

The Global Guide to Trusts

A SYSTEMATIC ANALYSIS OF THE LEGAL REGIME
AND TAX TREATMENT OF TRUSTS IN 21 JURISDICTIONS

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Edited by Jean-Marc Tirard

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INDIA

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Authors : Daksha Baxi, Khaitan & Co and Shabnam Shaikh, Khaitan & Co

Legal considerations

1. What is the legal system based on in your jurisdiction?

India's legal system is common law, having adopted it from its colonial past. Upon independence, India adopted its constitution in 1950 as a supreme charter to govern all public interactions amongst individuals, states (including authorities formed by the state) and between individual and states. India has a federal system, such that both the central government and the state governments as well as local authorities are given powers to legislate on issues allocated to each authority. There are certain issues where the central government and the states have concurrent power to legislate. These are the items which are listed in the constitution under the 'concurrent list'. The constitution, while allocating law-making powers between the central government, the states and the local government, also laid down limits for each arm of the state, namely the legislature, the executive and the judiciary. While the legislature has the primary responsibility of framing and drafting the law, the executive and the judiciary often supplement the law-making function of the legislature through either subordinate legislation (in case of the executive) or through judicial review and judicial directives and interpretation of law.

In consonance with the organic nature of the Indian legal system, India has adopted, modified and adapted pre-existing colonial legislations into modern statutes. Common examples of such statutes are the laws governing contracts, transfer of property, substantive criminal law, and trusts. The judiciary in India is headed by the Supreme Court of India at the apex level, followed by High Courts for each state and subordinate courts which are administered and managed by the High Courts under whose jurisdiction such courts lie. The Supreme Court and the High Courts are constitutional courts which uphold fundamental rights and are empowered to undertake judicial review of the administrative and legislative functions to uphold the rule of law including prevention of any legislative or administrative excess.

The executive branch of the government is headed by the prime minister and the cabinet at the centre, and the chief minister with the council of ministers at the state level. The executive is further supplemented by the members of the civil service.

2. Is the concept of trust part of your domestic law?

Yes, very much so. The Indian Trusts Act, 1882 (“Trusts Act”) is the principal legislation which recognises and gives legal basis to the concept of trust as was understood in Britain and its colonies. The Trusts Act (framed and passed prior to independence) is the main law governing the formation of trust, the rights and obligations of trustees, settlors and the beneficiaries of a private trust. The trusts governed by the Trusts Act are the private trusts, formed by individual or body corporates, for the benefit of finite identified class of beneficiaries. The Trusts Act defines trusts as “an obligation annexed to the ownership of property and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner”.

Public trusts set up in India are categorised into charitable and religious trusts and are governed by the Charitable and Religious Trusts Act, 1920, the Religious Endowments Act, 1863, the Charitable Endowments Act, 1890 and are additionally regulated by specific state legislations such as the Maharashtra Public Trusts Act, 1950 and the Gujarat Public Trusts Act, 1950. The object of these trusts is one of charity, promoting education, art, culture, spreading religious and spiritual awareness and other objects of public good for the benefit of the public at large or a large section of the public.

Private trusts set up under the Trusts Act need to be registered under the Registration Act, 1908 in the event immovable property is devolved on such private trusts. Public trusts set up in India and declared through a non-testamentary instrument, apart from any state specific registration, need to be compulsorily registered under the Registration Act, 1908.

While Indian laws do not recognise trusts as a separate legal entity, they recognise trusts as an obligation of the trustee to hold and own the property, not as an absolute owner (i.e., both legal and beneficial owner), but to use and manage the trust property for the benefit of the beneficiaries.

There are 3 (three) parties to a trust - the settlor, being the person who creates the trust, the beneficiary for whose benefit the trust has been created and the trustee, who is appointed by the settlor to manage the funds and affairs of the trust. A trust (under the Trusts Act) could either be discretionary where the trustee in his personal discretion may decide the share of the beneficiaries from within the named beneficiaries and the quantum and time of distribution of the trust property and/or income to the beneficiaries or

determinate/non-discretionary trust, where the share of the beneficiaries in the trust property and its income is pre-determined and spelled out in the trust deed. A person may be a settlor and a trustee, or a settlor and a beneficiary or a trustee and beneficiary but such person can be all three if he is only one of the many beneficiaries. While there is no such limitation provided in the Trusts Act, the Gujarat High Court¹ has held that “there cannot be a case where the creator of the trust would also be the trustee and also the sole beneficiary, because in such cases a man cannot enforce a trust against himself”.

It is also pertinent to highlight a particular issue with respect to appointment of the trustee. Under the Trusts Act, the beneficiaries have the right to have the trust property be protected and administered by ‘proper’ persons. The Trusts Act goes on to elaborate that such proper persons do not include persons residing permanently outside India or persons domiciled abroad. This provision has given way to discussions on whether a non-resident Indian can be appointed as a trustee. It should be borne in mind that as per the Trusts Act, this provision is subject to the provisions of the trust deed and with the consent of the beneficiaries, the trust can be managed by a non-resident Indian trustee. However, the same has to be looked in the context of exchange control laws in India as to whether a non-resident trustee can hold properties in India, since the ownership of the trust property is legally vested in a trustee.

3. Has your country ratified the Convention?

India has not ratified the Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition (“Hague Trust Convention”). However, the Indian law on trusts gives due recognition to the principle as laid down in the Hague Trust Convention. The Trusts Act gives the settlor, trustee and beneficiary wide powers for establishing and managing the affairs of the trust, subject to the limitations of the same being for a lawful purpose and not in contravention with provisions of any laws of India.

4. When the answer to the above two questions is negative, is a trust created under foreign law recognised as such? Alternatively, is the trust (or trustee) analogised to any specific type of domestic person or comparable entity?

Yes, offshore trusts are recognised under Indian laws. The principle and nature of the offshore trust is recognised and it is accepted legally that the trustee and not the Indian resident beneficiaries are the owners of the properties and income of the trust. The treatment of the corpus as well as

¹ Bhavna Nalinkant Nanavati vs Commissioner Of Gift-Tax (2002 255 ITR 529 Guj).

income of the offshore trusts would be different under the taxation laws and the exchange control laws from those of Indian trusts. While this is respected, it is not advisable to set up a trust under the trust laws of another jurisdiction since the provisions of the Income Tax Act, 1961 (“IT Act”) and the exchange control laws in India would make it difficult for such a trust to be freely administered as may be desired under the trust deed. In fact, an offshore trust, though governed by trust laws of the country where it is set up, may well become resident in India for the purposes of taxation in India and for the purposes of exchange control restrictions in certain circumstances. These include situations such as the trustee of the offshore trust being an Indian resident, the offshore trustee taking instructions from an Indian resident for the purposes of administration and management of the trust fund (other than those set out in the trust deed while settling the trust).

5. Are there “similar” or comparable legal structures which can be used in your jurisdiction instead of a trust for estate planning purposes?

Though not strictly legal in terms of its formation, as regards personal wealth and sharing of the family legacy, there are many concepts that exist under the uncodified customary laws in India. A ‘Hindu joint family’ is one such concept. Joint and undivided family is the normal feature of the Hindu society and the presumption is that the members of a Hindu family are living in a state of union unless the contrary is established. The fact that the members of the Hindu family live and work at different places would not be the basis to say that they did not form a joint Hindu family, especially when there is a joint family house which is owned by the family.

The concept of Hindu joint family is embedded in twofold principles:

It is extended to include not only parents and their offspring but also many other relatives connected by blood provided that they descend from a common ancestor.

The carrying on of economic activity- agricultural, commercial, industrial – and ownership of property by the family as a distinct and separate unit from its members.

A Hindu family has a concept of coparcenary. Coparceners are those members who are within four degrees of lineal descent from the common male ancestor. Coparceners qua inherited property include:

- (a) The one who inherited the property, i.e., the one in whose time the family acquired property by inheritance for the first time (usually the ‘Karta’ of origin);
- (b) His sons and daughters;
- (c) His grandsons and granddaughters; and
- (d) His great grandsons and great granddaughters.

The group formed by the individuals in such a manner is termed as Hindu 'coparcenary'. This concept of Hindu joint family has been accepted in a modified form under the tax laws in India. Under the tax laws, it is referred to as Hindu Undivided Family ("HUF"). HUF is one of the taxable 'persons' defined under the IT Act. It is separate and distinct from its members.

The HUF has members as well as coparceners. Coparceners are those members who have a right in the property of the HUF and can seek partition of the HUF. As opposed to this, while members may benefit from the joint use of the HUF property and income, they cannot demand partition and do not have a direct right to the property of the HUF. Their right to such property is through the coparceners. For instance, the wife of a coparcener of a HUF is a member but not a coparcener.

One of the coparceners would be "Karta" of the HUF. In general, Karta is the grandfather or the father or the eldest member of the family which is the descendent of the person who has originally formed the HUF which is created either through the property inherited from ancestors or from self-generated property in which the individual would like the family to participate. Automatically, all the property which forms the part of the HUF is to be shared with the coparceners who will comprise of sons and daughters, grandsons and granddaughters and great grandsons and great granddaughters, unless the HUF has been partitioned before the third or the fourth generation comes into existence. There are complex provisions and interpretations with regard to the manner of partition of HUF.

The Karta is said to be the owner of the property of the HUF but he/she cannot use the HUF property or income for himself. The Karta thus holds the HUF property for and on behalf of the coparceners and members of the HUF, though there is no codified provision with regard to how the HUF would be regulated.

Thus, HUF is a concept, apart from trusts set up under the Trusts Act, which has been used in the past extensively for estate planning purposes. Due to complexities involved in respect of its operation and interpretation of the uncodified law from where this concept arises and also due to the fact that this is not a structure which is recognised in other parts of the world, the use of HUFs as a structure for estate planning is declining. Very often private limited companies incorporated under the Companies Act 2013 (as well as under the erstwhile Companies act, 1956) and limited liability partnerships formed under the Limited Liability Partnership Act are considered and used for estate planning & structuring of succession. These forms may not exactly achieve all the purposes that typical succession and estate planning would, e.g. they would not provide protection against the levy of estate duty, if and when it is enacted in India.

6. What legal constraints should be taken into consideration when transferring assets into a trust?

Trust structures can be used to achieve succession planning in India. For instance, personal laws for Indian Muslims are not codified and they are still governed by the uncodified customary law applicable to individuals following Islam, i.e., Sharia law. Sharia law incorporates the forced heirship rules and prohibits bequeathing more than 1/3rd property of a testator under a Will. Moreover, the State of Goa in India is governed by Portuguese Civil Code. It is the only state in India which has community property rules. Thus, a trust structure helps in navigating laws such as forced heirship, community property rules, etc. In case of Sharia law, there are certain aspects through which inter-vivos trusts can be used to address forced heirship rules. Under the Hindu customary law (read with the Hindu Succession Act, 1956 and Indian Succession Act, 1925), the forced heirship provisions would not pose a problem in creating a trust as long as the coparcenary interest of the person in a HUF is dealt with in accordance with the provisions of the customary Hindu law.

It is also to be borne in mind, that it is always advisable to create a trust under a deed of trust incorporating all the terms and conditions of settlement. One of the important aspects is providing amendment of the trust deed to accommodate changed circumstances such as addition of beneficiaries, change of trustees, etc. In the absence of such a provision, the trustee will have to approach all the beneficiaries for their consent which might pose a problem in case the beneficiaries are minors or approach a court for approval which is a time-consuming process. Furthermore, the trust deed should clearly state when it will come to an end or be terminated so that the provisions of the Trusts Act need not be operationalised in order to wind up as a private trust.

It is worthwhile to mention herein the concept of 'rule against perpetuity' incorporated in one of Indian statutes viz., Section 14 of the Transfer of Property Act, 1882 ("TP Act"). The TP Act provides for a rule against tying the property in perpetuity. So whilst settlement or creation of trusts by contract or Will, the provisions of Section 14 of the TP Act should be observed in order to save the trust being declared unlawful or void under the Trusts Act.

7. Can a trust acquire property in its own name and be registered as such when registration is required? If not, can this be achieved indirectly (for example, through a domestic or foreign corporation)?

Yes, the trust can acquire properties and hold properties through the trustee for the benefit of the beneficiaries. Trusts do not have a separate legal

personality under Indian law. As mentioned above, the Trusts Act defines trusts as an obligation which is annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner. A trust set up in India is represented by its trustees, who hold and manage the affairs of the trust property for the benefit of the beneficiaries of the trust. Under the Trusts Act, a trust is set up when the trust property is transferred by the settlor to the trustee. Further, under the Trusts Act, the declaration of trust in case of immovable property should be either through a non-testamentary instrument executed by the settlor or the trustee, or through a will of the settlor. A trust deed in respect of an immovable property needs to be registered under the Registration Act, 1908. In case of movable property, a trust is considered to be settled when the trust property is transferred to the trustee. Hence, any property acquired for the purpose of the trust is registered in the name of the trustee holding it in trust for the benefit of the beneficiaries.

Even under the Companies Act, 2013, since the trust is not regarded as a legal entity, if any shares are acquired by the trust the same are recorded in the 'Register of Members' of the company in the name of the trustee on behalf of the trust. Therefore, trustees make disclosures under the Companies Act, 2013 to declare the beneficial interest of the persons for whose benefit the shares are held by the trustees.

Tax considerations

8. What are the main taxes which are relevant in respect of trusts?

The domestic income tax law in India is governed by the IT Act. Indian residents are subject to tax on their worldwide income (i.e., based on the residence rule) whereas non-residents are subject to tax in India only on income that is sourced in India (i.e., based on the source rule).

Income is taxed in India under five heads, namely, income from salary, income from house property, income from business or profession, income from capital gains and income from other sources. In addition to direct taxes, India also levies a number of indirect taxes such as excise duty, service tax, sales tax, value added tax etc. Even if there may not be any income tax payable, due to exemption or due to the income not being above the minimum threshold amount for attracting tax, indirect taxes, by their very nature, are payable by all. Furthermore, on the instrument of transfer of property (movable or immovable, as the case may be), stamp duty is payable as prescribed under the Indian Stamp Act, 1889 or the relevant state specific

stamp laws.

As noted above, tax liability in India is determined either through residence of a tax payer or the source of income with respect to which the tax liability arises. There are different rules for determining residency for different entities and taxable units. Whereas individuals, body corporates, companies, HUFs, partnerships (both general and limited liability partnership) as well as unincorporated body of individuals or association of persons who come together for a particular business or venture are the taxable entities or units, a “trust” per se is NOT a taxable unit. Therefore, determination of residence of trust in India is a tricky issue. In general, if neither the trustee nor the protector or the person who has the ability to control the management of the assets of the trust fund and determine their distribution is not located in India at any time during the financial year, and the trust is not subject to Indian laws, then the trust should not be regarded to be a resident in India. For the purpose of ascertaining the residency of the trust, the residence of the beneficiaries also has some bearing. In order for an offshore trust not to be subject to tax in India based on the source rule, none of its assets or source of income should be in India. A non-natural person is considered to be resident in India, if the control and management of such non-natural person lies in India.

An individual is considered tax resident in India if he stays in India for (“Basic Residence Test”):

- (a) 182 days or more in any tax year¹ or
- (b) 60 days² or more in a tax year and has spent 365 days in India in the 4 (four) years preceding the tax year in which the individual has spent 60 days or more in India.

An individual who does not satisfy the Basic Residence Test is considered to be a non-resident (“NR”). Income earned by an NR is liable to be taxed in India only to the extent the same accrues, or is received and has arisen in India or is deemed so under the IT Act.

The IT Act further bifurcates this residency test by providing for rules for determination if an individual is ordinarily resident of India (“ROR”) or an individual is resident but not ordinarily resident (“RNOR”). If an individual’s residential status under the IT Act is ROR then his global income is taxable in India whereas if it is an RNOR then only that income which arises or accrues or is deemed to arise or accrue in India and global income only to the extent that the same arises out of business controlled or profession set up in India will be taxable in India. An individual is considered RNOR if he satisfies the Basic Residence Test but has been an NR in 9 (nine) out of the

1 Indian tax year runs from 1 April to 31 March.

2 This number is increased to 182 days under certain circumstances.

previous 10 (ten) tax years or has not been physically present in India in the previous 7 (seven) tax years for more than 729 (seven hundred and twenty-nine) days. A person is ROR if he is resident and does not satisfy the tests for being recognised as an RNOR i.e., temporarily resident in India.

Under Indian laws, a trust does not have a separate legal personality. Also, a trust is not included to be a person within the definition of 'person' under the IT Act. However, the IT Act incorporates the concept of 'representative assessee' for taxing income of assesseees which are not assessable to tax since their income is being received by another, i.e. in a trust scenario, where the trustee receives the income for the benefit of the beneficiaries. The IT Act enables the tax officer to recover the tax either from the trustee, or directly from the beneficiary. The trustee is taxed on the income for and on behalf of the beneficiary. Once the income has been taxed in the hands of the trustee or the beneficiary the same income cannot be brought to tax again.

9. Has your jurisdiction developed specific tax rules to deal with trusts? As a general principle is the trust taxable as such or is it fiscally transparent with all or some taxes due differently according to the nature of the trust?

The IT Act does not recognise trusts as a separate taxable unit, since a trust does not fall under the definition of person as laid down under Section 2 (31) of the IT Act. The IT Act provides for the concept of representative assesseees where, in case of a trust, the trustee is deemed to be the assessee for the purpose of the IT Act. Under Section 161(1) of the IT Act, "Every representative assessee, as regards the income in respect of which he is a representative assessee, shall be subject to the same duties, responsibilities and liabilities as if the income were income received by or accruing to or in favour of him beneficially, and shall be liable to assessment in his own name in respect of that income; but any such assessment shall be deemed to be made upon him in his representative capacity only, and the tax shall, subject to the other provisions contained in this Chapter, be levied upon and recovered from him in like manner and to the same extent as it would be leviable upon and recoverable from the person represented by him". Thus, for the purpose of taxation, trustees are assessed in the same manner in which the beneficiaries would be assessed. Assessment of income of the trust via the trustees is nothing but assessment of beneficiaries and the tax payable by the trustees in respect of such income can be recovered from the beneficiaries. It is pertinent to note herein that if either the trustee or beneficiary has paid taxes on the income, the same income cannot be taxed in the hands of the other.

A trust would effectively have a fiscally transparent tax implication impact, if the share of the beneficiaries in the assets and income of the trust is determinate. Where it is not so determinate though, the trustee is taxed in

representative capacity. The tax levied on the trustee on the income of the trust funds would be the maximum marginal rate of tax applicable to an individual, regardless of the actual taxability of the individual beneficiaries.

Non-discretionary/Determinate trust

If the income of a determinate trust is exigible to taxation under the IT Act, the income of such a trust is either assessable in the hands of the trustee or the beneficiary. Section 166 of the IT Act allows a tax officer to treat the trust structure as fiscally transparent and levy tax on the beneficiaries, on whose behalf the trust has been set up. Hence, it is possible, in case of a non-discretionary trust where the settlement of the property is for the benefit of an identified person or persons and in a specified manner, to tax the income of the trust in the hands of the beneficiary directly. Thus, for the purpose of taxation, trustees are assessed in the same manner in which the beneficiaries would be assessed. A private determinate trust is not an assessable unit under the IT Act and is treated as a 'pass through' entity for the purpose of taxation.

Discretionary Trust

In case of a discretionary trust where the share of the beneficiaries in the income and property is indeterminate or not specified and is left to the discretion of the trustee, the income of the trust is taxed at the maximum marginal rate ("MMR") (highest rate of tax which is applicable to an individual) as provided under Section 164 of the IT Act. Thus, it is possible that in case of a trust where the beneficiaries are a mix of tax residents and non-residents, the entire income of the trust will be taxable at the MMR. If the income of the trust is distributed in the same year when it is received before the payment of tax on such income, then, the courts have held in several cases that the tax authorities have an option to assess such income either on the beneficiaries or the trustees. Clearly, this option can only be exercised when the income of a discretionary trust is distributed. If income of such trust is not distributed, the assessment will have to be made on the trustees.

Revocable Trust

Where a settlor transfers the property to a trust under such provisions that any part of the income or assets so transferred may be re-transferred to the settlor or where the settlor has reserved powers to re-assume control over the trust property, then, such a trust is treated as a revocable trust under Section 63 of the IT Act. The income of the property of such a revocable

¹ Please see: CIT vs Kamalini Khatau (1994) 209 ITR 101 (SC); Jyotendrasinhji vs S.I.Tripathi (1993) 201 ITR 611 (SC); CIT vs Fertilisers & Chemicals (Travancore) Ltd. [1987] 166 ITR 823 (Ker).

trust continues to be regarded to accrue to the settlor. Such income becomes chargeable as the income of the settlor and is included in his total income.

10. Are domestic and foreign trusts treated differently in relation to tax?

As seen above, a trust is not a legal entity. As such, there is no concept of a domestic or a foreign trust under Indian laws. If a trust is formed under the Trusts Act then it is a domestic trust. If a trust is formed under foreign laws, it would also be regarded as domestic trust for tax purposes if by virtue of the presence of its management and control, the trust is considered resident in India, regardless of which law governs such a trust.

It is to be noted that since transfer of property in a trust is for the benefit of the beneficiaries, income of a non-discretionary offshore trust where some of the beneficiaries are Indian residents could be subject to taxation in India, to the extent of the income of the trust which is allocated to the Indian beneficiaries. As regards offshore discretionary trusts, it has been clarified by the Supreme Court of India¹ that Indian resident beneficiaries of an offshore discretionary trust shall not be taxed on the trust's income until discretion has been exercised to make a distribution of income to the beneficiaries.

A person intending to set up an offshore trust would however be required to comply with the provisions of Foreign Exchange Management Act 2000 ("FEMA") and all such notifications and regulations issued under FEMA.

11. When is a trust considered to be resident for tax purposes in your jurisdiction?

This has already been discussed under the first bullet of this section. Some additional points are elaborated below. Section 6(4) of the IT Act provides that every other person (who is not an individual, Hindu Undivided Family or a company) is said to be resident in India in a tax year in every case, except where during that year the control and management of its affairs is situated wholly outside India. In case of a trust, the trustee is the legal owner of the property and is usually vested with the power to manage and administer the affairs of the trust subject to the provisions of the trust deed.

Hence, unless proven otherwise a trust would be considered to be tax resident in India if the trustee is a resident of India for the purpose of the IT Act or is present in India during a year while he manages the trust funds thereby failing the test that the control and management of the affairs of the trust is wholly situated outside India. Thus, in case of an offshore trust, if any part of its management and control is seen to be located in India, including

¹ Commissioner of Wealth Tax, Rajkot v Estate of Late HMM Vikramsinhji of Gondal Civil Appeal No 2312 of 2007.

the presence of a protector, such offshore trust would be treated as resident of India for tax purposes.

Further, along with the trustee, it is essential to look at the residency status of the beneficiaries especially in case of a non-discretionary trust, where the share of the beneficiaries in the trust property has been pre-determined in the trust deed itself. As discussed earlier, in case of a non-discretionary trust, the assessing officer has the option to directly tax the beneficiary rather than the trustee.

Tax treatment of the creation of a trust

12. What are the tax consequences of the creation of a trust?

Under the IT Act, any transfer of a capital asset under a gift or a will or an irrevocable trust is exempt from any capital gains taxation in the hands of the transferor. At the time of settling of the trust property by the settlor to the trustee in an irrevocable trust, in the absence of any consideration there are no gains made by the settlor and hence such settlement of trust property does not attract payment of any capital gains tax in the hands of the settlor. So far as revocable trusts are concerned, the IT Act does not regard “revocable transfers” as transfers and hence there are no tax implication on settlement of such kind of trusts.

From the perspective of taxability in the hands of the transferee, i.e., the trustee, it is important to mention the provisions of Section 56(2)(x) which have been recently introduced in the IT Act by the Finance Act, 2017 and is quite significant in the context of private trusts. Section 56(2)(x) provides that if any person receives any property from any person, which exceeds INR 50,000 without or for inadequate consideration, then the difference between the fair market value of the property and the consideration paid (if any) is taxed as ‘income’ in the hands of the recipient. This could thus attract taxation in the hands of a trustee when he receives the assets for creation of a trust. However, fortunately, the same provision has carved out an exception. Thus, in case of a trust, if the assets are transferred to the trust by an individual and the trust is created solely for the benefit of the individual’s relatives as defined in the IT Act, then taxation under this section would not be attracted in the hands of the trustee.

13. Are any transfer and/or capital gains tax due upon lifetime or testamentary transfers of assets to trusts?

Please refer to the response to question 12 above.

14. Is the treatment different depending on whether the transfer is made to a revocable or irrevocable trust? To a life interest or to a discretionary trust?

Revocable Trust

As per Section 63 of the IT Act a transfer, which includes settlement into a trust, would be deemed as a revocable transfer if:

(a) there is any provision for the re-transfer directly or indirectly of the whole or any part of the income or assets to the transferor i.e., the settlor/contributor in case of a trust;

(b) the transfer in any way gives the transferor i.e. settlor/contributor in case of a trust, a right to re-assume power over the whole or any part of the income or assets. Where a transfer is to a trust, it is not treated as a revocable transfer of assets if the trust is not revocable during the lifetime of the beneficiaries and where the settlor does not derive any direct or indirect benefit from the assets settled into the trust.

Thus in case of a revocable trust as provided under Section 61 of the IT Act all income arising to a person by virtue of a revocable transfer of assets is chargeable to tax as the income of the transferor and included in his total income.

Irrevocable Trust

In case of an irrevocable trust, the settlor no longer maintains control of the trust property as the settlor of the property in his capacity of a settlor. In such a situation, the settlor does not receive any gains from the trust property which he has settled and hence will not be taxable on the income of the trust property.

Tax treatment of income and capital gains

15. Is a trust a taxable entity?

As discussed above, a trust is not a taxable entity but a pass through structure where the trustee is taxed on the income of the trust property in representative capacity for the beneficiaries.

16. If not, who is subject to income/capital gains taxes in respect of the trust's income and gains?

As discussed above, in case of discretionary trust, the same would be taxed in the hands of the trustee on behalf of the beneficiaries in the capacity of a representative assessee. In case of a non-discretionary trust, the tax officer

may tax the income in the hands of the beneficiaries directly. Alternatively, there may be as many assessments on the trustee as there are beneficiaries, since the taxation in the hands of each of the beneficiaries may be different.

However, the incidence of tax shall not fall twice, hence in the event the applicable tax has been paid by the trustee, the beneficiaries will not have any obligations towards payment of tax on the income of the trust and vice versa.

Tax treatment of distribution from a trust to its beneficiaries

17. What taxes apply to distributions of trust income to resident/non-resident beneficiaries?

The provisions set out below with regard to taxation of distribution of income by trusts to beneficiaries apply equally to resident and non-resident beneficiaries, in view of the source and residence based taxation rules in India. If the discretionary trust is resident in India, it would be subject to tax on its entire income regardless of whether the asset from which income arises is Indian or foreign. In case of determinate trust, also, if the income is arising out of assets in India, it would be taxable in India in the hands of the trustee upon accrual or receipt in the same manner as it would be taxed in the hands of the beneficiary. Therefore, if a non-resident beneficiary is not liable to tax in India for any reason, including an applicable tax treaty between the non-resident beneficiary's home jurisdiction and India, the trustee would not be taxed on that part of the income. When such income is later distributed to the non-resident beneficiary, the same would also not be taxed in the hands of the non-resident beneficiary in India.

Distribution of income - Onshore Trusts

As noted above, Section 161 of the IT Act provides that in respect of income for which the trustee is a representative assessee, tax shall be levied upon and recovered from him in like manner and to the same extent as it would be leviable upon and recoverable from the person represented by him, i.e. the beneficiaries. In the case of a discretionary trust, the income is taxed at MMR in the hands of the trustee. The trust income is, therefore, already taxed in the hands of the trustees as if it were taxed in the hands of the beneficiaries. The income already taxed in the hands of the trustees of the discretionary trust would not be taxable again in the hands of beneficiaries at the time of actual distribution to the beneficiaries.

Distribution of income - Offshore Trusts

In case of an offshore discretionary and irrevocable trust which is not controlled and managed from India, the income earned by such trust from

offshore assets would not be taxable in India in the hands of the trustee. The same would also not be taxable in the hands of the beneficiaries who are tax residents of India until the income from trust accrues or arises to the beneficiaries upon the trustees exercising their discretion to make the distribution. Thus, Indian tax implications, if any, would trigger only when the trustees decide to distribute income/ assets inter se the beneficiaries which is when income can be said to accrue or arise to the beneficiaries. This principle of law has been upheld by the Supreme Court of India (“SC”) in its decision where it was held that the Indian tax resident beneficiaries of an offshore discretionary trust shall not be subject to tax on the trust’s income until the trustee exercises their discretion and make distribution of income to the beneficiaries.

It may be noted that the issue of whether Indian resident beneficiaries would be able to claim credit in India for any foreign taxes paid (if any) on the income of the foreign discretionary trust, distributed to them is debatable and dependent on the country in which the income arises.

18. What taxes apply to distributions of capital gains from a trust?

Onshore Trusts

The IT Act incorporates a beneficial tax regime for taxation of short term capital gains tax at the rate of 15% upon sale of listed securities on which securities transaction tax has been paid (Section 111A of the IT Act). Short term capital gains in the context of listed securities are gains arising on sale of an asset which is held for a period of less than 12 months. Long term capital gains arising on sale of listed securities where the securities transaction tax is paid, are exempt from levy of capital gains tax. Also, in case gains arising on transfer of a capital asset which has been held for 36 months or more (24 months or more in case of unlisted shares, 12 months or more in case of listed shares which are not sold on the stock exchange) i.e., long term capital asset, at the rate of 20% (a lower rate in certain other circumstances) (Section 112 of the IT Act). Thus, the capital gains realised by a discretionary trust would be taxed in the hands of trustee as representative assessee in this manner.

So far as determinate trusts are concerned, the income of such trusts are taxed in like manner and to the same extent like the beneficiaries which the trustees are representing. Thus, the benefits of Section 111A and/or Section 112 can be extended to a determinate trust as the characterisation of the income in the hands of the trustee would be the same as that in the hands of the beneficiaries.

A question arises whether a discretionary trust which is assessable under

1 Commissioner of Wealth Tax, Rajkot v Estate of Late HMM Vikramsinhji of Gondal Civil Appeal No 2312 of 2007.

the provisions of Section 164 of the IT Act (taxation of a discretionary trust at MMR) can take benefit of the reduced tax rates mentioned under Section 111A or Section 112 of the IT Act. Interpretation of various judicial decisions and the wordings of the applicable sections do lead to a conclusion that capital gains arising to a discretionary trust ought to be taxable at the rates prescribed under Section 111A and Section 112 (as the case may be) and not at MMR pursuant to Section 164 of the IT Act.

19. What taxes apply to distributions of capital from a trust?

Distribution of capital or corpus by a trust to the beneficiaries, where the trust has been settled by an individual for 'specified relatives' will not be taxable in the hands of the beneficiaries or the trust making the distribution.

Tax implications on settlor's death

20. What are the tax implications for the trust, trustee, settlor's estate and/or beneficiaries of the settlor's death?

In case of an irrevocable trust, the property is treated as having gone out of the ownership and control of the settlor and hence upon the death of the settlor there is no impact on the taxability of the property or the income from the property in the trust on either the settlor, the trustee, the trust or the beneficiaries. Further, there is no death or estate duty in India and even if it were to be there, in case of irrevocable trust, where the ownership of the property and its income is transferred without recourse to the settlor, then, the same cannot be taxed as the settlor's estate unless there is some provision under the estate duty law (as and when introduced), similar to some other jurisdictions, which bring such property within the ambit of estate duty if certain conditions are satisfied.

In case of a revocable trust, where there are provisions for direct or indirect re-transfer of the assets to the settlor or where the settlor has reserved the right to assume power over the trust property during his lifetime, such trust would become irrevocable on the settlor's death. Thus the income of the trust would no longer be taxable in the estate of the settlor. The legal ownership of the corpus of the trust anyway remains with the trustee and hence in absence of death or estate duty provisions, the trust, trustee settlor or the beneficiaries would have no adverse impact on the death of the settlor. The income of the trust will from that time onwards be taxed in the hands of the trustee as representative assessee instead of being taxed in the hands of the settlor. If, however, the terms of the revocable trust are such that

upon the death of the settlor, the property reverts to his estate or the property is to be distributed to the beneficiaries, then the income of the property will be taxable in the hands of the estate of the settlor upon reversion. The distribution to the beneficiaries would have the same implications as discussed under 'tax impact on distribution of the trust property and income' earlier in this chapter.

Tax implications of the termination of a trust

21. What are the tax implications for the trust, trustee, settlor and/or beneficiary on termination of a trust?

A trust under the Trusts Act can be extinguished on the happening of the following events: (i) when the purpose of the trust is fulfilled; (ii) when the trust becomes unlawful; (iii) when the fulfilment of its purpose becomes impossible; (iv) when the trust is revoked (one of the ways of revocation is all the beneficiaries unanimously decide to extinguish the trust and convey the same to the trustee).

In the event of a trust being terminated, the property held by the trust shall be distributed amongst the beneficiaries as per the provisions of the trust deed. The taxation of income and capital of the trust will be the same as discussed above.

Reporting obligations

22. Are the trust, trustees, settlors and/or beneficiaries subject to reporting obligations in relation to the trust?

Trustees are required to file tax return in India if the trust is subject to tax in India and / or the trustee is resident in India. Therefore, like any other person the obligation of filing a tax return is tied to the residence of a trustee as well as the source of income of the trust. As and when the beneficiaries receive the distribution, in case of a discretionary trust, they are required to report this in their annual tax return, to be filed by them. In case, the taxes are paid by the beneficiaries directly in case of a determinate trust, then in that case, the same will have to be reported accordingly in their tax return.

As per the IT Act, individuals who are ordinarily residents of India are required to mandatorily report their offshore assets (including financial interest in any entity) in their annual tax return even if such person does not have any taxable income from such offshore asset or interest. Forms for such disclosure are notified for every assessment year and the disclosures to be made by an ordinarily resident individual, if such individual is a trustee,

beneficiary or a settlor, include the country in which the trust is created, the details of the settlors, trustees and beneficiaries. In case of offshore discretionary trust, a resident beneficiary is required to disclose only when he derives any financial benefit from such trust during the tax year.

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The Global Guide to Trusts

Edited by Jean-Marc Tirard

The massive and growing increase in the use of trusts for estate planning and asset protection, particularly in civil law jurisdictions, make it increasingly important for wealth planning practitioners to understand the complexity of the legal regimes and the tax treatment of trusts worldwide and to plan for optimal specific solutions in each cross-border operations. International tax planning stands to be significantly enhanced by the kind of analysis presented in this one-of-a-kind guide, combining as it does detailed answers on the tax treatment of trusts in 21 jurisdictions and practical guidance on international tax planning involving the use of trusts.

The Global Guide to Trusts represents the work of a team of leading outstanding tax practitioners active in 21 jurisdictions under the editorship of an internationally recognized trust expert. The Global Guide to Trusts facilitates the understanding of international tax issues and provides specific guidance in such facets of international taxation of trusts as the following:

- Tax treatment of the creation of a trust
- Tax treatment of income and capital gains
- Tax treatment of distribution from a trust to its beneficiaries
- Tax implications of settlor's death
- Tax implications of the termination of a trust
- Reporting obligations

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