

Beyond Headlines

Taxing Non-Compete Payments in M&A: Capital Gains or Business Income?

Welcome to this edition of Beyond Headlines!

In M&A transactions, it is common for buyers to include non-compete obligations restricting sellers from engaging in similar businesses for a defined period. These clauses help protect the buyer's investment. However, while non-compete clauses are a standard practice, their **tax treatment in Seller's hands remains highly debated.**

The key question? Should consideration linked to a non-compete be taxed as capital gains or as business income?

The answer has significant tax cost implications:

- Capital gains (assuming long term) are typically taxed at ~15%
- Business income could be taxed at rates up to 39% for individual sellers.

In this edition, we unpack the legal framework and judicial precedents that determine how non-compete consideration is taxed — and what promoters can do to strengthen a capital gains position.

Globeview updates

This month, our team had the opportunity to assist clients with the following projects:

- Advised a family in transferring their majority stake in a business jointly run by three families.
- Assisted a Nashik-based fertilizer manufacturer in transitioning from a partnership firm to a corporate structure.
- Assisted a transport solutions company to implement a value consolidation plan by shifting from a parallel structure to a holding-subsidiary model.

 Advised on tax implications for pooling land from various individuals into a partnership firm for development and sale.

The Legal Framework on Non-complete fees receipts in Seller's hands

Section 28(va) of the Income-tax Act, 1961, taxes as business income any payment (in cash or kind) received under an agreement for not carrying out any activity related to any business or profession. However, the section does not apply to sums received on account of transfer of a right to carry on a business or profession – which is chargeable to tax as capital gains.

Capital Gains vs. Business Income: What Makes the Difference

The tax treatment of non-compete consideration **hinges on how the** transaction is structured and the profile of the recipient.

Courts have treated non-compete payments as capital gains in several rulings, especially where:

- An investor sells shares and agrees to customary non-compete clauses embedded within the main agreement, without assigning specific value to the non-compete¹.
- Consideration was primarily for transfer of assets (e.g., trademarks, goodwill), with non-compete being incidental².
- Regulatory requirements mandated elimination of explicit non-compete consideration³.

Conversely, tax authorities and courts have taxed such receipts as business income where:

- A separate non-compete agreement was executed, or a specific amount was allocated to non-compete obligations⁴.
- Non-compete payments were made only to select promoters despite a broader share sale by all shareholders⁵.
- An indemnity clause specified a quantifiable penalty for breach of restrictive covenants, signalling embedded value⁶.

Besides Income-tax, **GST at 18%** is a major consideration to the deal structure. A non-compete clause with specific consideration will attract GST and adds to the cost.

What can promoters do to support a Capital Gains tax position?

For promoters and directors — who are often actively involved in the business — tax authorities may lean toward treating non-compete payments as business

income. However, a capital gains position may still be defensible with thoughtful structuring and documentation. Subject to commercial feasibility, here are some thoughts that can help:

- Avoiding standalone non-compete agreements where not commercially necessary. Instead, embed restrictive covenants within the main share purchase agreement without separate allocation.
- Not assigning separate consideration to non-compete clauses. Where total consideration is consolidated and commercially justifiable, courts have supported capital gains treatment.
- Demonstrate that consideration received for share or business transfer is on fair market value basis and the restrictive covenants are nothing but customary clauses as per general trade practices.

Ultimately, tax treatment is determined not only by what is written in the agreement — but by the underlying substance, structure, and role of the seller.

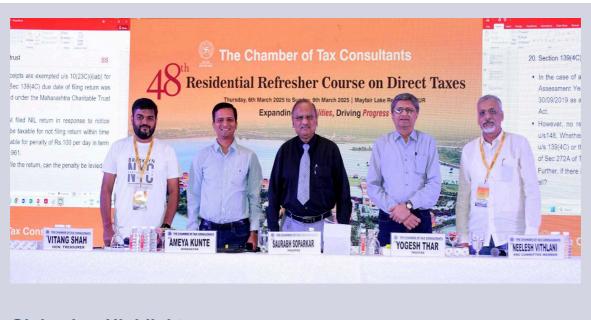
Final Thoughts

Non-compete consideration sits at the intersection of commercial practice and tax law. With a differential of over 24% in tax rates, the stakes are high. The challenge lies in balancing commercial protections for the buyer while optimising the tax position for the seller.

For promoters and founders entering into M&A transactions, the key lies in early-stage planning, thoughtful drafting, and clear legal positioning of the contractual elements.

- [2022] 144 taxmann.com 195, [2010] 126 ITD 100 [2011] 337 ITR 178 [2012] 17 ITR(T) 366 [2015] 375 ITR 270 [2011] 48 SOT 324

- [2023] 156 taxmann.com 458



Globeview Highlights

Mr. Ameya Kunte moderated the Brains Trust session at the residential conference at Raipur hosted by the Chamber of Tax Consultants (CTC) attended by over 300 professionals across India,

Mr. Vasudevan G was invited as a speaker at The Institute of Chartered Accountants of India to deliver a lecture on 'Recent judicial developments in India pertaining to International taxation'.

Mr. Chirag Chordia was invited as a speaker at The Institute of Chartered Accountants of India, Pune on the topic of 'Highlights of Union Budget – Practical considerations'.

We look forward to bringing you more updates in our next edition. Until then, feel free to reach out to us at contact@globeviewadvisors.com for any discussions.

About Globeview Advisors LLP

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