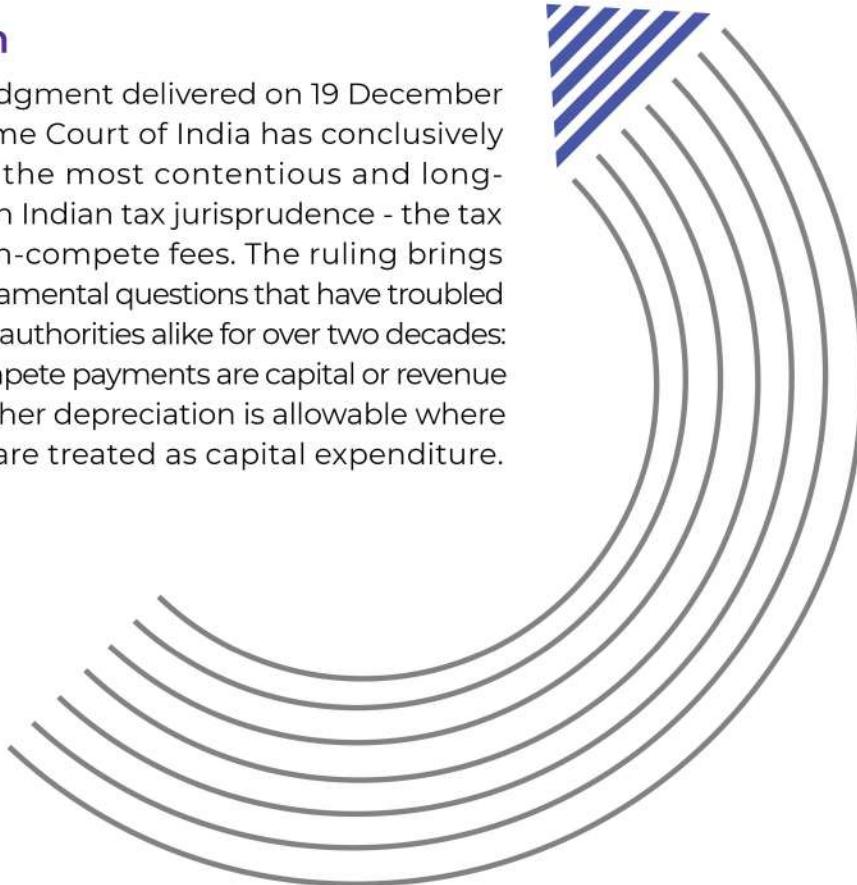


TAX UPDATE

Supreme Court finally settles the tax treatment
of Non-Compete Fees Capital expenditure eligible
for depreciation as an intangible asset

Introduction

In a landmark judgment delivered on 19 December 2025, the Supreme Court of India has conclusively resolved one of the most contentious and long-standing issues in Indian tax jurisprudence - the tax treatment of non-compete fees. The ruling brings clarity to two fundamental questions that have troubled taxpayers and tax authorities alike for over two decades: whether non-compete payments are capital or revenue in nature, & whether depreciation is allowable where such payments are treated as capital expenditure.



The decision, rendered in *Sharp Business System v. Commissioner of Income Tax*¹ and a batch of connected appeals, harmonises divergent High Court views & provides much-needed certainty for mergers and acquisitions, slump sales, joint venture exits, & strategic business reorganisations. Importantly, the judgment aligns tax treatment with commercial and economic substance, rather than formalistic classifications of rights.

Evolution of the controversy

Non-compete payments are a familiar feature in business transactions. Typically, when a business or division is acquired, the acquirer seeks assurance that the seller, promoter, or group entity will not compete with the acquired business for a specified period. The consideration paid for such restrictive covenants is intended to protect market share, preserve goodwill, and ensure business continuity.

From a tax perspective, however, such payments have historically occupied a grey area. Tax authorities have consistently taken the position that non-compete fees confer an enduring benefit and therefore constitute capital expenditure. Taxpayers, on the other hand, have frequently argued that these payments merely facilitate efficient conduct of business and should be allowed as revenue expenditure under Section 37(1) of the Income-tax Act, 1961.

Even where courts accepted the capital nature of non-compete fees, a second and more vexed issue arose: whether such capitalised payments qualified for depreciation under Section 32(1)(ii). Revenue authorities often denied depreciation on the ground that a non-compete covenant is a "negative right", does not constitute an asset capable of ownership or use, and therefore falls outside the scope of depreciable intangible assets.

This divergence resulted in inconsistent judicial outcomes. While the Delhi High Court denied depreciation, other High Courts—including Bombay, Madras, Gujarat, and Karnataka—adopted a more commercial approach and allowed depreciation on non-compete fees. The lack of uniformity created uncertainty, particularly in high-value M&A transactions.

Matters before the Supreme Court

To resolve this conflict, the Supreme Court heard a batch of appeals arising from different High Court judgments, including those involving Sharp Business System, Pentasoft Technologies, and Piramal Glass. The appeals raised two interconnected questions of law:

First, whether non-compete fees paid by an assessee constitute revenue or capital expenditure. Second, if such expenditure is capital in nature, whether the resulting right constitutes an "intangible asset" eligible for depreciation under Section 32(1)(ii).

The Court undertook a detailed examination of statutory provisions, legislative intent, & decades of jurisprudence on capital versus revenue expenditure & depreciation of intangible assets.

Capital or revenue: reaffirming settled principles

The Supreme Court began its analysis by revisiting well-established principles governing the distinction between capital and revenue expenditure. Drawing upon classic decisions such as Assam Bengal Cement², Empire Jute³, Alembic Chemical Works, and Madras Auto Service⁴, the Court reiterated that no single test is conclusive. Instead, the nature of the advantage obtained, viewed in a commercial sense, is determinative.

The Court observed that where an expenditure alters the profit-making structure of the business or secures an enduring commercial advantage, it falls in the capital field. Non-compete payments, by their very nature, are intended to restrain competition and protect the acquirer's business environment over a defined period. Such payments do not merely facilitate routine operations but affect the competitive framework within which the business operates.

Accordingly, the Court held that non-compete fees cannot be treated as revenue expenditure allowable under Section 37(1). The enduring benefit obtained by eliminating or restricting competition places such payments squarely in the category of capital expenditure.

Are non-compete rights “intangible assets”?

Having affirmed the capital nature of non-compete fees, the Court addressed the more complex issue of depreciation. Section 32(l)(ii) allows depreciation on specified intangible assets, including know-how, patents, copyrights, trademarks, licences, franchises, and “any other business or commercial rights of similar nature”.

The Revenue argued that this provision should be narrowly construed and limited to traditional intellectual property rights or “positive rights” capable of active use. The Supreme Court rejected this restrictive interpretation. It held that the expression “any other business or commercial rights of similar nature” is deliberately broad and designed to encompass commercially valuable rights arising from business arrangements, even if such rights are not statutorily protected intellectual property.

The Court emphasised that non-compete rights are identifiable, enforceable, and capable of generating economic benefits. By restraining competition, such rights protect revenue streams, preserve customer relationships, and enhance profitability. These characteristics place non-compete rights well within the ambit of “business or commercial rights” contemplated by Section 32.

Rejection of artificial distinctions

A significant aspect of the judgment is the Court’s rejection of artificial distinctions advanced by the Revenue. The argument that depreciation is available only for “positive rights” and not for “negative rights” was categorically dismissed. The Court noted that the Income-tax Act does not classify intangible assets based on such jurisprudential categories.

Similarly, the distinction between rights in rem and rights in personam was held to be irrelevant for depreciation purposes. The statute does not mandate that an intangible asset must be enforceable against the world at large. What matters is whether the right has commercial value and is capable of being exploited in the course of business.

The Court adopted a substance-over-form approach, holding that a non-compete covenant confers a positive commercial benefit on the payer, even if it operates as a restraint on the payee.

Ownership and use: a commercial interpretation

Another critical issue addressed by the Court was whether non-compete rights satisfy the requirement of being “owned” and “used” by the assessee. The Court held that ownership of intangible assets is not confined to absolute or perpetual ownership. Contractual rights, if enforceable and exclusive for the agreed period, constitute ownership for tax purposes.

On the concept of “use”, the Court recognised that intangible assets are often used passively. Unlike tangible assets, they do not require physical or active deployment. A non-compete right is “used” the moment it shields the business from competitive threats and enables the assessee to operate in a protected commercial environment. This passive or protective use is sufficient to satisfy the statutory requirement.



Consistency with taxation of non-compete receipts

The Court also examined the broader tax framework governing non-compete payments. It noted that non-compete receipts are taxable as business income in the hands of the recipient under Section 28(va), introduced by the Finance Act, 2002. In this context, the Court observed that denying depreciation to the payer while taxing the recipient would result in an inequitable and inconsistent tax outcome.

The judgment thus reinforces symmetry in tax treatment and underscores the importance of consistency in interpreting interconnected provisions of the Act.

Practical implications for businesses

This ruling has far-reaching implications for Indian and cross-border transactions. It provides certainty that non-compete payments, though capital in nature, form part of the block of intangible assets and are eligible for depreciation. Businesses engaged in mergers, acquisitions, & restructuring transactions can now structure non-compete arrangements with greater confidence regarding tax outcomes.

Taxpayers with pending litigation or assessments involving disallowance of depreciation on non-compete fees may find substantial relief based on this judgment, subject to procedural constraints and limitation periods. The ruling also necessitates a review of deferred tax positions & provisioning in financial statements.

From a compliance and risk-management perspective, it will be important for transaction documents to clearly articulate the commercial rationale for non-compete arrangements and for valuations to appropriately support the consideration allocated to such rights. Consistency between accounting treatment & tax positions will assume increased importance.

Our comments

The Supreme Court's decision marks a significant milestone in Indian tax jurisprudence. By recognising non-compete rights as depreciable intangible assets, the Court has aligned tax law with commercial reality and global M&A practices. The ruling resolves long-standing uncertainty, reduces litigation, and enhances predictability in the taxation of complex business transactions.

In doing so, the Court has reaffirmed that tax law must evolve in tandem with modern business structures and economic substance, rather than being constrained by rigid or artificial classifications.