TRUST AS A VEHICLE FOR SUCCESSION PLANNING AND TAX CONSEQUENCES OF THE SAME

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1. Background:

Family-run businesses continue to be the norm rather than the exception in India; with most progressing fast on the path to globalization, succession planning has never been as important as it is today. Trust structures have gained popularity over the years in India as vehicles for pooling of investments and for estate /succession planning by high net-worth individuals. However, the taxability of trusts in India remains a vexed issue due to a myriad of factors, primary among them being the nature of the trust itself. Thus, the article endeavors to explain the concept of the trust structure and why the same could beneficially be used as an effective succession planning tool for achieving flexibility and ease in control and management of family wealth. The article also examines the key facets of the Indian tax regime within which a trust thrives by evaluating the tax implications arising at various stages in case of a domestic trust.

2. Need for succession planning:

Succession planning is imperative in India, since the families are often large with multiple groups involved in the business. It is not uncommon for the Indian family run businesses to be passed onto the following generations, with the result that frequently individuals with different ideologies and varied visions are obligated to manage the business cohesively. A look back at the history of corporate India reveals the immense disruption due to improper or absent succession planning. Familial ties have been irreparably damaged, wealth accumulated over generations has been squandered, protracted and endless litigation between family members has taken up significant time and effort, draining valuable resources that could have been put to better use, and most importantly, once-leading business houses have taken a huge hit to their finances, glory and reputations.

Succession planning not only provides a method to ensure that legacies remain alive and keep up with changing times with minimum conflict or impact on business but also ensures that wealth is protected, preserved, and passed onto future generations in the intended manner. Thus, a well-planned structure, which can ease the issues surrounding family succession, is therefore the need of the hour.

3. Alternative tools for succession planning

Some of the popular tools used for succession planning are discussed as under:

3.1 Wills

A Will has been defined under the Indian Succession Act, 1925 as "the legal declaration of the intention of the testator, with respect to his property, which he desires to be carried into effect after his death." Traditionally, a Will has been generally employed for succession. A Will in a common parlance is a legal declaration of a person's (testator) wishes regarding the disposal of his or her property after death. A Will takes effect after death of the testator (being the person who has created such Will). Will can be amended as many times as desired and per the law, the latest will of the testator would apply.

If a person dies without leaving a Will (i.e. intestate succession), rules under the laws of intestate succession as provided in Hindu Succession Act, 1925 are triggered under which the deceased's properties passes to legal heirs. These default rules will not apply with respect to the property bequeathed under a valid Will.

3.2 Family arrangements

A family arrangement is a tool that enables the adjustment of, actual or perceived, imbalance of the wealth among the family members. Such an agreement assumes that there was an antecedent title of the parties, and the agreementacknowledges and defines what title is or was. Every party to the family arrangement who takes benefit under it need not necessarily be shown to have a share in the property. All that is necessary to show is that the parties are related to each other in some other way and have a possible claim to the property, a claim or even a measure of a claim on some other ground.

However, a family arrangement may not prove to be an adequate tool for succession planning in all cases because the basic intent of succession planning is to ensure that family properties remain with the family members without any restriction on sale or disposal of the property by any family member. In case of a family arrangement, ownership is directly in the hands of each member, and it would not be possible to ensure continuity of the holding of property within the family, as there is no restriction on individual members not selling or disposing the property owned by him/her

3.3 Limited Liability Partnership

The Limited Liability Partnership (LLP) is viewed as an alternative succession planning vehicle that provides the benefits of limited liability but allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement. Since the assets are owned by the LLP and not by individual partners, it provides total control over the assets held by it and provides enough flexibility for distribution of property by reconstituting the deed.

However, since the reconstitution of the deed requires confirmation by all partners, and hence, it does not provide absolute flexibility, like a trust, where the terms of distribution, etc. are decided by the settlor and are part of the Trust Deed. Further, it only caters the need of succession planning for the current generation and not for succeeding generation as the terms of distribution covered in such deed may not be accepted by subsequently introduced partners.

3.4 Hindu Undivided Family ('HUF')

According to Hindu Law, 'Hindu Undivided Family' is a family which consists of all persons lineally descended from a common ancestor and includes their wives and unmarried daughters. A 'Hindu Undivided Family' is neither the creation of law nor of a contract but arises from status. Every person that has a share in HUF is called a coparcener, individuals become co-parceners through birth/marriages and accordingly acquire an equal right on the property held under the HUF.

Since succession in an HUF would be as per the Hindu Succession Act, it would be legally challenging to delineate identified properties for specified individuals and may pose difficulties in distribution. Further, certain key aspects of the structure such as right of the coparceners to enforce partition of HUF and right of creditor in case of insolvency to obligate the coparcener to enforce partition may not optimize family unity and perpetual succession of assets. Considering the challenges with respect to disposition of property, control on succession and beneficiaries on account of co-parcener share by birth / marriage, HUFs are not generally suggested for succession planning.

Consultation paper of the Law Commission of India released in August 2018 in fact suggested abolishing HUFs considering the archaic law and its use more as a tax planning tool through creation of an additional taxable entity.

4. Need for Trust structure

4.1 Considering the shortcomings of above modes, it becomes imperative to adopt a more robust structure which adequately addresses the desired objective of succession and wealth planning. A trust demonstrates family cohesiveness to the world and provides effective joint control of family wealth through the trust deed. Thus, a trust serves as a means of united control and effective participation of all members in the decision-making process, leading to mitigation of disputes and legal battles. With large business houses in India being family-owned and controlled, trusts are being used as tools to bring a relatively large pool of assets/ investments under one umbrella as well as facilitate smooth transfer of wealth over generations.

4.2 Thus, a trust provides all types of flexibility. It provides for contingencies and facilitates clear directions for income and wealth distribution, accumulates balance and allows ultimate succession, even separation, as planned.

5. Concept of Trust &benefits of trust structure

5.1 Meaning of Trust

5.1.1 The Indian Trusts Act, 1882 ('Trust Act') which came into force on 1 March 1882, codified the law relating to private trusts. Section 3 of the Trust Act defines trust as *"**an obligation annexed to the ownership of property, and arising out of a confidence reposed in or accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner**"*.

5.1.2 **The trust is not a separate entity rather, it is an obligation. Acceptance of the obligation, therefore, is a necessary condition for a valid Trust to come into existence.**

5.1.3 Unlike most common law jurisdictions, the Trust Act does not recognize duality of ownership viz., legal and equitable. The trustee is the legal owner of the trust property and hold the property in fiduciary capacity for the benefit of the beneficiaries. The beneficiaries have a 'beneficial interest' in such property. This is evident from the abovementioned definition of 'trust' under the Trust Act.

5.1.4 Trusts are created when the settlor of the property indicates with reasonable certainty by an act or words an intention to create the trust, its objects and purpose, the beneficiaries who stand to benefit from the trust and transfers an identifiable property to the trustee(s).

5.1.5 A private trust need not be registered except in case of trust having / owning immoveable property. Section 5 of the Trust Act provides that no trust in relation to immoveable property is valid unless declared by a non-testamentary instrument in writing signed by the author of the trust or the trustee and registered, or by the will of the author of the trust or of the trustee.

5.2 Key components of the trust

The Trust Act provides that the person who declares the trust is called the 'author of the trust' or 'the settlor'. The person who accepts the confidence is called the 'trustee' and the person for whose benefit the confidence is accepted is called the 'beneficiary'. The details of each of the parties/elements playing vital role in the trust structure is discussed below:

5.2.1 Settlor:

The “settlor or author” establishes the trust by placing a particular asset that s/he owns into the trust by way of transfer to the trustee. Section 3 of the Trust Act defines 'author' of the trust as a person who reposes or declares the confidence.The settlor's role is restricted to settlement of the trust and defining the framework within which the trust shall be governed by the trustees for the benefit of the beneficiaries.

Further, per Section 9 of the Trust Act every person capable of holding property can be beneficiary in the trust, thus the settlor can also be a beneficiary of the trust provided that s/he is not the sole beneficiary of the trust. The settlor can also be the trustee of a trust. Also, where the settlor is himself the trustee or beneficiary of a trust, it needs to be considered whether the same would result in the settlement becoming a 'revocable transfer' within the meaning under section 63 of the Income Tax Act, 1961('IT Act'). This aspect is dealt with under the taxability section.

5.2.2 Trustees:

Section 3 of the Trust Act provides that the person who accepts the confidence reposed by the settlor is a trustee. The trustee accepts and undertakes an obligation under the trust to administer and manage the trust property for the benefit of beneficiaries. The trustee holds the trust property in a fiduciary capacity. Thus, 'vesting of property in the trustee' by way of such fiduciary duty to so hold the property for the beneficiaries, does not give the trustee absolute ownership over the trust property and the trustee does not enjoy an unfettered right in the trust property as is ordinarily enjoyed by an owner in his or her own property.

As per section 10 of the Trust Act, every person capable of holding property may become trustee. However, in case of discretionary trust, only those persons who are competent to contract can become trustee. There is no restriction on number of maximum or minimum number of trustees, except that section 60 of the Trust Act provides that where the trust involves receipt and custody of money, there should be minimum two trustees. A trustee can be an individual, company, or any other entity. Further, a trustee may be a person resident or non-resident in India.

Acceptance of the obligation by the trustee is a primary condition for the creation of a trust. Further, a trustee is not bound to accept a trust. However, once the trust is accepted by the trustee, he can renounce the office of trustee only by virtue of special power granted under the trust deed. Further, a trustee cannot delegate his duties to a co-trustee or to a stranger unless the instrument of trust so provides, or the delegation is in the regular course of business, or the delegation is necessary or the beneficiaries consent to the delegation.

5.2.3 Beneficiary:

According to section 9 of Trust Act "Every person capable of holding property may be a beneficiary". Further, section 3 of the Trust Act provides that the person for whose benefit the confidence is accepted by the trustee is called the beneficiary. In simple words, beneficiary is the person for whose benefit the settlor has settled the Trust and holds the 'beneficial interest' in the trust property. The 'beneficial interest' of the beneficiary is his right against the trustee as owner of the trust property. It may be noted that the beneficial interest of a beneficiary is transferrable in nature, in which case the transferee would obtain same rights and liabilities as of the transferor beneficiary.

There is a possibility that a trust may also be created for the benefit of an 'unborn person' subject to compliance with the provisions of the Trust Act and Transfer of Property Act, 1882.

One interesting question which arises is whether the beneficiaries have the right to demand distribution of trust property from the trustees. Section 56 of the Trust Act confers on the beneficiaries, the right to have the intention of the author of the trust specifically executed to the extent of their beneficial interest. Further, a sole beneficiary or all the beneficiaries unanimously, may decide and enforce upon the trustees to transfer the property to them or to another person, as directed by them. Considering the provisions of section 56, where the beneficiaries have a vested beneficial interest in the trust, they may require the trustees to transfer possession of their interest in the trust property, if so unanimously agreed between the beneficiaries. However, whether such right to transfer of possession would operate where there is a possibility of further beneficiaries being added is something which is debatable.

5.2.4 Protector:

A 'protector' or 'advisor' may also be appointed in some cases, where such person oversees the decisions taken by the trustee. Protector is a person appointed under the trust deed to direct or restrain the trustees to ensure that the trustees exercise their administrative and dispositive powers in accordance with the intentions of the settlor. A protector may (even during the lifetime of the settlor) play a pivotal role in providing guidance and inputs to the trustee. In some instances, where the settlor would not like to reserve any powers vis-à-vis key decisions of the trust, the trust deed may provide for the trustee to seek the prior or simultaneous consultation of the protector prior to executing a decision. Generally, the role of the protector is advisory or recommendatory in nature and not binding on the trustees.

5.2.5 Trust property

Section 8 of the Trust Act states that the subject-matter of the trust must be transferable property. The term property is wide enough to cover assets of every kind, whether related to business or not. Accordingly, virtually all assets, whether personal or business related and whether movable or immovable, can be subject matter of trust property.

As per proviso to section 8 of the Trust Act, ***mere*** beneficial interest under a subsisting trust could not be treated as 'subject-matter' of trust. In other words, section 8 bars the creation of a trust (say 'sub-trust') with beneficial interest in another trust (say 'master-trust') being the only subject-matter of the trust viz. a trust cannot be settled through ***mere*** contribution of beneficial interest in another trust. If the sub-trust contains any other property other than the beneficial interest in the master trust, the same should be permitted under the Trust Act.

Accordingly, a sub-trust can be added as a beneficiary of master trust.The only requirement in such cases is that the trust property of the sub-trust should consist of some other property, apart from beneficial interest in the master-trust.

5.2.6 Trust deed

A trust deed, as an instrument, is similar to an agreement and contains clauses similar to an agreement between two parties, in this case, the settlor and trustee, however which would have implications for the beneficiaries. Therefore, like any other agreement, a trust deed usually provides for rules in relation to each of the three parties and is a complete code by itself for operating the relationship within them.

There are no formal rules regarding the format or the contents of the trust deed. A trust deed would usually cover the below mentioned illustrative aspects apart from information regarding the relevant parties and trust property:

- Defining trustee lineage – this is important so that the structure continues even when the original trustees cease to exist as well as rights, powers (and restrictions thereon), duties, liabilities and disabilities of trustees, including the procedure for their appointment, removal, resignation or replacement and minimum/maximum number of trustees
- Rights, obligations and disabilities of beneficiaries, including the powers and procedure for addition and/or removal of beneficiaries, including the person who would be entitled to exercise such powers
- Delegation of authority and the decision-making matrix – to provide for matters that are to be decided by majority/unanimous consent of the trustees
- Policy for the distribution of the corpus and the income from the trust
- Providing veto powers to identified trustees for specific decisions
- Providing directions with respect to non-compete clauses and exit conditionalities
- Providing distributions and support policies in the event of specific circumstances such as marriage, death, medical emergency, divorce, etc.
- Safeguarding the interests of specific family members, for instance, a spouse (after the demise of the head of the family)
- Specific policies regarding the discipline and behavior of the next generation
- Allocation of a certain portion of wealth for philanthropic purposes
- Terms of extinguishment of the Trust
- Alternative dispute resolution, etc.

Thus, the trust deed becomes a document of prime importance, since it lays out the essential framework for the governance, control, and management of family businesses and wealth across generations. It therefore needs to be drafted with the utmost care and caution. It would be preferable that a trust deed contains clear instructions, including the process and provisions for amendment thereof and adequately addresses the plausible scenarios that may take place in future such that it does not lead to deadlock in genuine cases.

5.2.7 Letter of wishes

A Letter of Wishes (the "Letter") is an informal way by which the settlor of a trust imparts his or her intentions/wishes to the trustees. The Letter is non-binding written guidance that conveys to the trustee the settlor's goals in creating the trust and his or her thoughts about the trustee's exercise of discretionary powers in management and administration of trust. The Letter is a separate writing read by the trustee in conjunction with the trust deed, however it is neither an amendment/substitute for the trust nor it forms part of such trust deed.

Because the Letter is non-binding, it does not limit a trustee's flexibility to adapt to circumstances that may change over time, however it effectively communicates settlor's instructions to trustees as to how the trust is to be administered particularly after settlor's death.

5.2.8 Extinguishment of trust

A trust is extinguished when its (i) purpose is completely fulfilled; (ii) purpose becomes unlawful;(iii) fulfilment of its purpose become impossible by destruction of the trust property or otherwise; or(iv) when the trust is a revocable trust, and it is expressly revoked[1].

5.3 **Benefits of trust structure**

5.3.1 A trust, as a means of succession planning, is not prone to extensive statutory framework and is easy to operate. Statutory formalities are limited. Being less regulated, it offers great flexibility in structuring the succession plan in a smooth manner.

5.3.2 A trust is created, nourished, and attains necessary maturity in the presence of the creator/settlor. The settlor, who may also be a trustee, can be a witness to the result of implementation of succession plan conceptualized by him during his lifetime. Requisite alterations to the succession plan so laid down can also be undertaken by the trustees if deemed necessary for ensuring that the objectives of the trust are met. It provides effective joint control of family wealth through a well-laid rulebook in the form of a well-documented trust deed.

5.3.3 A trust structure provides the opportunity for the family to pre-empt all possible scenarios, and to document the same in an orderly manner, in order to avoid potential family disputes thereby enabling efficient operation of the family business and preservation of family wealth.

5.3.4 A trust structure can thereby help to create an enduring family legacy, by keeping intact the predecessors' vision of the family business, although not at the expense of the dynamism and the adaptability that will be necessary for any required changes. A trust structure can also create a structured format for a family office and enable efficiency in the management and running of the office.

5.3.5 The information of private trusts is not publicly available unless registered and hence provide privacy to the settlor and family members.

5.3.6 Through the appointment of a professional trustee or by the appointment of advisors who may manage the property, the settlor can ensure that the trust funds are managed and deployed in an optimum manner.

[1] *section 77 of Trust Act*

5.3.7 Under the erstwhile estate duty law, property passing under will on death of a person was liable for estate duty. However, trust, if structured appropriately, could serve as an adequate mechanism for ring fencing against potential estate duty exposure (*if reintroduced*).

6. Types of trust

For the purpose of evaluating the regulatory and tax implications it is essential to classify or identify the nature of the private trust. The trusts are broadly classified in four major categories such as revocable/irrevocable, discretionary/specific, testamentary/non testamentary and offshore-onshore based on key parameters as discussed below:

6.1 Revocable and Irrevocable

- A **revocable trust** is a trust which can be terminated anytime till the author survives by retaining/resuming power over the trust property and income by the author. The key distinction is based on whether the settlor or creator of the Trust retains the power to control the assets held under the trust so as to benefit by re-transferring the assets or income thereof to himself. In case the settlor is also a beneficiary, the transfer of assets may be considered revocable to that extent. Even if the settlor is not a beneficiary but derives any direct or indirect benefit from the income or assets thereon, such a transfer would be regarded as revocable to that extent. A revocable trust may evolve into an irrevocable trust upon the death of the settlor/creator.

- A trust that is not a revocable trust is an **irrevocable trust**. An irrevocable trust is one which cannot be altered, changed, modified or revoked after its creation. Further the settlor does not have any right to re-assume any power over the trust property or income there from. In case of irrevocable trust, the settlor is devoid of any control over the trust assets or income of the trust as the settlor relinquishes legal ownership of the assets to the trustee for the benefit of beneficiaries. Once properties are transferred to such irrevocable trusts, it is certain that such assets at some time will be distributed to the beneficiaries, or such person as provided in the trust deed. It comes to an end only when the term / purpose of the trust has been fulfilled or the trustees mutually decide to dissolve the trust.

- Such categorization of trust is crucial from an Indian tax perspective wherein the tax implications vary depending on whether the trust is revocable or irrevocable.

6.2 Specific and Discretionary trust

- Specific trust is a trust in which the beneficial interests of the beneficiaries are determinate and specific in terms of trust deed. In case of a specific trust, it is possible to determine the beneficiaries of the trust and the quantum of share which each beneficiary is entitled to in the trust fund. Such trust is also popularly referred to as a 'determinate trust'. If beneficiaries and/or their shares are not specific/ determinate, the trust is known as discretionary / non-determinate Trust.

- Explanation 1 to section 164 of the IT Act provides that for a trust to be determinate, (i) the beneficiaries should be expressly stated and identifiable as on the date of the trust deed; and (ii) their individual shares should be expressly stated and as certainable as on the date of the trust dee.

- Explanation 1 to section 164 has created lot of controversy on the characterization of trust as 'specific' or 'discretionary', especially dealing with the issue whethe rthe name of beneficiary should be expressly stated in the trust deed or where the deed sets out the manner in which beneficiaries are to be ascertained, for a trust to be regarded as 'specific trust'. Judiciary[2] seem to be divided on the topic.

6.3 Testamentary and non-testamentary Trust

Trusts created under a will are called testamentary trusts. A person may specify in his will that the whole or part of his property should be settled for the benefit of specified persons. The actual trust is then executed by the executors of the will upon demise of the testator. The testator may provide the draft of the trust deed and identify the trustee in the will.

A trust settled and executed by a settlor during his lifetime is called a non-testamentary. In other words, the trust wherein the property passes from the settlor to the trustee during the lifetime of the settlor are called non-testamentary trusts.

6.4 Offshore trusts

- Offshore private trusts are trusts which are set-up and governed in jurisdiction outside India. Offshore private trusts are popular structures as a means for wealth protection, wealth accumulation abroad, confidentiality, succession planning and exploring tax efficiencies.

- This is because every country has a distinct regulatory framework for recognition, administration, management, and taxation of trusts and the same may be leveraged for maximum efficiency from asset protection, tax, and succession perspective.

- Typically, jurisdictions such as Jersey, Guernsey, Singapore, BVI, New Zealand and Cayman Islands are good jurisdictions for setting up an offshore trust-holding structure. The general criteria considered for selecting a trust jurisdiction include how robust the trust law regime is, asset protection, ease of setting up the structure and its administration, reputation of the jurisdiction, confidentiality, disclosure and exchange of information relating to the trusts, costs of setting up and administration of the trust, taxation of income and distributions from the offshore trust and impact of Indian exchange control regulations on the structure.

7. Tax implications in case of various kinds of trust

7.1 Taxability of revocable trust

7.1.1 Section 61 of the IT Act provides that income arising to any person by virtue of revocable transfer of assets shall be taxed in the hands of the transferor / settlor. Thus, all income arising by virtue of a revocable transfer of assets shall be clubbed and chargeable to tax as income of the 'transferor' and included in his total income. Section 63 of the IT Act provides that a transfer shall be deemed to be revocable if –

– it contains any provision for the re-transfer directly or indirectly of the whole or any part of the income or assets to the transferor, or

[2] *Some prominent judicial precedents which have thrown light on the issue include the decision of Atreya Trust 193 ITR 716 (Calcutta HC)(1990), Trustees of Keshav Mohta Family Trust 232 ITR 875 (Calcutta HC)(1998), AAR in case of Companies Incorporated in Mauritius, In Re 224 ITR 473 (1997), DLJMB Mauritius Investment Co. 89 Taxman 125 (AAR) (1996), India Advantage Fund-VII [2017] 392 ITR 209 (Karnataka HC), and TVS Shriram Growth Fund [2020] 121 taxmann.com 238 (Madras HC). Also, interesting to note are CBDT Circular explaining Finance (No. 2) Act, 1980 and CBDT Circular No. 13/2014, dated 28-7-2014*

– it, in any way, gives the transferor a right to re-assume power *directly or indirectly* over the whole or any part of the income or assets

7.1.2 Further, in case wherein the transfer of an asset to a trust is not revocable during the lifetime of the beneficiaries then the taxability during the lifetime of the beneficiary shall be governed per the provisions of section 161 to section 164 of the IT Act as discussed in detail in ensuing paragraphs.

7.1.3 It is pertinent to note that the obligation to determine whether a transfer is revocable or not is cast on the income tax officer given that Section 63 of the IT Act is essentially an *anti-abuse* provision.

Considering the aforementioned discussions, it could be noted that from income tax perspective, generally it would not be comparatively advantageous if the trust is settled by way of a revocable transfer of assets, subject to commercial considerations or the circumstances otherwise require. Thus, tax implications considering the nature of trust as revocable, are not discussed further in greater detail.

7.2 Taxability of irrevocable trust

The provisions are contained in section 160 to 166 of the IT Act lay down important aspects in respect of taxability of private trusts. The structure of irrevocable private trust gives rise to the situation wherein the settlor contributes/settles any asset/property in the hands of trustees, for the benefit of beneficiaries who are the real owners of the income arising there from. The provisions of IT Act provide mechanism for taxation of such irrevocable trust based on further classification as follows:

7.2.1 Taxability of irrevocable specific trust

- Section 160 of the IT Act treats trustees as **'representative assessee'** in respect of the income earned or received on behalf or for the benefit of the beneficiaries. Section 161 of the IT Act provides manner of taxing income in the hands of 'representative assessee' and provides that, the income earned or received by the trustee in representative capacity shall be taxed in **'like manner and to the same extent'** as the tax would be leviable upon and recoverable from the person represented by him.

- Further, section 166 of the IT Act provides the assessing officer with an option to directly assess the beneficiaries in respect of the income received or earned by trustees on behalf of beneficiaries.

- **In simple words, the assessment of the trustee (as a 'representative assessee' of the beneficiaries) would have to be made in the same manner, as that of the beneficiary whose interest is sought to be taxed in the hands of the trustee and the amount of tax payable by the trustee would be the same as that payable by each beneficiary in respect of his beneficial interest, if he were assessed directly.**

- While section 161 does not specifically provide the rate of tax at which the representative assessee would be charged for income (other than business income) earned on behalf of the beneficiaries, however, considering the provisions of the section 161 and the usage of the phrase 'like manner and to the same extent', it is clear that assessment on trustee is nothing but an assessment on the beneficiary and therefore, the rate of tax and slab benefits respectively applicable qua each beneficiary shall be applicable for the trustee as well.

- In case of CWT vs. Trustees of H. E. H. Nizam's Family (Remainder Wealth) Trust (1977) 108 ITR 555 (SC), the Supreme Court held that the department has two modes of assessment i.e., assessment in the hands of the trustee in a representative capacity or assessment directly in the hands of the beneficiary. The same view has been upheld by Supreme Court in case of Commissioner of Income-tax v. Smt. Kamalini Khatau [1994] 74 Taxman 392.However, once the option under section 166 is exercised by the assessing officer, recourse to section 161(1) cannot be invoked.

- As per section 161(1A) of the IT Act, where income of the trust comprises of profits and gains arising from business, whole income of the Trust shall be taxed at maximum marginal rate. However, an exception is carved out for trust settled through testamentary instrument. Accordingly, where the trust is created through testamentary instrument, exclusively for the benefit of relative dependent for support and maintenance and such trust is the only trust so declared, the income of the trust would be taxed at the same amount of tax payable by each beneficiary in respect of their beneficial interest, if he were assessed directly, irrespective whether the income of the trust comprises of any income from business or not.

7.2.2 Taxability of irrevocable discretionary trust

- The charge of income-tax under section 4 of the IT Act is on total income of a person. Section 2(31) of the IT Act defines the term 'person' as under:

  "person" includes –

  (i) an individual,

  (ii) a Hindu undivided family,

  (iii) a company,

  (iv) a firm,

  (v) an association of persons or a body of individuals, whether incorporated or not,

  (vi) a local authority, and

  (vii) every artificial juridical person, not falling within any of the preceding sub-clauses

  Based on the above definition, it can be noted that section 2(31) of the IT Act does not specifically include "Trust" within its ambit. As certainment of the status of trust under the IT Act as 'individual' or 'association of persons' or 'body of individuals' is a vexed issue.

- As against the specific trust wherein trust is to be taxed considering the status of its beneficiaries, in case of discretionary trust, income is taxed in the hands of representative assessee at the highest applicable rate without any benefit of slab(s).

- As per section 164 of the IT Act, income of the discretionary Trust shall be taxable **at the maximum marginal rate of tax**(other than special rates income) without any benefit of any slab(s). Maximum marginal rate of tax, considering the highest surcharge and cess rate currently applicable for resident assessees, would be 42.744%.

- However, in following scenarios, income received by the discretionary Trust will be taxed at the rate of tax as applicable to association of persons:

– Where none of the beneficiaries have income exceeding basic exemption limit;

– Where income of the Trust created through testamentary instrument does not include any income from business and such Trust is only Trust so declared by him; or

– Where income of the Trust created through testamentary instrument for the benefit of relative dependents includes income from business and such Trust is only Trust so declared by him; or

– Where the income is received/receivable by the trustee on behalf of provident fund, superannuation fund, gratuity fund, pension fund or any other fund created bona fide by a person carrying on a business or profession exclusively for the benefit of persons employed in such business or profession.

- Supreme Court in case of CIT vs Smt. Kamalini Khatau [1994] 74 Taxman 392 is a landmark judgement which deals with taxability of discretionary trust. The key takeaways from the Supreme Court ruling are discussed in separate section.

7.3 Special rate of tax or maximum marginal rate of tax

7.3.1 Section 2(29C) of the IT Act defines the term maximum marginal rate ('MMR') to mean the rate of income-tax (including surcharge on income-tax, if any) applicable in relation to the highest slab of income in the case of individual, as specified in the Finance Act of the relevant year. Thus, MMR, for the purpose of the IT Act is such tax rate which is applicable in respect of income in the highest slab in the case of an individual.

Rate of tax applicable to discretionary trust in case of income from capital gains, etc.(special rates)

7.3.2 Where private discretionary trust earns income otherwise taxable at specific rate of tax (say for instance, long term capital gain chargeable to tax at 10% under section 112A of the IT Act or 20% under section 112 of the IT Act or 15% under section 111A), the question would arise whether the trust would be liable to pay tax at 10% (i.e. special rate of tax) or at maximum marginal rate of tax as specified in section 164?

7.3.3 As per Section 2(3) of the Finance Act, in case where the provisions of Chapter XII (which includes section 112) or section 164 apply, the tax chargeable shall be determined as provided in that chapter or that section. Accordingly, the provisions of chapter XII and section 164 (which provides for MMR in case of an indeterminate trust) are both placed on an equal footing and none specifically, overrides the other. Further, while section 164 is more specific to the *category of person* (i.e. a discretionary trust) to whom it would be applicable, section 111A, section 112, etc. are more specific to the *category/nature of income* to whom it would be applicable.

7.3.4 The concessional rate of tax stipulated under section 111A or section 112 or section 112A of the IT Act is applicable to all persons assessed under the IT Act and as such there is no legislative intent to recover taxes at a rate higher than the rate of tax prescribed under section 111A or section 112 or section 112A of the IT Act. **This rate is considered as the maximum rate of tax for income arising on transfer of such specified assets**. There is nothing in the scheme of the taxation of trusts where under discrimination is sought to be created between trusts on the one hand and other taxpayers on the other hand. The purpose of section 164 is to supply the computation machinery rather than creation of a charge or levy. Considering the same, it can be contended that the legislative purpose will be well served by applying uniform concessional rate in relation to income taxable at special rates under section 111A, section 112 or section 112A.

7.3.5 As held by SC in the case of CIT v. Kamalini Khatau (1994) (209 ITR 101) and as confirmed by the SC in the case of CIT v. Moti Trust, [1999] 236 ITR 37 (SC) in a case where income of a discretionary trust is actually distributed during the very same year to the beneficiaries, the beneficiaries can be directly assessed to tax. Now, assuming such is the situation, as per one view, the beneficiary who is directly assessed will bear tax @10% or 20% on such income from capital gains. Having regard to the option theory, an arguable view of the matter could be that the legislature wanted to control the mischief of a beneficiary trying to alter his tax liability base through the medium of multiple discretionary trusts. Given that the assessment on trustees is, in effect, an assessment on beneficiaries, arguably, the intent may not be to substitute MMR in lieu of a flat rate which is prescribed in respect of a specific source of income across all assesses. Accordingly, as between two specific rates, it may be possible to consider MMR to be a general rate whereas rate specific to long term capital gains income may be considered as being more specific to a given stream of income.

7.3.6 The said issue of rate of tax on special income earned by discretionary trust, was examined by the Mumbai Tribunal in the case of Jamsetji Tata Trust[3] wherein it was held that where the short-term capital gains chargeable to STT are chargeable to tax at MMR as per section 164 of the IT Act, such rate cannot exceed the maximum rate as provided under the provisions of the IT Act, i.e. under section 111A of the IT Act. Placing reliance on the decision of Jamsetji Tata Trust (supra), the Mumbai Tribunal, in the case of Mahindra and Mahindra Employees' stock option Trust[4] also held a similar view that in the case of a trust, long-term capital gains is chargeable to tax at MMR which cannot exceed the rate as provided under section 112 of the IT Act.

7.3.7 However, the AAR in the case of AIG (1997) (224 ITR 473) has, on the specific issue of applicability of tax rates between section 112 and section 164, upheld applicability of section 164 in preference to section 112. According to AAR, the correct solution would be to give weight age to section 164 which is designed to meet the issue of liability in special cases and to counter a strategy of tax avoidance – thus priority is given to section 164 over section 112.Similarly, in the case of India Cements Educational Society [2016] 67 taxmann.com 236 (Chennai - Trib.), it was held that where capital gain earned by assessee-trust became non-exempt under section 11 due to contravention of section 13(1)(c), such capital gain would be taxed at maximum marginal rate in terms of section 164(2) and benefit of section 112 could not be given to it.

7.4 Rate of tax applicable to **dividend income** earned/ received by a discretionary trust

7.4.1 In respect of tax rates applicable on dividend income in the hands of individuals/ HUFs/ AOP/ BOI, the Finance Act, 2020 imposed a cap on the surcharge rate at 15%. Thus, a question would arise whether this capped surcharge benefit of 15% will be available in respect of dividend income received by a discretionary trust having resident individual beneficiaries or the same will be subject to highest rate of surcharge i.e., 37% per section 2(29C) of the IT Act. **Succession planning structures through discretionary trusts generally comprise of investments in shares of group companies (whether listed or unlisted)and hence this issue could be of significant relevance.**

7.4.2 In this regard, it may be noted that section 164 does not provide the rate at which the dividend income received by a discretionary trust is taxable, but instead specifies that the income will be taxable at the maximum marginal rate ('MMR'). MMR is defined in section 2(29C) of the Act. The definition of MMR under section 2(29C) provides that rate should be seen in relation to the highest slab of 'income' and not 'total income'. Further, it does not provide for any specific tax rate but directs one to refer to the Finance Act. Further, section 2(3) and 2(9) of the Finance Act, though do make a carve out for section 164, but then fail to specify the applicable rate of surcharge. Similarly, the opening paragraph of Part III to First Schedule carves out section 164 but does not specify the surcharge rate applicable to a discretionary trust.

[3] *[2014] 44 taxmann.com 447 (Mumbai – Trib.)*
[4] *2015 (11) TMI 69 – Mumbai Tribunal*

7.4.3 It can also be argued that the intent of law is to tax discretionary trusts at the highest applicable tax rates for individuals (including surcharge). If the surcharge on the underlying dividend income is capped at 15%, a case may persist that surcharge on such dividend income earned by discretionary trust should also not exceed 15%.Accordingly, it could be construed that the purpose of MMR is to apply such rate of income-tax to income earned by an assessee which is maximum applicable rate of income-tax vis-à-vis that source of income.

8. Tax implications in case of specific transactions of domestic irrevocable discretionary trust

8.1 Tax implications on contribution/transfer of assets to the trust by the settlor/transferor

In case of contribution of assets by the settlor or transferor to a private trust, one needs to examine the tax implications under the IT Act.

Taxation in hands of settlor/ transferor - capital gain tax implications under the IT Act

8.1.1 Section 45 of the IT Act levies gains arising upon transfer of capital assets to capital gains tax. Thus, where the settlor transfers his assets into the trust, it is relevant to evaluate if settlement of assets into a trust will constitute a 'transfer' and hence be chargeable as capital gains under section 45 of the IT Act.

8.1.2 Section 47 of the IT Act provides certain transactions which will not be regarded as a transfer for the purpose of section 45 of the IT Act. It inter alia provides that any transfer of a capital asset *under* a gift or will or an irrevocable trust is exempt from any capital gains taxation.

8.1.3 Based on the above provisions of section 47, it seems clear that no capital gains tax implications should arise under the IT Act on (a) initial contribution of capital assets into the irrevocable trust by settlor/transferor or (b) subsequent transfer by way of gift by any person (whether settlor or otherwise) to such trust.

Implications under section 56(2)(x) of the IT Act – in the hands of trustee / beneficiary

8.1.4 As per section 56(2)(x) of the IT Act, any sum of money received by any person without consideration, the aggregate value of which exceeds Rs.50,000, is taxable in the hands of recipient as income from other sources. Further, where any property [as defined under Explanation to section 56(2)(vii)] is received by any person without consideration or for inadequate consideration, the excess of fair market value of the property computed in the prescribed manner over consideration paid is taxable as income from other sources in the hands of the recipient.

8.1.5 Thus, section 56(2)(x) of the IT Act is a deeming fiction which postulates following three conditions for taxability of deemed income in the hands of recipient:

- The assesses is in receipt of the property;
- The assessee has received the property without consideration or for inadequate consideration; and
- The receipt is not covered specifically under exclusions prescribed under proviso to section 56(2)(x) of the IT Act.

8.1.6 Clause (x) of proviso to section 56(2)(x) of the IT Act provides express exemption for receipt of property by trust from an individual if such trust is created or established solely for the benefit of relatives of such individual. There is also a generic exemption under clause (I) of the proviso for receipt of property by an individual from any relative. While evaluating exemption under proviso (I), it needs to be tested whether recipient is a relative of donor. However, while evaluating exemption under clause (x) for trusts, the relationship needs to be tested from donor's perspective and not from recipient's perspective, i.e. it needs to be tested if the donor is a relative of the beneficiaries for whose benefit the trust has been settled.

8.1.7 Further, as mentioned above, the proviso to Section 56(2)(x) of the IT Act reads as "from an individual by a trust *created or established solely* for the benefit of relative of the individual". The clause therefore requires trust to be established solely for the benefit of relative of individual contributing property to the trust. In such case, it needs to be considered as to what would be the implications if the contributor himself is also one of the beneficiaries along with his relatives. Whether the clause is to be read strictly so as to exclude the benefit of the proviso or whether in view of the same being an exemption provision, it needs to be construed liberally so as to allow the exemption as long as other beneficiaries are the relatives of the contributor. The following are certain other questions that arise in relation to interpretation of the exemption clause (x) of the proviso.

– Whether the trust deed at the time *of inception for the trust* itself should restrict the beneficiaries of the trust to relatives of the settlor or the beneficiaries of the trust as at the time *of contribution* by an individual to the trust need to be considered?

– What would be the implications if at the time of contribution, the contributor is the relative of the beneficiaries; but subsequently a non-relative is added as a beneficiary in the trust?

In addition to exemption provided under proviso to section 56(2)(x) as above, it would be imperative to evaluate based on first principles whether at all, there would be exposure /implications under section 56(2)(x) before resorting to any exemption or in a scenario where conditions of exemption are not satisfied. The said principles are discussed as under separately qua the beneficiary and qua the trustees.

Implications u/s 56(2)(x) in hands of beneficiaries

8.1.8 In the case of discretionary trusts, the share of beneficiaries is not ascertained unless distributed. One of the essential limbs to section 56(2)(x) of the IT Act is *the receipt of property*. A charge under section 56(2)(x) of the IT Act is created in the year of receipt of the asset by the trust. Thus, one may argue that in the case of a discretionary trust, where until the year in which the discretion vested on the trustee is exercised by the trust, it may not be possible to ascertain the actual recipient of the property, and hence, the charge under section 56(2)(x) of the IT Act ought not to be attracted in the year of settlement in the hands of the beneficiaries.

8.1.9 Since the section 56(2)(x) of the IT Act is a deeming provision charging a capital receipt to tax, the charge should be construed strictly, and its scope cannot be extended to cover a situation which does not get covered within the ambit of the section on strict interpretation of the provisions.

8.1.10 It can also be argued that the charge of section 56(2)(x) of the IT Act is created upon receipt of specified property and not merely a beneficial interest (which, also, in the case of discretionary trust

is contingent in nature qua each beneficiary). 'Beneficial interest', which is defined in the Trust Act, received by the trust/ beneficiary does not fall within the meaning of specified property for the purpose of section 56(2)(x).

8.1.11 Thus one may contend that the provisions of section 56(2)(x) of the IT Act ought not to trigger in the hands of beneficiary at the time of settlement of assets into a discretionary trust or upon further contributions to such trust. However, considering that the provisions of section 56(2)(x) of the IT Act are relatively new provisions and the aforesaid arguments are untested and litigation in this regard cannot be ruled out, one needs to wait till jurisprudence on interpretation of the same gets evolved.

Implications u/s 56(2)(x) in hands of trustees

8.1.12 In the context of section 56(2)(x) when one speaks of property being 'received', it would mean received beneficially by the recipient with complete power of use and enjoyment. A perusal of definition of 'trust' under section 3 of Trust Act makes it clear that though the title in the trust property vests in the trustee, this is coupled with an obligation annexed to the trust property arising out of confidence placed in him by the settlor.

8.1.13 In a scenario where contribution of property to a trust does not qualify for exemption under clause (x) of proviso to section 56(2)(x) of the IT Act, it can be argued that the provisions of the aforesaid section 56(2)(x) ought not to apply to the Trustees, as a Trustee receives the property with an obligation to hold and administer it for the benefit of the beneficiaries. This obligation taken over ought to be good and sufficient consideration for receipt of properties by the Trustees, and therefore, the receipt of property cannot be said to be without/for inadequate consideration.

8.1.14 However, considering that the provisions of section 56(2)(x) of the IT Act are relatively new provisions and the aforesaid arguments are untested and litigation in this regard cannot be ruled out, one needs to wait till jurisprudence on interpretation of the same gets evolved.

8.2 Tax implications on distribution of annual income earned by the Trust

Distribution of income earned by the trust in the same year in which receipt/accrual

8.2.1 As per section 164 of the IT Act, income of the discretionary trust would be taxable in the hands of 'representative assessee' at the maximum marginal rate of tax. Supreme Court in case of CIT vs Smt. Kamalini Khatau [1994] 74 Taxman 392 (SC) unequivocally held that

- Section 164 of the IT Act is not a charging section, but a section which merely creates a special scheme for levy of tax.
- In case of discretionary trust, when a trustee is assessed to tax upon the income of the trust, it is 'really the beneficiaries who are sought to be assessed in respect of their interest in the trust properties through the trustee'. Accordingly, the income received on behalf of or for the benefit of the beneficiaries if taxed in the hands of trustees in representative capacity at MMR, cannot be said to have accrued once again in the hands of the beneficiary upon distribution in the same year. In other words, the trustees and beneficiaries both cannot be taxed in respect of the same income. It would lead to double taxation.
- Accordingly, once the tax has been discharged by the representative assessee at applicable rates in accordance with the provisions of section 164 and due assessment has been done thereof, assessment of same income cannot be again made in the hands of beneficiary

8.2.2 Section 166 of the IT Act provides the assessing officer ('AO') with an option to directly assess the beneficiaries in respect of the income received by trustees on his behalf. Having exercised his option once, it will not be open to the Income-tax Officer to assess the same income for that assessment year in the hands of the other person (i.e., the beneficiary or the trustee)[5].

8.2.3 An interesting issue arises for consideration is whether distributions from income of the current year can be taxed in the hands of the beneficiaries (as per section 166) or does mandate of section 164 of the IT Act require that assessment needs to be only in the hands of Trust/trustees at maximum marginal rate of tax.

8.2.4 In a scenario where income is earned by trust but not distributed to the beneficiary in the same year, the provisions of section 166 cannot be invoked by the department to assess the said income directly in the hands of beneficiary given that the share of beneficiary is not ascertainable until actual distribution of income. In such case, the only alternative available with the tax department is to levy tax in accordance with the provisions of section 164 in the hands of representative assessee at MMR.

8.2.5 However, in a scenario where income is earned by trust is distributed to the beneficiaries in the same year, there would be an option available to the tax department to levy/ assess such income either in the hands of the trust/trustee or in the hands of beneficiary. In order that there is no loss of revenue, the tax department at the time of raising the initial assessment either of the trust or the beneficiaries, generally adopts the course most beneficial to the revenue.

8.2.6 It can be inferred that where the income of a discretionary trust is distributed in the year of accrual, the revenue may seek to tax such income either in the hands of the trustee under section 164 of the IT Act or the beneficiaries under section 166 of the IT Act. Hence if the commercial considerations permit, one may explore to distribute the income to beneficiaries in the subsequent years. The implications in such scenario are discussed hereunder.

Distribution of income in subsequent years

8.2.7 In the case of a discretionary trust, given that the share of beneficiary is not ascertainable until actual distribution of income, where the income accruing during the relevant previous year remains undistributed until the end of the year, such income cannot be assessed in the hands of the beneficiary (in the year of accrual) as the share of beneficiaries in such income is contingent in nature. However, such income would have been assessed to tax in the hands of the Trustee (in its representative capacity) in accordance with the provisions of section 164 of the IT Act.

8.2.8 Even though the share of beneficiaries in such cases is not ascertained, the same belongs to the beneficiaries only. Thus, once such income is taxed under section 164 of the IT Act, taxing such income in the hands of the beneficiaries upon its distribution would tantamount to double taxation.

8.2.9 The Supreme Court in the case of Nizam Trust (supra) and Kamalini Khatau (supra) held that the income of a trust belongs to the beneficiaries and that the assessment on trust is effectively assessment on the beneficiaries who are in receipt of income through the hands of the trustees. An income, which has already been charged to tax at the trust level (through the trustee in his capacity as a representative assesse), cannot be charged once again in the hands of the beneficiaries.

[5] *CBDT Circular No. 157 [F.No. 228/8/73-IT (A-II)], dated 26-12-1974.*

8.2.10 The Mumbai ITAT ruling in case of JCIT v Shantaben Patel (ITA No 5000/Mum/2001) is directly on the proposition. In this case, ITAT affirmed the following conclusions of the CIT (Appeals) to support that distribution from accumulation represents capital receipt for the beneficiary.

- Amount received from past accumulations is capital sum and not receipt of income. Also, taxation under the IT Act has to be in respect of direct or first receipt and not on remittance.
- It is undisputed that income needs to be taxed only once either in the hands of the beneficiaries or in the hands of the trustee. Once the income is assessed as that of trust, there cannot be further assessment in the name of the beneficiary.
- Once the trust is assessed on accrual of income, the income gets transformed into the capital fund. Thus, for the beneficiary, the remittance in subsequent year is capital receipt.

8.2.11 If the trustee is taxed in the year of receipt and the beneficiaries again are taxed on the same income when they receive it in subsequent years, it would lead to double taxation of the same income. It would amount to treating the distribution of income by the trustee to the beneficiary as a separate passage of income which may not accord with the position of the status of the trustee as a "representative assessee" representing the beneficiary and paying tax on behalf of beneficiaries.

8.2.12 Given the aforesaid, it seems clear that distribution of past years' income of the trust assessed on the trustee should not be taxed once again, in the hands of the beneficiary in the subsequent year of distribution.

8.3 **<u>Tax implications on renunciation of beneficial interest by a beneficiary in favor of other beneficiaries</u>**

8.3.1 Where a beneficiary renounces its beneficial interest in favour of other beneficiaries, it is relevant to consider the implications under section 56(2)(x) of the IT Act upon such renunciation in the hands of the incoming beneficiaries.

8.3.2 As discussed above, where an individual or an HUF receives inter-alia, a sum of money exceeding INR 50,000 or any property (other than immovable property) for inadequate or nil consideration, it will be taxed in the hands of the recipient as Income from other sources.

8.3.3 For the purpose of section 56(2)(x) of the Act, the term property has been defined to mean capital assets of the assessee, viz. immovable property being land or building or both; shares and securities; jewellery; archaeological collections; drawings; paintings; sculptures; any work of art; bullion.

8.3.4 In the case of a discretionary Trust, the beneficial interest of each of the beneficiary is contingent in nature. What is contingent in nature cannot per se regarded as a 'receipt' in the hands of other person.

8.3.5 Further, the distribution of income/ corpus in the case of a discretionary trust is solely at the discretion of the trustee. Thus, a certain proportion of distribution towards a particular beneficiary(s) higher/ lower vis-à-vis other beneficiaries should not constitute renunciation of beneficial interest by the beneficiary in favour of other beneficiaries.

8.3.6 Accordingly, a better view would be that renunciation of beneficial interest by a beneficiary in favour of other beneficiaries ought not to trigger the provisions of section 56(2)(x) of the Act.

8.4 **Tax implications on distribution of corpus to beneficiaries from the Trust**

Tax implications in the hands of beneficiaries

8.4.1 Distribution of corpus(whether during lifetime of the trust or on dissolution) by the trust amongst the beneficiariescomprises of assets part of the initial settlement, contributions of the settlor and the accumulated income of the trust.

8.4.2 Section 56(2)(x) of the IT Act seeks to tax receipt of any property by any person without consideration or for inadequate consideration as 'income from other sources' in the hands of the recipient.

8.4.3 It can be argued that the sum received by the beneficiary always belonged to the beneficiaries. The distribution merely results in a change in legal title from the trustee to the beneficiaries whereas the economic/ beneficial title always vested in the beneficiaries. Accordingly, distribution of corpus should not result into a tax liability in the hands of the beneficiaries.

8.4.4 The trustees are never the real owners of the assets, they are only the legal owners. It is by fiction of law that the trustee is treated as the full owner of the property against third person but as between the trustees and beneficiaries, the property belongs to the latter and not to the former. The beneficial owner of such assets are the beneficiaries named in the trust deed by the settlor of the trust. Trustees only hold the assets in trust for the beneficiaries until the time of distribution. A trustee is obliged to hold, manage, dispose-off and utilize the trust property for a specific purpose and in accordance with the terms of the trust deed. The above understanding that trustee is a legal owner and beneficiaries are the real owners of trust property has been observed by certain judicial precedents[6]:

8.4.5 Basis the above judicial precedents, it can be contended that beneficiaries have pre-existing rights in the property of the trust. Hence, distribution is merely an adjustment of pre-existing rights of the beneficiaries. A property received by beneficiaries always belonged to them which was held by the trustees only in fiduciary capacity and accordingly distribution merely results in a change in legal title from the trustees to the beneficiaries, whereas the economic/ beneficial title always vested in the beneficiaries. Accordingly, receipt of one's own asset cannot be regarded as receipt without consideration within the scope of section 56(2)(x).

8.4.6 Another argument which is relevant to consider is that to enable trigger of section 56(2)(x) of the IT Act, the receipt is required to be for Nil or inadequate consideration. In the case of distribution of corpus by the Trust, there is no possibility for the beneficiary to pay any consideration.

8.4.7 Based on arguments as discussed above, the Mumbai ITAT, in the case of Ashok C Pratap[7] and Bangalore ITAT in case of Mrs. Sharon Nayak[8] held that the then prevailing provisions of section 56(2)(vi) of the IT Act (now section 56(2)(x) of the IT Act) do not apply in case of distribution of assets by the trust to the beneficiaries. Thus, analogy could be drawn from such judicial precedents to contend that the provisions of section 56(2)(x) of the IT Act do not apply in case of distribution of assets by the trust to the beneficiaries.

[6] *Yasmin Properties (P.) Ltd. v. ACIT[1993] 46 ITD 331 (Bom.); Abad Trust [2018] 171 ITD 50 (Cochin - Trib.)*

[7] *[2012] 23 taxmann.com 347 (Mum.)*

[8] *[2016] 159 ITD 143 (Bangalore – Trib.)*

8.4.8 Basis the above arguments it can be contended that the distribution of accumulated corpus / capital ought not to give rise to income under section 56(2)(x)in the hands of the beneficiaries.

8.4.9 However, given that the provisions of the IT Act do not capture this situation directly, litigation by the tax authorities, especially at the lower levels, cannot be ruled out.

Tax implications in hands of trust/trustees

8.4.10 As per the provisions of section 45 of the IT Act, any profits or gains arising from the transfer of a capital asset shall be chargeable to income tax under the head capital gains and shall be deemed to be the income of the year in which the transfer took place. Hence, income from *transfer* of a capital asset is taxable as capital gains in the hands of the transferor.

8.4.11 The term 'transfer' in relation to a capital asset has been defined under section 2(47) of the IT Act to inter alia include sale, exchange, relinquishment of an asset. The terms sale, exchange and relinquishment have not been defined under the IT Act. Based on the general meaning of the said terms, it appears that existence of two parties is essential for transfer.

8.4.12 As discussed above, the beneficiaries are the real owners of the trust property and trustees hold such property only in fiduciary capacity. Hence, it can be argued that passing of assets to beneficiaries which already belonged to them ought not to constitute a transfer as there are no distinct transferor and transferee. It is essentially nothing but handing over possession of assets to the actual owners on distribution. Further, a trust is an obligation created by a person (settlor / contributor) in favour of another person (trustee) for ownership of the property for the benefit of a third party or the person himself (beneficiaries) and mere discharging such obligation by way of distribution to beneficiary ought not to be treated as 'transfer'.

8.4.13 It is pertinent to note that in the context of family arrangements, Courtshave consistently held that there is no transfer since each person who is a party to the family arrangement is presumed to have a pre-existing title in the property which is the subject matter of family arrangement. Further, the Courts have consistently held that an event of dissolution of firm or an event of liquidation of company or an event of partition of HUF is an event of crystallizing the interest of the shares and did not, under general law, constitute a 'transfer'

Similar analogy can be imported to trust structures, wherein distribution merely results in working out of pre-existing rights of the beneficiaries of the trust, to conclude that there is no 'transfer'.

8.4.14 Without prejudice to the above proposition that there is no 'transfer' u/s 2(47), one may also explore additional arguments of (a) claiming exemption provided u/s 47 for any transfer of a capital asset *under* an irrevocable trust, and /or (b) absence of 'consideration' accruing to the trust on distribution of assets to beneficiaries.

8.4.15 Based on above discussion, it may be argued that the distribution of assets/ shares by trust to its beneficiaries should not be regarded as transfer under section 2(47) and therefore, there ought to be no implications under section 45 in such case. The issue, however, remains debatable and not free from litigation.

9. Concluding remarks:

Succession plan needs to be tax efficient and compliant with the regulatory scenario and at the same time it needs to ensure that the transition of a family's wealth and business over generations is conducted in a conducive manner, without frustrating the individual desires and wishes of the family members. This can be achieved by way of a suitable trust structure in place. Succession planning through trust structure has been in use in India since several generations and is not a new concept. However, with the various complications of business, the multitude of laws that today surround any kind of action, the glare that any business house comes under, and the uncertainty surrounding the reintroduction of inheritance tax, makes it an exciting subject. However, the taxation of trust remains a vexed issue and hence nuances would need to be considered before creation of trust structure so that the same serves as an effective succession planning tool thereby leading to preservation of family wealth and a serving as a tax efficient vehicle.