6

No Equity in Tax Treatment of Trusts

IT has been observed that the tax laws in India present the spectacle of seemingly high rates of tax, which are practically nullified by loopholes which are open invitations to tax avoidance. For example, if a trust having four beneficiaries, with equal shares in a business conducted or assets owned by it, makes large long-term capital gains in the sale of some of its assets, deduction of Rs. 5,000 under section 80T in respect of the gains can be claimed separately for each beneficiary. This seems to be an unintended benefit, for it is not available to a registered firm with several partners or a limited company with a large number of shareholders.[1]

There are special provisions in sections 78 and 79 of the Income-tax Act regarding the carrying-forward of losses if there is a change in the constitution of a firm or one firm is succeeded by another or the controlling interest in a close company has changed hands. A trust carrying on a business is free from such restraints, even if the same beneficiaries do not continue to have an interest in the trust during its periods of losses as well as its periods of profits or a beneficiary has transferred his interest to somebody else.

Though there is not much difference from the point of view of objectives and methods between a family trust, a firm and a family corporation, a trust pays less tax than a firm and much less tax than a close corporation. Table 6.1 shows the sharp difference in incidence.

TABLE 6.1

TAX (INCLUDING SURCHARGE) PAYABLE IN RESPECT OF INCOME EARNED BY A TRUST WITH FOUR BENEFICIARIES (INDIVIDUALS), A FIRM WITH FOUR PARTNERS (INDIVIDUALS) AND A CLOSE COMPANY IN THE ASSESSMENT FOR FINANCIAL YEAR 1982-83

(Rs.)

Income	*Tax payable by the beneficiaries of a trust*	*Tax payable by a registered firm and its partners*	*Tax payable by a close company*
1,00,000	13,200 (all the four beneficiaries together)	11,000 (by firm) 12,872 (by the four partners together) 23,872 (in the aggregate)	66,625
2,00,000	55,880 (all the four beneficaries together)	37,400 (by firm) 39,524 (by the four partners together) 76,824 (in the aggregate)	

Notes : 1. It has been assumed that the beneficiaries of the trust and the partners of the firm have no other source of income.

2. The shareholders of the company will have to suffer additional tax on the income they derive from the company by way of dividend, depending on their other taxable income.

The disparity in tax rates between close companies, firms and trusts puts a premium on tax avoidance through trusts as against tax avoidance through companies and firms. The very simplicity of the action required to avoid tax through trusts makes a trust more attractive than a company or a firm. It has been held, for instance, that one who is assessed as an individual on the income from the business he carries on can straightaway constitute himself as the trustee for the same business in a trust for the benefit of his sons, and the income is split instantaneously.[2]

It may be argued that a company enjoys several privileges like recognition as a legal entity, perpetuity, and the right to sue which are denied to a trust. The argument is averted by the fact that firms are more popular and have increased in much larger numbers in recent years than companies, despite their not having these rights. In any case, the practical value of the privileges of a company is negligible. Moreover, a trust has advantages which are not available to companies and firms. The corporate veil can, for instance, be pierced by the Revenue but a trust is entitled to protection from its prying eyes[3]. A distinctive feature of a trust is that it is made to order. It is tailored to suit the requirements of the beneficiaries in whom a settlor is interested. Unless prohibited expressly under the terms of the trust, a beneficiary's interest can be transferred to a third party. While a remainderman's interest or a life-tenant's interest is disposable, just like the shares of a company in the articles of which there is no restriction on transfers, a partnership stands dissolved when a partner retires or dies. By and large, a trust has as much privacy as a partnership or a close company; and it is a charmed circle which outsiders cannot enter except on sufferance. There is, therefore, no ground, equitable or other, for letting it get away with a lighter tax burden.

It is not merely the disparity in the tax rates that is anomalous; certain other aspects in the assessments of persons interested in a firm and in trusts are equally incongruous. For example, the income of minor children from partnership concerns is added, at present, to the income of either of their parents, depending on whose income is the higher. On the same principle, income of children who have not attained majority (other than married daughters) from all trusts conducting business, should also be aggregated irrespective of whether or not the business runs with capital provided by either of the parents of the beneficiaries. Such a step will remove one of the adventitious benefits currently offered by trusts.

Another example of the operation of an unconscious bias is the aggregation of the income of a husband and his wife when they are partners in the same firm. This rule is not applicable to a trust in which both are beneficiaries or in which one of them is a beneficiary and the other is a trustee whose services are at the disposal of the trust. The role of a trust is not limited to its utility as an alternative medium for conducting business[4] It can also be used to divert the income of a partnership concern or an individual through an over-riding title in favour of persons in whom the firm or individual may be interested.[5] An assignment of the income before it accrues or arises, for the benefit of the widow of the deceased partner of a firm, or the minor grandsons of a beneficiary with life-interest in a property held under trust, will reduce the tax liability of the firm or the individual, as the case may be.[6]

Doctrine of Double Taxation

In the UK, the trustees are charged a tax on the trust income in the first instance at a flat rate of 30 per cent or 45 per cent, as the case may be. Later, when a beneficiary receives any income from the trust he is also liable to be assessed, taking into consideration the tax paid by the trustees. As mentioned earlier,[7] the present legal position about the income tax and wealth tax assessments of trust income is that they can be made either in the hands of the trustees or in the hands of the beneficiaries, but not in both. The courts have pointed out that wherever any income is excluded from chargeability to tax, either expressly or by implication, the exclusion operates for all purposes in computing the total income. It cannot be taken into account for determining either the tax payable on the income, or even the rate at which the tax is payable on the rest of the income. The courts have been of the view that if the intention of the legislature was to exclude such income from the computation of the total income only for the purpose of chargeability to tax, and not for the purpose of determination of rate, a specific provision should have been made in this behalf. Unless such a specific provision is found in the statute, exclusion of such income from the total income for the purpose of chargeability to tax must be held to carry with it the exclusion from the total income for the purpose of determination of rate. If the trustees have been assessed to the income tax under section 160, read with section 161, the income receivable by the beneficiaries will not accordingly be included in their total income, even for determining the rate of tax applicable to the rest of their income.[8] The Revenue has also countenanced this untenable position.[9]

But, what is the basis in equity, for this view? Why should the Revenue suffer if the assessing official has not taken the trouble to find out what course is really more advantageous to it? Why should there be any discrimination between tax-payers in identical circumstances, one being taxed at a higher rate and the other at a lower rate, though the sources and even the extent of their income may be similar? While it may cause hardship if the same income is taxed twice, where is the difficulty in subjecting the other income of the beneficiaries to tax at the average rate applicable to their aggregate income, including the income taxed to the trustees? The principle of double tax avoidance should not be so exaggerated as to negate the obligation of every taxpayer to pay the tax due on his income. The two rules may not be found incompatible or irreconcilable if an *a priori* construction of the existing legal situation is avoided.[10]

It is the option given to the Revenue that creates the avoidable chaos. There is bound to be a confusion if some of the beneficiaries are assessed directly and others are not. The Act should, therefore, make it clear that while it may be open to the assessing officer dealing with a beneficiary's case to assess him on the income shown as received from a trust, such an assessment does not preclude the trust's being subjected to tax on its entire income at the maximum rate or the appropriate marginal rate, where so required by the law. The law should impose no time limit or other restriction on the revision or rectification of the assessments of the beneficiaries in the light of the assessment made on the trust. At present there may be loss of revenue as a result of even a discretionary trust's not being assessed to tax by reason of the prior assessment of one of the beneficiaries who might have received any payment from the trust. Such a loss can be prevented only if it is made possible to tax a trust, discretionary or specific, without reference to the assessments made, earlier or later, on any of the beneficiaries. Similarly, the beneficiaries should not be permitted to escape the tax due from them in respect of their income from a trust in the event of the trust's not being assessed for any reason.[11] The appropriate marginal rate of tax should be applied to their total income, including their share in the trust income, even if the trust income has already been taxed in the hands of the trustees.

In the case of beneficiaries who are mentally incapacitated and also in the case of non-residents, the responsibility for compliance with the requirements of the tax laws should be fixed on the trustees.

Unequal treatment of oral trusts and benami property holdings

It is not always that a trust is pampered with a preferential treatment. Oral trusts provide an example of the unmerited hardship imposed by the Revenue's excessive reaction to the methods adopted by some of the tax-dodgers.

Oral trusts may be cheap attempts to avoid tax; but, sometimes, they may also be necessitated by circumstances beyond the control of the persons creating them. A trustee may also be prevented by genuine difficulties from declaring details of the trust before the Income Tax Officer within the period pescribed in explanation I to section 160 (1). An oral trust shall be deemed to be a trust declared by a duly executed instrument in writing if a statement in writing, signed by the trustee and setting out the purpose of the trust and particulars as to (a) the trustees, (b) the beneficiaries, and (c) the trust property, is forwarded to the Income Tax Officer. This had to be done where the trust had been declared before the 1st June, 1981, within a period of three months from that day; and in any other cases, compliance is required within three months from the date of declaration of the trust[12]. Let us suppose the trustee is prevented by genuine reasons from complying with this requirement, or he is dead and another trustee is to be appointed in his place by the court. The Commissioner of Income Tax should have the discretion to extend the period for compliance if he is satisfied that the trustee has been prevented by sufficient cause from filing the statement as prescribed. In any case, the moment a formal instrument is executed by the trustee, it ceases to be an oral trust. If the author is alive, he can join and reaffirm that declaration. The Indian Trusts Act does not specify when exactly an instrument of trust has to be executed and how. There is nothing to prevent the author of an oral trust from making a formal declaration in a written document and registering it after the lapse of some time. The limitations laid down in the Income-tax Act will cease to have any relevance, once an instrument is executed. The trust cannot be treated as an oral one after the deed is drawn up and the immovable property, if any, held in trust is registered in the name of the trustee, irrespective of whether or not the trustees have complied with the requirements of explanation 1 to section 160 (1) of the Income-tax Act. And even a formal declaration of the trust before the tax authorities or the execution of a trust deed will not make the trust complete till the immovable properties are transferred from the name of the creator of the trust to the name of the trustee, unless the author of the trust is himself the trustee. An oral trust can be immediately effective only in respect of movable properties.

An oral trust for immovable properties registered in the name of the trustee will, in effect, involve a transaction, where the holder of the properties is not a bare trustee for the owner, as visualised in sections 81 and 82 of the Indian Trusts Act[13] but a secret trustee for some other beneficiary. An oral trust for movable properties has also all the characteristics of a *benami* transaction. This underlines the need to subject all *benami* income and wealth to a treatment not less stringent than that accorded to oral trusts. Section 281 A of the Income-tax Act rules out a suit to enforce any right in property held *benami* if the property has not been disclosed and the income from it returned for income tax purposes with a "notice in the prescribed form and containing the prescribed particulars" to the Income Tax Officer. Neither the income nor the wealth would suffer any additional tax if, at the appropriate time, the taxpayer who is the beneficial owner of the property, declares it in his income-tax return. Why should the beneficiary of an oral trust, the genuineness of which is not doubted by the revenue authorities, be taxed at the maximum marginal rate if the settlor-cum-beneficiary of the oral trust that goes under the name of *benami* holding pays taxes at the rates applicable to his income and wealth? One can settle immovable property in a third party's name for the benefit of a person in whom he is interested; the settlement becomes an oral trust if it is not supported by an instrument. It gets the stigma of a *benami* transaction but enjoys a less unfavourable tax treatment, if the person in whose name the immovable property is registered or any business is conducted, is not called a trustee but a *benamidar* for the beneficial owner. This is an anomaly which calls for correction.[14]

NOTES

1. In contrast, the development rebate granted to a firm is withdrawn under section 155(5) of the Income-tax Act when its assets and liabilities are transferred to a trust in which all the partners of the firm are beneficiaries : Radhas Printers v CIT (1981) 132 ITR 300 (Ker).
2. A. Razzak v CIT (1963) 48 ITR 276 (Cal).
3. K.T. Doctor v CIT (1980) 124 ITR 513 (Guj).
4. CIT v V.S. Kumaraswamy Reddiar Trust (1982) 138 ITR 808 (Ker) relating to transfer of a business from a firm to a trust.
5. CIT v Smt. Nandiniben Narottamdas (1981) 7 Taxman 389 (Guj).
6. CIT v Crawford Bayley & Co. (1977) 106 ITR 884 (Bom); CIT v Smt. Kamlabai Juthalal (1977) 108 ITR 755 (Bom).
7. Vide Chapter 3, pp. 33, 34, 39, 43, 46, 53. Curiously, the Revenue's action to reassess the value of trust property under sec. 17 of the Wealth-tax Act in the hands of the beneficiary, despite the actf that the trustees had been assessed to tax on that property has been sustained in Mrs. Gladys S. Koder v ITO (1976) 104 ITR 220 (Ker).
8. C.R. Nagappa v CIT (1969) 73 ITR 626 (SC) affirming C.R. Nagappa v CIT (1961) 67 ITR 740 (Mys); CIT v Arvind Narottam (1969) 73 ITR 490, 497 (Guj); CIT v Balwant Rai Jethalal Vaidya (1958) 34 ITR 187 (Bom); Panna Sanjay Trust v CIT Gujarat (1969) 74 ITR 396 (Guj); Trustees of Chaturbhuj Raghavji Trust v CIT (1963) 50 ITR 693 (Bom); CIT (Central) v N.M. Raiji (1949) 17 ITR 180 (Bom); CIT v Trustees of Miss Gargiben and others (1980) 130 ITR 479 (Bom); Saifuddin Ali Mohammed v CIT (1954) 25 ITR 239, 247 (Bom); Saldhana v CIT 6 ITC 114, 117 (FB-Mad).
9. Vide CBDT Circular No. 157, dated 26.12.1974, published in (1975) 98 ITR 41 (Statute) and Circular No. 45-78/66 ITJ 5, dated 24.2.1977.
10. Ganpatrai Sagarmal v CIT (1981) 7 Taxation 279 (Cal); (1981) 25 CTR (Cal) 36; (1982) 138 ITR 294 (Cal). See pp. 48-49 and nn. 7 and 9 above.

11. In the UK, receipts from discretionary trusts as also amounts applied by the discretionary trusts for a beneficiary's education, etc., are treated as part of his total income: Drummond v Collins (1915) 6 TC 525; IR v Blackwell Minors' Trustees 10 TC 235. This income will be includible in his total income for the year in which the trustees exercise their discretion in his favour: Lindus and Hortin v IR (1933) 17 TC 442. The payment received by the beneficiary is grossed up at the tax rates relevant to the year in which the trustees take their decision.

12. Vide Chapter 3, pp. 37-38, 41.

13. The following is section 82 of the Indian Trusts Act :

    "Where property is transferred to one person for a consideration paid or provided by another person, and it appears that such other person did not intend to pay or provide such consideration for the benefit of the transferee, the transferee must hold the property for the benefit of the person paying or providing the consideration."

    In CED v Aloke Mitra (1980) 126 ITR 599 (SC), the Supreme Court has observed that the cardinal distinction between a trustee known to the English law and a *benamidar* lies in the fact that a trustee is the legal owner of the property standing in his name and the *cestui que* trust is only a beneficial owner, whereas in a *benami* transaction the real owner has the legal title though the *benamidar* has lent his name to the property. What the Supreme Court had in mind was apparently the case of a person who admitted that he was a name-lender. The very purpose of resorting to registration of property in the name of a third party is to hide the ownership. If the real owner and the *benamidar* go about proclaiming the secret arrangements into which they have entered, it will be a very unusual *benami* transaction. The fact is that in the eye of the general public, the *benamidar is* the legal owner of the property standing in his name, unless his title to it is disputed by anyone. If the *benamidar* claims the ownership of the property standing in his name, the burden of establishing that the apparent is not the real will rest on the person who makes such an allegation, i.e., who seeks to dislodge the title-holder on the ground that he is a mere name-lender.

14. This is all the more necessary because according to the Supreme Court [CIT v S P Jain (1973) 87 ITR 370 (SC)] it is not sufficient if the revenue authorities establish that a person is a mere *benamidar* of somebody. They should go further and prove that he has lent his name to a particular assessee, before the income in his name can be treated as the assessee's and properly taxed.