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

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Decision delivered on: 13.09.2023

+ **ITA 399/2005**

THE COMMISSIONER OF INCOME TAX-III Appellant

Through: Mr Prashant Meharchandani, Sr
Standing Counsel with Mr Akshat
Singh, Standing Counsel.

versus

M/S SAEED MUSTAFA SHERVANI Respondent

Through: Mr Ajay Vohra, Sr Adv. with Mr
Vaibhav Kulkarni and Mr Udit
Naresh, Advs.

+ **ITA 1200/2005**

SAEED MUSTAFA SHERVANI Appellant

Through: Mr Ajay Vohra, Sr Adv. with Mr
Vaibhav Kulkarni and Mr Udit
Naresh, Advs.

versus

COMMISSIONER OF INCOME TAX Respondent

Through: Mr Prashant Meharchandani, Sr
Standing Counsel with Mr Akshat
Singh, Standing Counsel.

CORAM:

HON'BLE MR. JUSTICE RAJIV SHAKDHER

HON'BLE MR. JUSTICE GIRISH KATHPALIA

[Physical Hearing/Hybrid Hearing (as per request)]

RAJIV SHAKDHER, J. (ORAL):

1. These appeals concern Assessment Year (AY) 1999-2000.
2. The appellant/ revenue and the respondent/assessee seek to assail, *albeit* for different reasons, the order dated 16.12.2004, passed by the Income Tax Appellate Tribunal [in short, "Tribunal"].
3. The above-captioned cross-appeals were admitted by the court *via* an



order dated 10.03.2006.

3.1 The court framed the following questions of law for consideration:

“(i) Whether the ITAT was correct in law in holding that the proceedings u/s 147 read with Section 148 of the Income Tax Act, 1961 had not been validly initiated against the assessee?

“(ii) Whether the ITAT was correct in law in holding that an amount of Rs.8 crores received by the assessee, in the facts and circumstances of the case, was capital receipt, hence not taxable?”

4. Insofar as the first question of law is concerned, it concerns the appeal filed by the respondent/assessee which is ITA No.1200/2005, while the second question of law, as framed, has been raised by the appellant/revenue in ITA No.399/2005.

5. Mr Ajay Vohra, learned senior counsel, who appears on behalf of the respondent/assessee, says that if the court were to rule in favour of the assessee insofar as the second question of law is concerned, then it would not be necessary to press the first question of law as it would be rendered academic.

5.1 The statement of Mr Vohra is taken on record.

6. Therefore, we propose to deal with the second question of law as framed by the court *via* an order dated 10.03.2006.

7. The broad facts in the backdrop of which this question of law arises for consideration are as follows:

7.1 The assessee at the relevant point in time was the Joint Managing Director of an entity going by the name Geep Industrial Syndicate Ltd. [hereafter referred to as “GISL”].

7.2 The assessee in his individual capacity filed his Return of Income (ROI) on 18.06.1999. In the ROI, the assessee declared his income as Rs.23,24,590/-. An intimation with regard to ROI was served on the



petitioner under Section 143 (1) of the Income Tax Act, 1961 [in short, “Act”]. The record discloses that the assessee was served with a notice for assessment and consequently an order dated 23.01.2003 was passed under Section 143(3) read with Section 147 of the Act.

7.3 *Via* the aforementioned order, the Assessing Officer (AO) concluded that Rs.8 crore received by the assessee from an entity going by the name, Wilkinson Swords India Ltd. [hereafter referred to as “WSIL”] under a non-compete agreement was taxable as revenue receipt.

7.4 Being aggrieved, the assessee filed an appeal before the Commissioner of Income Tax (Appeals) [in short, “CIT(A)”]. The CIT(A), *via* order dated 19.08.2003, sustained the assessment order. It is in this background that the respondent/assessee approached the Tribunal.

7.5 Before the Tribunal, the issues with regard to the jurisdiction to trigger reassessment proceedings under Section 147 of the Act as well as on merits were raised.

7.6 The Tribunal, insofar as the issue regarding jurisdiction was concerned, ruled in favour of the revenue. However, on merits, the Tribunal concluded that Rs.8 crores received by the assessee was a capital receipt and hence not eligible for tax.

7.7 Given this background, the aforementioned cross-appeals have been filed.

8. Before we proceed further, it may be relevant to note that several agreements were executed both with GISL and its Managing Directors/Joint Managing Directors.

For convenience, the agreements that were executed are set forth hereafter:

(i) Asset purchase agreement dated 25.11.1998 was executed between



WSIL and GISL. *Via* this agreement, WSIL purchased the intellectual property of GISL and took over the distribution network.

(ii) Agreement dated 25.11.1998 whereby, WSIL purchased the Mysore Unit of GISL which included land and building erected thereon.

(iii) Acquisition agreement for torches and lamps dated 25.11.1998 whereby WSIL purchased movable assets of GISL's Mysore Unit.

(iv) Sourcing agreement dated 25.11.1998 executed between WSIL and GISL whereby, GISL was obliged to manufacture and supply torches and lamps solely and exclusively to WSIL.

(v) A non-compete agreement dated 25.11.1998 executed between WSIL and GISL. *Via* this agreement, GISL agreed not to engage or participate directly or indirectly in any business in India or any other country in the world which involved manufacturing, trading, selling, marketing and distribution of the products or any components thereof or providing any services in connection therewith for a specified period, which was 10 years. The only exception which was provided was in Clause 5 of the said agreement whereby GISL could manufacture and supply the products referred to in the agreement to WSIL.

(vi) Non-compete agreement dated 25.11.1998 executed between the assessee i.e., S.M. Sherwani and WSIL.

(vii) Non-compete agreement dated 25.11.1998 executed between Mr S.I. Shervani, who was the Managing Director of GISL at the relevant point in time and WSIL.

9. As would be evident, out of the seven agreements, five agreements were executed between two corporate entities, i.e., GISL and WSIL. The remaining two agreements were executed between individuals, one of whom



was the assessee.

10. As noticed above, at the relevant point in time, the assessee was a Joint Managing Director of the GISL. The other individual with whom WSIL had entered into a non-compete agreement was Mr S.I. Shervani, Managing Director of GISL.

11. There is no dispute that agreements executed between WSIL and the two individuals, including the assessee, were identical in nature. The obligation placed on the two individuals who were holding the post of Joint Managing Director and Managing Director in GISL, refraining from competing with WSIL is captured in Clauses 2 and 4 of the said agreement. For the sake of convenience, the two clauses are set forth hereafter:

“2. Non-Compete Covenant :

In consideration of the premises and the mutual covenants and consideration contained herein, the Covenantor does hereby agree and covenant with and undertake to, the Covenantee that the Covenantor shall not , save as provided for in Clause 4 below, for a period of ten years from the date hereof, engage or participate directly or indirectly whether as shareholder, director, partner, proprietor, member or otherwise, in any business in India or any other country in the world which involves manufacture, trading, marketing and distribution of the Products or providing any services in connection therewith.

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xxx

4. Exceptions :

4.1 *Notwithstanding anything to the contrary set forth herein, the Covenantee expressly agrees that the Covenantor may through GISL engage in or carry on the business of manufacture of the Products at its facilities located at Allahabad and Mysore for supply to the Covenantee or its affiliate, in accordance with the provisions of the Sourcing Agreements dated 25th November, 1998 entered into between GISL and the Covenantee.*

4.2 *Notwithstanding anything to the contrary set forth herein, the Covenantor shall be free to engage or participate in the business of manufacture, trading, selling, marketing and distribution of flashlights and bulbs following the expiration or termination, whichever date occurs earlier, of the Sourcing Agreement.”*



12. Therefore, the nature of controversy veers around the impact of Clauses 2 and 4 of the non-competing agreement.

13. A careful perusal of the said Clause 2 of the non-competing agreement shows that the assessee undertook an obligation that for a specified period, i.e., 10 years, he would not engage or participate directly or indirectly whether as a shareholder, director, partner, proprietor, member or otherwise in any business in India or any other country in the world which involves manufacture, trading, marketing and distribution of products or providing any services in connection therewith.

14. A plain reading of the clause would show that the negative covenant embedded in the non-competing agreement prevents the assessee from participating both directly and indirectly in his capacity, not only as a shareholder, director, partner, proprietor, member, but also as a Director. The negative covenant is wide enough to include any other capacity apart from the ones which are specifically noticed in the non-competing agreement.

15. Therefore, clearly for ten (10) years, the assessee for a valuable consideration which was received by him i.e., Rs.8 crores, agreed not to indulge in competing business of any capacity whether directly or indirectly.

15.1 The only exception to this restraint is provided in Clause 4 whereby, the assessee has been given leeway to engage in or carry on business of manufacture of products *albeit* through GISL at the facilities located at Allahabad and Mysore for the purposes of supplying the products manufactured exclusively to WSIL or its affiliates. This clause is tied-in with the sourcing agreement of even date i.e., 25.11.1998.

16. Furthermore, in terms of Section 4.2 of the non-compete agreement,



the assessee has also been given the liberty to engage or participate in the business of manufacture, trading, selling, marketing and distribution of two (2) products, i.e., flash lights and bulbs, following the expiration or termination whichever occurs earlier of the sourcing agreement.

17. Therefore, the argument which was put forth before the Tribunal that the assessee had lost its source of income, according to us, has both merit and weight, the reason being that one of the tests for determining whether or not a receipt is of the nature of capital or revenue relates to the source of receipt.

17.1 If the source of income is, in a figure of speech, closed, the recipient is entitled to take the stand that the receipt is capital in nature. This test has been recognized in several judgments including the judgment rendered by the Supreme Court in *Shiv Raj Gupta v CIT*, (2020) 425 ITR 420 SC. For the sake of convenience, the relevant part of the said judgment is extracted hereafter:

“19. It only remains for us to point out the judgment in Guffic Chem (P) Ltd. v. CIT (2011) 4 SCC 254. In this case, the question set out by the Court is as follows:

“Whether a payment under an agreement not to compete (negative covenant agreement) is a capital receipt or a revenue receipt is the question which arises for determination in this case?”

Here, the Court was dealing with an amount of INR 50 lakhs received by the appellant-assessee from Ranbaxy as a non-compete fee under an agreement dated 31.03.1997. This Court in negating the application of Section 28(ii)(a) to such receipt, held as follows:

“Decision

4. The position in law is clear and well settled. There is a dichotomy between receipt of compensation by an assessee for the loss of agency and receipt of compensation attributable to the negative/restrictive covenant. The compensation received for the loss of agency is a revenue receipt whereas the compensation attributable to a negative/restrictive covenant is a capital receipt.

5. The above dichotomy is clearly spelt out in the judgment of this Court in



Gillanders case [(1964) 53 ITR 283 (SC)] , in which the facts were as follows: the assessee in that case carried on business in diverse fields besides acting as managing agents, shipping agents, purchasing agents and secretaries. The assessee also acted as importers and distributors on behalf of foreign principals and bought and sold on its own account. Under an agreement which was terminable at will the assessee acted as a sole agent of explosives manufactured by Imperial Chemical Industries (Export) Ltd. That agency was terminated and by way of compensation Imperial Chemical Industries (Export) Ltd. paid for first three years after the termination of the agency two-fifths of the commission accrued on its sales in the territory of the agency of the appellant and in addition in the third year full commission was paid for the sales in that year.

Imperial Chemical Industries (Export) Ltd. took a formal undertaking from the assessee to refrain from selling or accepting any agency for explosives.

6. Two questions arose for determination in Gillanders case [(1964) 53 ITR 283 (SC)] , namely, whether the amounts received by the appellant for loss of agency was in normal course of business and therefore whether they constituted revenue receipt? The second question which arose before this Court was whether the amount received by the assessee (compensation) on the condition not to carry on a competitive business was in the nature of capital receipt? It was held that the compensation received by the assessee for loss of agency was a revenue receipt whereas compensation received for refraining from carrying on competitive business was a capital receipt.

7. This dichotomy has not been appreciated by the High Court in its impugned judgment. The High Court has misinterpreted the judgment of this Court in Gillanders case [(1964) 53 ITR 283 (SC)] . In the present case, the Department has not impugned the genuineness of the transaction. In the present case, we are of the view that the High Court has erred in interfering with the concurrent findings of fact recorded by CIT (A) and the Tribunal.

8. One more aspect needs to be highlighted. The payment received as non-competition fee under a negative covenant was always treated as a capital receipt till Assessment Year 2003-2004. It is only vide the Finance Act, 2002 with effect from 1-4-2003 that the said capital receipt is now made taxable [see Section 28(v-a)]. The Finance Act, 2002 itself indicates that during the relevant assessment year compensation received by the assessee under non-competition agreement was a capital receipt, not taxable under the 1961 Act. It became taxable only with effect from 1-4-2003. It is well settled that a liability cannot be created retrospectively. In the present case, compensation received under the non-competition agreement became taxable as a capital receipt and not as a revenue receipt by specific legislative mandate vide Section 28(v-a) and that too with effect from 1-4-2003. Hence, the said Section 28(v-a) is amendatory and not clarificatory.

9. Lastly, in CIT v. Rai Bahadur Jairam Valji [(1959) 35 ITR 148 (SC)] it was held by this Court that if a contract is entered into in the ordinary course of business, any compensation received for its termination (loss of agency)



would be a revenue receipt. **In the present case, both CIT(A) as well as the Tribunal, came to the conclusion that the agreement entered into by the assessee with Ranbaxy led to loss of source of business; that payment was received under the negative covenant and therefore the receipt of Rs. 50 lakhs by the assessee from Ranbaxy was in the nature of capital receipt.** In fact, in order to put an end to the litigation, Parliament stepped in to specifically tax such receipts under the non-competition agreement with effect from 1-4-2003.”

[Emphasis is ours]

18. The AO, however, as noticed above, added the compensation received by the assessee on the ground that the business was not being carried out by the assessee, i.e., the individual, but by his employer, i.e., GISL. Therefore, according to the AO, the assessee was not compensated one way or the other for any loss of right.

19. Based on this rationale, the AO concluded that the receipt of Rs.8 crores was in the nature of revenue receipt.

20. Mr Prashant Meharchandani, learned senior standing counsel, who appears on behalf of the appellant/revenue, relies upon the view of the AO in support of his argument.

20.1 Furthermore, Mr Meharchandani submitted that the entire agreement was a charade. According to him, the compensation for the purchase of two units of GISL located in Mysore was artificially configured to include the compensation for non-compete agreements which was paid to the two individuals referred to hereinabove, i.e., the assessee and Mr S.I. Shervani.

21. According to us, the submission advanced by Mr Meharchandani is untenable.

21.1 Insofar as the argument advanced before us that there was no loss of right for the assessee and, therefore the compensation received by him was revenue in nature is contrary to the express obligation undertaken by the



assessee in the non-compete agreement.

21.2 The revenue, in our view, cannot wish away the non-compete agreement which in plain terms restrained the assessee, *albeit* for a specified period, from carrying on any business activity directly or indirectly which would compete with the business activity of WSIL.

22. The other submission made by Mr Meharchandani is founded on the proceeding note dated 23.07.2003 which records what transpired between CIT(A) and the authorised representative of the assessee. In this context, it would be relevant to refer to what is noted by the CIT(A) in its order:

“5.9 During the course of hearing I asked the appellant to explain to me the method of valuation of business done by them which resulted in receipt of Rs. 75 crores from WSIL and besides this receipt of Rs. 8 crores each by 2 senior family members. It was explained to me that the final negotiation concluded with the settlement of the consideration at Rs. 75 crores and this amount was split as under:

1. Mysore Factory - The factory land had been valued a few years ago at Rs. 5.5 crores. The replacement value of the major plant and machinery was known as the same had been manufactured in house. On this basis the total value was determined at Rs.9.5 crores.

2. Against the non compete agreement between WSIL and GISL a consideration of Rs. 10 Crores was fixed.

3. After having taken the above valuation, the value towards the Brand, intellectual property assets, GEEP Trade Marks GEEP copyrights GEEP designs and all assets of Distribution network was taken at Rs.55.5 crores.

5.10 The above mentioned statement very clearly shows that the sale consideration was first arrived at and then it was decided to split the same under various heads. This would also mean that the payments of Rs. 10 crores to GISL shows as non compete fees was actually part of sale consideration only. This is not a conclusion derived by me but this is part of the note given to me on 23.7.2003 by the appellant's AR when Sh. Sherwani was also present. After going through this, when I wanted to confront this, they could not explain properly except saying that non compete agreement between WSIL and GISL was separate. This factual position clearly shows that the non compete fees for GISL was part of the sale consideration and was camouflaged as non compete agreement between WSIL and the appellant



and that is why I have mentioned this fact in this order.”

23. According to us, a bare perusal of what is recorded by the CIT(A) in paragraphs 5.9 and 5.10 of his order would show that the consideration was paid against various agreements, which included the non-compete agreements.

23.1 A plain reading of the extract embedded in the aforementioned proceeding order does not convey that the assessee had conceded, as is sought to be portrayed before us, that the non-compete agreements were sham agreements and the consideration was artificially bifurcated into that which were paid for various assets [both fixed and movable] and transfer of IPR rights.

24. There is, in fact, no elucidation of the note said to have been submitted by the authorized representative of the assessee.

25. The Tribunal, in our view, has applied the correct test, which is that there was no material on record for the CIT(A) to conclude that non-compete fee was a camouflage for payment of money or transfer of business.

26. The relevant observations made by the Tribunal in this behalf are extracted hereafter:

“The Commissioner of Income tax (A) was not justified in rendering a finding that the sale consideration payable WISL [sic:WSIL] to GISL for transfer of business was split in to several portion under sum of Rs. 8 crore was to the assessee as non compete fee which in fact was a payment for transfer of the business of the business and the non compete fee was merely camouflage. There is no material on record to arrive at this conclusion. There is no material on record to arrive at this conclusion. The CIT(A) seems to rely on conversation that took place between him and the Assessee in the course of the appellate proceedings for arriving a conclusion that the sale consideration for the transfer of the entire business was arrived at first at Rs. 75 crores and thereafter the consideration was split under heads and the sum



of Rs. 8 crores was in reality sale consideration for transfer of the business which has been camouflaged as a non compete fee and paid to the Assessee. The revenue authorities cannot go beyond the terms of agreement. The parties are at liberty to agree upon various terms and conditions under an agreement. These terms would depend upon the exigencies of business. The Revenue Authorities seek to overlook the right's and obligation of the parties arising out of agreement.”

27. We may note that what the Tribunal, in brief, is seeking to convey is that because the assessee had executed a non-compete agreement with WSIL, the conversation the CIT(A) had with the assessee could not be used to vary, add or subtract from the obligations contained in the said agreement.

28. As noticed above by us, the assessee had been restrained both directly and indirectly from undertaking any business which would compete with the business of WSIL.

28.1 Clearly, for the period in which the non-compete agreement was to operate, which in this case was 10 years, the assessee's source of income had been clamped and, therefore, compensation received by him could only be treated as capital receipt.

28.2 Thus, we have no difficulty in holding that the conclusion arrived at by the Tribunal was correct.

29. Accordingly, the second question of law which is framed in the above-captioned appeals is answered against the revenue and in favour of the assessee.

30. As recorded above, given the fact that on merits, we have sustained the impugned order passed by the Tribunal, the other question which concerns the jurisdiction of the AO to trigger proceedings under Sections 147/148 of the Act has become academic, and is not pressed on behalf of the assessee.



31. The above-captioned appeals are disposed of in the aforesaid terms.
32. Parties will act based on the digitally signed copy of the judgment.

RAJIV SHAKDHER, J

GIRISH KATHPALIA, J

SEPTEMBER 13, 2023/aj