Non-compete fee paid to directors to restrain them from engaging in same business was allowable deduction

Summary – The High Court of Madras in a recent case of Hatsun Agro Products Ltd., (the Assessee) held that where assessee engaged in business of manufacture, marketing and distribution of ice cream and dairy based frozen products, made payment of non-compete fee to two of its directors, since advantage of restraining individuals from engaging in competition was in field of facilitating assessee's own business and rendering it more profitable and there was no increase in fixed capital, payment in question was to be allowed as revenue expenditure

Facts

- The assessee was initially a private company engaged in business of manufacture, marketing and distribution of ice cream and dairy based frozen products.
- Subsequently, assessee initiated the process of conversion from private limited to a public limited company to facilitate growth and expansion in business at that stage, assessee made payment of non-compete fee to two of its directors to ensure that it was not deprived of their services, or worse, lost to a competitor.
- The assessee's claim for deduction of said expenditure under section 37(1) was rejected by Assessing Officer on ground.
- The benefit obtained under the agreement was an enduring one, and consequently expenditure in question was capital in nature.
- The Tribunal upheld the order of Assessing Officer.
- On appeal:

Held

- The question comes up before the Court is the categorization of expenditure of non-compete fee as either capital or revenue. The distinction is fine. Courts have, over time, evolved various tests to determine such categorization, but there is no straightjacket method and the application of the tests would vary upon the facts of the case in hand. In the present case, while neither the Assessing Officer nor the Tribunal dispute the long association and valuable services rendered by the individuals as well as the importance of retaining these advantages, particularly at the time when it was going public, both officers deny the claim solely based on the fact that the payments results in an enduring benefit.
- The test of enduring benefit cannot be applied blindly without regard to the facts and circumstances that arise in the given case. The conclusion of the Tribunal that the payment has an enduring benefit

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and is capital in nature does not take into account the commercial benefit received by the company. In fact, the Tribunal appears to have been guided solely by an earlier decision.

- The advantage of restraining the individuals from engaging in competition was in the field of facilitating assessee's own business and rendering it more profitable. Since there is no increase in fixed capital, the payment does not encroach in the capital field.
- The payments made towards restrictive covenants ensured the continued presence and support of the individuals in its business operations. Equally importantly, it also ensured credibility in public perception and reassured potential investors that the performance of the company would remain optimum through this continued association. Though there was no actual or impending threat of the Directors severing their ties with the company or starting competing businesses, the possibility was always real and prudence dictates that the company protect itself against such a probability. This assumed particular significance at a time when the company was proposing to go public and it thus becomes vital that the public continued to see that the company was associated with, and had the benefit of services and loyalty of the individuals who had been, and were continuing to be, fundamental to the growth of the company.
- In the light of the above discussion it is held that the payments towards non-compete fee to two directors constitute revenue expenditure in the hands of the assessee.

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