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Splitting family settlements?

Check out whether you come under the purview of the Gift, Wealth and Registration Acts as also stamp duty laws when dividing family property

IT IS in the nature of things that families must split and properties be taken over by one branch or another. The values of properties can be very high and although every member of a family may desire that an allocation of family assets be made, one question is — what will be the financial implications under the various laws, particularly the Income-tax, Gift Tax and Registration Acts and also Stamp Duty Laws.

The courts have considered questions relating to family settlements on many occasions. It is often found that there are a number of assets, some in the names of various members but not necessarily all the members of the family. These assets may include capital assets and stock in trade and may be in the form of immovable property or of jewellery and shares.

Sometimes properties are held in the names of individuals or Hindu Undivided Families and sometimes in the names of companies or partnership firms. Members of the family may feel that they have a right to assets by way of inheritance or on account of the fact that they have contributed either financially or in the form of service and work in making the assets and businesses grow and that the historical reflection of ownership is no longer correct or just.

Even apparently simple situations could have enormous tax implications. For instance, if two brothers hold two plots of land, each plot in both the names and if the brothers now wish to separate so that one takes over all rights to one plot of land and the other takes over rights to the other plot, gift-tax and stamp duty may be payable in the ordinary course and would registration of such a document be necessary?

The courts have accordingly laid down several principles as the question of family settlements has not been directly addressed in the Income-tax Act or the Gift-tax Act or the Stamp Duty laws. This is an entirely judge-made law.

The principle laid down by the courts is that when assets are allocated under a family settlement, even though there may be a change in the name of the holder, this would not amount to a transfer as long as there are some prior rights or even if some claim has been made by the allottee. Because there has been some pre-existing right or even just a claim, a fresh right is not created but it is merely that an existing right or claim has been recognised by the others and quantified in some form.

What has happened then is not a 'transfer' from one person to another but merely a mutation from one person's name to another person's name. The consequences of an allocation or allotment under a family settlement not being treated as a transfer, but merely as a crystallisation of existing rights are very important.

Firstly, even though there may be a change in the holding of immovable property, because it is not a transfer, the document may not be compulsorily registrable under Section 17 of the Registration Act.

Secondly, because it is not a transfer, Section 2(47) of the Income-tax Act, which defines a transfer, would not apply, and a capital gain would not accrue even on a change of ownership or mutation.

Thirdly, Section 2(xxiv) of the Gift-tax Act which defines 'transfer of property' would not apply.

Fourthly, the stamp duty laws may not apply.

Fifthly, there could be other implications, such as that if there is a transfer of shares and premises in a Co-operative Society, a 'transfer fee' may not be payable, as there is no transfer.

However, while these are the legal effects of a bona fide family settlement, one must also examine what kind of arrangement would fall within the scope of a family settlement and what would not.

Firstly, should there be disputes, either existing or anticipated, and there should at least be a present claim. So if a person were merely to record that he expects disputes after his death and therefore allocates his assets amongst his family without there being evidence of any claims from the others, this could amount to a gift (DCGT v. Priyambhai B. Mehta 58 TTD 11 (Ahd) and GTO v. Shamjibhai K. Patel 51 ITD 484 (Ahd).)

Therefore, if property moves only from one person to another, this may not amount to a settlement, but would only be in the nature of a unilateral action. If however, each party gives something and gets something, this could be a family settlement.

The settlement could be arrived at by the parties themselves, or with the help of well-wishers and friends, or the settlement could have been effected by way of an arbitration award.

It is not only Hindu families which can resolve their disputes by way of a family settlement. There are several decisions of the courts relating to Muslim families too, and the principles would be applicable to people of all faiths.

In addition to the substantive principles laid down by the courts, one must also consider the form in which the recording is to be done so that the form is consistent with, and in fact complements the substance.

It is not essential that a settlement be in writing. It could even be oral, and as long as it is acted upon by the parties, it would be valid and binding. If, therefore, parties to a family settlement merely put each other in possession of the properties allocated to each, and exercise rights of ownership by mutual consent, this would be in order. It is obviously, however, preferable where circumstances permit to record the terms of settlement in writing.

This recording should be in the form of an aide-memoir, and could be styled 'Memorandum Recording Oral Family Settlement.' In this way it would be a document not creating rights, but merely recognising rights and claims and crystallising them.

But it is not fatal to a family settlement even if it is recorded in a document styled as an Agreement or a Deed. The reason is that in fact the disputes must have existed already and must have been resolved before being recorded in writing and the courts will look to the substance rather than the form. It is however preferable if the Memorandum speaks for itself as one merely recording the settlement, and that the form matches the substance.

All the parties to the dispute should confirm the Memorandum, if possible. Guardians should sign on behalf of minors. If the members of the family are not shown to be parties, it may be treated as a unilateral transaction, and thereby a gift or a transfer.

Since the word 'transfer' has a definite meaning, and bona fide family settlements do not result in a transfer, the use of other words is more appropriate.

So when property is to go from one person to another, it should not be recorded as 'A transfers to B'. More neutral terms should be used, for example 'This asset has been allotted to B' or 'This asset has been allocated to B'. One may ask a society for instance, for mutation of its records so as to bring the asset into the name of another, but should not ask for the asset to be 'transferred'.

The Memorandum should, as far as possible, and to truly reflect the settlement, record that the parties had disputes and that the disputes have already been resolved, and the settlement is now only a record of past events, and a record of actions and steps which have still to be taken to give effect to a past allotment.

It is important that there should be a give and take by the parties. Sometimes this may be of tangibles but it could also be of intangibles, i.e. that one of the parties may confirm that he will not claim certain rights of inheritance in future.

However, it is sometimes specified that the cost of an asset has been agreed to be reimbursed to the original holder. This is then just a reimbursement by way of family settlement and not a consideration for transfer.

Section 2(42A) of the Income-tax Act read with Section 49 provides that where a person has acquired an asset by a gift or will etc. the period of holding in the hands of the earlier owner will be taken into account in determining whether the gain on sale is a short term or a long term gain. Section 49 does not specifically refer to family settlements. Therefore if an asset is allotted to a person under a family settlement, in order to avoid controversy, he should by way of abundant caution try not to sell it for three years, in order that the benefits available to long-term capital gains are not questioned.

With the introduction of Schedule II to the Gift-tax Act and Schedule III to the Wealth-tax Act, which provide for the valuation of some kinds of assets, the Income-tax and Gift-tax implications are less than they used to be, and built-up property for instance may even be transferred at cost in some situations without attracting a capital gains tax or a gift-tax. However the Stamp Duty issues are the ones now with the greatest financial implications.

In view of the fact that a bona fide family settlement does not result in a transfer, stamp duty ought not to be payable.

The Stamp Office sometimes does not accept this view, and treats the document as one of partition. As this is chargeable with stamp duty at a lower rate than a conveyance, parties sometimes accept this, in order to avoid litigation.

The principles of a family settlement are however now well established and the sympathetic consideration given by the Courts to bona fide settlements has truly helped in avoiding or cutting short litigation in many cases.

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