



## Family Arrangements Taxation Aspects Involving Companies

Over the years, India has witnessed the rise of many prominent family empires. A family business generally starts with a small business being set up by a member, which is expanded into diversified business operations and the legacy of which passes through several generations ahead. Many families start their businesses with sole proprietorship, and the journey of many such family businesses is taken forward to a multinational brand parked in various legal entities. Such entities are operated and managed by different members of the family.

Over the period, with a generational change and changes in family sensitivities such as ideologies, value systems, aspirations, etc., differences in opinions or views between the family members may result in separation requiring allocation of family businesses and assets. Moreover, these aspects can hamper the operations and management of the entities. Even at a personal level, this could impact the family members' understanding of their rights and entitlements, family asset ownership, etc.

Hence to ensure a fair and equal division of family rights and assets a family arrangement is used to settle existing/potential disputes or differences.

### What is a Family Arrangement?

A family arrangement is an agreement between members of the same family, intended to generally and reasonably benefit the family members either by compromising doubtful or disputed rights or by preserving the family property or the peace and security of the family by avoiding litigation, or by saving its honor. The central idea of family arrangements is that rights are settled in a manner whereby a family's peace, happiness, and welfare are secured, and litigation is avoided.

The general principles of a family arrangement are bonafide and voluntary nature, pre-existence of some antecedent title, claim, interest, or even a possible claim in the property acknowledged by other parties to the arrangement, etc. Other aspects include arrangements undertaken to end existing or potential differences between the family members, maintaining peace and harmony and protecting the family from long-drawn litigation. The Supreme Court, in the case of *Kale vs Dy. Director of Consolidation*<sup>1</sup> has laid down the above principles as to what would constitute a valid family arrangement. Similar principles have also been followed or emanated from various other judicial precedents.

1. AIR 1976 SC 807



Typically, the understanding inter-se between the family members is documented through a family settlement deed.

### Various Modes For Giving Effect to Family Arrangement

To give effect to a family arrangement, the following modes are generally used independently or in combination:



### Taxation of Family Arrangements

Considering the objective for which the family arrangements are undertaken, it is a settled position that a transfer pursuant to a bonafide family arrangement entered between the individual family members cannot be considered as a 'Transfer' for the purpose of capital gains taxation. This is a principle that has been accepted and upheld by several judicial precedents<sup>2</sup>.

In a nutshell, any capital gains or any other income arising from the family arrangement in the hands of the individual's party to the family arrangement would not be subjected to taxation.

### Interplay with Involvement of Corporate Structure

Considering the families would also be stakeholders in various closely held companies, as a part of the family arrangement, the shareholdings in the companies can be rejigged. Where the arrangement is between the family members, the above principles should hold good, and the family arrangement should not be subjected to tax<sup>3</sup>. However, a question arises about the taxability when a corporate entity is also a party to the family arrangement. This is especially where any actions under the arrangement are required to be undertaken at the entity level.

Whether a corporate entity can be a party to the family arrangement was under consideration before the Karnataka High Court in the case of Sea Rock Investment Ltd.<sup>4</sup> and before the Bombay High Court in the case of B.A. Mohota Textiles Traders (P.) Ltd.<sup>5</sup> "In both these cases," it has been held that the company being a separate legal entity, the transfer of shares, even though under a family arrangement through Court, would be subjected to tax, and the principles discussed would not apply in such cases. The Courts held that such transfers would be assessable to capital gain tax. The Courts observed that extending the benefit of no taxability in such situations would amount to the lifting of the corporate veil, which would mean the denial of corporate existence. Interestingly, in both these decisions, the issue has been with respect to the taxability in the hands of the companies. In these cases, the companies were trying to take the benefit of non-taxability on family arrangements, pursuant to which the companies transferred the shares held by them to individual members of the family.

An interesting aspect for consideration would be whether this principle would hold good even when the corporate entities are involved in the arrangement, but the taxability under consideration is of the individuals. In this regard, it is pertinent to note the ruling of the Chennai Tribunal in the case of SKM Shree Shivkumar<sup>6</sup>, where the receipt of assets, including cash, by the individual taxpayer from a company in which he had substantial interest, pursuant to a family arrangement, was held as non-taxable in the hands of the individual (applicability of deemed dividend provisions was ruled out in the hands of the individual).

2. CIT vs R. Nagaraja Rao [2012] 21 taxmann.com 101 (Karnataka), CIT vs AL Ramnathan [2003] 128 TAXMAN 87 (MAD.)  
 3. CIT vs Kay Arr Enterprises [2008] 299 ITR 348 (Madras)  
 4. [2009] 317 ITR 253 (Karnataka)  
 5. [2017] 82 taxmann.com 397 (Bombay)  
 6. [2014] 48 taxmann.com 346 (Chennai - Trib.)



This principle has also been recently applied by the Mumbai Tribunal in the case of *Sujan Azad Parikh*<sup>7</sup>. In this case, the matter was referred to the Company Law Board (CLB). Based on the directions of CLB, under a family arrangement, the desired shareholding was to be achieved by way of buyback (i.e., other shareholders were given an exit under buyback mode). Noting that the transfer (an indirect increase of shareholding of desired family members) was under a valid family arrangement, it was held that the same would not be subjected to capital gains tax. Notably, the Tribunal has distinguished the Bombay High Court decision on the basis that in the said case, the taxpayer was a company that is not a family member.

Notably, this ruling pertained to the financial year 2006-07, where the shareholders were liable to capital gains tax on buyback. Thus, the Tribunal extended the relief of family arrangement in this case, considering the taxability of the individuals. While currently, buyback is subject to buyback tax in the hands of the company and consequently exempt in the hands of the shareholders, the outcome of the decision indirectly extends the exemption on account of family arrangement despite the involvement of a corporate entity.

### Way Forward

Over the years, it has been a settled position that bonafide family arrangements between family members are not transfers liable for capital gains taxation. The challenges arise when the corporate structure gets involved. In such cases, Courts have held that where the income arises in the hands of the corporate entities, the same should be taxable as the corporate veil cannot be lifted at the instance of the family members and that the corporate entities cannot be considered to be part of the family.

However, Tax Tribunals in some of the recent decisions have upheld an interesting position that in the scenario where the corporate entities carry out a restructuring exercise and as an outcome, the same income arises to the family members due to deeming provisions (for e.g., dividends, deemed dividends, capital reductions, etc.) the tax exemption shall still be available. Notably, the decision is silent on the lifting of the corporate veil at the instance of the taxpayer.

While possibly this aspect could be examined with a fresh lens when the matter reaches higher levels or even in other cases, this is certainly an interesting perspective on the issue.

Considering the contentious flavor of the issue, from a certainty standpoint, certain pre-steps from commercial, tax, and regulatory perspectives could be considered before implementing the arrangement to achieve the desired objectives. These could involve corporate restructuring exercises, realignment of shareholdings, and various plausible measures to bring the overall structure to an easily implementable and efficient state for giving effect to the family arrangement.

## Nexdigm can help answer the important questions

Can a trust structure help in ring-fencing of assets?

Will inheritance tax be applicable in a foreign jurisdiction?

How do I manage my overseas income and assets to avoid double taxation?

Do I have to file my tax returns in the countries where I earn revenue?

Do you get a consolidated real-time view of your wealth?



7. *Sujan Azad Parikh vs DCIT* [2022] 145 taxmann.com 167 (Mumbai - Trib.)



# About Nexdigm

Nexdigm is an employee-owned, privately held, independent global organization that helps companies across geographies meet the needs of a dynamic business environment. Our focus on problem-solving, supported by our multifunctional expertise enables us to provide customized solutions for our clients.

We provide integrated, digitally driven solutions encompassing Business and Professional Services, that help companies navigate challenges across all stages of their life-cycle. Through our direct operations in the USA, Poland, UAE, and India, we serve a diverse range of clients, spanning multinationals, listed companies, privately-owned companies, and family-owned businesses from over 50 countries.

Our multidisciplinary teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm is of utmost importance, and we are ISO/ISE 27001 certified for information security and ISO 9001 certified for quality management.

We have been recognized over the years by global organizations, like the International Accounting Bulletin and Euro Money Publications.

**Nexdigm** resonates with our plunge into a new paradigm of business; it is our commitment to **Think Next**.

USA Canada Poland UAE India Hong Kong Japan

[www.nexdigm.com](http://www.nexdigm.com)

Reach out to us at [ThinkNext@nexdigm.com](mailto:ThinkNext@nexdigm.com)

Follow us on



Listen to our podcasts on all major platforms

This document contains proprietary information of Nexdigm and cannot be reproduced or further disclosed to others without prior written permission from Nexdigm unless reproduced or disclosed in its entirety without modification.

Whilst every effort has been made to ensure the accuracy of the information contained in this document, the same cannot be guaranteed. We accept no liability or responsibility to any person for any loss or damage incurred by relying on the information contained in this document.