Income-tax Provisions for Private Trusts

Bengaluru Branch of SIRC of ICAI

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Scope of Presentation

Covering ITA as applicable to Private Trusts.

Not considering Charitable Trusts.

Briefly touching upon
Indian Trust Act,
FEMA & Succession Planning
as may be relevant.

Why Tax Provisions for Trust are complicated?

Trusts have been used more for tax planning than for genuine purposes. So Government comes out with several series of Anti-Avoidance provisions.

Planning:

1. Increase number of taxable entities. Benefit of basic exemption, Deductions & lower rates.
2. Transfer assets & income from wealthier to others.
3. Divest ownership to avoid Estate Duty but retain benefits.

Why more tax entities?

Tax Rates around AY 1973-74
Income-tax 97% Wealth Tax 8%
Estate Duty 80%.
Socialistic/Usurious taxes.

Every entity meant basic exemption +
Chapter VIA deductions &
Lower slab rates.
To avoid ED, divest ownership through trust

Specific Anti Avoidance Rules
SAAR

Clubbing with Transferor
Clubbing with Parents
MMR Provisions

Disclosure Requirements
Attacks on Tax Evasion

Complicated Tax Law

If a professional starts reading SAAR
Without understanding
the tax planning being attacked,
He will not find it easy
to interprete the law.
E.G. Some experts are confused on
AOP taxation

Made Easy

We will see tax avoidance plans
Attack on plans
Final outcome.

What kind of trusts can now be settled?

What is a Trust?

When a person	Settllor
Transfers a specific property	Trust Fund
To another trusted person	Trustee
To hold & manage	Trustee duties
For the benefit of others	Beneficiaries

What is a Trust?

And the **obligation** is accepted
By the trustees, it is called a Trust.

The **confidence** reposed by Settllor
Is called Trust

Trust is a relationship of trust amongst Settllor, Trustees and Beneficiaries.

Is trust an Entity or a Person?

Trust is a matter of a feeling, confidence in another. It is NOT a person/ separate legal entity like a Limited Liability Company/ Society etc.

Trust is not specifically deemed to be a person U/s 2 (31). (Unlike an HUF, a firm, an AOP etc.)

In limited circumstances trustee is taxed as an AOP. S. 164 (1) (1st Proviso).

Separation of Ownership, Management & Benefits

Company means separation of “Ownership & benefits = Dividends”From Management.

Commercial Arrangement.

Governed by Co. Law & SEBI

Trust means separation of Management from Benefits. Ownership is divided into Legal & Beneficial ownerships

Social/Family arrangement. No Regulator.

Why Settle a trust?

In a trust, the owner of an asset-		Father
Transfers the assets to another -		Trustee
For the benefit of his	-	Children.

Why he does not continue to own himself?
Why he does not transfer to his own children?

Illustration- ageing father with handicapped child.

Trustee

Ideally one should continue to own himself.
Next best choice: gift to children.
Why transfer to a third party?

Involve Third party only when
circumstances justify.

Settllor himself may be a Trustee also.

Life Tenant & Remaindermen

Consider a genuine concept in Trusts

Life Tenant can enjoy the benefits for his life.
He cannot sell/ use Corpus of the Trust.

On death of LT
The remaining beneficiaries get the benefits.

Life Tenancy

Life Tenant will generally have
very low value
For Estate Duty purposes.

Genuine need
Settllor wants to take care of two generations.
Wife & children.

Life Tenancy - illustration

Settllor has one child mentally challenged
He wants to take special care of the child
But after the child,
Benefits to go to other children.

In such a situation
Life Tenancy is suitable.

Registration of Trust Deed

Trust deed cannot be registered with a Trust Regulator. There is no Regulator for Trusts.

Unlike:

Company:	ROC.
LLP:	ROC.
Firm:	Registrar of Firms.
Collective Investments:	SEBI.

Registration of Trust Deed

Banks & others ask for registration of
a Trust Deed.
When there is no Registrar,
where do you register?
As a practical way out – register with registrar of Sub-Assurances. It has no legal significance.
But banks accept it as a registered deed.
Confidential matters become public.

Trust is not a Contract

Trust is not governed by Indian Contract Act.
It is governed by Indian Trust Act.
(Foreign trusts are governed by the
Laws of the Jurisdiction where they are settled.)

There is no consideration in a Trust Relationship.
A contract without consideration is invalid.

How to tax a Trust

ITA does not target to tax a Trust.

Beneficiaries are **taxed**.

In a **Specific Trust**,

The Beneficiaries are taxed for their benefits.

For administrative convenience

Trustees are taxed

In Representative Capacity

Beneficiaries taxed through Trustees

S. 160 (1) (iv) & (v) – Trustees are Representative Assessees.

S. 161 (1) Liable to tax "in the like manner & to the same extent as….Beneficiaries"

S. 161 (2)Trustees' personal assessments are Separate.

In the Like Manner & to the Same Extent explained

ITA will apply as if the beneficiaries are being taxed.

Trust income will be divided into as many shares as there are beneficiaries. Then there will be separate computations for each beneficiary.

These orders will be sent to the Beneficiary’s AO for adding to his other incomes.

Like Manner – Same Extent- Illustrations

Consider Illustrations:

(i) One beneficiary is a Company.

Its share will be taxed in Trustees’ hands at rate applicable to a company.

(ii) Another beneficiary is a non-resident.

His share will be taxed after applying Double Tax Avoidance Treaty.

TDS - procedure

From the interest, rent etc. earned by Trustees,

TDS may have been deducted.

When Specific Trust income is distributed amongst all beneficiaries,

Trustee's income becomes Zero.

Trustee's tax liability is Zero.

TDS should be available for credit to the beneficiaries.

Trustee's Rights

ITA S. 162.

Trustee can recover the taxes paid on behalf of Beneficiaries from trust funds;

Or recover from beneficiaries.

Under Trust Act

Subject to Trust Deed -

Trustees not to get remuneration

Discretionary Trust

S. 164 (1) When the shares of beneficiaries are Unknown or Indeterminate,

The trust is considered as Discretionary.
Tax at MMR –S. 2(29 C).

Anti Avoidance

Ultimately tax is suffered by beneficiaries.

Benefit sharing ratio

S. 164(1) Explanation 1 (i):
Benefit sharing ratio should be known
On execution of Trust Deed.

Anti- Avoidance

Why Settle Discretionary Trust?

Bonafide Needs:
Beneficiaries may have different & **changing** needs. One beneficiary may be rich, another may be handicapped.

Tax Planning:
Create a separate taxable entity &
Save on lower rates of IT,
Save on wealth tax.

NR Settllor

NR Settllor – IR Beneficiaries
Sections 4 & 8 of FEMA.

IR required to bring Into India
every foreign assets.
Hence tax planners make Discretionary
Trusts.

Foreign Discretionary Trust

"Legal" Planning:
"NR trust" [S. 6(2)]

NR Settllor, NR Trustees,
NR Protector
At least one NR beneficiary.
Preferably a Charitable Trust

Foreign Discretionary Trust

Illegal Tax Evasion
Indian black money stored
Through Tax Haven Discretionary Trusts.
Trying to avoid Indian FEMA, ITA
And Black Money Law.
No income taxable in India
FEMA cannot be applied.

FEMA

Under FEMA
Trusts settled by IR – Settllor;
IR trustees, NR beneficiaries
need prior permission.
Cross Border asset/liability
is a Capital Account Transaction

Impractical now

Automatic Exchange of Information.
Passport copies submitted to Trustees.

Under changed judicial approach
Judiciary may not accept impractical claims.
Forget Tax havens & Discretionary Trusts.

Tax Planning

Trusts were used extensively for
IT & WT planning.

Sarabhai family –
Names of all the rivers
Used up as their discretionary trusts’ names.

Clubbing with Transferor

S. 60 Transfer of income without Asset –Tax Transferor.

S. 61 Revocable Transfer – Tax Transferor.

S. 62 Irrevocable for the life of transferee – not to be clubbed.

Section 63 (a) Definitions
Revocable Transfer

Transfer is "Revocable" if there is a provision for

63 (a) (i) Retransfer – directly or Indirectly – whole or part of the asset.

If settllor is also a **beneficiary**, it means, even part of trust fund can be transferred to the Settllor. Hence Trust's full income to be taxed in the hands of Transferor – even if in reality

No funds have been distributed.

Trust Act permits. ITA taxes.

S. 63(a) (ii) Revocable Transfer

Right to reassume **Power over the asset** –
directly or Indirectly –
whole or part of the asset.

Where the Settllor himself becomes **trustee** –
even if not a beneficiary,
Whole of trust income may be
taxable in the hands of transferor.

63(b) Definition of Transfer

Definition: Transfer includes Settlement
[Different from S. 2(47)]

Hence S. 56 can be applied.
However, see S. 56 (2) (x) 5th Proviso clause X
Settlement exempted if –
Settllor is individual
& settles solely for relatives.
If a charitable trust is beneficiary,
exemption is lost.

63(b) + 56 (2) + 2(31)

2 (31) Trust is not a person.
Hence settlement is not a transfer to Trust.
Transfer is to Beneficiaries.

S. 56 (2) (x) – Where a person receives…
Ignore trust. Consider beneficiary.
If settllor & Beneficiaries are related,
S. 56 cannot be applied.

Distribution to Beneficiaries –S. 56

Distribution to beneficiaries is not deemed as a transfer U/s. 63 (b).

A beneficiary receives what is beneficially owned by him.

Hence there is no "receipt" without consideration. S. 56 (2) (x) cannot be applied.

63 + 56 to Discretionary Trust

Will this argument apply to
Discretionary Trusts?

If the settllor + Transferor of assets
Related to All Beneficiaries
S. 56 may not apply.

S. 64 Clubbing with Spouse

S. 64(1) (iv) Gift to the spouse –
Directly or Indirectly – through Trust.
Settllor settles a property into a trust
Where wife is a beneficiary.

Income earned on that Gifted amount will be clubbed in the hands of Transferor.

Gift to Daughter-in-law

S. 64(1) (vi) similarly covers where a daughter-in-law is a beneficiary.

Note: This provision applies as long as the beneficiary is a daughter-in-law.

Whereas S. 64(1A) clubbing of income to children ceases to apply when

Child becomes major.

Why this distinction?

S. 64 (1A) Clubbing with Parents

When a minor child earns any income –
As a beneficiary of a Specific Trust,
That income will be taxable in the hands of Father or Mother.
Explanation to S. 64(1A)
Income will be clubbed with that parent whose Income is greater.

MMR

This is a different kind of attack on Tax Planning.

In a **Discretionary Trust** one cannot determine How much income will be earned by minor child/ spouse/ daughter-in-law.

So tax the whole of the income At MMR.

Business Income

If a Trust earns Business Income
It will be taxed at MMR
Irrespective of whether it is
Discretionary or
Specific
Section 164

Foreign Discretionary Trust

One Plan suggested for several objectives.

Indian Resident (IR) remit funds abroad under Liberalised Remittance Scheme (LRS).

Settle a discretionary trust abroad.
Underlying Company
Investments in Indian Companies of Settllor.

Foreign Discretionary Trust

Trustees - Foreign Bankers/ Solicitors/ CAs
(Why trust a foreigner?)
Beneficiaries Settllor & his family
(FEMA S. 4 & 8)

Capital Account Transaction-
Prior RBI permission required.
RBI will not permit Tax Planning Schemes

IT Return Disclosure

S. 139 it is necessary to disclose in IT Return -
if you are a Trustee/ Beneficiary in foreign trust.

Non-disclosure attracts penalty.
Also, if Government finds out through Information Exchange, there will be serious action.

If you disclose, there will be scrutiny assessment.

Black Money abroad

In the past, world over people have used
Tax Haven Discretionary Trusts
For hiding black money.
More than 20 years back,
Under PMLA laws
All banks & financial institutions are forced
To take copies of passports of
Ultimate Beneficial Owner.

Lifting all Veils

Most Anti Black Money laws
Bypass all entities – trusts & companies
& hold the passport holder –Ultimate Beneficiary
as guilty of Black Money.

Almost all Tax Havens have
To comply with Disclosure requirements.
Forget Tax Havens.
Forget foreign Trusts.

When Trust Justified?

1. Circumstances force:

Aging Parents who are not sure to be alive till handicapped children live.

Etc.

2. Prepared to pay full tax on trust income.

Not interested in Income-tax or Estate Duty planning.

Presentation Concluded

Pranam

Best wishes for Safe Practice

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