

A man with a beard and glasses, wearing a brown jacket over a dark polo shirt, is smiling. He is positioned in the upper half of the image against a dark blue background.A complex geometric pattern of blue triangles and lines covers the bottom half of the image, creating a modern, architectural feel.

**Newsflash – Supreme Court rules
on allowability of non - compete
fees as revenue expenditure**

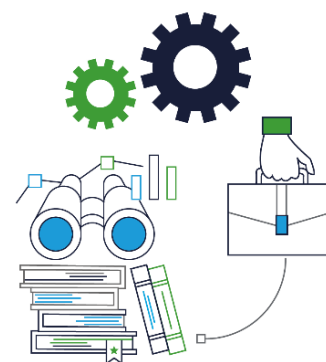
Newsflash - Supreme Court rules on allowability of non-compete fees as revenue expenditure

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1.0 Background

1.1 Recently, in the case of ***Sharp Business System Thr. Finance Director Mr. Yoshihisa Mizuno vs. Commissioner of Income Tax-III N.D.***¹(lead matter), the Hon'ble Supreme Court of India has ruled, while hearing a batch of appeals with similar question of law and facts, **that payment of non-compete fee is an allowable revenue expenditure under section 37(1) of the Income-tax Act, 1961 ('the Act')**.

1.2 Sharp Business System ('the Appellant') was incorporated as a joint venture of M/s. Sharp Corporation, Japan and M/s. Larsen & Toubro Limited ('L&T'), and engaged in the business of importing, marketing and selling electronic office products and equipments in India. During Assessment Year 2001-02 ('year under consideration'), the Appellant paid a sum of INR 3 crores to L&T as consideration for L&T not setting up or undertaking or assisting in the setting up of or undertaking any business in India of selling, marketing and trading in electronic office products for a period of seven years ('non-compete fee').



1.3 The central issue in this batch of appeals² was whether the non-compete fee paid by the Appellant is a revenue expenditure or a capital expenditure? Corollary to the said issue is whether such expenditure, if considered to be capital in nature, is entitled for depreciation under section 32(1)(ii) of the Act?

2.0 Contentions of the Appellant

2.1 The expenditure incurred in the form of non-compete fee is on revenue account since been expended wholly and exclusively for the purpose of establishing and enlarging the business of Appellant, and therefore an allowable deduction under section 37(1) of the Act.

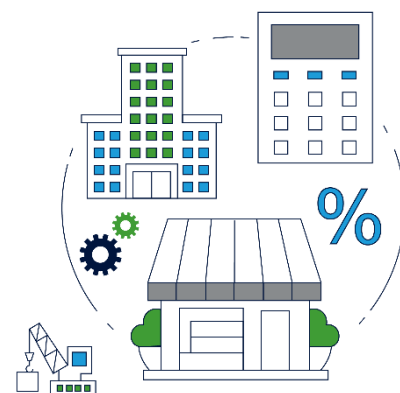
2.2 The test of enduring benefit may fail in certain situations or circumstances³ and may not be universally applicable to determine the character of an expenditure. The expenditure resulting into a benefit of enduring nature would not ipso-facto make it a capital expenditure, if such benefit or advantage merely facilitates in carrying on the business more profitably and efficiently.

¹ Civil Appeal No. 4072 of 2014

² Sharp Business System (supra), Pentasoft Technologies Limited vs. DCIT (Civil Appeal No. 15048 and 15051 of 2025), PCIT-VII vs. Piramal Glass Limited (Civil Appeal No. 15049 of 2025), CIT, Chennai vs. M/s Pentasoft Technologies Limited (Civil Appeal No. 15050 of 2025),

³ Empire Jute Company Limited vs. Commissioner of Income Tax (1980) 124 ITR 1

- 2.3 The period or length of time over which the enduring advantage may accrue does not determine the nature of expenditure⁴ where the advantage only facilitates in carrying on of the business more efficiently and profitably, leaving the fixed assets untouched.
- 2.4 The payment can be treated as a capital expenditure if made to ward off competition in business or with an objective of deriving benefit by eliminating competition over a period of time⁵. However, if there is no certainty of the duration of advantage and the same can be put to an end at any time, then such an expense would be revenue in nature.
- 2.5 The non-compete fee was paid by Appellant to L&T not to eliminate competition or create any monopoly over the business of electronic products, etc., but only to run its business more smoothly. The said payment does not bring into existence any new asset or accretion to the profit earning apparatus, and instead merely seeks to protect and enhance the profitability of its business. The benefit that may arise is due to restriction of a competitor/ potential competitor and is not in the capital field even if of an enduring or ephemeral nature.
- 2.6 Alternately, the Appellant contended that if such payment is construed as a capital expenditure, then depreciation under section 32(1)(ii) of the Act should be allowed on the same as it results in acquisition of an intangible asset ('any other business or commercial right of similar nature'). Reliance was placed on the Apex Court's decision of *Techno Shares & Stocks Limited vs. CIT*⁶ wherein membership card of Bombay Stock Exchange was held to be in the nature of 'license to trade' and entitled to depreciation as an intangible asset.



3.0 Contentions of the Revenue

- 3.1 Supporting the judgement of Delhi High Court in this case and reliance on various decisions⁷, the Revenue argued that payment of non-compete fee constitutes capital expenditure in the hands of payer, been incurred for acquiring an enduring benefit of an ephemeral nature.
- 3.2 Even though such capital expenditure leads to accrual of intangible asset, it would be eligible for depreciation under the Act if the right acquired on payment of non-compete fee falls within one of enumerated categories, viz., know-how, patents, copyrights, trademarks, licenses, franchises or 'any other business or commercial right of similar nature' and is 'owned' (wholly or partly) by the Appellant and 'used' for the purpose of its business.

⁴ Commissioner of Income Tax vs. Madras Auto Services (P) Limited (1998) 233 ITR 468

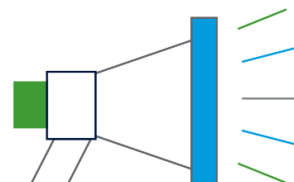
⁵ CIT, West Bengal-II, Calcutta vs. Coal Shipments (P) Limited (1971) 82 ITR 902, by considering the decision in Assam Bengal Cement Company Limited vs. CIT (1955) 27 ITR 34

⁶ (2010) 327 ITR 323

⁷ Empire Jute Co. Ltd. (supra), Guffic Chem (P.) Ltd. vs. CIT (2011) 332 ITR 602, CIT vs. Bharti Hexacom Ltd. (2023) 458 ITR 593, Pitney Bowes India (P) Ltd. vs. CIT (2011) SCC OnLine Del 5114

3.3 By placing reliance on various decisions⁸ and applying the principles of statutory interpretation and *ejusdem generis*, it was submitted that the expression ‘any other business or commercial rights of similar nature’ does not constitute a separate category but would follow or must be read as being limited to rights/ assets specified by the preceding words, i.e. know-how, patents, etc.

3.4 The intellectual property rights (IPRs) or specific words such as ‘know-how, patents, copyrights, trademarks, licenses and franchises’ constitute a distinct class or category of ‘positive rights’ brought into existence by experience and/ or reputation, granted either under a statute or a contract, and capable of being ‘owned’ (either in *rem* or in *personam*) and ‘used’/ ‘put to use’ for the purpose of business⁹. Reliance was placed on several decisions¹⁰ with respect to interpretation of the words ‘owned’ and ‘used’ in this context.



3.5 The right acquired by payer on payment of non-compete fee is a ‘negative covenant’ that imposes an obligation on the recipient to desist from doing something. Negative covenant or obligation merely ‘exists’ – cannot be or not inherently capable of being owned and/ or used/ put to use (whether actively or passively) for the purpose of business in the manner envisaged in case of other specified intangible assets. Hence, the statute does not seem to allow depreciation on such rights/ assets.

3.6 The only ‘right’ obtained by a payer of non-compete fee is the right to pursue legal remedies in the event of breach of contract on the part of payee, which as such cannot be owned or used. There is no provision in the Act which specifically lays down that a right which is not capable of being put to use is nonetheless eligible for depreciation.

4.0 Decision by the Hon’ble Supreme Court (‘SC’)

4.1 The Hon’ble Apex Court adverted to various jurisprudence on the aspect of revenue vs. capital expenditure, fixed vs. circulating capital, and overall construct of section 37 of the Act¹¹ to examine the nature and character of non-compete fee.

4.2 Non-compete fee is paid by one party to another to restrain the latter from competing with the payer in the same line of business (whether by way of written agreement or through oral understanding). The restriction may be limited to a specified territory, for a specified period, etc. The purpose of such payment is to give a head start to the business of the payer.

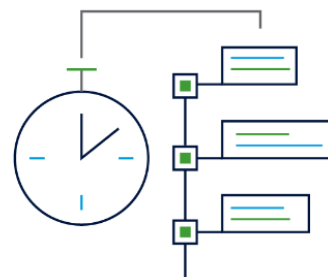
⁸ Siddeshwari Cotton Mills (P) Ltd. vs. Union of India (1989) 2 SCC 458, CIT vs. McDowell & Co. Ltd. (2009) 314 ITR 167, Sree Durga Distributors vs. State of Karnataka (2007) 4 SCC 476, Mohd. Shabir vs. State of Maharashtra (1979) 1 SCC 568

⁹ CIT vs. Hindustan Coca Cola Beverages (P) Ltd. (2011) 331 ITR 192

¹⁰ Liquidators of Pursa Ltd. vs. CIT (1954) 25 ITR 265, Mysore Minerals Ltd. vs. CIT (1999) 239 ITR 775

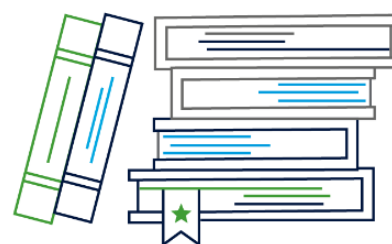
¹¹ Alembic Chemicals Works Co. Ltd. vs. Commissioner of Income Tax, Gujarat (SC), Atherton vs. British Insulated and Helsby Cables Ltd. (1925) 10 TC 155, John Smith and Son vs. Moore (1921) 12 TC 266, Assam Bengal Cement Company Ltd. (supra), Bharti Hexacom Ltd. (supra), Coal Shipments Pvt Ltd. (supra), Empire Jute Company Ltd. (supra), Madras Auto Services (P) Ltd. (supra)

- 4.3 Non-compete fee only seeks to protect or enhance the profitability of business by insulating the payer from competition, thereby facilitating carrying on of business more efficiently and profitably. The enduring advantage of restricting a competitor is not of capital nature, as it does not result in creation of any new asset or accretion to profit earning apparatus of payer.
- 4.4 The payment of non-compete fee is made in anticipation that absence of competition from the other party may secure a benefit to the party paying such compensation. However, there is no certainty that such benefit would accrue, and the payer may end up not achieving the desired result.
- 4.5 As long as the enduring benefit is not in the capital field and it merely facilitates carrying on the business more efficiently and profitably leaving the fixed assets untouched, the payment made to secure such advantage would be an allowable business expenditure, irrespective of the period or length of time over which the advantage may accrue to the payer.
- 4.6 The Hon'ble Apex Court therefore reversed the decision of Hon'ble Delhi High Court in this case and held that non-compete fee paid by the Appellant to L&T is an allowable revenue expenditure under section 37(1) of the Act, as such payment did not create a monopoly of the Appellant over the business of electronic products/ equipments and was essentially made to keep a potential competitor out of the same business. The Court observed that the Appellant had not acquired any new business or there is no addition to the profit-making apparatus of the Appellant on account of such non-compete fee payment and the only object is to ensure that its business is operated more efficiently and profitably.



5.0 Our Comments

- 5.1 This judgement assumes considerable significance in the context of tax treatment of non-compete fee payments, particularly where such payments yield benefits extending over multiple years. The decision brings much-needed clarity and guidance by reaffirming that enduring benefit, by itself, may not be determinative of the true nature of expenditure.
- 5.2 Taxpayers entering into non-compete arrangements as part of commercial restructurings, business acquisitions, joint ventures, strategic exits, competitive strategies, etc. may need to reassess characterization of such payments with greater emphasis on the purpose, nature of rights acquired and impact on the profit-earning apparatus or new asset creation for the business, rather than merely the duration of restraint.
- 5.3 This is a welcome ruling expected to reduce litigation risk for the corporates, harmonizes the conflicting High Court views on this subject and aligns with the commercial realities of modern-age businesses.



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This newsflash summarizes the Supreme Court's ruling that non-compete fees are not in the nature of capital expenditure and are allowable as revenue expenditure for income-tax purposes. It may be noted that nothing contained in this Newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain thereof and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this Newsflash.

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