income were

processed separately under Section 143(1) of the Income Tax Act, 1961 (for short, “the Act”) and they were accepted by the Assistant Commissioner of Income Tax. However, the Deputy Commissioner of Income Tax, Circle-I, Hyderabad, passed an order for the assessment year 1998-99 on 30.3.2001 under Section 143(3) of the Act determining the total income of the appellant at Rs.1,74,68,625/- and in the process of determination, the said officer has included a sum of Rs.1,50,00,000/- received by the appellant from Ranbaxy Laboratories Limited (hereinafter referred to as “RLL”) towards “non-competition fee” included under the head “income from other sources” and treated it as revenue receipt and accordingly subjected the same to tax. As regards the assessment year 1999-2000, the Assistant Commissioner of Income Tax, Circle-2(2), Hyderabad, undertook a similar exercise and passed an order under Section 143(3) of the Act on 28.3.2002 determining the total income of Rs.2,26,94,970/- by including a sum of Rs.2,00,00,000/- received by the appellant from M/s. Sun Pharmaceuticals Industries Limited (hereinafter referred to as “SPIL”) under the head “income from other sources” treating the same as revenue receipt and subjecting the same to tax. As regards the Natco Pharma, the

Assessing Officer (AO) has treated the amount received towards non-competition fee during the assessment year 1998-99 under the head "capital gain".

3. The appellant as well as the company filed separate appeals before the Commissioner of Income Tax (Appeals), who dismissed the same confirming the orders of the AO. Aggrieved by those orders, the assessee has filed two appeals ITA Nos.642 and 782/Hyd/2002 for the assessment year 1998-99 and 1999-2000 respectively, and the company filed ITA No.361/Hyd/2003, for the assessment year 1998-99. By a common order passed by the Tribunal, it has rejected the plea of the appellant that money received by him must be treated as capital receipt and accordingly confirmed the view of the AO as confirmed by the appellate authority. It has also rejected the alternative plea of the appellant that even if it is not a capital receipt, it cannot be taxed under Section 10(3) of the Act. As regards the Company, the Tribunal held that the amount received by it towards non-competition fee is a capital receipt and reversed the order of the AO, who while holding that it is a capital receipt, brought the same to tax by treating the same as goodwill which was in fact covered by a separate agreement. The Tribunal accordingly held that the amount received by the

company being capital receipt, is not liable to tax. While the Revenue has not filed any appeal against the order qua the company, the appellant has filed these two appeals.

4. The appellant has raised the following substantial questions of law in ITTA No.159 of 2005.

- (i) “Whether on the facts and circumstances of the case, the consideration received by Appellant for the assessment year under the non-competition agreement with Ranbaxy Laboratories Ltd. is a capital receipt or a revenue receipt.
- (ii) Whether on the facts and in the circumstances of the case, the Tribunal failed to appreciate that the restraint on the appellant as per clause-2 of the non-competition agreement between RLL and the appellant is not merely that Appellant “shall not sell, supply, market or distribute the specified produces in the specified countries viz., Russia and CIS countries but he shall not advise, assist, and in establishing etc., competing business, directly or indirectly, in all manner of forms and there can be no doubt that if the appellant could help Time Cap Pharma Labs Pvt., Ltd., to establish a business in time release pharmaceutical products, the Appellant has capacity to help and aid other manufactures to manufacture and sell products competing with RLL in the specified territories”.
- (iii) Whether on the facts and in the circumstances of the case, the ITAT was right in holding that non competition fee received by the Appellant from RLL is not capital receipt in the hands of the Appellant.
- (iv) Whether the non-competition fee received by the Appellant is taxable under Income Tax Act, 1961 as it stood in the relevant year.
- (v) Whether the ITAT having regard to the amendment to Sec. 55(2)(a) of the Income Tax Act, 1961 the act in the Finance Act, 2002, applicable from the assessment year 2003-04, ought to have held that the non-competition

fee cannot be brought to tax prior to coming into force of the said Amendment.”

Similar questions have been raised by the appellant in ITTA No.160 of 2005 also.

5. The learned counsel for the appellant reframed the substantial questions of law in both the appeals by filing Memos dt.21.11.2017 which are taken on record. The reframed substantial questions of law in ITTA No.159 of 2005, which are similar in ITTA No.160 of 2005, read as under:

1. Whether on the facts and in the circumstances of the case, the decision of the Income Tax Appellate Tribunal is not perverse as it relied on a decision of Supreme Court which actually relate to provisions of Section 2(24)(ix) of the I.T.Act?”
2. Whether on the facts and in the circumstances of the case, the decision of the Income Tax Appellate Tribunal is not perverse in having held a part of the receipt by the Company to be Capital receipt, holding the part received by the assessee to be revenue though both are based on the same agreement of Non Competition?
3. Whether on the facts and in the circumstances of the case, the decision of the Income Tax Appellate Tribunal is not perverse in having given a finding that the sum of Rs.1,50,00,000 received actually is that of the Company Natco Pharma to hold the same as revenue receipt of the assessee?
4. Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal is right in law interpreting the agreement in part in a different manner when the other part is being accepted?
5. Whether on the facts and in the circumstances of the case, the Income-tax Appellate Tribunal is right in law

in holding that the amount is assessable under the head other sources though there is no finding that it does fall under any other head of income?

6. Mr. K. Vasant Kumar, learned counsel for the appellant, advanced the following submissions. (i) The Tribunal has failed to analyze the agreements entered into by the RLL and the SPIL with the NATCO GROUP, resulting in its arriving at an incorrect conclusion, that the money received towards the non-competition fees falls under the head “income from other sources” instead of treating the same under the head “capital receipt” as was done in respect of the amount received by the Natco. (ii) The Tribunal failed to appreciate that the RLL and the SPIL paid money to the Natco company and the appellant in restraint of their advising, assisting, aid in establishing, managing, providing or developing or act as consultant or technical advisor in respect of the specified products or any other products similar to the products either on their own account or on behalf of any other person whether as an agent or as a licensee or as an advisor, consultant etc., and that the restraint regarding the advise, assistance, advising, to act as a consultant or technical advisor is more particularly referable to an individual, like the appellant, and that the Tribunal failed to understand this aspect from proper perspective. (iii) On the

Tribunal's own observation, the appellant has pioneered in the time release technology and promoted the Natco Pharma Ltd., and that in the absence of any material before it showing that the appellant was barred once and for all from using his knowledge, expertise and technical know-how, either in establishing his own industry or aiding, advising or acting as a technical consultant for others who propose to establish an industry for manufacturing the drugs in respect of which the RLL and the SPIL entered into agreements for the territories specified therein, the Tribunal has committed a grievous error in finding that as the appellant has handed over the technical know-how to the company and the appellant having never spread his wings to the specified territory to carry on business in his individual capacity with the technical knowhow, brand names etc., invested as a capital asset, the amount received by him cannot be treated as on account of sterilisation of the capital asset or that it impaired the profit making structure or apparatus. (iv) It is clearly evident from the two agreements entered with the RLL and the SPIL, both the company and the appellant have received the amounts due to threat perception of either of them establishing a similar industry or aiding and advising or passing on technical know-how to a third party to

manufacture specified drugs and the same is covered by the agreements over which rights in all respects were in favour of the said two companies and that the appellant is also deserves to be treated on par with the company for treating the income as capital receipt. (v) The Tribunal erred in finding that the amount which was otherwise receivable by the company was diverted by the appellant and therefore it cannot be treated as capital receipt in the hands of the appellant and that even in case of such diversion this money at the hands of the appellant is not chargeable to tax, as public limited company is exempted from the definition of 'dividend' under sub-section (22)(e) of Section 2 of the Income Tax Act, 1961. In support of his submissions, the learned counsel relied upon the following judgments. **Commissioner of Income Tax v. Vazir Sultan & Sons¹, Gillanders Arbuthnot & Co. Ltd. v. Commissioner of Income Tax², Kettlewell Bullen and Co. Ltd. v. Commissioner of Income Tax³, Commissioner of Income Tax v. Best & Co. (P) Ltd.⁴, and Oberoi Hotel (P) Ltd. v. Commissioner of Income Tax⁵.**

¹ (1959) 36 ITR 0175 (SC)

² (1964) 53 ITR 0283 (SC)

³ (1964) 53 ITR 0261 (SC)

⁴ (1966) 60 ITR 0011 (SC)

⁵ (1999) 236 ITR 0903 (SC)

7. Opposing the above submissions, Ms. K. Mamata, learned Senior Standing Counsel for the Income Tax, made the following submissions. (i) The findings of the Tribunal are based on appreciation of facts and that therefore no question of law, much less substantial question of law, arises for consideration in these appeals. (ii) The Tribunal rightly rendered a finding that the appellant having transferred all the technical know-how to the company, has not suffered any capital loss as he had no capital available when the RLL and the SPIL entered into agreements with the NATCO GROUP for transfer of rights over the drugs in specified areas and therefore the amount received by him was rightly treated under the head “income from other sources”. (iii) In order to treat the income as capital receipt, the appellant has to prove that there is a capital loss and the said loss is of enduring value, that even if the appellant has suffered capital loss, it was only with respect to certain specified drugs over certain area and that therefore the income cannot be treated as against the capital loss. In support of her submissions, she relied upon the judgments in **Gillanders Arbuthnot & Co. Ltd. (2 supra)**, **Kettlewell Bullen and Co. Ltd. (3 supra)**, **Best & Co. (P) Ltd. (4 supra)**, **Commissioner of Income Tax v. G.R.**

Karthikeyan⁶, and Commissioner of Income Tax v. Biju Patnaik⁷.

8. We have carefully considered the respective submissions of the learned counsel for the parties. First, we would like to refer to the relevant terms of the non-competition agreements. As both the agreements are similar in content, it would suffice if terms of one of the agreements are referred to. Accordingly, we choose the agreement dt.20.06.1997 with RLL. This agreement was entered between “NATCO GROUP” and “RLL”. In the preamble of the agreement, the words “NATCO GROUP” was described as comprising V.C. Nannapaneni – the appellant, his wife and two children and Natco Pharma Limited. It was recited in the agreement that the NATCO GROUP is carrying on and is in business of manufacturing, selling and distributing certain products as listed in Annexure-I to the agreement and that through separate agreements the NATCO GROUP has agreed to effectively transfer its business, trade marks, and goodwill attached to the “Products” in the “Territory” specified in the agreement and that as a part of consideration for such transfer, it has been agreed that NATCO GROUP shall not carry on directly or

⁶ (1993) 201 ITR 866 (SC)

⁷ (1986) 160 ITR 674 (SC)

indirectly the business hitherto in the “Territory” specified in the agreement. The agreement defined the word “Products”, as described in Annexure-I and the word “Territory” as Territory of Russia & CIS countries, including Ukraine, Lithuania, Latvia, Estonia, Belarus, Moldova, Kazakhstan. Clauses 2 and 3 of the agreement which are very relevant for the present cases read as follows:

“2. NATCO GROUP hereby agrees with RLL that as provided in Clause 3 hereunder, it shall not sell, supply, market or distribute, advise, assist, aid in establishing, managing, providing or developing or act as Consultant or technical advisor in respect of the “Products” or any products similar to the “Products” either on its own account or on behalf of any other person whether as an agent or as a licensee or as an advisor, consultant under any other relationship in the “Territory”. Nothing contained in this agreement shall be considered to restrict the right of NATCO GROUP to sell in India or in any other place except in the “Territory” the “Products” similar or identical in content to the “Products” mentioned in Annexure-I.

3. In consideration of the Covenant, RLL shall pay to NATCO GROUP Rs.5,00,00,000 Crores (Rupees Five Crores only) in the following manner.

- | | |
|---|--------------|
| a) Non competition for 1 st year | Rs.296 lacs. |
| b) Non competition for 2 nd year | Rs.104 lacs. |
| c) Non competition for 3 rd year | Rs.75 lacs. |
| d) Non competition for 4 th year | Rs.15 lacs. |
| e) Non competition for 5 th year
and thereafter | Rs.10 lacs. |

However, each of such instalment shall become payable on the 7th day after the commencement of this agreement and on the expiry of seven days of each subsequent anniversary thereafter. Out of the first instalment of Rs.296 lacs. NATCO GROUP has agreed to share the receipt of the payment in the following manner.

- a) Rs.146 lacs in the name & favour of NATCO
- b) Rs.150 lacs in the name of Mr. V.C. Nannapaneni

Ranbaxy agrees to make the payment accordingly.”

9. From the contentions advanced by his counsel, the sheet anchor of the appellant's case is that the RLL and the SPIL have treated the appellant and the Natco Pharma Ltd., as two different entities from the point of view of threat perception and accordingly they not only entered into a joint agreement with the individual, his family members and the company, but also made separate payments towards non-competition fees. It is his further case that being deprived of the right to set up a similar industry or aid and advise or act as a consultant by using his knowledge and technical know-how for setting up an industry by a third party, the appellant has suffered as much capital loss as the Natco Pharma Company has suffered and that therefore the appellant cannot be treated differently from Natco Pharma. That further, the Tribunal has erred in assuming that in the absence of proof of existing income there cannot be capital loss, ignoring the position in law that even potential loss of future income also amounts to loss and any income derived towards the same must be treated as capital receipt.

10. Let us now consider the relevant case law on the aspect as to what constitutes a capital receipt in the context of a non-competition agreement.

In **Vazir Sultan & Sons** (1 supra), the assessee was the sole selling agents and sole distributors for the Hyderabad State for the cigarettes manufactured by M/s. Vazir Sultan Tobacco Co., Ltd., under the terms of a resolution of the board of directors dt.06.01.1931. In 1939, a fresh arrangement was made between the assessee and the company whereby the former was given a discount of 2% not only on the goods sold in the Hyderabad State, but also on all the goods sold outside the Hyderabad State. The board of directors of the company passed a resolution on 16.06.1950 to the effect that as the assessee had agreed to revert to the previous arrangement as per which sale and distribution of Charminar Cigarettes was confined only to Hyderabad State. It was further resolved that the assessee is paid compensation of a sum of O.S. Rs.2,26,263 and the assessee in turn has to pay D.B. Akki & Co., out of the said compensation amount the sum of O.S. Rs.6,920 also by way of compensation. The sum of Rs.2,19,343 received by the assessee was included in its total income and taxed it as a revenue receipt by the Income Tax Officer. On the appeal filed

by the assessee, the Appellate Assistant Commissioner held that the sum of Rs.2,19,343 was not a revenue receipt, but a capital receipt. On the appeal preferred by the Income Tax Officer against the said order, the Income Tax Appellate Tribunal, Bombay, held that the sum received by the assessee was a revenue receipt and liable to tax. The assessee applied to the Appellate Tribunal for a reference to the High Court under Section 66(1) of the Act and the Tribunal accordingly referred the question of law as to “whether the sum of O.S. Rs.2,19,343 received by the assessee firm from Vazir Sultan Tobacco Co., Ltd., is a revenue receipt or a capital receipt?”. The High Court reframed the question as to “whether the sum of Rs.2,19,343 received by the assessee firm from Vazir Sultan Tobacco Co., Ltd., is liable to be taxed under the Indian Income Tax Act?.” This question was answered in favour of the assessee. The Revenue has filed an appeal before the Supreme Court. The Supreme Court referred to its judgment in **Commissioner of Income Tax v. South India Pictures Ltd.**⁸, which in turn referred to the statement of Lord Macmillan in **Van Den**

⁸ [1956] 29 ITR 910 (SC)

Berghs Ltd. v. Clark⁹ and reproduced the following passage in **South India Pictures Ltd.** (8 supra):

“That though in general the distinction between an income and a capital receipt was well recognized and easily applied, cases did arise where the item lay on the border line and the problem had to be solved on the particular facts of each case. No infallible criterion or test can be or has been laid down and the decided cases are only helpful in that they indicate the kind of consideration which may relevantly be borne in mind in approaching the problem. The character of the payment received may vary according to the circumstances. Thus the amount received as consideration for the sale of a plot of land may ordinarily be a capital receipt but if the business of the recipient is to buy and sell lands, it may well be his income.”

The Supreme Court referred to the Privy Council judgment in **Commissioner of Income Tax v. Shaw Wallace & Co.**¹⁰ wherein it was held that “income” connotes a periodical monetary return coming in with some sort of regularity or expected regularity from definite sources which must be one whose object is the production of a definite return excluding anything in the nature of a mere windfall. The income was thus likened pictorially to the fruit of a tree or the crop of a field. However, in **Raja Bahadur Kamakshya Narain Singh of Ramgarh v. Commissioner of Income Tax**¹¹ a discordant note was struck by holding that a reference to the analogy of fruit or increase or sowing or reaping or periodical harvests cannot be used to limit the true character of

⁹ [1935] 3 ITR (Eng. Cas.) 17 (HL)

¹⁰ [1932] LR 59 IA 206 (PC)

¹¹ [1943] 11 ITR 513 (PC)

income in general. The opinion of Lord Wright in the said case was usefully extracted by the Supreme Court as under:

“Its applicability may, in particular cases, differ because the circumstances, though similar in some respects, may be different in others. Thus the profit realised on a sale of shares may be capital if the seller is an ordinary investor changing his securities, but in some instance at any rate it may be income if the seller of the shares is an investment or an insurance company. Income is not necessarily the recurrent return from a definite source, though it is generally of that character. Income again, may consist of a series of separate receipts, as it generally does in the case of professional earnings. The multiplicity of forms which 'income' may assume is beyond enumeration. Generally, however, the mere fact that the income flows from some capital assets, of which the simplest illustration is the purchase of an annuity for a lump sum, does not prevent it from being income, though in some analogous cases the true view may be that the payments, though spread over a period are not income, but installments payable at specified future dates of a purchase price. {Vide *Secretary of State for India v. Scoble* : [1903] A.C. 299}.”

The Supreme Court also referred to its earlier case in **Raghuvanshi Mills Ltd. v. Commissioner of Income Tax**¹² wherein it was observed that the definition of “income” in **Shaw Wallace’s case** (10 supra), as a periodical monetary return coming in with some sort of regularity or expected regularity from definite sources must be read with reference to the particular facts of that case. The Supreme Court also quoted the judgment in **Van Den Berghs Ltd.** (9 supra), and framed the following questions for determining whether a

¹² [1952] 22 ITR 484

particular payment received by the assessee was income or has to be regarded as a capital receipt:

- (i) “whether the agreements in question were entered into by the assessee in the course of carrying on its business of distribution of firms, and
- (ii) whether the termination of the agreements in question could be said to have been brought about in the ordinary course of business.”

The Supreme Court held that when a question arises whether a payment of compensation for termination of an agency is a capital or a revenue receipt, it would have to be considered whether the agency was in the nature of capital asset in the hands of the assessee, or whether it was only a part of his stock-in-trade. The following passage in **Kelsall Parsons & Co. v. Inland Revenue Commissioners**¹³ was quoted by the Supreme Court:

“But apart from these and similar instances it might, in general, be stated that payments made in settlement of rights under a trading contract are trading receipts and are assessable to revenue. But where a person who is carrying on business is prevented from doing so by an external authority in the exercise of a paramount power and is awarded compensation therefor, whether that receipt is a capital receipt or a revenue receipt will depend upon whether it is compensation for injury inflicted on a capital asset or on a stock-in-trade. The decision in *Glenboig Union Fireclay Co., Ltd. v. Commissioners of Inland Revenue* {[1922] 12 Tax Cas. 427} applies to this category of cases. There, the assessee was carrying on business in the manufacture of fireclay goods and had, for the performance of that business, acquired a fireclay field on lease. The Caledonian Railway which passed over the field prohibited the assessee from excavating the field within a certain distance of the rails, and paid compensation therefor in accordance with the provisions of a statute. It was held by the House of Lords that this was a capital

¹³ [1938] 21 Tax Cas. 608

receipt and was not taxable on the ground that the compensation was really the price paid 'for sterilising the asset from which otherwise profit might have been obtained. 'That is to so, the fireclay field was a capital asset which was to be utilised for the carrying on of the business of manufacturing fireclay goods and when the assessee was prohibited from exploiting the field, it was an injury inflicted on his capital asset. Where, however, the compensation is referable to injury inflicted on the stock-in-trade, it would be a revenue receipt {Vide *Commissioner of Inland Revenue v. Newcastle Breweries Ltd.*: [1927] 12 Tax Cas. 927}.

Applying the ratio laid down by the case law to the facts of the case, the Supreme Court held that the amount received by the assessee was capital receipt and not income on the following reasoning:

“In the case before us the agency agreement in respect of territory outside the Hyderabad State was as much an asset of the assessee's business as the agency agreement within the Hyderabad State and though expansion of the territory of the agency in 1939 and the restriction thereof in 1950 could very well be treated as grant of additional territory in 1939 and the withdrawal thereof in 1950, both these agency agreements constituted but one employment of the assesses as the sole selling agents of the company. There is nothing on the record to show that the acquisition of such agencies constituted the assessee's business or that these agency agreements were entered into by the assesses in the carrying on of any such business. The agency agreements in fact formed a capital asset of the assessee's business worked or exploited by the assesses by entering into contracts for the sale of the Charminar cigarettes manufactured by the company to the various customers and dealers in the respective territories. This asset really formed part of the fixed capital of the assessee's business. It did not constitute the business of the assesses but was the means by which the assesses entered into the business transactions by way of distributing those cigarettes within the respective territories. It really formed the profit-making apparatus of the assessee's business of distribution of the cigarettes manufactured by the company. If it was thus neither circulating capital nor stock-in-trade of the business carried on by the assesses it could certainly not be anything but a capital asset of its business and any payment made by the company as and by way of compensation for terminating or cancelling the same would only be a capital receipt in the hands of

the assesses.

It would not make the slightest difference for this purpose whether either one or both of the agency agreements were terminated or cancelled by the company. The position would be the same in either event. As was observed by Lord Wrenbury in the *Glenboig Union Fireclay Co., Ltd. v. Commissioners of Inland Revenue*; at page 465 :

"The matter may be regarded from another point of view; the right to work the area in which the working has to be abandoned was part of the capital asset consisting of the right to work the whole area demised. Had the abandonment extended to the whole area all subsequent profit by working would, of course, have been impossible but it would be impossible to contend that the compensation would be other than capital. It was the price paid for sterilising the asset from which otherwise profit might have been obtained. What is true of the whole must be equally true of part."

If both the agency agreements, viz., one for the territory within the Hyderabad State and the other for the territory outside Hyderabad State, had been terminated or cancelled on payment of compensation, the whole profit-making structure of the assessee's business would have been destroyed. Even if one of these agency agreements was thus terminated, it would result in the destruction of the profit-making apparatus or sterilisation of the capital asset *pro tanto* and if in the former case the receipt in the hands of the assessee would only be a capital receipt, equally would it be a capital receipt if compensation was obtained by the assessee for the termination or cancellation of one of these agency agreements which formed a capital asset of the assessee's business."

11. In **Kettlewell Bullen & Co. Ltd.** (3 *supra*), the Supreme

Court has lucidly explained the proposition as under:

"Whether a particular receipt is capital or income from business, has frequently engaged the attention of the courts. It may be broadly stated that what is required for loss of capital is a capital receipt: what is received as profit in a trading transaction is taxable income. But the difficulty arises in ascertaining whether what is received in a given case is compensation for loss of a source of income, or profit in a trading transaction. Cases on the borderline give rise to vexing problems. The Act contains no real definition of income; indeed it is a term not capable of a definition in terms of a general formula. Section 2(6C) catalogues broadly certain categories

of receipts which are included in income. It need hardly be said that the form in which the transaction which gives rise to income is clothed and the name which is given to it are irrelevant in assessing the exigibility of receipt arising from a transaction to tax. **It is again not predicated that the income must necessarily have a recurrent quality.** We are not called to enter upon an extensive area of enquiry as to what receipts may be regarded as income generally, but merely to consider in this case whether receipt of compensation for surrendering the managing agency may be regarded as capital or as revenue. In the absence of a statutory rule, payment made by an employer in consideration of the employee releasing him from his obligation under a service or agency agreement or a payment made voluntarily as compensation for determination of right to office arises not out of employment, but from cessation of employment and may not generally constitute income chargeable under sections 10 and 12.”

(emphasis is ours)

The Court, referring to certain English cases, further held:

“These cases illustrate the principle that compensation for injury to trading operations, arising from breach of contract or in consequence of exercise of sovereign rights, is revenue. These cases must, however, be distinguished from another class of cases where compensation is paid as a solatium for loss of office. Such compensation may be regarded as capital or revenue : **it would be regarded as capital, if it is for loss of an asset of enduring value to the assessee,** but not where payment is received in settlement of loss in a trading transaction.

(emphasis is ours)

The Court further held:

“On an analysis of these cases which fall on two sides of the dividing line, a satisfactory measure of consistency in principle is disclosed. Where on a consideration of the circumstances, payment is made to compensate a person for cancellation of a contract which does not affect the trading structure of his business, nor deprive him of what in substance is his source of income, termination of the contract being a normal incident of the business, and such cancellation leaves him free to carry on his trade (freed from the contract terminated) the receipt is revenue : Where by the cancellation of an agency the trading structure of the assessee is impaired, or such cancellation results in loss of what may be

regarded as the source of the assessee's income, the payment made to compensation for cancellation of the agency agreement is normally a capital receipt."

12. Referring to its judgment in **Kettlewell Bullen & Co. Ltd.** (3 supra), the same three-Judge Bench in **Best and Co (Pvt.) Ltd.** (4 supra), observed:

"Whether the compensation received by an assessee for the loss of agency is a capital receipt or a revenue receipt depends upon the circumstances of each case. Before coming to a conclusion one way or other, many questions have to be asked and answered: what was the scope of the earning apparatus or structure, from physical, financial, commercial and administrative stand points? If it was a business of taking agencies, how many agencies it had, what was their nature and variety? How were they acquired, how one or some of them were lost and what was the total income they were yielding? If one of them was given up, what was the average income of the agency lost? What was its proportion in relation to the total income of the company? What was the impact of giving it up on the structure of the entire business? Did it amount to a loss of an enduring asset causing an unabsorbed shock dislocating the entire or a part of the earning apparatus or structure? Or was it a loss due to an ordinary incident in the course of the business? The answers to these questions would enable one to come to a conclusion whether the loss of a particular agency was incidental to the business or whether it amounted to a loss of an enduring asset. If it was the former, the compensation paid would be a revenue receipt; if it was the latter, it would be a capital receipt. But these questions can only be answered satisfactorily if the relevant material is available to the income-tax authorities. The evidence of witnesses in charge of the business, the relevant accounts and balance-sheets of the assessee before and after the loss, other evidence disclosing the previous history of the total business and the relative importance of the agency lost and the present position of the business after the loss of the said agency have to be scrutinized by the department."

Considering the restrictive covenant in the agreement between the parties in that case, the Supreme Court observed:

"The letter written by the assessee to the principal is not on the file. But it is clear from this letter that the restrictive covenant

was one of the terms of the agreement relating to consideration. It was a part of the consideration that passed from the assessee for receiving the compensation. We cannot also agree with Mr. Viswanatha Sastri, who went to the other extreme and contended that the restrictive covenant was only an act of grace on the part of the agent and that it did not enter into the bargain. We, therefore, hold 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 specific period.”

Having framed the question whether that part of the compensation attributable to the restrictive covenant is a capital receipt or a revenue receipt, the Supreme Court referred to the judgment of House of Lords in **Beak v. Robson**¹⁴ and its judgment in **Gillanders Arbuthnot & Co. Ltd** (2 supra), and held that “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 part of the compensation attributable to the restrictive covenant was a capital receipt and hence not assessable to tax.”

13. In **Gillanders Arbuthnot & Co. Ltd.** (2 supra), which was decided by the same three-Judge Bench, which decided **Kettlewell Bullen & Co. Ltd.** (3 supra), and **Best and Co (Pvt.) Ltd.** (4 supra), the Supreme Court distinguished between

¹⁴ [1942] 25 Tax Cas. 33

a case where compensation is received for loss of goodwill and compensation received for loss of agency, and held that in the latter category of cases where such cancellation did not affect the profit-making structure of the assessee, or it did not involve a loss of an enduring trading asset, and if it merely deprived the assessee of a trading avenue, leaving it free to devote its energies after the cancellation to carry on the rest of the business, the amount received must be regarded as revenue receipt, and not capital receipt.

14. In **Oberoi Hotel (P) Ltd.** (5 supra), the assessee company was operating many hotels belonging to others for a fee. It had a contractual right to exercise the option of purchasing the hotel in question in case its owner desires to transfer the same during the currency of the agreement. The receiver of the hotel executed a supplementary agreement with the assessee whereunder the latter has given up its right to exercise its option to purchase and/or operate his hotel. On these facts of the case, the question was whether the amount received by the assessee under the supplementary agreement was a capital receipt or not? The Supreme Court relied upon the Judgment in **Kettlewell Bullen & Co Ltd.** (3 supra), and also referred to **Karam Chand Thapar & Bros. (P) Ltd. v.**

C.I.T.¹⁵ which in turn referred to the judgment in **C.I.T. v. Chari & Chari Ltd.**¹⁶, wherein it was held that ordinarily compensation for loss of an office or agency is regarded as capital receipt, but this rule is subject to an exception that payment received even for termination of an agency agreement would be revenue and not capital in the case where the agency was one of many which the assessee held and its termination did not impair the profit-making structure of the assessee, but was within the framework of the business, it being a necessary incident of the business that existing agencies may be terminated and fresh agencies may be taken. Applying this ratio to the facts of that case, the Supreme Court held as under:

“Applying the aforesaid test laid down by this Court in the present case, in our view the Tribunal was right in arriving at a conclusion that it was a capital receipt. Reason is that as provided in art. XVIII of the first agreement assessee was having an option or right or lien, if owner desired to transfer the hotel or lease or part of the hotel to any other person, the same was required to be offered first to the assessee (operator) or its nominee. This right to exercise its option was given up by a supplementary agreement which was executed in Sept., 1975, between the Receiver and the assessee. It was agreed that Receiver would be at liberty to sell or otherwise dispose of the said property at such price and on such terms as he may deem fit and was not under any obligation requiring the purchaser thereof to enter into any agreement with the operator (assessee) for the purpose of operating and managing the hotel or otherwise and in its return, agreed consideration was as stated above in cl. X. on the basis of the said agreement the assessee has received the amount in question. **The amount was received because the assessee had given up its right to purchase and/or to operate the property. Further, it is loss of source of**

¹⁵ (1971) 80 ITR 167 (SC)

¹⁶ (1965) 57 ITR 400 (SC)

income to the assessee and that right is determined for consideration. Obviously, therefore, it is capital receipt and not a revenue receipt.

(emphasis is ours)

15. The legal position that could be summarised from the case law discussed above is as follows:

- (i) When a question arises whether payment of compensation for termination of agency is a capital or a revenue receipt, it would have to be considered whether the agency was in the nature of capital asset in the hands of the assessee or whether it was only a part of his stock-in-trade.
- (ii) Broadly stated, what is received for loss of capital is a capital receipt; what is received as profit in a trading transaction is taxable income.
- (iii) It is not predicated that the income must necessarily have a recurrent quality and that it would be regarded as capital if it is for loss of an asset of enduring value to the assessee.
- (iv) The form in which the transaction which gives rise to income is clothed and the name which is given to it are irrelevant in assessing the exigibility of receipt arising from a transaction to tax.
- (v) There is a clear distinction between a case where compensation is received towards loss of capital and compensation received towards loss of agency; in the latter category of cases where

cancellation of an agency did not affect the profit-making structure of the assessee, or it did not involve a loss of an enduring trading asset, and if it merely deprived the assessee of a trading avenue, leaving it free to devote its energies after the cancellation to carry on the rest of the business, the amount received must be regarded as revenue receipt and not capital receipt.

16. Now the stage is set to apply the settled legal position as referred to above to the facts of the present case. The two transferee companies entered into multiple agreements, in addition to non-competition agreements, namely, product registration cooperation agreement, technology transfer agreement and deed of assignment of un-registered trade marks only with the Natco Company excluding the assessee and his family members. In consideration of the product registration agreement, the transferee companies have paid separate consideration to the company. Similarly for technology transfer agreement and deed of assignment of un-registered trade marks also, separate consideration was paid to the company. However, only in case of non-competition agreement, the entire NATCO GROUP, comprising the company, the assessee and his wife and two children, entered into agreements with the

two transferee companies. The terms of the agreement unequivocally reveal that the amounts thereunder were paid to the company as well as the appellant - assessee in consideration of the covenant set forth in paragraph-2 of the agreement, i.e., restraining the NATCO GROUP from selling, supplying, marketing, distributing, advising, assisting, aiding, establishing, managing, providing, developing or acting as a consultant or technical adviser in respect of any products.

17. It is thus very clear that the amounts received under the non-competition agreement are towards consideration for restraining the NATCO GROUP from competing with the transferee companies both in respect of specified products as well as the specified areas, as distinguished from the amounts received by the company in consideration of product registration agreement, technology transfer agreement and deed of assignment of un-registered trade marks. On a close analysis of the terms of the non-competition agreement, it is abundantly clear that as the consideration paid to the company as well as to the appellant is for preventing them from competing with the transferee companies in respect of specified products in specified areas. The consideration received under non-competition agreement, in our opinion, is similar to the amount

received for giving up right to distribute and sell cigarettes in areas other than in Hyderabad State in **Vazir Sultan & Sons** (1 supra) and for giving up right to acquire the hotel under supplemental agreement in **Obero Hotel (P) Ltd.** (5 supra). Therefore, in our view, the income does not fall under the category of profit in a trading transaction, but it clearly falls under the category of income derived from loss of capital. Indeed, the Tribunal treated the income in the hands of the company as capital receipt, but as income from other sources in the hands of the appellant. As regards the income in the hands of the company, the tribunal held as under:

“Insofar as Natco is concerned, though the company could not develop and capture substantial market in the specified territory, it nevertheless penetrated into those markets with respect to the specified products and it can be said that by virtue of the restrictive covenant, there was impairment of the capital structure vis-à-vis the products specified in the agreement. Thus, by applying the principles laid down by the Apex Court as discussed above, it can be said that the amount received by the assessee-company is a capital receipt. In fact, the AO has admitted in his order that it was a capital receipt, but sought to tax by treating it as goodwill, overlooking the fact that goodwill separately transferred by another agreement. Thus, the amount received by the assessee-company cannot be treated as a consideration for transfer of goodwill. In other words, the impugned sum received by Natco is a capital receipt not liable to tax, and we direct the AO accordingly.”

The reasons assigned by the Tribunal for its conclusion that the income in the hands of the appellant as income from other sources, are as follows:

“Reverting to the facts of the case before us, Shri VCN, who pioneered the Time Release Technology, promoted the company by name Natco Pharma Ltd., and handed over the technical know-how with regard to the manufacture of certain medicines to the said company. Thus, the technical know-how has become the property of the company. Though Shri VCN was the Managing Director, further research was done at the expense of the company, brand names were the property of the company and the goodwill, if any, was the property of the company. Thus, Shri VCN has no right whatsoever in the products specified in the agreement and has never entered the market in his individual capacity in the specified territory. The surrounding circumstances show that Shri VCN never intended to carry on business in his individual capacity. As rightly observed by the learned CIT (A), there is no change in the income pattern of Shri VCN in the subsequent years, i.e., after the agreement was entered into with RLL and SPIL. **Knowledge with regard to manufacture of certain medicines can be considered in certain circumstances as a capital asset.** It is for the assessee to prove that such specialized knowledge was treated as a capital asset and income was earned in the specified territory on account of such knowledge and that by virtue of a restrictive covenant, he was deprived of using his specialized knowledge in the specified territory. The facts and circumstances in the instant case show that Shri VCN has utilized the specialized knowledge in promoting the company viz. Natco Pharma Ltd. and handed over the technical know-how to the said company. The assessee having never spread his wings to the specified territory to carry on business in his individual capacity with the technical know-how, brand names etc., invested as a capital asset, it is difficult to hold that the amount received by the assessee was on account of sterilisation of a capital asset or that it impaired the profit making structure or apparatus. The assessee was all along free to carry on the business in other territories and thus there were no fetters on him on the use of technical know-how or the knowledge Shri VCN possessed with regard to certain pharmaceutical formulations. As rightly observed by the learned CIT (A), Shri VCN and his family members had control over Natco in view of the larger share-holding. The amount which was otherwise receivable by the company was diverted to the assessee, and thus it cannot be treated as a capital receipt in the hands of Shri VCN. The case of the assessee that merely because it is not a capital receipt, it cannot be taxed under sec. 10(3) of the Act, is not acceptable in view of the decision of the apex court in the case of *G.R. Karthikeyan* (supra) and also in the light of the decision of the Hon’ble Allahabad High Court in the case of *Wg. Cdr. K.P.K. Ghose*, 268 ITR 260.”

(emphasis added)

18. In the above reproduced paragraph, the Tribunal accepts that knowledge with regard to manufacture of certain medicines can be considered in certain circumstances as a capital asset. It, however, proceeded on certain assumptions which, as rightly argued by the learned counsel for the appellant, are not based on material on record. As regards the technical know-how possessed by the appellant the Tribunal has proceeded on the assumption that the same has become the property of the company and therefore the appellant has no right whatsoever in the products specified in the agreement and that he has never entered the market in his individual capacity in the specified category. In rendering these findings, the Tribunal has not examined whether any arrangement existed whereby the appellant was prevented by the company from using his technical know-how for establishing his own industry or advising a third party to set up an industry for manufacturing the same drugs.

19. Similarly, the Tribunal has failed to distinguish between the right to manufacture the products at present and right to use the technical know-how in future. While undoubtedly the right to manufacture the products was with the company when the non-competition agreement was entered into, in the

absence of any material showing that a similar non-competition agreement was entered between the company and the appellant, it cannot be inferred that merely because the company was at the relevant time using the technical know-how possessed by the appellant, the latter was barred from using the same in future. Indubitably knowledge and technical know-how are intellectual properties and they undoubtedly constitute capital. When an individual is deprived of using such property in future, the same amounts to capital loss and the income derived from such capital loss constitutes capital receipt. In our opinion, the Tribunal has fallen into error in holding that the appellant has failed to prove that the specialized knowledge was treated as a capital asset. On its own finding the Tribunal held that it is the appellant who pioneered the Time Release Technology and promoted the company. This by itself would show that the technical know-how constituted a part of the capital. As observed hereinbefore, unless any specific material existed showing that the appellant has once and for all transferred the technical know-how in favour of the company and that there was no possibility for him to use the same in future without the permission of the company, it would be highly presumptuous for the Tribunal to hold that the appellant

had no right to use the technology. Though a vague finding was rendered that the amount which was otherwise receivable by the company was diverted by the appellant, the same was not substantiated by the Tribunal. This finding, in our opinion, is based on a mere surmise or conjecture in the absence of a finding that the two agreements entered with RLL and SPIL are sham and nominal.

20. In **G.R. Karthikeyan** (6 supra), on which the reliance was placed by the learned Standing Counsel, the question was whether the remuneration received by a person who participated in a car rally falls within the definition of 'income' under Section 2(24) of the Income Tax Act? While holding that the word 'income' is of the widest amplitude and it must be given its natural and grammatical meaning, the Supreme Court held that the car rally in question was a contest, if not a race, and the assessee entered the contest to win it, that what he got was the "return" for his skill and endurance and it was income, construed in its widest sense and that though it was casual in nature, it is nevertheless income. The facts in that case and in the present case do not bear any similarity as in the said case the income was not earned by the assessee under a non-competition agreement or for capital loss.

21. Though, as held by the Courts, the form in which the transaction which gives rise to income is clothed and the name which is given to it are irrelevant in assessing the nature of receipt arising from a transaction, for ignoring the specific terms of an agreement, a finding has to be necessarily rendered that those terms are a mere cloak or subterfuge for avoiding taxation. Neither any material in respect thereof was before the fora below, nor any specific finding in that regard has been rendered. Therefore, we do not find any reason to ignore the specific terms of the agreements and render findings contrary thereto as regards the nature of the income received by the appellant. In the light of the specific finding of this Court that the income in the hands of the appellant is a capital receipt, the finding of the Tribunal on the alternative submission based on the judgment in **G.R. Karthikeyan** (6 supra), need not be dealt with.

22. As regards the submission of the learned Standing Counsel that no substantial questions of law arise for consideration in these appeals, she has referred to the judgment of the Supreme Court in **Biju Patnaik** (7 supra). The leading judgment of the Apex Court in **Sree Meenakshi Mills Ltd. v.**

C.I.T.¹⁷ was referred to in **Biju Patnaik** (7 supra). The following conclusions in **Sree Meenakshi Mills Ltd.** (17 supra) have been quoted in the judgment.

- (i) “When the point for determination was a pure question of law, such as construction of a statute or document of title, the decision of the Tribunal was open to reference to the Court.
- (ii) When the point for determination was a mixed question of law and fact, while the finding of the Tribunal on the facts found was final, its decision as to the legal effect of those findings was a question of law which could be reviewed by the Court.
- (iii) A finding on a question of fact was open to attack under reference under the relevant Act as erroneous in law when there was no evidence to support it or if it was perverse.
- (iv) When the finding was one of fact, the fact that it is itself an inference from other basic facts will not alter its character as one of fact.”

Conclusion No.(i) surpa is squarely attracted to these cases which involve pure construction of the terms of the non-competition agreements and the nature of consideration received under these agreements.

In **I.C.I (India) (P) Ltd. v. C.I.T.**¹⁸, which was also referred to in **Biju Patnaik** (7 supra), the Supreme Court while reiterating the legal position that construction of a statute or document of title gives rise to a pure question of law, further held that a finding on a question of fact was open to attack as

¹⁷ [1957] 31 ITR 28 (SC)

¹⁸ [1972] 83 ITR 710 (SC)

erroneous in law when there was no evidence to support it or if it was perverse. These judgments are complete answer to the submission of the learned Standing Counsel.

23. For the aforementioned reasons, the order of the Tribunal to the extent it pertains to the appellant is not sustainable and we accordingly set aside the same by holding the substantial questions of law as reframed in favour of the appellant and against the Revenue.

24. In the result, the appeals are allowed.



C.V. NAGARJUNA REDDY, J

T. AMARNATH GOUD, J

05-01-2018

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Note: LR copies to be marked.

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