5

Vagueness in the Law

Revenue losses in a business conducted by a trust

There is a general criticism that the English trust concept has been grafted not only on the Indian Trust Act but also on the Indian tax laws without due consideration of all its implications. The structural flaws are many and it is not fair to expect all of them to get sorted out through judicial pronouncements. For instance, the Income-tax Act does not indicate clearly whether the income to be assessed in the hands of the beneficiaries, either directly or through the trustees, is the income computed in accordance with the provisions of the Act or the income actually distributed by the trustees to the beneficiaries. In the case of a partnership that is registered under the Income-tax Act, its entire assessed income is apportioned among the partners, whether they receive a larger or a smaller amount. In the case of a private trust, however, a beneficiary is generally taxed only on the basis of the income actually received or receivable by him.

There are also other complications resulting from the interaction of the trust law and tax statutes. A private trust is an esoteric, specialised and individualistic financial arrangement, which defies routine application of some of the provisions of the tax laws. For instance, the income of a trust may be assigned to one individual and the corpus to another by the author of a trust. In such a case, in the event of a loss from any business conducted by a trust, it is not evident from the Income-tax Act whether the loss that is carried forward should be set off only against the income of the trust under the same head in the succeeding years or it may be adjusted against the beneficiary's income, if any, from any other business, particularly in a case in which the beneficiary has an interest only for a few years in the business of the trust. Will he get the benefit of off-setting the unadjusted loss even in the years in which he has ceased to have any interest in the trust business? In fact, the Income-tax Act does not have any separate provision at present for the treatment of the losses suffered by a trust. Some trust instruments may indicate how the trustees should deal with the losses, if any. Income is an accretion to the capital, while a loss depletes it. If a beneficiary is entitled only to the income of a trust and there is a remainderman who will eventually get the trust capital, it is an open question whether the brunt of the losses will be borne by the former or the latter. If the trust-deed requires the capital to be maintained at the same level, the losses may not merely be adjusted against the subsequent income but even where no losses are brought forward, the current income payment may be pruned and reserves built up to safeguard against unexpected losses and diminution in capital. If the settlor has not given any direction in the matter, losses will operate to the detriment of both the life-tenant and the remainderman. The annual income may decrease with the erosion of the capital and the remainderman may eventually get a reduced volume of capital. There is also the possibility that the loss may not be deducted from the trust income in the following year in calculating the income entitlement of an income beneficiary, but may be either immediately met out of the trust capital or carried forward and charged against capital gains, if any. There is a view that the loss cannot be deducted from the net income of the trust estate in determining the tax liability on the income beneficiary in a subsequent year in such circumstances. How far such denial of loss off-set is strictly tenable under the Income-tax law as it is, is controversial, even if it is assumed that the loss has been suffered under the head "business". Such denial may be inevitable if the income beneficiary ceases to have an interest in the income after the loss year, i.e., if he is entitled to the income for a limited period and the period expires with the close of the year in which the loss is incurred. There will be complications if the taxable income is larger and the trust income is reduced to the extent of the brought-forward losses, and there is a new income beneficiary. Such difficulties will be unavoidable as long as the person who, in fact, bears the loss in terms of the trust deed is different from the person who reaps any advantages from it in tax assessments.[1]

Capital allowances

When the income and the capital beneficiaries are not identical, capital receipts[2] and also allowances, like the investment allowance or even depreciation, ordinary or accelerated, may pose similar conundrums. Since the capital allowances are meant to compensate or serve as an incentive to the owners of the capital assets, there is no warrant in equity, for allowing the relief to the beneficiaries entitled to the income from the assets. The inherent anomaly can be illustrated with reference to a trust in which a beneficiary is entitled to an annuity for his life, irrespective of whether income from the trust is adequate or not to cover the annuity and the interest in the corpus of the trust is assigned to some other beneficiary.[3]

Losses due to maladministration of trust

Losses due to fraud may cause slightly different problems. They are not deductible in the computation of taxable income unless it can be established that they have been incurred in the ordinary course of the business or they are incidental to the business. The position in regard to trusts needs clarification. It is settled law that a trust is not voided by the misfeasance or mismanagement of a trustee, irrespective of whether the trust is an *inter vivos* or a testamentary one; but there can be two opinions on the admissibility of claims of losses due to the trustee's defalcation or errors of omission in the assessments of the trust or of the beneficiaries. If the losses resulting from any misappropriation or negligence on the part of the trustees are disallowed, there is bound to be some hardship in the assessment of the beneficiary.

Trust expenses

Trust expenses are deductible in working out the income payable to a beneficiary but not in determining the income of the trust for tax purposes.[4] This difference in the treatment of a trust and its beneficiaries will always lead to anomalies.

Capital gains

A related issue is the treatment of trust receipts including capital gains as against losses or expenditure. The capital gains are added to the capital in some trusts while some others contain directions for their distribution. Where a trust gets a property by way of bequest or gift, the market value determined for estate duty or gift-tax purposes may reasonably serve as its cost to the trust and later, on its disposal, there may be gain or loss, depending on the consideration, if the sale is genuine. The treatment of the capital gains or losses has become the subject of dispute in several cases.

Transfer of assets by or to a trust is regarded as a disposal in the UK, except when a transfer is made by way of security. If a trustee has been vested with any property for the benefit of a single beneficiary, whether a child or a person suffering from any disability, the gain, if any, from the disposal of the property, will be attributed to the beneficiary unless the beneficiary's interest is contingent on his reaching a particular age.[5] Where a beneficial interest in the property is not held by a single person, the trustee pays tax at a flat rate in the UK.[6]

In the USA where a taxpayer sold her life estate in a testamentary trust to the trust's remainderman, for cash consideration of $ 55,000 and claimed a capital loss of $ 8,000 in the process on the ground that the actuarial valuation of her interest was $ 63,000, her claim was allowed by the Court[7]. This is one extreme view. On this logic, will the person who acquired the interest in the income from the property for his life be assessable to the wealth tax on the amount paid by him or on the actuarial value? If he is already the remainderman with a right to the corpus, he gains to the extent that he can seek the termination of the trust. Since he has become the absolute owner of the income as well as the corpus of the property and he can take any measures he considers fit to increase the income or the value of the property producing the income, should not the market value of the property be charged to the wealth tax without reference to the consideration he has paid for the life-interest ?

At the other extreme is the case of a taxpayer who was the sole beneficiary for her life-time under a trust-deed.[8] The trustees were to utilise the income from the trust funds for her maintenance, support and education for her life-time and thereafter the trustees were to hold the trust funds for all her children in equal shares and, if she had no child, for the benefit of the person appointed by her. The trust-deed empowered the trustees in their absolute discretion to spend a portion of the corpus of the funds for the maintenance, support and education of the beneficiaries or on the occasion of serious illness or an emergency. The trustees sold some shares forming part of the corpus of the trust funds which resulted in capital gains, and the question was whether the capital gains could be taxed in the hands of the beneficiary under section 166 of the Income-tax Act. The Court held that the capital gains received by the trustees were not assessable in the hands of the beneficiary. The mere fact that the trustees were to hold the corpus of the trust for the benefit of the assessee and in her absence for those beneficiaries specified in the trust deed, would not mean that accretion to such corpus would, because it might fall under the definition of "income" under the Income-tax Act, be virtually an income received by the trustees specifically on behalf or for the benefit of the present beneficiary. There is an obvious saving in tax in getting the trustees assessed separately on gains which are accumulated and also on receipts which are deemed to be income under the law but for the distribution of which the beneficiaries are not entitled.[9]

Other legal issues

i. Income accruing in one year and paid to beneficiary later

The income of a trust may not be receivable by a beneficiary as and when it accrues or immediately after it has accrued.[10] If a trustee is empowered to make payment to a beneficiary not when the income actually arises but in a later year, the questions that come up for consideration are (a) whether the beneficiary or the trustee should be assessed to tax for the year in which the income arises, (b) whether any action should be taken in the beneficiary's case in the year in which the income is paid to the beneficiary, and (c) whether the beneficiary should be taxed on the entire income of the trust or only on so much of it as is distributed to him.[11]

ii. Life insurance policies on settlor's life kept up by trust

Disputes arise at times in respect of life insurance policies on settlor's life maintained by a trust for different beneficiaries. The disputes in such cases centre round the question whether the amount of premium should be treated as the income of the donor on whose life insurance has been affected or as the income of the beneficiary of the trust. It is reasonable to hold that when a policy is maintained by a trust, the amount of premium should be treated as the income of the settlor and appropriate relief allowed as if the premium has been paid by him out of his income.

But, unfortunately, the Revenue tends, sometimes, to adopt a legalistic attitude and impose an unfair tax burden, in disregard of reality. For instance, there is liability to the estate duty on the settlor's death where a policy "is wholly kept up" for an assignee. This provision operates harshly where the policy amount is fully paid up long before the death of the assured but the insurance company expresses inability to make it over to the trustees to whom it has been assigned till his death. It is obviously unrealistic and unfair to levy the estate duty on the amounts receivable in respect of such policies which are paid up more than two years before the death of the disponer.[12]

iii. Treatment of expenses incurred by a trust for political or private religious purposes

A trust for influencing the legislature or for political propaganda or for advancing the interests of any particular party or group, is not entitled to tax exemption, no matter what it calls itself—"Education Centre" or "Fund for Adult Education" or "Institute for Social Services". The problem for consideration is how such trusts should be taxed—in particular, whether voluntary contributions received from the public should be taken to be income or capital receipts, since they are not covered by the definition of income in section 2(24) of the Income-tax Act, and whether it would make any difference to the situation if the donations are large and anonymous.[13] The expenditure incurred in a trust for political purposes may not lend itself to check, or be inadmissible under the current provisions of the Income-tax Act, but if the casual donations are treated as income while the expenses are disallowed, it will be inconsistent and the trust may be taxed out of existence.

Similarly, the scope of an income tax assessment on a private trust for religious purposes is not also very clear from the Act. An idol can get a donation of property not only when it is consecrated but also later, from either the founder of the *debuttar* or even outsiders. What the law should specify is whether donations received by the trust should be treated as income or non-income receipts and whether expenditure incurred in connection with the daily worship of a deity and so on should be allowed in computing the total income of the trust. Merely because the object of the trust is to ensure regular observance of rituals, performance of daily worship, etc., the expenses do not become admissible deductions. The logical course would be to treat the idol just like an individual and levy tax on that basis. Receipts which will be ignored in the assessment of an individual will not assume the character of "income" in the case of a private trust, but if the receipts are large and it is not possible to verify the identity of the donors, the question of including them in the assessment of the trust as income from undisclosed sources may need consideration. Expenses which would not be allowed in the case of an individual as being of a personal nature should not also be deductible in the assessment of a juridical entity. If the claims are inadmissible in the case of an individual, there is no reason why they should become chargeable to the revenue account only because the individual has transferred some of his income-yielding assets to the deity as symbolised by an idol. It may be pleaded that the imposition of tax will reduce the amount of income available for meeting the expenses for which the trust has been set up, but the obvious answer to this plea is that the income tax should be treated as an item of cash out-go like the other expenses of the trust and there is no justification for the author of the trust to expect the expenses of the deity to be borne by the State.

iv. Anonymous receipts in a private trust

The problem of secret or unverifiable contributions to a private trust may prove to be intractable in certain circumstances. If the trustees of a trust are unable to offer a satisfactory explanation about the source and nature of any money received by them in trust, the sum will be liable to the income tax as the income of the trust from undivulged sources, in terms of section 68 of the Income-tax Act. But should the Revenue be content with invoking section 68 of the Income-tax Act? The rate of tax may be much higher in the unseen hands that have transferred their presumably unaccounted funds to the trust. Since, in the very nature of its scheme, a trust cannot have undeclared assets or sources of income, it may not be improper or harsh to tax the funds as also the value of other assets which a trust gets from unknown quarters, as the maximum rate of income tax to which an individual may be liable, plus an additional tax based on (a) the gift tax avoided by the pseudonymous donor, and (b) a suitable penalty for his concealment of the income in his own income tax assessment. Where a trust is for minor children or an individual with a richer spouse, it may not also be unkind to draw an adverse inference about the identity of the donor : for the purpose of aggregation of income under section 64 of the Income-tax Act and wealth under section 4 (1) of the Wealth-tax Act, transfers of cash or other assets unsupported by sufficient details which may serve to check the source, can be reasonably attributed to the parent or the spouse, as the case may be, and treated in the latter's assessments on the same lines as openly-transferred assets. It will also be appropriate to deny the relief for which section 71 of the Income-tax Act provides, *viz.*, setting off loss under one head against income from another, in respect of all such receipts deemed to be secreted income, since they are really somebody else's money, subjected to tax through the trustee or beneficiary only because the person who has made it is using the trust as his stalking-horse. There can be no injustice in permitting losses iucurred by a trust to be set off only against income which it has itself earned and not the tax-evaded income of a third party transferred to it.

v. Need for acknowledgment of interest by beneficiaries

A trust may occasionally be faced with the problem not merely of an anonymous donation but a reluctant beneficiary or a beneficiary who is not even aware of the benefit that is being conferred on him. In Scotland, a trust does not become effective unless and until the beneficiaries concerned are intimated their rights; even the knowledge of the beneficiaries may not suffice without their specific concurrence. A lady took out a policy of assurance on her life to be held by her upon trust as trustee for three other ladies each of whom was to be entitled to a separate portion of the policy moneys. Unfortunately, she failed to notify two of the beneficiaries of their interest in the trust. It was held that the portions of the policy moneys belonging to these two beneficiaries should be aggregated with the rest of the estate of the settlor when she died, since the trust was not complete to that extent.[14]

In India, a formal communication to the beneficiary is not required.[15] If he is aware of his interest in the trust and has not rejected it, the trust is valid. In the UK, the declaration of trust may be a purely unilateral act and the beneficiary's acceptance of his interest, express or even tacit, is not needed. The settlor has to be unequivocal in the declaration of the trust but he may be the trustee himself and retain any document that he executes without any intimation to the beneficiaries.

It is desirable to bring on record all the parties involved in any *inter vivos* trust as soon as possible after the trust comes into existence, as in the case of a partnership which is sought to be registered for tax purposes. It is also essential to insist on the acknowledgment of the interest by the beneficiaries as a prerequisite for the completion of the trust, since no one can be compelled to accept a benefit; and a reversion of the interest to the settlor after it becomes an interest in possession for the beneficiary has further tax implications. A trust which does not take even the beneficiaries fully into confidence can only be an avenue for tax avoidance.

vi. Residence of Trust

With the steady increase in the number of Indian nationals abroad, and the measures being taken by the Government to induce them to invest in India, thought has to be given to the treatment of trusts created outside the country with some beneficiaries, properties or trustees in this country and also trusts set up in this country with some of their beneficiaries, properties or trustees in other countries. No data are readily available to show how many such trusts exist at present.

In the case of a beneficiary who is ordinarily resident and who has an interest in an off-shore trust, section 5 of the Indian Income-tax Act enables the Revenue to reach all the income which may accrue or arise to him in the foreign trust or may be paid to him by the trust.[16] A trust is administered in accordance with the law of the country in which it is constituted. The income of the beneficiary of such a trust, who is resident in India, cannot be worked out as if it is income from his personal investment abroad, since he does not own the trust property but has only a beneficial interest in it. His income will, therefore, be unavoidably affected by the application of the foreign law.[17] Where, for instance, a trust instrument provides for the accumulation of income in the hands of non-resident trustees or leaves the discretion with the trustees to make payments as they consider fit, the beneficiary can be assessed only on the basis of payments made to him.[18]

Though the trust income or wealth may be assessed to tax, the trustee really pays the tax on behalf or in respect of the beneficiaries who should, therefore, be eligible for the deductions and exemptions admissible under the law.[19] The beneficiary's tax liability will be determinable with reference to his residence, domicile, allowances and reliefs, if any income is directly payable to him or his bankers under the trustee's mandate.[20]

Where income has been accumulated by a foreign trust on the ground of the beneficiary's disability and paid to him later in a lump sum, it may be contended that he has not received income but an amount paid to him in satisfaction of his interest in the trust. In all such cases and also where a foreign source income has been applied, directly or indirectly, to the beneficiary's advantage, the amount so paid or applied should be deemed to be the assessee's income in the year of payment or application and taxed to him if he is ordinarily resident.

The problem is complicated by several variable factors where the trust is itself to be assessed to tax through the trustees. A settlement in trust may be made by an Indian citizen or a foreign national, in this country or abroad. The settlor may either be a resident or a non-resident, depending on the length of his stay in India during the relevant period, i.e., the year in which he creates the trust. Some of the properties or trustees may be in India and some outside; and the trustees may be either residents or non-residents. The Indian tax laws do not indicate how a trust should be treated for tax purposes in different situations and what attributes or combination of them should determine the residence and accordingly the tax liability of the trust.

NOTES

1. See Wolfe D. Goodman (1983): "The Allocation of Tax Burdens Between Income Beneficiaries and Capital Beneficiaries," *Canadian Tax Journal*, Vol. 31, No. 2, (March-April), pp. 169-82.
2. Bouch v Sproule (1887) 12 App. Cas. 385.
3. The impracticability of holding that any income belonged to any particular beneficiary from the moment it arose and became payable to the time it was paid has been indicated by Viscount Sumner with reference to a trust for accumulation, in Archer-Shee v Baker 11 TC 749.
4. Vide Chapter 4. Also Macfarlane v IR (1929) 14 TC 532; Murray v IR (1926) 11 TC 133. Payments made for the services of a trustee amount to an expense in the administration of the trust but they are not allowable deduction in the computation of the income of the trust for tax purposes.
5. Tomlinson v Glyns Executor & Trustee Co. (1970) Ch. 112; (1970) 1 All ER 381; 45 TC 600.
6. 30 per cent.
7. McAllister v Commissioner [157 F 2nd, 235 (2nd CIR) (1946)].
8. Kumari Pallavi S. Mayor v CIT (1981) 127 ITR 701 (Guj); CIT v J.B. Wadia (1963) 48 ITR 135 (Bom); Anarkali Sarabhai v CIT (1982) 138 ITR 437 (Guj).
9. A life tenant entitled to the income of a trust cannot be subjected to tax on receipts which are to be treated as part of the corpus of a trust under the trust-deed but which are deemed to be income under the Income-tax Act. Capitalised distributions made to the shareholders of a company on its liquidation, which are attributable to its accumu-

lated profits or the gains made in frequent variations of investments can be taxed to the trustees but not to the beneficiaries: CIT v J.B. Wadia (1963) 48 ITR 135 (Bom); CIT v Arvind Narottam (1963) 73 ITR 490 (Guj); R.H. Pandit v CIT (1972) 83 ITR 136 (Bom).

10. In the UK, a beneficiary is liable to tax on income to which he is entitled by virtue of his "interest in possession" in a trust, irrespective of whether he receives the income or not. The law in the USA is different : Archer-Shee v Garland (1931) AC 212. A mistaken assumption regarding the American law on this point had resulted in Lady Archer-Shee's losing her case earlier in the House of Lords: Baker v Archer-Shee (1927) AC 844.

11. In the UK, when a beneficiary is assessed on the trust income that he receives, it is related back to the appropriate years : IR v Hawley (1928) 13 TC 327.

12. In re. Hodge's Policy : Hodge v IR (1958) Ch. 239 (1959) 37 ITR ED 1.

13. For the tax exemption claim of trusts for political propaganda etc., see *Halsbury's Laws of England*, Vol. 4, 3rd ed., p. 242, para 523. Donations made by a company to the corpus of a private discretionary trust formed by it for providing financial assistance to its employees cannot be treated as the income of the trust liable to tax : order dated Feb. 4, 1983 in the case of Escorts Employee Welfare Trust v ITO, ITAT (Delhi Bench C) (1983) 5 ITD 226.

14. Allen's Trustees v IR (1969) TR 377.

15. P.L S.K.R. Chettiar v CIT 5 ITC 50.

16. In the UK, foreign trust income is liable to tax, whether remitted or not, unless the beneficiary is domiciled abroad or is a British subject not ordinarily resident in the UK. The resident trustee is taxed on the income from foreign securities, etc., if the beneficiary is not a non-resident entitled to accumulation of income under a foreign trust: Kelly v Rogers (C/A-1935) 19 TC 692.

17. Archer-Shee v Garland (1931) AC 212; 15 TC 693; Baker v Archer-Shee (1927) AC 844; 11 TC 749; Ransom v Higgs (1974) 1 WLR 1594; (1973) STC 330; Drummond v Collins (1915) AC 1011; 6 TC 525.

18. In the UK, remittances from foreign trustees of discretionary trusts are assessable when the trustees exercise their discretion and make remittances: Drummond v Collins 6 TC 525.

19. Williams v Singer (1920) 7 TC 387; (1921) 1 AC 65.

20. Reid's Trustees v IR (1929) 14 TC 512 ; Kelly v Rogers 19 TC 692; Baker v Archer-Shee 11 TC 749 (HL).