

EY Tax Alert

Supreme Court holds non-compete fees to be revenue expenditure; allows interest deduction on borrowings for acquisition of controlling stake

Executive summary

This Tax Alert summarizes a Supreme Court (SC) decision dated 19 December 2025 in a batch of appeals, with the lead case being *Sharp Business System v. CIT*¹. The issues before the SC were two-fold: (a.) Whether non-compete fees paid were in the nature of revenue or capital expenditure. (b.) Deductibility of interest on borrowed funds used for acquiring controlling stake in a sister concern.

On the first issue, the SC held that payment for non-compete fees is revenue expenditure, allowable as deduction under the Indian Tax Laws (ITL). The SC held that non-compete fees which do not create any monopoly are made to protect or enhance business profitability by protecting the payer from competition, which facilitates the carrying on of business more efficiently and profitably. The SC further held that non-compete fees do not result in the creation of any new capital asset or accretion to the profit-earning apparatus of the business, nor is there any enduring advantage in the capital field.

The SC further observed that a negative covenant restraining competition does not confer ownership of any transferable or exploitable right on the payer. The benefit obtained is protective and operational in nature, aimed at preserving the existing business structure rather than expanding or replacing it. Accordingly, non-compete fees paid wholly and exclusively for business purposes qualify as revenue expenditure, irrespective of the duration of the restraint.

On the issue of interest on borrowings, the SC noted the findings of the Income Tax Appellate Tribunal (Tribunal) and the High Court (HC) that borrowings were utilized for investment in the shares with the objective of acquiring or having a controlling interest in the subsidiary and was as a measure of commercial expediency. Following its ratio in *S.A. Builders v. CIT*², the SC affirmed the Tribunal and HC decisions which allowed deduction for interest under the ITL. The SC further observed that even interest-free advances to directors and sister group/concern were driven by considerations of commercial expediency and are allowable as deduction.

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¹ [TS-1685-SC-2025]

² [288 ITR 1]



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Background

- ▶ Section (S.) 37 of the ITL allows deduction of business expenditure not specifically covered under other provisions, provided such expenditure is not capital or personal in nature and is incurred wholly and exclusively for business purposes. Courts have consistently emphasized that the capital-revenue distinction must be determined based on the commercial substance and purpose of the expenditure, and not merely on its form or description.
- ▶ S. 36(1)(iii) of the ITL permits deduction of interest on capital borrowed for business purposes.
- ▶ S. 32 of the ITL grants depreciation, *inter alia*, on intangible assets being know-how, patents, copyrights, trademarks, licences, franchises, or any other business or commercial rights of a similar nature.
- ▶ Non-compete fees are paid to restrain specified persons from carrying on competing business for a defined period and geography. Judicial scrutiny has traditionally focused on whether such payments result in acquisition of a capital asset or an enduring advantage, or whether they merely protect or facilitate the conduct of business.
- ▶ With the introduction of depreciation on intangible assets under S. 32(1)(ii) of the ITL, controversies arose on whether non-compete rights qualify as “any other business or commercial right of similar nature” or whether such payments are deductible as revenue expenditure.

Facts for non-compete fees

- ▶ The SC heard a batch of appeals involving, *inter alia*, Sharp Business System³ (Taxpayer 1), Pentasoft Technologies⁴ (Taxpayer 2), and Piramal Glass⁵ (Taxpayer 3).
- ▶ The common issues arising for consideration before the SC in these batch appeals were as follows:
 - Whether non-compete fees paid by a taxpayer constitute revenue expenditure or capital expenditure.
 - If such non-compete fees are regarded as capital expenditure, whether depreciation u/s 32(2)(ii) is allowable.
- ▶ In examining the above issues, the SC considered the specific factual matrix of the appeals. The relevant facts pertaining to each of the appeals, to the extent material for adjudication of the issues, are summarized below:

³ Civil Appeal No. 4072 OF 2014

⁴ SLP(C) NO. 16277/2014

⁵ SLP(C) NO. 719/2020

Particulars	Taxpayer 1	Taxpayer 2	Taxpayer 3
Relevant year	<ul style="list-style-type: none"> Financial Year (FY)2000-01⁶ 	<ul style="list-style-type: none"> FY2000-01⁷ FY2001-02⁸ FY2002-03⁹ 	<ul style="list-style-type: none"> FY2000-01¹⁰
Facts	<ul style="list-style-type: none"> The Taxpayer, an Indian company, was incorporated as a joint venture (JV) between a Japanese company and another Indian company (I Co). The Taxpayer was engaged in the business of importing, marketing and selling electronic office products and equipment in India. I Co was engaged in a similar line of business in respect of consumer products. During the year, the Taxpayer paid a sum of INR30m to its JV partner, I Co, as non-compete fees in consideration for I Co agreeing to not set up or undertake or assist in setting up or undertaking similar competing business in India for a period of seven years. The entire amount was claimed as revenue expenditure in the year of incurrence in the return of income of the Taxpayer. The tax authority disallowed the expenditure of non-compete fees on the reasoning that they were capital in nature. 	<ul style="list-style-type: none"> The Taxpayer is a public limited company engaged in the business of software development, hardware sales, technical training and engineering services. The Taxpayer acquired the software development and training division of Pentamedia Graphics (I Co 1), pursuant to which it acquired various intangible assets, including intellectual property rights and non-compete rights. In consideration of the non-compete covenant and the acquisition of the trademark "Pentasoftware," the Taxpayer paid an aggregate consideration of INR1,800m. Under this arrangement, I Co 1 agreed not to enter into, either directly or indirectly, any business competing with that of the Taxpayer for a period of 10 years. 	<ul style="list-style-type: none"> The Taxpayer, a subsidiary of Nicholas Piramal India (I Co2), acquired the glass division from its parent company during FY1998-99. In connection with the acquisition, it paid non-compete fees of INR180m. The Taxpayer treated such expenditure as capital in nature and, consequently, claimed depreciation in return of income.
Issue under consideration	<ul style="list-style-type: none"> Whether the amount paid to I Co as non-compete fees was considered as revenue in nature or capital expense. 	<ul style="list-style-type: none"> Whether the amount paid towards non-compete fees constitutes an intangible asset eligible for depreciation. 	<ul style="list-style-type: none"> Whether the amount paid towards non-compete fees constitutes an intangible asset eligible for depreciation.
The first and second appellate authorities	<ul style="list-style-type: none"> The appellate authorities denied revenue deduction to the Taxpayer and also 	<ul style="list-style-type: none"> The Taxpayer raised an additional ground before the first appellate authority, seeking depreciation on 	<ul style="list-style-type: none"> The first appellate authority upheld the decision of the tax

⁶ Civil Appeal No. 4072 Of 2014

⁷ Civil Appeal No. 15048 Of 2025 or SLP 16277/2014

⁸ Civil Appeal No. 15050 Of 2025 or SLP 38046/2025 or Dairy no 22308/2022

⁹ Civil Appeal No. 15051 Of 2025 or SLP 24756/2014

¹⁰ Civil Appeal No. 15049 Of 2025 or SLP 00719/2020

Particulars	Taxpayer 1	Taxpayer 2	Taxpayer 3
	<p>rejected the alternative contention that the payment resulted in the creation of an intangible asset eligible for depreciation.</p>	<p>the intangible assets acquired, and such claim was allowed.</p> <ul style="list-style-type: none"> The second appellate authority, however, held that depreciation could not be allowed on non-compete fees. 	<p>authority, disallowing depreciation on non-compete fees.</p> <ul style="list-style-type: none"> However, the second appellate authority allowed the claim of depreciation on the amount of non-compete fees, treating it as intangible asset.
Jurisdiction	<ul style="list-style-type: none"> Delhi 	<ul style="list-style-type: none"> Madras 	<ul style="list-style-type: none"> Bombay
High Court	<ul style="list-style-type: none"> The Delhi HC upheld the stand of the tax authority and held that the expenditure incurred on payment of non-compete fees was capital in nature and no depreciation was allowable¹¹. 	<ul style="list-style-type: none"> The Madras HC decided the issue in favor of the Taxpayer and held that non-compete fees constitute an intangible asset eligible for depreciation. 	<ul style="list-style-type: none"> The Bombay HC decided the issue in favor of the Taxpayer and allowed claim of depreciation.
By whom is the appeal filed before the SC?	<ul style="list-style-type: none"> Taxpayer 	<ul style="list-style-type: none"> Tax authority 	<ul style="list-style-type: none"> Tax authority

¹¹ Refer EY Tax Alert dated 7 November 2012 "Delhi HC rules on tax treatment of non-compete fee paid (Sharp Business System)"

Tax authority's contentions

- ▶ The Tax authority contended that non-compete fees are capital in nature and cannot be allowed as revenue deduction. Being capital expense, the question is whether depreciation is allowable.
- ▶ The rights which arose on payment of non-compete fees are distinguishable from the intangible assets eligible for depreciation under the ITL. The rights referred are those that confer positive, ownable and usable rights. A non-compete covenant, being a negative restraint, does not create any such right capable of ownership or use and, therefore, does not qualify for depreciation.

SC ruling on non-compete fees

Capital v. revenue expenditure

The SC accepted the contentions of Taxpayer 1 and held that the non-compete fees paid constituted revenue expenditure and were, accordingly, allowable as deduction while computing taxable income.

The SC referred to its earlier precedents to conclude that "once for all payment" and "enduring benefit" tests are not conclusive. In its view, non-compete fees constituted revenue expenditure on account of the following:

- ▶ The purpose of non-compete fees is to provide a head start, protection or enhanced profitability to the payer's existing business by insulating it from competition.
- ▶ Such payments merely facilitate the more efficient and profitable conduct of business and do not result in the creation of any new asset or accretion to the profit-earning apparatus.
- ▶ Any enduring advantage arising from restriction of competition is not in the capital field. The duration for which the benefit may subsist is not determinative of the nature of expenditure.
- ▶ Even where the advantage is long-term, if it only enables the business to be carried on more efficiently and profitably without impacting fixed assets, the expenditure retains the character of revenue expenditure.
- ▶ A non-compete arrangement is based on a mere anticipation of reduced competition, with no certainty that the intended commercial benefit will materialize.
- ▶ The taxpayer does not acquire a new business, monopoly or exclusive market position; the payment only restrains a potential competitor without eliminating competition altogether.
- ▶ Accordingly, the payment is neither for acquisition of a capital asset nor for creation of a new profit-earning apparatus and, therefore, falls on the revenue account.

Allowability of depreciation

Since the SC upheld the payment to be involving revenue expenditure, it regarded the alternative ground of depreciation to have been "rendered redundant".

Basis above, in respect of the other batch of appeals, the SC remanded matters to the respective Tribunals with directions to revive all appeals/cross-appeals and to be heard afresh having regard to the ratio laid down in it in present appeal. The SC also held that the parties would be at liberty to raise additional ground(s) before the Tribunals based on the present judgment.

Issue regarding tax treatment of interest on borrowing

Facts

- ▶ In the case of Taxpayer 3, the Taxpayer had a subsidiary based in Sri Lanka. It was in the same line of business as the Taxpayer. The Taxpayer had availed of borrowings and utilized the funds for the following transactions:
 - Transaction 1: Borrowings utilized for acquisition of a controlling interest in a subsidiary (Sri Lankan entity).
 - Transaction 2: Borrowings utilized for providing onward interest-free lending, by way of loans, to the sister concern of the Taxpayer.
 - Transaction 3: Borrowings utilized for interest-free advanced funds to the directors of the Taxpayer entity.
- ▶ The tax authority had disallowed interest attributable to borrowings used for investment in the subsidiary, holding that the purpose was acquisition of controlling interest and not earning income. The tax authority further contended that interest on borrowed funds that was used to give interest-free advances to sister concerns and directors, was also to be disallowed on the ground that such use was for non-business purpose.
- ▶ On appeal, the first appellate authority confirmed the disallowance and upheld the assessment order. Aggrieved by the said order, the Taxpayer preferred an appeal before the Tribunal i.e., the second appellate authority. The Tribunal reversed the disallowance, holding that the investment in the subsidiary was made out of commercial expediency and with the objective of acquiring a controlling

interest in a company engaged in a similar line of business.

- ▶ The HC upheld the Tribunal's order. Being aggrieved, the tax authority preferred an appeal before the SC.

SC's ruling on interest deductibility

- ▶ The SC concurred with the Tribunal's findings and affirmed that interest on borrowings utilized for acquisition of a controlling interest in a subsidiary/sister concern, which is driven by commercial expediency, is allowable as a deduction under the ITL. The SC followed its earlier ruling in the case of S.A. Builders (*supra*).
- ▶ The SC further noted that interest-free advances made to a sister concern or its directors were for purposes of commercial expediency and are held to be covered by the principles laid down in S.A. Builders.

Comments

Non-compete fees

The present SC ruling puts at rest the issue of capital v. revenue characterization of non-compete fees. The SC held that such payments which do not bring a monopolistic position are incurred to protect or enhance business profitability by protecting the payer from competition. This facilitates the carrying on of business more efficiently and profitably and is, therefore, allowable as revenue expenditure. Consequently, the SC regarded the alternative ground of depreciation to have been "rendered redundant". In other words, since non-compete fees do not qualify as capital asset, much less intangible asset, the question of granting depreciation thereon does not arise.

The SC's ruling appears to apply to all kinds of non-compete fees, whether paid as part of business acquisition¹² or otherwise¹³. This is supported by the fact that the SC did not adjudicate the claim for depreciation in the case of the other two Taxpayers before it where, admittedly, the Taxpayers had considered non-compete fees as part of business acquisition as capital expenditure and claimed

¹² Refer, illustratively, Pitney Bowes India v. CIT [(2012) 204 Taxman 333 (Del)]

¹³ Refer, illustratively, CIT v. Career Launcher India [(2012) 207 Taxman 28 (Del)] - non-compete fees paid to exiting faculty members of an educational institution held to be revenue in nature

depreciation as intangible asset. Instead, the SC considered the question of depreciation admissibility as "rendered redundant". Therefore, the SC remanded the matters to the respective Tribunals by reviving the appeals/cross appeals and directed the Tribunals to hear the matter afresh. Furthermore, the SC gave liberty to the parties to raise additional ground(s) based on the present judgement. This implies that the Taxpayers could also raise additional ground, if they had not done so earlier, that the non-compete fees constitute revenue expenditure that is fully allowable as deduction, instead of depreciation as intangible asset.

There could be some practical challenges in implementing this SC ruling in certain cases where the year in which expenditure was incurred is closed and not pending in assessment or appeal.

It is significant to note that post amendment by Finance Act, 2021 w.e.f. tax year 2020-21, goodwill is a non-depreciable asset. On the other hand, by virtue of the present SC ruling, non-compete fees are revenue deduction. Hence, the course of future litigation in business acquisitions may flow in the direction of classification between the two, and proper allocation of values between the two.

Interest on borrowing

Reiterating its ratio from S.A. Builders (*supra*), the SC held that investment made for acquiring controlling interest in a company in the same line of business by purchase of shares, is clearly for commercial expediency and, hence, interest paid on borrowing for such acquisition is allowable as revenue deduction. Incidentally, the ratio of S.A. Builders (two-judge bench ruling) may be revisited by the Larger (three-judge) Bench in the case of Popular Vehicles & Services v. CIT [(2010) 325 ITR 523], where certain matters involving a similar issue are tagged and are pending disposal by the SC.

Our offices

Ahmedabad

22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon Temple
Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

8th Floor, Building No. 14A
Block 14, Zone 1
Brigade International Financial Centre
GIFT City SEZ
Gandhinagar - 382355, Gujarat
Tel +91 79 6608 3800

Bengaluru

12th & 13th Floor
"UB City", Canberra Block
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground & 1st Floor
11, 'A' wing
Divyasree Chambers
Langford Town
Bengaluru - 560 025
Tel: + 91 80 6727 5000

3rd & 4th Floor
MARKSQUARE
#61, St. Mark's Road
Shantala Nagar
Bengaluru - 560 001
Tel: + 91 80 6727 5000

1st & 8th Floor, Tower A
Prestige Shantiniketan
Mahadevapura Post
Whitefield,
Bengaluru - 560 048
Tel: + 91 80 6727 5000

Bhubaneswar

8th Floor, O-Hub, Tower A
Chandaka SEZ, Bhubaneswar
Odisha - 751024
Tel: + 91 674 274 4490

Chandigarh

Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai

6th & 7th Floor, A Block,
Tidel Park, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR

Aikyam
Ground Floor
67, Institutional Area
Sector 44, Gurugram - 122 003
Haryana
Tel: +91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad

THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jaipur

9th floor, Jewel of India
Horizon Tower, JLN Marg
Opp Jaipur Stock Exchange
Jaipur, Rajasthan - 302018

Kochi

9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata

22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

Mumbai

14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

3rd Floor, Unit No 301
Building No. 1
MindSpace Airoli West (Gigaplex)
Located at Plot No. IT-5
MIDC Knowledge Corridor
Airoli (West)
Navi Mumbai - 400708
Tel: + 91 22 6192 0003

Altimus, 18th Floor
Pandurang Budhkar Marg
Worli, Mumbai - 400 018
Tel: +91 22 6192 0503

Pune

C-401, 4th Floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000

10th Floor, Smartworks
M-Agile, Pan Card Club Road
Baner, Taluka Haveli
Pune - 411 045
Tel: + 91 20 4912 6800

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