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Transfer of shares or other interests pursuant to a family arrangement is not a transfer and hence not liable to capital gains tax

In brief

In a recent decision in the case of Shri R. Nagaraja Rao¹ (assessee), the Karnataka High Court has held that shares transferred to a family member pursuant to a family arrangement/partition cannot be construed as **a transfer under section 2(47) of the Income-tax Act, 1961** (the Act) for the purpose of capital gains and hence not liable to capital gains tax.

Facts

- The assessee was a party to a family arrangement. The family arrangement was reached through a deed dated 21 December 1992.
- Each of the parties to the arrangement held personal properties as well as family properties and shares in different business concerns and each of the family business has been **independently managed by one of the parties**.
- Dispute arose between the parties, which was referred to arbitration. The arbitrator suggested a settlement, to which the parties agreed.

¹ CIT v. R Nagaraja Rao [TS-222-HC-2012(KAR)]

- As per the terms of the settlement, the assessee had to transfer his shares. In turn, the other family member also transferred shares held by them in favor of the assessee.
- The Assessing officer (AO) treated the above family arrangement as a 'transfer' and held that the assessee was liable to pay capital gains tax.
- The Commissioner of Income-tax (Appeals) confirmed the order of the AO.
- The Income-tax Appellate Tribunal (the Tribunal), after considering the judgment of Supreme Court in the case of Ram Charan Das² and also of the Gauhati High Court in the case of Ziauddin Ahmed³, ruled in favour of the assessee and held that the family arrangement made between the assessee and other family members on the suggestions made by the arbitrator is not a 'transfer', and therefore, the assessee is not liable to pay any capital gains tax.

Issue

- Whether the transfer of shares **by virtue of a family arrangement was not a 'transfer'** as there was a family dispute and such arrangement took place at the instance of the arbitrator?
- Consequently, whether the sale proceeds received by the assessee out of sale of shares can be treated as income and brought to capital gains tax?

Assessee's contentions

- The assessee claimed that there was no 'transfer' which gives rise to any capital gains tax.

Revenue's contentions

- There was a 'transfer' and therefore, the assessee is liable to pay capital gains tax.

High Court ruling

- The referred to its own decision in the case of K.N. Madhusudhan⁴, wherein it was held that:
 - *The word 'transfer' does not include partition or family settlement as defined under the Act.*
 - *It is well settled that a partition is not a transfer. What is recorded in a family settlement is nothing but a partition.*
 - *Every member has an anterior (i.e. pre-existing) title to the property which is the subject matter of a transaction, that is, partition or a family arrangement. So there is adjustment of shares, crystallization of the respective rights in family properties and therefore it cannot be construed as a transfer in the eyes of law.*
- It is further observed that the Tribunal, on a proper consideration of entire material on record, has categorically held that the **transaction in question was a family arrangement.**
- Thus, it is concluded that there was no 'transfer' and therefore, no capital gains and no liability to pay capital gains tax.

² Ram Charan Das v. Girija Nandini Devi [AIR 1963 DC 323]

³ Ziauddin Ahmed v. Commissioner of Gift Tax [1975] 102 ITR 253

⁴ Commissioner of Gift Tax v. K.N. Madhusudhan [Gift Tax Appeal Nos. 1& 2/2008]

Conclusion

The Court held that family arrangement/partition entails adjustment of shares and crystallisation of respective rights in family properties and therefore, the same cannot be treated as a transfer under the Act.

The ruling is relevant for assesseees who transfer shares and other assets pursuant to a family arrangement or partition.

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