

## M&A Hotline

August 29, 2012

### INCOME-TAX APPELLATE TRIBUNAL RULES ON TAXATION OF BUSINESS TRANSFERS

The Income Tax Appellate Tribunal ("ITAT") in a recent case of Assistant Commissioner of Income Tax, New Delhi vs. Smt. Sangeeta Wij<sup>1</sup> ("**Seller**") has pronounced that the lump sum consideration received by the Seller in a slump sale transaction is a capital receipt and such consideration cannot be treated as 'compensation' for complying with the non-compete obligations by the Seller as contained in the slump sale agreement.

#### FACTS OF THE CASE

Facts of the case As a matter of background, the Seller was a proprietor of SD Engineering Consultants, which was a sole proprietorship concern engaged in the business of designing of structures, public health and fire protection services. The Seller had alongwith Mr. K.K. Kapila formed a company by the name ICT-SD Engineering Consultants Private Limited ("**Buyer**"). A slump sale agreement dated December 4, 2007, was entered into by and between the Seller and the Buyer pursuant to which the entire business of the Seller was transferred to the Buyer with effect from October 31, 2007, for a total consideration of INR 1,20,00,000 inclusive of goodwill, receivables, work in progress and all other rights and entitlements pertaining to the business. Since the transaction was by way of a slump sale<sup>2</sup>, no values were assigned to individual assets or liabilities of the sole proprietorship concern.

According to the report of a chartered accountant submitted by the Seller in support of her contentions, it was brought to the notice of the assessing officer ("**AO**") that the total net worth of the undertaking was INR 4,73,725. Based on the same, the Seller had computed the capital gains on an amount of INR 1,15,26,275. The Buyer had also recorded a similar amount as goodwill in its books.

Upon being investigated by the AO, the Seller submitted the requisite documentation in relation to the business transfer, purchase of house property, return of income, report of the chartered accountant in Form 3 CEA and the tax audit report in support of her contentions. After analyzing the facts of the case, the AO held that the consideration received by the Seller for the slump sale was chargeable as 'business profits' and not as 'capital gains' under the provisions of the Income-tax Act, 1961 ("**ITA**").

Aggrieved by the order of the AO, the Seller filed an appeal before the Commissioner of Income Tax ("CIT") who after considering the case on record, struck down the order of the AO and held that the AO was not justified in changing the treatment of income from capital gains under Section 50B3 of the ITA to business profits under Section 28 (va) (a)<sup>4</sup> of the ITA.

The AO filed an appeal against the order of the CIT before the ITAT.

#### SUBMISSIONS BY THE AO

The AO relied upon the terms of the slump sale agreement under which the Seller had agreed to serve exclusively as a whole time director of the Buyer with a salary; and agreed not to compete with the business of the Buyer.

Based on the above, the AO contended that the Seller received the consideration not for the purpose of business transfer but as compensation for not competing with the business of the Seller and hence such consideration should be taxed as 'profits and gains of business'.

#### SUBMISSIONS BY THE SELLER

Having placed all pertinent documents on record, the Seller submitted that the primary transaction undertaken by the contracting parties was not to restrain the Seller from not competing with the business of the Buyer but to transfer the business from the Seller to the Buyer and that being so, the transaction was squarely covered within the provisions of Section 50B of the ITA and the proviso to Section 28(va)(a) of the ITA.

#### ORDER OF THE ITAT

In view of the facts of the case, submissions made by the parties and the evidence placed on record, the ITAT was of the opinion that:

1. The payment of INR 1,20,00,000 was not to restrict the Seller from not competing with the business of the Buyer. The ITAT specified that the terms of the slump sale agreement were specific, clear and unambiguous and the intention of the parties to transfer the business was clearly reflected by the same. The ITAT was unable to decipher the reasons behind the AO's act of 'lifting the veil' over the agreement and misinterpreting the provisions of the same to suit his interpretation.
2. The consideration of INR 1,20,00,000 was indeed taken in return for the transfer of business of the Seller on a going concern basis and such consideration undoubtedly accounted for the goodwill, receivables, work in

## Research Papers

### New Age of Franchising

June 20, 2025

### Life Sciences 2025

June 11, 2025

### The Tour d'Horizon of Data Law Implications of Digital Twins

May 29, 2025

## Research Articles

### 2025 Watchlist: Life Sciences Sector India

April 04, 2025

### Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

### INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

## Audio

### CCI's Deal Value Test

February 22, 2025

### Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

### Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

## NDA Connect

Connect with us at events, conferences and seminars.

## NDA Hotline

Click here to view Hotline archives.

## Video

### Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia | NewsX

April 01, 2025

progress and all other rights and entitlements of the Seller's business. According to the ITAT, the amount of INR 1,15,26,275 (which was the amount remaining after deducting the net worth amount of INR 4,73,725 from the total consideration of Rs. 1,20,00,000) was the long term capital gain and not business profits as contended by the AO. The ITAT also referred to the CBDT Circular no. 779 dated September 14, 1999 explaining the sale of business for a lump sum consideration and elucidated that Section 50B of the ITA dealt with computation of capital gains on slump sale and paid no heed on the question of computation of the goodwill allocation.

3. Lastly, on the issue of the non-compete restrictions being imposed on the Seller, the ITAT stated that the AO while determining such restriction on the Seller failed to appreciate that the Seller had executed full time employment agreement with the Buyer and it is fairly common to have such non-compete restrictions imposed upon the employee during the term of employment as well as on the seller of a business transferred. Such restrictions were not primary to the slump sale transaction and were wholly unconnected to the consideration being paid for the business transfer.

ANALYSIS

From an Indian tax perspective, it is important that in slump sale transactions a lump sum consideration is paid by the buyer to the seller without assigning values to individual assets or liabilities. From a seller's point of view, the treatment of long term capital gains would be beneficial for the seller and available only if the entire consideration is treated as a capital receipt, provided that the undertaking as a whole is more than three (3) years old. As against that, from a buyer's point of view, he may want part of the consideration to be allocated to non-compete to claim revenue expenditure. On account of such conflicting tax objectives, frequently in negotiations of slump sale agreements, an issue comes up on whether to attribute separate considerations to non-compete and to business transfer or to club both the considerations into business transfer and not allocate any separate consideration for non-compete.

It can be argued that a non-compete is merely in the nature of fees paid, which can well be independent of the acquisition of the undertaking and to that extent, payment of non-compete fees should not impact the nature of the 'slump sale'. However, since non-compete payments post Finance Act 2012 fall under the 'service tax' net, the feasibility of such option needs to be weighed carefully.

On the other hand, from a contract law perspective, enforceability of non-compete hinges on the extent of goodwill that the buyer has purchased. Non-compete provisions may not be enforceable if no goodwill has been purchased as per section 27 of Indian Contract Act, 1872. Again, from a buyer's perspective, it is always better to allocate as much price as possible to goodwill to fortify the non-compete provisions against the seller; however allocating any value to goodwill may impact the nature of the 'slump sale' and lead to the tax authorities contending that the sale is in nature of 'asset sale'. As a middle ground, parties may agree not to specify any value to goodwill in the contract and may embed the purchase price of the goodwill in the total purchase consideration for business transfer to strengthen the argument of 'slump sale' without assigning specific values. Buyer may then take a call on how to regard the excess consideration in its books - whether as goodwill or otherwise. Recent Supreme Court judgment on CIT vs. SMIFS Securities Limited (Civil Appeal no. 5961 of 2012) supporting depreciation on goodwill may be a good case for allocating values to goodwill and claiming 25% depreciation thereon.

Having said that, as a compromise, buyer and seller may agree to not attribute a separate consideration to non-compete payments or goodwill but at the same time clearly mention in the Business Transfer Agreement that the seller acknowledges that the consideration for business transfer is sufficient for him to comply with the obligations of non-compete under the Agreement. This ruling by ITAT clarifies that any excess payment made to the seller above the net worth of the undertaking cannot be considered as business profits since such excess payment would squarely fall under Section 50B of the ITA and hence be considered as capital gains inspite of the fact that the buyer has recorded the excess payment as goodwill in its books and the seller has undertaken obligations to not compete with the buyer in future.

Harshita Srivastava, Sahil Shah & Nishchal Joshipura

You can direct your queries or comments to the authors

<sup>1</sup> IT Appeal No. 4274 (Delhi) of 2011

<sup>2</sup> Slump Sale as defined under Section 2(42C) of the ITA means "the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales...."

<sup>3</sup> Section 50B of the ITA states that "any profits or gains arising from the slump sale effected in the previous year shall be chargeable to income tax as capital gains arising from the transfer of long-term capital assets and shall be deemed to be the income from the previous year in which the transfer took place.....".

<sup>4</sup> Section 28 (va)(a) of the ITA states that "The following income shall be chargeable to income tax under the head 'Profits or gains of business and profession:.....any sum whether received or receivable, in cash or kind, under an agreement for- (a) not carrying out any activity in relation to any business; or (b) not sharing any know how, patent, copyright, trademark, license, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services. Provided that sub clause (a) shall not apply to (i) any sum, whether received or receivable, in cash of kind, on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on any business, which is chargeable under the head 'Capital Gains'...."

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.