Tax Alert: Chennai ITAT invokes guardianship law, rejects tax-planning attempt through minor sons

Issued on: 9 June 2020

Summary

The Chennai bench of Income Tax Appellate Tribunal (ITAT) has held in a recent case that the taxpayer being a natural guardian of minor sons cannot discharge his personal liabilities with the sale proceeds of assets belonging to minor sons. Further, the ITAT also held that amount of consideration paid directly to bank to settle taxpayer's personal liability would be regarded 'application of income' and not 'diversion of income by overriding title'.

As regards taxability of non-compete fee, the ITAT held that non-compete fee received by the taxpayer is a capital receipt that would not be chargeable to tax in assessment year 2001-02 (AY02). In this regard, owing to the facts of the case, the ITAT held that the amount of consideration claimed to have not been received by the taxpayer would be adjusted with the portion representing non-compete fee.

Facts of the case

- The taxpayer[1] is engaged in the business of modelling, cricket commentary, journalism and consulting and Bharat Petroleum. Corporation Ltd (BPCL) dealership.
- The taxpayer held 125 shares (0.01% shares) in Kris Srikkant Sports Entertainment Private Limited (KSSEPL). Majority of shares were held by other shareholders mainly consisting of taxpayer's minor sons and wife. KSSEPL is engaged in providing cricket coaching through electronic media.
- In AY02, the taxpayer sold shares of KSSEPL to another company for a total consideration of INR 15 crores as follows:
  - INR 7.5 crores towards non-compete fee, which would not be chargeable to tax
  - INR 4.25 crores paid directly by buyer to Indian Bank, against personal guarantee of taxpayer invoked by the bank, which would tantamount to diversion by overriding title, and therefore not chargeable to tax
  - INR 3 crores not received by the taxpayer, hence not chargeable to tax

[1] Shri K. Srikanth (ITA No.1324/Chny/2012)

The balance amount of INR 0.25 crores was offered to tax as capital gains by the taxpayer.

- The return of income for AY02 was processed[2] and no scrutiny assessment[3] was conducted.
- However, the tax officer opened[4] the assessment observing that following income of the taxpayer has escaped assessment:
  - Assessee was a director in the buyer company, and therefore, the tax officer was of the view that the amount of INR 7.5 crores was given the name of non-compete fees only with a view to escape taxes
  - INR 4.25 crores paid to bank was an application of income received by the taxpayer. It cannot be said to be diversion of income by overriding title and should accordingly be taxed
  - INR 3 crores, which the taxpayer claims to not have received, should be offered to tax on accrual basis
- The taxpayer filed an appeal against order of the AO before the Commissioner (Appeals) (CIT(A)). The CIT(A) allowed the taxpayer's appeal in respect of non-taxability of non-compete fees. However, other items of income were held taxable by the CIT(A) as well.
- Aggrieved by the order, the taxpayer filed an appeal before the Chennai bench of ITAT. The tax department also challenged the CIT(A) order with respect to taxability of non-compete fee.

ITAT's observation and order

Non-compete fees

- The ITAT observed that the taxpayer is a renowned cricketer, and accordingly, has agreed to enter into a non-compete agreement for a period of 6 years for a total consideration of INR 7.50 crores.
- Accordingly, claim of the taxpayer that the amount of INR 7.5 crores was received as non-compete fee was to be accepted.
- The ITAT also held that since non-compete fee is a capital receipt[5], the same would be exempt from tax in AY02.

Application of income vs diversion of income

- The ITAT observed that almost entire shareholding of KSSEPL (to the tune of 99%) was held by minor sons and the taxpayer merely held 125 shares of the said company.
- Further, the amount payable to Indian Bank is on account of default by a company in

[2] under section 143(1) of the Income-tax Act, 1961 (the Act)
[3] under section 143(3) of the Act
[4] under section 147 of the Act

[5] and taxability of non-compete fee as business income was introduced vide Finance Act 2002 with effect from 1 April 2003, Guffic Chem Pvt. Ltd vs CIT (332 ITR 602)

which the taxpayer is a director. Since the said company was unable to repay the bank loan, personal guarantee of the taxpayer was invoked by the bank. The guarantees were given by the taxpayer and therefore, it was his liability to settle the bank dues.

- The taxpayer, being a natural guardian of his minor sons is duty-bound[6] to protect the interest of his minor sons. It is because of this reason that the taxpayer could not have diverted sale proceed of shares held by his minor sons to repay the bank against his personal guarantees. **Thus, the ITAT held that the said payment would therefore be deemed to be paid out of the non-complete fee received by the taxpayer.**
- Further, the ITAT[7] for the sake of completeness, held that the taxpayer was not entitled to deduction by way of diversion by overriding title as there was no charge held by the bank and there was merely a compromise entered into between the taxpayer and the bank to pay the defaulted loans. Thus, the payment to the bank was merely an application of income and not diversion of income by overriding title.[8]

Taxability of amount not received

- The taxpayer claimed INR 3 crores have not been received and that the same shall be attributed towards sale consideration, and not towards non-compete fees.
- The ITAT, going by the same principal of protection of minor sons' interests, held that non receipt of INR 3 crores was on account of non-compete fee, which is already held to be exempt income.

Our comments

The judgment clearly distinguishes between income attributable to sale of shares held by taxpayer's minor sons and income accruing to the taxpayer as non-compete fee. Further, although income attributable to the sons is clubbed with income of the taxpayer and taxable in the hands of the taxpayer, it is protected by laws relating to minority and guardianship in India. Accordingly, income of the minors cannot be utilised by the taxpayer to settle his own liabilities.

[6] under the minority and guardianship laws prevalent in India i.e. Section 8 of The Hindu Minority and Guardianship Act, 1956

[7] even while observing that discussion on taxability of the amount paid to the Bank is not relevant

[8] Third Member of ITAT, Mumbai in case of Perfect Thread Mills Limited v. DCIT reported in (2020) 181 ITD 1(Mum-trib.)(TM)

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