Shri V.C. Nannapaneni Vs. Asstt. Cit

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Court : Income Tax Appellate Tribunal ITAT Hyderabad

Decided On : Dec-31-2004

Reported in : (2005)94ITD309(Hyd.)

Judge : D Manmohan, J S Reddy

Appellant : Shri V.C. Nannapaneni

Respondent : Asstt. Cit

Judgement :

1. These three appeals are directed against orders of the CIT (Appeals) III, Hyderabad. Since the issue involved in these appeals is identical, we proceed to dispose of these appeals by a combined order, for the sake of convenience.

2. The only issue urged in the grounds of appeal is with regard to taxability of the amount received as "Non-competition Fee". In the case of Natco Pharma Ltd., (hereinafter referred to briefly as Natco), an amount of Rs. 1.46 crores was received by the assessee from Ranbaxy Laboratories Ltd. (briefly RLL) under an agreement dated 20-6-1997.

Under the same agreement, Shri V.C. Nannapaneni (hereinafter referred to as Shri VCN) received a sum of Rs. 1.50 crores. According to the assessee, the impugned sum is not assessable to tax since it is a capital receipt. However, according to the Assessing Officer, the amount received by Natco is assessable to tax for the assessment year 1998-99 under the head 'capital gain'; the AO considered the receipt as a return for the sale of goodwill. In the case of VCN it was assessed as income from other sources.

3. Under another agreement dated 7-9-1998, Shri VCN received a sum of Rs. 2 crores from Sun Pharmaceutical Industries Limited (SPIL in brief). The payment is stated to be "Non-competition Fee". Since this payment was received during the previous year relevant to asst. year 1999-2000, the AO brought to tax the said income under the head 'income from other sources' by treating it as a revenue receipt.

4. The first appellate authority confirmed the orders passed by the AO in all the three cases; detailed order was passed in the case of Shri VCN in respect of asst. year 1998-99 and by following the said order, other two appeals were also dismissed. Thus, the discussion and reasons given by the CIT (A) are found in the appellate order for asst. year 1998-99 in the case of Shri VCN.5. Further aggrieved, the assessees are in appeal before us. Before we record the submissions of the learned counsel for the assessee as well as the learned departmental representative, it may be necessary to briefly mention the reason given by the AO as well as the CIT (A) in bringing to tax the impugned sums.

6. In the case of Natco, the AO noticed that four agreements were signed by the assessee with RLL, viz. (a) Product registration co-operation agreement, (b) Technology transfer agreement, (c) Deed of assignment of unregistered trade marks, and (d) Non-competition agreement. By virtue of the first agreement, Natco received a consideration of Rs. 2,70,00,000. The second agreement earned Rs. 4,30,00,000. By virtue of the

third agreement, Natco agreed to assign the unregistered trade marks along with goodwill to RLL for the territories of Russia and CIS countries. The fourth agreement, with which we are concerned herein, is entered into between "Natco Group" comprising of Natco and Shri V.C. Nannapaneni, Managing Director, and his family members on one side, and RLL on the other side. Natco Group agreed to refrain from selling, supplying, marketing, distributing, advising, assigning, aiding and establishing/managing/providing/developing, acting as consultant or technical advisor in respect of the specified products or any similar products, in the territories of Russia and CIS countries, in consideration of which a sum of Rs. 1,46,00,000 was receivable by the assessee company and Rs. 1,50,00,000 by Shri VCN. The AO noticed that none of the agreements can exist or be enforceable without the other-agreements. In short, each of these agreements constitutes smaller part of a larger whole. By virtue of the first three agreements, Natco has not only relinquished the technical know-how in respect of the specified products, but has also relinquished its right to manufacture, market and sell these products or any other similar products in the markets of Russia and CIS countries. The fourth agreement is a restrictive covenant to prevent the assessee from encashing its knowledge of the technology and also its brand image association with pharmaceutical products of a certain variety in the markets of Russia and CIS countries, even after selling the existing market to the competitor. The AO was of the view that the term 'non-competition' should not be seen in isolation, but has to be appreciated with regard to the facts and circumstances in their entirety; read in that spirit, the fourth agreement amounts to transfer of goodwill of Natco in Russia and CIS countries in favour of a competitor. The AO has also considered in detail the meaning of the term 'goodwill'. In the backdrop of the facts and circumstances of the case, he was of the view that the assessee company had transferred its goodwill for a consideration, under the fourth agreement and thus it is not simply a case of losing a source of income. Since the consideration was held to be a capital receipt, for sale of goodwill, it was brought to tax under the head 'capital gains' as per Section 55(2)(a) of the Income-tax Act, 1961. The AO was of the view that the goodwill is self-generated and hence the cost of acquisition has to be taken at Nil. Thus, the entire sum of Rs. 1.46 crores was brought to tax under the head 'long-term capital gain'. While dealing with the cases relied upon by the assessee's counsel, the AO observed that the case laws have no application here inasmuch as the dispute in those cases was whether the relinquishment of a managing agency was a revenue receipt or a capital receipt, whereas in this case it is accepted that the receipt is a capital receipt.

7. In the case of Shri VCN, the AO has taken note of the various agreements entered into between Natco Group and RLL and, in his opinion, the impugned sum of Rs. 1.50 crores is assessable to tax as income from other sources. The case of the assessee before the AO was that he was the Chairman and Managing Director of Natco which was manufacturing and exporting different pharmaceutical products to Russia and CIS countries. By virtue of agreement dated 20-6-1997, Natco Group agreed to withdraw its business activities in respect of certain pharmaceutical products from the markets of Russia and CIS countries and also agreed to refrain from selling, supplying, marketing, acting as consultant in respect of the said products, either directly or indirectly, in the territories of Russia and CIS countries, and in pursuance of the Non-competition agreement, the impugned sum was received, which is nothing but a price for the loss of a source of income and, therefore, is a capital receipt. It is the case of the assessee that the payment was in lieu of agreement to refrain from carrying on business in Russia and CIS countries and thus it is a capital receipt. Reliance was placed on the decision of the apex court in the case of Gilander Arbuthnot v. CIT, 53 ITR 283, wherein the court observed that a payment received to compensate the loss of what may be regarded as the source of assessee's income, is a capital receipt.

Reliance was also placed upon the decision of Hon'ble Supreme Court in the case of Kettlewell Bullen & Co. Ltd. v. CIT, 53 ITR 261. It was also submitted that the fee received was not for transfer of his capital asset and, therefore, the question of treating it as capital gain does not arise. To highlight the point that the assessee was duly eligible to receive such sum from RLL, it was submitted that Shri VCN is a Postgraduate in Pharmacy and Science with work experience as In-charge of Quality Assurance and R & D with Time Cap Inc. in the USA.The assessee also floated Natco Pharma Ltd. and developed different trade marks/brand names, which are all well established and certain brands became popular in Russia and CIS countries. It was thus submitted

that the amount is not assessable to tax.

8. The AO discussed the issue in the same line as has been stated in the case of Natco, to bring home the point that what had been transferred by Natco was its goodwill and it was not simply a case of losing a source of income, but he quickly added that the above discussion is valid only from the point of view of Natco Pharma Ltd. since the brand names in question belonged to Natco and no one else.

The brands transferred were not perceived to be products belonging to or associated with Shri VCN but to Natco. The company had its own status both legally and in terms of goodwill and reputation in the market and by no stretch of imagination can the status and goodwill of Natco become coterminus with that of the assessee. The AO observed that if the brands transferred were to be perceived as brands belonging to or associated with Shri VCN, the head of R & D Division and the head of marketing or any other shareholder can also lay a claim to a share of the non-competition fee. He thus concluded that the goodwill, which had accrued on these products, was of Natco and not of the assessee. He thus concluded that the entire consideration received by the assessee in pursuance of the so-called non-competition agreement was assessable to tax under the head 'other sources'. The AO further added that the assessee had no subsisting business or source of income with respect to the sale of the products in Russia and CIS countries. Therefore, there was no question of loss of any source of income so as to treat the receipt as a capital receipt.

9. A similar agreement was entered into with SPIL whereby Shri VCN received Rs. 2 crores during the previous year relevant to asst. year 1999-2000. The AO brought to tax the said amount in the asst. year 1999-2000 for identical reasons as those mentioned in the assessment order for asst. year 1998-99. An alternative contention of the assessee was that the impugned receipt was not assessable to tax since it was exempt under Section 10 of the Act. The AO observed that the amount was received by the assessee for being a party to the non-competition agreement between Natco and SPIL and thus it is a revenue receipt in the hands of the assessee for the services rendered. Therefore, he brought to tax the said amount as income from other sources under Section 56 of the Act.

10. The learned CIT (A) observed in the appellate order for asst. year 1998-99 in the case of Shri VCN that compared to the total turnover of Natco, the percentage of sales in Russia and CIS countries was not a substantial one - varying between 2.68% to 10.7%. The learned CIT (A) further noticed that even after the sale, the assessee continued to receive almost the same amount of remuneration and thus there was no loss of source of income to Shri VCN on account of Natco's decision to withdraw its business activities in respect of specified products in Russia and CIS countries. He further observed that Natco developed these products and; marketed them. Expenditure on development and marketing was allowed as a revenue expenditure in the hands of Natco, Therefore, if at all anybody has to receive compensation, it should be only the company and not anybody else. The learned CIT (A) highlighted that the agreements did not have any mention that the payment was made to Shri VCN because of his qualification, experience and ability. He observed that the invention of time release technology by Shri VCN is not the only basis on which it could be concluded that on transfer of such technology Shri VCN should get a share inasmuch as Natco had used R & D facility and considerable money was spent on R & D. He also noticed that Shri VCN had received royalty income from Time Cap Inc.

for invention of time release technology. In other words, the specified products were developed, marketed and owned by Natco and Shri VCN cannot claim any share in it on the transfer of such technology.

11. The learned CIT (A) further observed that as per the agreement, Natco Group consisting of Shri VCN, his wife and children, agreed not to carry on any business in countries specified in Annexure II to the Non-competition agreement, but the statistics show that from the accounting year 1997-98 onwards the sales had slightly decreased and the company had incurred losses. The said losses were not due to stoppage of sales to Russia and CIS countries but due to other reasons, as the percentage of drop in the profit/loss was more than the percentage of sales in Russia and CIS countries. Thus, according to the learned CIT (A), even after the

stoppage of sales to Russia and CIS countries, Natco could make profit and the source of income of Natco being sale of pharmaceutical formulations, there was no extinguishment of source to the company - the impact of the extinguishment on sales at Russia and CIS countries being nominal.

12. The learned CIT (A) highlighted the observations of the apex court in the case of Best Company (P) Ltd., 60 ITR 11, wherein the court observed that whether a particular receipt was capital or revenue in nature depends upon various factors such as the nature of activity, its proportion in relation to the total income of the company, the impact of giving it up on the structure of the entire business and several other such factors have to be looked into. Applying the principles enunciated in the aforesaid decision, the learned CIT (A) concluded that only when there is loss of an enduring nature, the receipt in lieu of such loss has to be treated as capital in nature and if the loss is only incidental to the business, the compensation received has to be treated as revenue in character. He also referred to various other case law, wherein the aforementioned principles were reiterated. By applying the aforementioned principles, the learned CIT (A) observed that Natco has sold a small portion of its share of right to sell in Russia and CIS countries and Shri VCN has appropriated Rs. 1.5 crores out of that sum even though the entire compensation must have been accounted only in the books of the company. Bearing in mind the facts and circumstances of the case, the learned CIT (A) held that it is a revenue receipt in the hands of Natco which was diverted to Shri VCN and thus it cannot be treated as a capital receipt in the hands of Shri VCN.13. It is not in dispute that the amount received in the previous year relevant to asst. year 1999-2000 is also based upon a similar agreement with SPIL and thus, for the same reasons, the learned CIT (A) affirmed the order of the AO in respect of asst. year 1999-2.000.

14. In the case of Natco also, the learned CIT (A) has not given any independent reasons. He merely observed in his order as under:- "4.1 The issue has been dealt by me in detail in the case of Sri V.C. Nannapaneni in Appeal No. 586/Tr/CC-I/CIT(A)-III/01-02 dated 22.3.2002 for the Asst. Year 1998-99. I enclose a copy of my findings in that case and for the reasons stated therein, I confirm the action of the AO in bringing to tax this sum of Rs. 1,46,00,000/-." It is essential to notice that the AO had brought to tax the amount received by Natco under the head 'capital gains' and the observations of the CIT (A) would give an indication that the head under which it was brought to tax was affirmed by the CIT (A). However, the detailed reasons given by the learned CIT (A) in the appellate order for asst.

year 1998-99 in the case of Shri VCN indicate that the learned CIT (A) was of the view that it was a revenue receipt in the hands of Natco also, though it-was not stated in so many words in his appellate order.

15. Before us, the learned counsel for the assessee as well as the learned departmental representative advanced their arguments in great detail and also filed written submissions. Upon exchanging written submissions, the learned DR has also filed reply to the submissions filed by the assessee's counsel. It may be noticed that barring minor differences, the arguments advanced for all the three cases were same and hence we proceed to record the submissions of the parties accordingly.

16. The case of the learned counsel for the assessee is that Shri VCN is a Postgraduate in Pharmacy and Science and worked in the R&D Department in a reputed company of USA for 13 yers and, apart from gaining sufficient experience in pharmaceutical line, he invented Time Release Technology and transferred all the registered formulations in the name of Natco without taking any consideration from the company.

The company has sold the formulations under different brand names not only in India, but in various other countries including Russia and CIS countries. Shri VCN as well as the company entered into an agreement with Ranbaxy Laboratories Ltd. The agreement dated 20-6-1997 is termed as "Non-competition agreement". There were four agreements between RLL and Natco. The amount received under the Product registration and co-operation agreement was offered by Natco as a business income. So far as the fourth agreement is concerned, Natco and Shri VCN and family members, referred to as Natco Group, on one part, entered into a non-competition agreement with RLL by which Natco was prevented from selling the products mentioned in Annexure I within the territory mentioned in the agreement, though RLL was not prevented from

manufacture and sale of the products under a different brand name in India and elsewhere. The learned counsel has taken us through the Deed of assignment of unregistered trade marks and the other two agreements and then referred to the non-competition agreement, to submit that RLL was interested in binding Shri VCN and his family members by a restrictive covenant from aiding, advising or assisting, either directly or indirectly, any person to sell, supply, market or distribute the specified products within the specified territory. The relevant clause reads as under:- "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 containing 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." The learned counsel submitted that while appreciating as to whether it was a restrictive covenant or not, one has to look at it from the perception of the parties. The case of the learned counsel is that in the perception of RLL, Shri VCN and his family members having promoted the company Natco and introduced into the market several time release drugs under specified brand names, Shri VCN is capable of entering into the market again in any form such as advising, assisting etc., and to put an embargo on such capability, a restrictive covenant was entered into whereby the assessee was paid the impugned sum. Similar is the case with regard to the payment received from SPIL. Thus, it is not a payment made for transfer of goodwill as mentioned by the AO. The learned counsel asserted that future capacity or possibility of a person, who can be a threat, was taken into account by RLL and SPIL.

17. Meeting the observations of the learned CIT (A), the learned counsel submitted that the learned CIT (A) has mistakenly understood the term 'non-competition' as a covenant which requires the agreed party to stop doing any other profit making business, whereas the real import of the term non-competition is to restrict the party from embarking upon any venture in that direction in future in respect of the specified products within the specified territory. In other words, there need not be any stoppage of profit making business so as to treat the non-competition fee as a capital receipt. The learned counsel filed four sets of paper books, out of which three contain the appeal papers concerning the appeals before us and certain material papers filed before the revenue authorities, whereas the fourth paper book, containing 159 pages, consists of copies of case laws relied upon by the learned counsel [hereinafter referred to as Case Law Paper Book or CLPB in brief]. He adverted our attention to pages 143 [Saroj Kumar Poddar v. JCIT, (ITAT Calcutta 'E' Bench) - (2001) 72 TTJ (Cal) 120] at 147 (paragraph 11) and 148 [ACIT v. A.S. Wardekar, (ITAT Calcutta 'C' Bench -77 ITD 405] at 152 & 154, of CLPB, in support of his contention that when there is a loss of the capital structure of a particular assessee, or drying up of a source of income, any compensation received by the assessee for such loss would also have to be treated as a capital receipt and such receipt cannot be treated as either a revenue receipt or a casual receipt. In the case of A.S. Wardekar (supra), the Bench observed that a casual receipt is one which occurs quite accidentally or fortuitously and comes without stipulation, contract, calculation or design as otherwise it would not fall within the provisions of Section 10(3) of the Income-tax Act, 1961. The learned counsel also relied upon the following two unreported decisions of the ITAT in support of his contention that an amount received in consideration for a restrictive covenant put on the assessee is a capital receipt not liable to tax:- 18. The learned counsel also referred to the non-competition agreement with SPIL to submit that the same arguments are applicable in respect of the taxability of the non-competition fee received from SPIL. As regards the amendment to various provisions of the Act to bring to tax the income received under a non-competition agreement, the learned counsel submitted that the amendments are prospective in nature and have no application to the asst. years under consideration.

19. On the other hand, the learned DR submitted that in the hands of the company it is a business income whereas in the case of Shri VCN it is assessable under the head 'other sources'. He has taken us through the order of the CIT (A) to submit that there is no impairment of the profit making structure on account of the restrictive covenant and thus the amount received both by the company and the individual would partake the

character of revenue receipt. Explaining further, it was submitted that Natco manufactured and marketed 150 products out of which only 15 products are subject to restrictive agreement, that too in a limited territory. For example, with regard to the agreement entered into with RLL, the territory was Russia and CIS countries. It was also submitted that Shri VCN was only a salaried employee and had never manufactured or marketed the products mentioned in the agreement, in his individual capacity, and hence the restriction is applicable only to the company and not to Shri VCN. Even the so-called restriction to the company has not hampered the income earning source of Shri VCN in any form. Adverting our attention to paragraph 5 of the order of the learned CIT (A), the learned DR submitted that the percentage of sales in Russia and CIS countries to the total sales was not substantial and Shri VCN continued to receive almost the same amount of remuneration even after entering into the aforementioned agreements. Thus, the agreements have not even remotely impaired the income of Shri VCN. He also adverted our attention to the fact that Shri VCN continued to receive royalty from Time Cap Inc. for the invention of Time Release Technology. In particular, the learned DR adverted our attention to paragraphs 5.3 to 5.8 of the order of the CIT (A) to submit that the Hon'ble Supreme Court in the case of Best Company (P) Ltd. (60 ITR 11), laid down certain tests to consider as to whether a particular receipt is of capital or revenue character and the case of the assessee, on an application of the said tests, leads to the only irrebuttable conclusion that the impugned receipts are revenue in character since it was a loss incidental to the business and there was no loss of an enduring asset. Shri VCN has not lost any asset of an enduring nature.

He was merely a salaried employee of Natco and he was not directly involved in manufacture and marketing. There were no assets such as goodwill, brand name etc., in his name. Merely because the parties have given a particular nomenclature like non-competition fee, the character of the receipt would not change. The essence of the agreement has to be looked , and looking at the surrounding circumstances, there being no threat of the assessee starting a business in Russia or CIS countries, there is no question of loss of any such source of income to Shri VCN.In this regard, the learned DR adverted our attention to page 6 of the assessment order in the case of Shri VCN in respect of asst. year 1998-99. He submitted that the amount was received by Shri VCN, not in his capacity as an inventor, but because of his position in the company - Shri VCN and family enjoyed majority shareholding i.e. 53%. The learned DR has also adverted our attention to clause 10 of the Technology Transfer agreement and the Preamble to the said agreement, to submit that the products were well known because of the incessant research done by R&D wing of Natco and there is a condition oh RLL for non-transfer of the technical know-how till 7 years from the date of agreement, whereas no such limitation was placed on Natco or Shri VCN.Thus, it can only be said that Shri VCN has a new source of income in the form of non-competition fee. There is no loss of source of income, but in fact gain of new source of income. In other words, it cannot be said that a trading avenue is completely lost to the assessee or there was loss of earning. The learned DR relied upon the following case laws in support of his contention that under such circumstances the receipt in the hands of Natco as well as Shri VCN has to be treated as revenue in character:- The learned DR submitted that even as per the assessee's statement, because of certain problems in those countries, Natco could not run the business in those countries. Thus, there is no loss of revenue either to Natco or to Shri VCN.20. The learned DR distinguished the case laws relied upon by the learned counsel for the assessee on facts by submitting that in those cases it was a true and genuine restrictive covenant, whereas in the instant case there is no restriction placed on the assessee and the income of the assessee was not affected. In other words, there was no loss to the capital structure and the amount received is assessable to tax.

21. Joining the issue, the learned counsel for the assessee submitted that the court cannot re-write the agreement entered into between the parties and one has to look at the agreement dispassionately from the perception of the parties so as to appreciate as to whether the character of the receipt is revenue or capital. The learned counsel also pointed out that there is variation between the conclusions reached by the AO and the findings of the CIT (A), inasmuch as the AO treated the receipt in the hands of the company asgoodwill and as a capital receipt and the logical conclusion that follows is that in the case of Shri VCN also the character of the receipt cannot change, in which event, it has to be treated as a capital receipt; whereas the learned CIT

(A), in a cryptic order, has affirmed the assessment order in the case of Natco, which implies that it is a capital receipt, but in the appellate order in the case of Shri VCN, it was treated as a revenue receipt. The learned counsel adverted our attention to the principles laid down by the apex court in the case of Best and Co. (P) Ltd., 60 ITR 11, and by the Calcutta Bench of the Tribunal in the case of A.S. Wardekar, 77 ITD 405, to submit that if there is a restrictive covenant and the payment is in lieu of such restriction placed upon the assessee, the amount received should be treated as capital in nature.

It was further submitted that the provisions amended from time to time to bring to tax the amount received towards non-competition fee, are not applicable to the assessment years under consideration and also distinguishable on facts. He submitted that the contention of the Revenue that there was no immediate loss to the assessee, should not be looked into in isolation; what would happen in future, nobody can predict, but the assessee was prevented from carrying on business in respect of specified products in a specified territory, and that would certainly amount to loss of an enduring trading asset. With regard to the contention of the learned DR that royalty income was earned by Shri VCN, the learned counsel submitted that there are various ways of earning income and the assessee has earned income in the form of royalty, but that does not prove that the income earned from imparting technical know-how would not amount to use of a capital asset. Placing reliance upon the decision of the House of Lords in the case of Rolls-Royce Ltd. v. Jeffrey (Inspector of Taxes), 56 ITR 580, in particular the observations of Lord Radcliffe, he submitted that earning income from imparting know-how is part of business. He also relied upon the decision of the Hon'ble Bombay High Court in the case of CIT v. Cilag Ltd., 70 ITR 760. The case of the learned counsel is that the knowledge in Time Release Technology is the capital of Shri VCN and that capital is being used to earn business income. Thus, any receipt on account of a restrictive covenant to make use of his intellect in a particular territory would partake the character of a capital receipt. He also submitted that the issue of application of Section 10(3) of the Act was not raised by the Revenue earlier and even otherwise, merely because an amount is not assessable to capital gains tax, it cannot be treated as casual or non-recurring income.

22. As has already been stated, detailed written submissions were filed by the learned counsel as well as by the learned Dr and reliance was placed on several case laws. It is not necessary to reproduce the details from the written arguments. Suffice it to say, that we have carefully gone through the record, the written submissions and the case law relied upon by both the parties. Upon a careful perusal of the case law relied upon by both the parties and the principles enunciated therein, we notice that the issue as to whether an income received would fall in the capital field or revenue field depends largely on the facts and circumstances of each case. The nomenclature given by the patties to a particular receipt is not conclusive. The facts and circumstances of each case have to be looked at in a broad perspective, since there is no infallible test to draw a clear-cut demarcation between a capital receipt and a revenue receipt, as observed by the Hon'ble jurisdictional High Court in the case of Barium Chemicals Ltd., 168 ITR 164. In the case of Blue Star Ltd., 217 ITR 514, at 520, the Hon'ble Bombay High Court relied upon the judgment of House of Lords in the case of Quinn v. Leathem [1901] AC 495 (HL), and observed that every judgment must be read as applicable to the particular facts proved or assumed to be proved, since the generality of the expressions which may be found there are not intended to be expositions of the whole law, but governed and qualified by the particular facts of the case in which such expressions are found and a case is only an authority for what it actually decides.

23. Before going into the facts and circumstances of the case, it is necessary to bear in mind the following principles enunciated by various courts, including the Hon'ble Supreme Court. - (A) In the case of Blue Star Ltd. (supra), Hon'ble Bombay High Court observed that if a payment is made to compensate a person for cancellation of a contract which does not affect the trading structure of the recipient's business nor deprive the recipient of what in substance is the source of income, termination of the contract being a normal incident of the business, and such cancellation leaving the recipient of the amount free to carry on his trade, the receipt is 'revenue'. However, where by cancellation of agency the trading structure of the assessee is impaired or such cancellation results in the loss of what may be regarded as the source of the assessee's income, payment made may be regarded as the source of the assessee's income, payment made to

compensate for such cancellation of agency is normally a 'capital receipt'.

(B) In the case of CIT v. Dr. R.L. Bhargava, 256 ITR 42, Hon'ble Delhi High Court extracted the following observations of Hon'ble Bombay High Court in the case of Raliwolf Ltd., 143 ITR 720, to come to the conclusion that if there had been no absolute parting by the assessee with the technical know-how and consideration was received for imparting know-how, not in association with the disposal of a capital asset, such receipt should be treated as a revenue receipt: "The legal opposition on these authorities, therefore, is that know-how is not strictly a fixed asset and the nature of receipts from the know-how would essentially depend upon the transactions out of which the receipts arise and the context in which the receipts are received. If the imparting of know-how is really in the nature of services rendered without anything more, the receipt must be treated as a revenue receipt. But when consideration is received for imparting in association with the disposal of a capital asset, then the receipt will have to be treated as a capital receipt." (C) In the case of Vadilal Soda Ice Factory v. CIT, 80 ITR 711, Hon'ble Gujarat High Court observed that if the amount was received as compensation for loss of profit, it was a revenue receipt liable to tax.

(D) In the case of K. Ramasamy v. CIT, 261 ITR 358, Hon'ble Madras High Court observed that if the purpose of the deed of compensation in reality was only to screen the payment made under that deed from liability to income in the hands of the assessee, it should be treated as a revenue receipt.

(E) In the case of Ram Kumar Agarwalla and Brothers v. CIT, 63 ITR 623, Hon'ble Supreme Court observed that if the consideration was received towards remuneration for services rendered and not for refraining from competing in the purchase of the controlling interest, the receipt must be regarded as a revenue receipt.

(F) In the case of CIT v. Manna Ramji and Co., 86 ITR 29, Hon'ble Supreme Court observed that in order to resolve the controversy as to whether a receipt is of revenue character or capital in nature, one must try to ascertain the true nature and character of the payment. In border-line cases, the controversy has to be resolved on the facts and circumstances of the individual case. If the payment is received on account of sterilisation and destruction of a capital asset and if the assessee was permanently deprived of a source of income, it could be held as a capital receipt; otherwise, it is a revenue receipt.

(G) In the case of CIT v. Shamsher Printing Press, 39 ITR 90, Hon'ble Supreme Court observed that if an amount was received for an injury to the assessee's capital assets including goodwill, it would be treated as a capital receipt, and if it was received as a compensation for loss of profit, it was a revenue receipt liable to tax.

(H) In the case of Gillanders Arbuthnot and Co. Ltd. v. CIT, 53 ITR 283, the apex court observed that there is no immutable principle that compensation received on cancellation of an agency must always be regarded as capital. If by cancellation of an agency the trading structure of the assessee is impaired, the payment should be treated as a capital receipt. In this regard, the court followed its earlier decision in the case of Kettlewell Bullen and Co. Ltd. v. CIT, 53 ITR 261. Further, having regard to the vast area of business done by the assessee as an agent, it was held that the acquisition of agency was in the normal course of business and determination of individual agencies a normal incident not affecting or impairing the trading structure and, therefore, the amount received for the cancellation of such agency did not represent price paid for loss of a capital asset. However, if the compensation was for agreeing to refrain from carrying on a competitive business in the commodities in respect of the agency terminated, or for loss of goodwill, such receipt was held to be in the nature of a capital receipt.

(I) In the case of Godrej & Co. v. CIT, 37 ITR 381, the apex court observed that although the language used in the resolution was not decisive and the question had to be determined by a consideration of all the attending circumstances, it could not be ignored altogether but had to be taken into consideration along with other relevant circumstances. It was further observed that if the compensation was for the deterioration or injury to the managing agency, the receipt is capital in nature.P.H. Divecha v. CIT, 48 ITR 222, the apex court observed that if the payment was not received to compensate for a loss of profit of business, it cannot be described as income. To constitute income, profits or gains, there must be a source from which the particular receipt has

arisen, and a connection must exist between the quality of the receipt and the source. If the payment is by another person, it must be found out why that payment has been made. It is not the motive of the person who pays that is relevant.

More relevance attaches to the nature of the receipt in the hands of the person who receives it. Whether the amount involved was large or was periodic in character has no decisive bearing. The description of the payment is not determinative of its quality. In that case, a firm which was conducting business in electrical gods entered into an agreement with a company under which the firm was given exclusive rights to purchase and sell electric lamps manufactured by the company. Upon termination of such agreement, the company paid compensation. The court observed that the agreement secured to the firm an advantage of an enduring nature and was not an ordinary trading agreement and thus the receipt is capital in nature.

(K) In the case of Addl. CIT v. Dr. K.P. Karanth, 139 ITR 479 (AP), the assessee having technical know-how for manufacture of drugs, had given up his right to manufacture drugs and such receipt was held to be capital in nature. The other cases relied upon by the assessee and the Revenue broadly lay down the same principles.

(L) In the case of CIT v. G.R. Karthikeyan, 201 ITR 866, Hon'ble Supreme Court observed that the expression "income" should be given a wider meaning and though an income is casual in nature, it can nevertheless be treated as income assessable to tax.

(M) In the case of Elegant Chemicals Enterprises P. Ltd. v. ACIT, 271 ITR (AT) 56, this Bench had an occasion to consider the issue as to whether an amount received by the assessee is capital or revenue in nature. In that case, the Bench observed that the surrounding circumstances have to be taken into consideration to find out the reality of the recitals made in the documents, and by applying the test laid down by the apex court, it was held that the particular receipt was a revenue receipt liable for taxation. The Bench observed that the totality of the circumstances indicate that the trading structure of the assessee was not impaired and it was a normal incident of the business, i.e. loss of the future profits.

24. 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 utilised 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 Section 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.

25. 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-a-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 it by treating it as goodwill, overlooking the fact that goodwill was 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.

26. At the time of hearing, the learned counsel for the assessee raised an additional ground in the appeal of Shri VCN in respect of asst. year 1998-99. The case of the learned counsel is that the assessee had borrowed funds for investment in shares of Natco Pharma Ltd. and the interest on such loan is allowable as a deduction against the income from other sources. The learned counsel submitted that though the facts are on record, by inadvertence, the issue had not been raised before the first appellate authority and, being a legal issue, it can be raised at any stage. Placing reliance upon the decision of the apex court in the case of National Thermal Power Co. Ltd. v. CIT, 229 ITR 383, the learned counsel requested the Bench to admit the additional ground.

27. The facts in short are that the assessee had debited a sum of Rs. 26,59,826 against income from other sources. The AO disallowed the claim of the assessee on the ground that the dividend income arising out of the investment in shares being exempt from tax for the asst.

year 1998-99, deduction of expenditure is not permissible, presumably under Section 14A of the Act. The alternative contention of the assessee was that the dividend declared/distributed on or after 1-6-1997 was exempt from tax and thus the interest paid up to 31-5-1997 amounting to Rs. 5,96,611 should at least be allowed as a deduction.

The AO rejected the alternative contention also. He observed that Section 10(33) of the Act has been introduced into the statute book from 1-4-1998 and thus dividends received at any time during the financial year 1997-98 are exempt from tax and no portion of the interest is, therefore, allowable as a deduction. The learned counsel placed reliance upon the decision of the ITAT, Mumbai Bench 'C', in the case of Mafatlal Holdings Ltd. v. Addl. CIT [I.T.A. No. 2935/M/02] dated 23-4-2002, to submit that as per Section 115-O of the Act, a company declaring dividends is liable to deduct tax and the dividends declared after they suffered tax become the income of the shareholder and thus it has to be assumed that the dividend income has suffered tax in the hands of the shareholder, in which event, the expenditure is allowable as a deduction. On the other hand, the learned DR submitted that this would render the provisions of Section 14A ineffective, which is not the intention the legislature. It was further submitted that the contention of the assessee that even though the tax is paid by the company under Section 115O of the Act, it should be treated as tax paid by the assessee, is a far-fetched argument.

28. We have carefully considered the rival submissions and perused the record. Since the issue raised before us is a pure legal issue for which no fresh facts are necessary, we admit the additional ground, particularly in view of the fact that this issue was raised before the AO. As regards the main contention of the assessee that the entire expenditure is allowable as a deduction, we are unable to accept this contention in the light of the decision of the ITAT, Ahmedabad Bench 'B', in the case of Harish Krishnakant Bhatt v. ITO, 91 ITD 311,

wherein the decision of the ITAT, Bombay Bench, (supra), was considered in detail. The same was view taken by the ITAT, Calcutta Bench, in the case of DCIT v. S.G. Investments & Industries Ltd., 89 ITD 44 (Kol).

29. This leaves us with the only issue as to whether expenditure referable to the period up to 1-6-1997 is allowable as deduction.

Admittedly, Section 10(33) of the Act does not cover the period up to 1-6-1997. In other words, dividend income received or receivable on or before 1-6-1997 is includible in the total income. Since the income is not exempt for such period, merely because there was no actual income earned by the assessee for such period, expenditure incurred in order to earn dividend income cannot be disallowed in the light of the decision of the apex court in the case of CIT v. Rajendra Prasad Modi, 115 ITR 519. We may further clarify that Section 14A of the Act comes into play only when the income received or receivable does not form part of total income and not otherwise. We, therefore, direct the AO to consider the claim of the assessee for deduction with regard to the interest expenditure referable to the period 1-4-1997 to 31-5-1997.

30. In the result, I.T.A. No. 642/Hyd/2002 is partly allowed, I.T.A.No. 782/Hyd/2002 is dismissed and I.T.A. No. 361/Hyd/2003 is allowed.