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Sum paid for obtaining approval from diff. authorities to purchase business unit of a co. was capital in nature

Summary – The High Court of Delhi in a recent case of GKN Driveline India Ltd., (the Assessee) held that where assessee entered into an agreement for purchase of assets and liabilities of a newly set up factory of a company (SML), and paid a certain sum for obtaining requisite permission and approvals in smooth transfer of factory to assessee, said payment was clearly for an enduring benefit and not just towards non-compete obligation

Facts

- The assessee was engaged in the manufacture and sale of front wheel drive axle assembly for vehicles. It entered into an agreement for purchase of assets and liabilities of a newly set up factory, established by a company, named, SML in Madras. According to the assessee, the consideration in the said agreement was in two parts - First Rs. 1.30 crores towards the net asset value and secondly Rs. 70 lakhs paid on account of non-compete clause for a period of five years.
- The Assessing Officer held that the intention of the assessee was to keep competitors out of the market thereby increasing sales, and, thus, the said amount could not be held to be revenue expenditure as it derived long term benefit and, thus, it was capital expenditure.
- The assessee approached the Commissioner (Appeals) who held that since the non-competition period was for a short term of five years, the expenditure was revenue in nature.
- The Tribunal reversed the order of the Commissioner (Appeals) and restored the finding of the Assessing Officer on the ground that the assessee was the only manufacturer in India for front wheel drive axle assembly for vehicles and being the sole manufacturer, it acquired an enduring benefit. Thus, the expenditure was capital in nature as the assessee eliminated its only competitor after acquiring the factory, thereby perpetuating its exclusivity in the market.
- On appeal:

Held

- A perusal of the agreement clearly points to the fact that while the consideration of Rs.1.30 crores was towards the net value of assets, the payment of Rs.70 lakhs is "*for obligations and covenants*".
- The clauses of the agreement go to show that the amount of Rs.70 lakhs is not merely payment towards the non-compete clause but also towards various other obligations which were imposed upon SML and had a direct bearing on the final execution and implementation of the agreement. To argue that the entire consideration was towards the non-compete fee would, therefore, be an incorrect statement, inasmuch as the clauses of the agreement do not reflect so. The emphasis in the agreement is towards the takeover of the assets of SML, and it was to ensure that the agreement bears fruition that the consideration of Rs.70 lakhs has been apportioned for various obligations and covenants imposed on SML.

- Under these circumstances, the question that is to be decided is whether the expenditure of Rs.70 lakhs incurred is of capital or revenue nature. The consideration of Rs.70 lakhs was clearly towards ensuring that there will be no impediment in the smooth transfer of SML's factory to the assessee. It should be complete and final. From the facts placed before the Court, there really did not appear to be any serious threat whatsoever in order for the assessee to pay the non-compete fee to SML which had not even commenced its manufacturing. From the nature of the transaction, it is clear that the acquisition of SML's unit was, for expansion purposes. It was to expand and increase production by acquiring a new undertaking. The entire business with capital assets was acquired. The payment was bifurcated into two parts, Rs. 130 lakhs towards net assets and Rs.70 lakhs for other obligations and recitals imposed upon SML, *i.e.,* obtaining permissions from financial institutions, obtaining approvals from governmental authorities, income tax authorities, indemnity towards other losses, if any, and maintenance of confidentiality about the agreement as also all the intellectual property and other data and information. The said payment was clearly for an enduring benefit and not just towards the non-compete obligation.
- Even the non-compete obligations in clause 11 appear to be illusory in nature and restricted to *'constant velocity joints or any other competitive products'*. Clearly, the same is of limited nature and there was also no obligation of non-compete imposed upon the promoter directors of SML. In fact, as stated during the course of arguments, the managing director of SML became the corporate director of the assessee. Thus, the non-compete clause and the consideration of Rs.70 lakhs are not completely and exclusively inter-linked. The payment of Rs.70 lakhs, which is a substantial sum, *i.e.,* more than half of the consideration paid for the net assets of the unit itself, was for a multitude of obligations and covenants which were fastened upon SML and not only towards the non-compete obligations.
- It is clear that the consideration of Rs. 70 lakhs was not expressly towards the non-compete obligation, but towards smoothening the process of acquisition of the asset, *i.e.,* the unit of SML in Madras as approvals that were required from the financial institutions, income tax authorities and other governmental authorities were towards the finalisation and closure of the acquisition process. Other covenants and obligations imposed upon SML, *i.e.,* warranties, confidentiality, etc., added value to the asset being acquired. There is no doubt that in the facts of the present case, the payment of Rs.70 lakhs is a capital expenditure and hence the question of law is answered in favour of the revenue and against the assessee.