

Decoding Family Settlements & Arrangements [Part II]

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In [Part I](#) of the article an attempt was made to lay down the salient features of a family arrangement by relying on many important judicial decisions as the entire law on the subject is a judge made law. Part II of the article focusses on the tax implications of a family arrangement. While tax should not be the driver for any arrangement much less a family arrangement its implications being consequential to the settlement still need to be understood.

There are two potential scenarios which could trigger a tax liability. The first being whether a family settlement is chargeable to capital gains tax and the second being whether the provisions of section 56(2)(x) are applicable to a family settlement. Both these scenarios are discussed threadbare in this article.

Whether a family settlement is subject to capital gains tax

There are two key elements for applicability of section 45 of the Act to any transaction. These are 'transfer' and 'capital asset'. Given the wide definition of 'capital asset' in section 2(14) of the Act, the assets forming part of the family settlement would get squarely covered under the said definition. Let us now examine whether there is any 'transfer' in a family settlement. 'Transfer' is defined in section 2(47) of the Act and inter-alia includes sale, exchange, relinquishment of an asset and extinguishment of any rights therein.

Before we get into the nuances of the taxability, it will be relevant to re-visit the basic principles of a family settlement through the two landmark decisions given below:

In **Sahu Madho Das v Mukand Ram AIR 1955 SC 481**, the Court observed that *"It is well settled that a compromise or family arrangement is based on the assumption that there is an antecedent title of some sort in the parties and the agreement acknowledges and defines what that title is, each party relinquishing all claims to property other than that falling to his share and recognising the right of the others, as they had previously asserted it, to the portions allotted to them respectively. But, in our opinion, the principle can be carried further and so strongly do the Courts lean in favour of family arrangements that bring about harmony in a family and do justice to its various members and avoid, in anticipation, further disputes which might ruin them all, that we have no hesitation in taking the next step (fraud apart) and upholding an arrangement under which one set of members abandons all claims to*

all title and interest in all the properties in dispute and acknowledges that the sole and absolute title to all the properties resides in only one of their number (provided he or she had claimed the whole and made such an assertion of title) and are content to take such properties as are assigned to their shares as gifts pure and simple from him or her, or as a conveyance for consideration when consideration is present."

In **Ram Charan Das v Girija Nandini Devi** [\[TS-5025-SC-1965-O\]](#), the Hon'ble Court relied upon the decision in the case of Mst. Hiran Bibi v. Mst. Sohan Bibi A.I.R. 1914 P.C. 44 which had approved an earlier decision in Khunni Lal v. Govind Krishna Narain I.L.R. 33 All. 356. The Privy Council held that a compromise by way of family settlement is in no sense an alienation by a limited owner of family property. Considering the facts before the Hon'ble SC, *it was held that in this case, once there is no alienation of assets in a family settlement, it does not amount to creation of any interest.*

The principles that emerge are:

1. A compromise or arrangement is based on the assumption that there is an antecedent title of some sort in the parties
2. In a family arrangement there is neither an alienation of property nor an exchange of property and the differences of parties having competing titles are resolved through a compromise.

It is clear that a family settlement does not involve a sale, but does it involve an exchange, relinquishment or extinguishment so as to bring it within the definition of transfer needs to be examined.

In **Rasiklal Maneklal (HUF)** [\[TS-9-SC-1989-O\]](#), the Court held that an 'exchange' involves the transfer of property by one person to another and reciprocally the transfer of property by that other to the first person. It also held that a 'relinquishment' takes place when the owner withdraws himself from the property and abandons his rights thereto.

In a family settlement however, as explained hereinabove, there is no transfer of property by one person to another as each member as a right in the subject property and inter-se between the family members. Accordingly, the concept of exchange cannot be read into the family settlement and therefore there cannot be any transfer. Further, as held by the Hon'ble Apex Court there is no alienation of property in a family settlement. Once there is no alienation there cannot be any relinquishment of any right in the property.

The Black's Law dictionary defines the term 'extinguishment' as 'the destruction or cancellation of a right, power, contract or estate. The annihilation of a collateral thing or subject in the subject itself out of which it is derived'. Under the tax law, the meaning of the term 'extinguishment' was enlarged by the decision of the Apex Court in the case of **Grace Collis** [\[TS-5-SC-2001\]](#). The Apex Court overruled its earlier judgement in **Vania Silk Mills** [\[TS-3-SC-1991\]](#) and held that extinguishment of a right in a capital asset is independent and otherwise on account of transfer.

Taking a cue from the meaning of the said term and the aforesaid judgement, it would mean that to fall within the definition of 'transfer', in a family settlement the rights of the members would need to get cancelled in simplistic terms qua all assets in the family pool. However, that is not the case as each member of the family continues to hold some asset by virtue of the family settlement and it is only a compromise between the members having competing titles.

Having understood that there is no exchange, relinquishment or extinguishment in a family settlement it is safe to conclude that a family settlement does not amount to a transfer and accordingly there is no capital gains tax on family settlement.

Whether a family settlement is subject to tax under section 56(2)(x)

As per section 56(2)(x) where any person receives, in any previous year, from any person or persons on or after the 1st April, 2017 -

(a) any sum of money, without consideration, the aggregate value of which exceeds Rs. 50,000, the whole of the aggregate value of such sum

(b) any immovable property, without consideration, the stamp duty value of which exceeds Rs. 50,000, or if it is for consideration then the stamp duty value of such property exceeds such consideration subject to certain conditions.

(c) Any property other than immovable property without consideration the aggregate fair market value of the property by an amount that exceeds Rs. 50,000, or if it is for a consideration then such consideration is less than the aggregate fair market value of the property by an amount exceeding Rs. 50,000.

In all the above cases the income arising to the recipient shall be taxed as income from other sources under the aforesaid section of the Act.

The essential conditions for the applicability of the said section are :

1. That assets that are received by a person should be “property”, as defined in section 56(2) of the Act; and
2. Such receipt of property should be without consideration or inadequate consideration

The term property for the purposes of the said section means immovable property being land or building or both, shares and securities, jewellery, archeological collections, drawings, paintings, sculptures, work of art or bullion.

If the assets received by a family member by virtue of a family settlement are of the above nature, then the first limb of the applicability is satisfied. The next element to be seen is whether the assets received under a family settlement are devoid of consideration or are they for an inadequate consideration.

Section 2(d) of the Indian Contract Act, 1872, defines consideration as “when, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise”.

The Black’s Law dictionary defines ‘consideration’ as ‘the inducement to a contract. The cause, motive, price, or impelling influence which induces a contracting party to enter into a contract. The reason or material cause of a contract. Some right, interest, profit or benefit accruing to one party or some forbearance, detriment, loss, or responsibility, given, suffered, or undertaken by the other.’

From a perusal of the definition under the Contract Act and as given by the dictionary it would be clear that consideration need not only be in monetary terms and that the consideration may be in kind. If that be so, then the next question that arises is whether there is a consideration in a family settlement or not.

It has been judicially well accepted that transfer under a family arrangement should not be considered as a transfer without consideration since the non-monetary consideration is:

- prevention of any protracted litigation,
- preserving the family property,
- peace and security of the family, etc

The consideration therefore in a family arrangement may be the preservation of the family property, preservation of peace and honor of the family for the avoidance of litigation. Therefore, owing to adequacy of consideration, albeit non-monetary, any receipt of property pursuant to a family arrangement should not trigger provisions of section 56(2)(x) of the Act.

Reliance is placed on the following judgments wherein it has been held that the *bona fide* family settlement is not without consideration –

1. Ram Charan Das Vs. Girijanandini Devi [\[TS-5025-SC-1965-O\]](#)
2. ACIT Vs. Bilakhia Holdings Pvt. Ltd. [\[TS-319-ITAT-2014\(AHD\)-O\]](#)
3. Gobind Kumar Khemka Vs. ACIT [\[TS-8896-ITAT-2019\(DELHI\)-O\]](#)
4. Dy. CIT v Paras D Gundecha [\[TS-5033-ITAT-2015\(MUMBAI\)-O\]](#)

5. CIT v Vajra Investment & Trading Co. Ltd. [\[TS-5768-HC-2013\(ALLAHABAD\)-O\]](#)

It is worthwhile to note that as per the Memorandum to the Finance Bill, 2017, section 56(2)(x) was introduced as an anti-abuse provision to cover property transferred under the garb of gift for inadequate consideration. Since a family settlement has been judicially recognized as a valid means of arranging family's affairs, the anti-abuse rule should not be triggered.

It may also be noted that any receipt of property from relatives as defined in section 56(2)(vii) is outside the purview of section 56(2)(x). Therefore, presuming but without conceding to the fact that there is inadequate consideration in a family settlement, receipt of property from relatives is outside the purview of the section and therefore it would have no tax implications. Going further, even if the family comprises of persons who do not get covered within the definition of relative under section 56(2), then also there would be no implications as the compromise is for an adequate consideration as discussed hereinabove.

Parting Thoughts

A family settlement is an effective alternative dispute resolution mechanism and should be a preferred route for families to protect generational wealth from being marred by disputes. Given the fact that genuine family arrangements/settlements are outside the purview of taxation, this mode of dispute resolution has gained popularity over a period. Civil proceedings in a court are not only time consuming but also a costly affair and therefore family settlements should be a preferred choice for dispute resolution amongst families.