The Global Guide to Trusts

Second edition

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INDIA

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Legal considerations

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

India's legal system is based on 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 individuals 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 lays 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 the case of the judiciary).

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 statues 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 ('Supreme Court') 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 a 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 classes 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 (ie as both legal and beneficial owner), but to use and manage the trust property for the benefit of the beneficiaries.

There are 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 or determinate/non-discretionary. The trustee of a discretionary trust may, at his discretion, 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. With a determinate/non-discretionary trust, the share of the beneficiaries in the trust property and its income is pre-determined and spelt out in the trust deed. A person may be a settlor and a trustee, or a settlor and a beneficiary, or a trustee and a beneficiary but such person can only be all three if he is one of many beneficiaries. While there is no such limitation provided in the Trusts Act, the Gujarat High Court[1] has held that

1 *Bhavna Nalinkant Nanavati v Commissioner of Gift-Tax* (2002 255 ITR 529 Guj).

'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 tested 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 jurisdiction ratified the Hague Convention on the Law Applicable to Trusts and on their Recognition (hereafter 'the Convention')?

India has not ratified the Convention of 1 July 1985. However, the Indian law on trusts gives due recognition to the principles as laid down in the 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 trustees, 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 income of the offshore trusts would be different from those of Indian trusts under the taxation laws and the exchange control laws. While this recognition of offshore trusts 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 and/or 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 that can be used in your jurisdiction instead of a trust for estate planning purposes?

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 placcess 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 the following two 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* who inherited property include:

(a) The one who inherited the property, ie 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. 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 who is the descendent of the person who originally formed the HUF. This HUF 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 part of the HUF is to be shared with the coparceners who will be comprised 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 cannot use the HUF property or income for personal use. 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 extensively in the past for estate planning purposes. Due to complexities involved in respect of its operation; and interpretation of the uncodified law from which 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, eg they would not provide protection against the levy of estate duty, if and when it is enacted in India.

Interestingly, the Consultation Paper on Reform of Family Law of the Law Commission of India dated 31 August 2018 ('Consultation Paper') proposes that the concept of HUF be abolished from the IT Act. It mentions, inter alia, that the Direct Taxes Enquiry Committee Report 1971, ie Wanchoo Committee, clearly stated that the institution of HUF has been used for tax avoidance. While the Consultation Paper brings forth that historically the HUF was a joint family that was held together by strong ties of kinship and entailed a variety of joint property relations among the members[2], in contemporary times the special status given to the HUF was being exploited only for the purpose of taxation.

6. What legal constraints should be taken into consideration when transferring assets to 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, ie Sharia law. Sharia law incorporates the forced heirship rules and prohibits bequeathing more than one third of the 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 Indi-

2 Chirashree Das Gupta and Mohit Gupta, 'The *Hindu Undivided Family* in Independent India's Corporate Governance and Tax Regime' [2017] South Asia Multidisciplinary Academic Journal <journals.openedition.org/samaj/4300> accessed 22 January 2018.

an 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. Upon a 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.

8. Under what circumstances might a trust be set aside in your jurisdiction on grounds of sham or for any other reasons (quote leading court cases if any)?

Section 4 of the Trusts Act provides that a trust may be created for any lawful purpose. The purpose of a trust is lawful unless it is:

(a) forbidden by law;

(b) is of such a nature that, if permitted, it would defeat the provisions of any law; or

(c) is fraudulent; or

(d) involves or implies injury to the person or property of another; or

(e) the court regards it as immoral or opposed to public policy.

If the purpose of a trust is unlawful, then such a trust is void.

Section 53 of the TP Act provides that if the transfer of an immovable property is with the intent to defraud creditors of the transferor, then such transfer is voidable at the option of the creditor. Thus, if a settlement of an immovable property falls within the scope of Section 53 of the TP Act then the settlement could be set aside pursuant to Section 53 of the TP Act and accordingly, the trust could be set aside as per Section 4 of the Trusts Act. Similarly, Section 53 of the Provincial Insolvency Act and Section 55 of the Presidency Towns Insolvency Act make provisions for avoidance of transfer made by a debtor within two years prior to insolvency. Thus, any voluntary settlement of assets within two years of the insolvency is voidable at the instance of the official receiver/official assignee as the case may be.

In the context of insolvency, the Sindh High Court had held that a trust is unlawful and marred by Section 4 of the Trusts Act if the trust has been created at the time of insolvency of the settlor and such settlement would be against the official assignee. The Supreme Court in the case of *Chogmal Bhandari v Dy Commercial Tax Officer*[3] had the occasion of examining an interesting question which was if a trust has been created by a debtor for the benefit of his creditors and if the debtor has provided an order of preference to pay the creditors will that render the trust unlawful under Section 4 of the Trusts Act. The Supreme Court held that such order of preference to pay the creditors does not by itself create grounds for the inference that the intent of the debtor is to defraud the creditors and the debtor is well within its right to lay out such preference. Hence, such a trust will be valid.

3 AIR 1976 SC 656.

Tax considerations

9. 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 (ie based on the residence rule) whereas non-residents are subject to tax in India only on income that is sourced in India (ie 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, Goods & Services 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 taxpayer 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 bodies of individuals or associations 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 considered 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 year[4]; or

(b) 60 days[5] or more in a tax year and has spent 365 days in India in the four years preceding the tax year in which the individual has spent 60 days or more in India; or

(c) if he is an Indian citizen and not liable to pay tax in any jurisdiction and has

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

5 This number is increased to 120 and 182 days under certain circumstances.

Indian-sourced income exceeding INR 1.5 million in a particular financial year ('Deemed Indian Tax Resident').

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. However, if the individual 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: (i) is a Deemed Indian Tax Resident; (ii) has been an NR in nine out of the previous ten tax years or has not been physically present in India in the previous seven tax years for more than 729 days; or (iii) is a person of Indian origin / non-resident Indian (as defined under the IT Act) who has India-sourced income exceeding INR 1.5 million in the relevant financial year and spends more than 120 days but less than 182 days in India. A person is ROR if he is resident and does not satisfy the tests for being recognised as an RNOR, ie 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 assessees which are not assessable to tax since their income is being received by another, ie 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.

10. 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 a trust 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 assessees 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 at the maximum marginal rate ('MMR') 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 MMR (the 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 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[6]. If income of such a trust is not distributed, the assessment will have to

6 *CIT vs Kamalini Khatau* (1994) 209 ITR 101 (SC); *Jyotendrasinhji vs S.I. Tripathi* (1993) 201 ITR

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

11. 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 a 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[7] that Indian resident beneficiaries of an offshore discretionary trust shall not be taxed on the trust's income until discretion to make a distribution of income to the beneficiaries has been exercised.

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

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

This has already been discussed under the response to question 9. 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

611 (SC); *CIT vs Fertilisers & Chemicals* (Travancore) Ltd. [1987] 166 ITR 823 (Ker).

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

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 the presence of a protector ('protector' is not defined under the Trusts Act), 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.

13. Are the tax treaties (or some of them) concluded by your jurisdiction applicable to trusts?

India has executed comprehensive double taxation avoidance agreements ('DTAA') with approximately 93 countries, limited agreements with about eight countries and tax information exchange agreements with around 19 countries.

A person will be entitled to the benefits of a DTAA only if such a 'person' is a 'resident of the contracting state'. In almost all the DTAAs concluded by India the term 'resident of a contracting state' has been defined to mean any person who is liable to pay tax in the jurisdiction by reason of domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature.

Further, if a DTAA is based on the UN Model Convention, then the definition of the term 'person' includes an individual, a company, and any other body of persons. Thus, based on the interpretation of the domestic law of the term 'person', it may encompass a 'trust' as well. Interestingly, some of the DTAAs - like the India-UK DTAA, the India-Germany DTAA, the India-UAE DTAA, and the India-Swiss DTAA - define the term 'person' as above, qualified by the terms: 'which is taxable under the laws in force in either Contracting State'; 'treated as a taxable unit'; and 'treated as an entity for tax purposes under the taxation laws…'. Thus, whether a trust will qualify as a person and thereby be considered as 'resident' of a contracting state will be dependent upon the terms of the DTAA and the provisions of the domestic law.

It is pertinent to note that eligibility for benefits under a DTAA for a fiscally transparent entity (such as the trust or partnerships) has been a matter of judicial debate in India. The majority judicial view has been that a tax-transparent entity is not eligible to DTAA benefits unless it is liable to tax in its own hands. The Authority for Advance Rulings in the case of *In Re General Electric Pension Trust* denied the DTAA benefit to a US pension trust as the latter could not substantiate that the income from sale of Indian investments would be taxable in the hands of the trust.

In the context of tax treaties in general, it is worth mentioning that in June 2019, India ratified the Multilateral Convention to Implement Tax Treaty Related Meas-

ures to Prevent Base Erosion and Profit Sharing ('MLI'). While the MLI has been enforced since 1 October 2019, its provisions will have an effect on India's DTAA from financial year 2020-21 onwards. The MLI provides that a partnership or a fiscally transparent entity can claim itself as a pass-through entity for purposes of applying DTAA benefits and to look through its members/partners. On this matter, India has reserved its right to not include in its tax treaties the provisions of fiscally transparent entities being treated as resident to the extent that the income of such entities is taxed in the contracting state.

14. Are there any specific anti-avoidance tax rules applicable to trusts? If the answer is affirmative do they apply to similar or comparable arrangements (eg civil law foundations)? Are there circumstances under which trusts are at risk under GAAR or anti abuse of law measures?

As noted above, trusts in India are taxed on a representative capacity, ie for and on behalf of the beneficiaries and in the same and like manner as the beneficiaries. The tax authorities have the option to either assess the trustee or the beneficiaries for the income of the trust unless the trust is discretionary. In the context of a revocable trust, the IT Act provides that income arising on revocable transfer of assets will continue to be taxable in the hands of the transferor. A transfer which includes settlement into a trust will be deemed revocable if:

(a) it contains any provisions for retransfer, directly or indirectly, of the whole or any part of the income or assets of the transferor; or

(b) 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.

Thus, if the terms of the trust are such that the settlement could be regarded as 'revocable', then the income of such a trust would be taxable in the hands of the settlor and not in the hands of the trustee/beneficiaries.

Apart from the above, India has enforced the general anti avoidance rules ('GAAR') with effect from 1 April 2017. Indian GAAR essentially seeks to classify an arrangement as an impermissible avoidance arrangement ('IAA'), if its main purpose is to obtain a tax benefit and the arrangement satisfies one of the following four conditions:

(a) creates rights or obligations not ordinarily created between persons dealing at arm's length;

(b) results, directly or indirectly, in the misuse or abuse of the provisions of the IT Act;

(c) lacks commercial substance or is deemed to lack commercial substance in whole or in part; or

(d) is entered into, or carried out, by means, or in a manner, not ordinarily employed for bona fide purposes.

Thus, if a trust has been set up for the purpose of avoiding taxes, then the structure could come well within GAAR and the structure may be disregarded to determine the ultimate tax effect.

Tax treatment of the creation of a trust

15. 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 is no tax implication on settlement of such kind of trusts.

From the perspective of taxability in the hands of the transferee, ie the trustee, it is important to mention the provisions of Section 56(2)(x). 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. One of the exceptions to this provision is if a trust is settled by an individual by transferring/settling assets and the trust is created solely for the benefit of the relatives of the individual as defined under the IT Act, then taxation under this section would not be attracted in the hands of the trustee, the recipient at the time of settlement of trust property.

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

Please refer to the response to question 15 above.

17. 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 noted above 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 retransfer, directly or indirectly, of the whole or any part of the income or assets to the transferor, ie the settlor/contributor in case of a trust;

(b) the transfer in any way gives the transferor, ie 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 the 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

18. 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.

19. 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 a discretionary trust, income of the trust property 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 with respect to payment of tax on the income of the trust and vice versa

Tax treatment of distributions from a trust to its beneficiaries

20. 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 is subject to tax on its entire income, regardless of whether the asset from which income arises is Indian or foreign. In case of a determinate trust, also, if the income is arising out of assets in India, it is 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, ie the beneficiaries. In the case of a discretionary trust, the income is taxed at MMR in the hands of the trustees. 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.

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 trustees. 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 only be triggered 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 decision of the Supreme Court[8] 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 trustees exercise their discretion and make distributions 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.

21. 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 trans-

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

action 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 taxed at the rate of 10%. 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 and immovable properties, 12 months or more in case of listed shares which are not sold on the stock exchange), ie 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 trustees as representative assessees in this manner.

So far as determinate trusts are concerned, the income of such trusts is taxed in like manner and to the same extent as the beneficiaries 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 trustees would be the same as that in the hands of the beneficiaries.

A question arises whether a discretionary trust which is assessable under 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.

22. 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.

However, in case of a trust which has not been settled by the 'specified relatives' of the beneficiaries, it may be argued that any receipt of distribution by the beneficiaries of such a trust is not taxable on the premise that the tax would have been paid by the trustees at the time of receipt of property under Section 56(2)(x) of the IT Act.

In fact, the Mumbai Bench of the Income Tax Appellate Tribunal ('Tribunal'), in the case of *Ashok C Pratap v ACIT*[9] held that the distribution by the trust to the beneficiaries upon its dissolution cannot be said to be without consideration and therefore does not attract the implications of Section 56(2)(vii) of the IT Act (equivalent of present Section 56(2)(x) of the IT Act). The beneficiaries receive the distribution in their capacity as beneficiaries and hence it cannot be said that it is without consideration. It needs to be noted that in this case the Tribunal observed that the trust had already paid taxes at MMR on its income. However, no distinction was made between the corpus and the income of the trust, especially since the trust would have paid tax only on the income and not on the corpus.

9 ITA No 4615 / Mum / 2011.

So far as distributions of corpus by an offshore trust to Indian resident beneficiaries are concerned, the same would be subjected to tax under Section 56 on a progressive basis. While there is no express provision relating to the taxability of distributions received by an Indian resident from an offshore trust, it could be argued that Section 56 is widely worded to take within its ambit such distributions. It is also arguable that the trust property received by the beneficiary is a capital receipt which has been passed on to the beneficiary on dissolution of the trust and hence is not taxable.

Tax implications of settlor's death

23. 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. 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 there were, 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). This is 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 retransfer 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 a 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 not be adversely impacted upon 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

24. 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 occurrence 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; or (iv) when the trust is revoked (one of the ways in which revocation can occur is if 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

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

Trustees are required to file a tax return in India if the trust is subject to tax in India and/or the trustees are 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, as in the case of a determinate trust, then 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 disclosures 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 an offshore discretionary trust, a resident beneficiary is required to disclose only when he derives any financial benefit from such trust during the tax year.

Trustees regulation

26. Are trustees regulated in your jurisdiction? What are the main regulatory requirements?

The trustees are required to exercise their fiduciary duty in accordance with the provisions of the Trusts Act. There are no specific regulations which are applicable to trustees.

Registers of trusts

27. Is there in your jurisdiction a register of trusts and/or of beneficiaries of trusts? Which trusts should be registered? What information should be provided? Who can access the information? What are the consequences of failure to comply?

India does not have a register of trusts. In case the trust deed is registered, the same is not accessible to the general public. In this context, it is worth mentioning that the government of India introduced the concept of 'significant beneficial ownership' by legislating Section 90 in Companies Act 2013 in order to ascertain the natural person owning the shares of an Indian company. The Companies (Significant Beneficial Owners) Amendment Rules 2019 were notified on 8 February 2019 stipulating the thresholds and circumstances under which an individual could be considered as a significant beneficial owner ('SBO') along with the various filings that have to be undertaken. The threshold for identifying the SBO is 10% shareholding in the Indian company (amongst other conditions like voting etc). In case a trust is an SBO, then the trustee/beneficiaries/settlor (depending upon whether the trust is determinate, discretionary or revocable) will have to make appropriate disclosures to the company which in turn will make such disclosures to the Registrar of Companies.