8

Remedies

Treatment of a trust as a taxable entity

THE concept of assessing the trustee in the same manner and to the same extent as the beneficiary, on which the existing provisions of the tax laws are based, assumes that the revenue authorities will be in a position to quantify the income which each beneficiary may get from the trust in a particular year. This assumption may not always be valid. A trust deed may not stipulate disbursement of all the trust income within the year in which the income is derived. It may permit payments over a period of time extending beyond the year in which the income arises. The trustees may be required to conserve the capital gains, if any, and also maintain a reserve to meet anticipated expenses or ensure the evenness of the annual payments made to the beneficiaries. The debit to the revenue account to create the reserve would not be allowable expenditure for tax purposes though it will reduce the distributable surplus of the trust. It will certainly hurt the beneficiaries if tax is collected from them on amounts which they have not actually received or to which they have no legal right, e.g., capital gains added to the trust corpus in terms of the trust deed. The Income-tax Act does not deem the entire trust income to be rateably theirs[1]. The beneficiaries can well plead that they can be called upon to pay tax only on amounts actually made over to them, unless the Revenue has reason to believe that disbursement of income is being avoided by the trustees with their connivance.

All things considered—the haziness of the provisions

covering trusts in the Income-tax Act, the deviations in the Act from the basic tenets of taxation like equity and neutrality and the tax avoidance techniques in vogue[2]—it appears advisable to have tax levied on the trust itself, treating it as a taxable entity. Once a trust is recognised as a taxable unit like a firm or a Hindu undivided family, which is not a legal entity but is still treated as an assessee in terms of the definition of a "person" in section 2 (31) of the Income-tax Act,[3] many of the legal issues that currently vex income tax assessment can be resolved without difficulty. When one talks of a business held in trust, what is denoted is a business carried on by a trustee in the interest of the beneficiaries. The trustee in India has no title to the trust properties, which vest in him only for administration and management.[4] The controversy about the circumstances in which trusts can be treated as bodies of individuals or associations of persons[5] can be avoided by the recognition of trusts which hold properties through trustees for the benefit of others as a new class of assessees. It has already been pointed out that, under the scheme of income taxation, whoever is in actual receipt and control of any income is generally charged with the tax on the income.[6] The Income-tax Act can provide for the filing of returns and the payment of tax by the trustees on behalf of a trust.[7] The trustees should be liable to be taxed for and on behalf of the trust which will be "personified" for this purpose, to use the Mead Committee's apt expression,[8] and not on behalf of the beneficiaries.

Alternatives in income tax assessment—maximum rate with or without tax credit for beneficiaries

There are four alternatives for the treatment of income so reported by the trustees of a trust :

(*a*) A private trust can be at par with a non-industrial close company, suffering the same rate of tax.[9]

(*b*) Unlike companies which, under the "classical" system of corporate taxation that is operative in India, bear tax themselves at the prescribed rate and also withhold tax at the specified rate from the dividends paid to the shareholders, a private trust can be required to pay tax at the maximum marginal rate applicable to individuals; and, unless it is a discretionary trust, the tax paid by it can be attributed to the beneficiaries on a

proportionate basis, with reference to the extent of the benefits enjoyed by them individually. To illustrate, if a trust has been taxed at 60 per cent[10] on an income of Rs. 1 lakh and income to the extent of Rs. 30, 000 out of Rs. 40, 000 with which the trust would be left is equally distributed to its two beneficiaries, each of the beneficiaries may get credit for tax to the extent of Rs. 22,500 if the total tax demand of Rs. 60,000 has actually been paid by the trust. No credit will be due to either of the beneficiaries for the balance of tax paid by the trust, *viz.*, Rs. 15,000. If any refund is due to either of the beneficiaries with reference to the tax assessed in his own case and the tax credit he gets for the payment by the trust, it may be made to him in the course of his own personal tax assessment. The beneficiaries of a discretionary trust should be given no tax credit for any income received by any of them from the trust. Tax imputation may be denied even in a specific trust, if the trust is engaged in any business or professional activity.

(*c*) On the analogy of a registered firm a trust can be subjected to an additional levy for which the beneficiaries will not be entitled to any credit. The additional trust tax will be deductible in the first instance and the balance of the trust income distributable among the beneficiaries thereafter. No tax credit will be available to the beneficiaries in respect of the income payments made to them by a trust, which will be added to their other income, if any, and subjected to income tax in the ordinary course.

(*d*) The trust will be liable to tax at the maximum marginal income tax rate applicable to individuals but no part of the tax will be ascribed to the beneficiaries. The tax will be collected from the trust, unless the trust assets have been distributed among the beneficiaries and there is any practical difficulty in effecting the recovery from the trust itself. On the other hand, the share of the income actually received by the beneficiaries from specific as well as discretionary trusts, *debuttar* estates and *waqfs* will be aggregated with their other income and considered for levying the income tax on the other income at the marginal rates applicable to the total income.

The first course may not be justified, in view of the fact that a private company is controlled and managed by the

beneficiaries or owners themselves and has greater freedom of operation than a trust, besides being entitled to some of the legal privileges not available to a trust. The Revenue will probably find the last course the most convenient from the administrative angle, since it will not be clouded by the uncertainty which the other two courses involve and will also dispense with the need for differentiating between discretionary and specific trusts, so far as their own tax assessments are concerned. Since a trust is frequently resorted to for disaggregating income and wealth, there is a view that no trust should be allowed a tax-exempt threshold, for such an allowance will encourage the splitting of wealth belonging to a single individual or family into innumerable trusts. If trusts proliferate primarily to fragment income and wealth and minimise tax liability, such proliferation may be stemmed by the levy of the income tax at the maximum rate and the wealth tax at a relatively high rate on the entire income and wealth of a trust. Whichever of the four alternatives indicated above is adopted, it will be necessary to provide for the deduction of all allowances under the Act, including capital allowances, in the assessment of the trust itself. All losses incurred by a trust in any business conducted by it should be allowed to be carried forward and set off against the income of the trust alone in the subsequent years, subject to the same conditions as the other taxpayers.

In the second and third alternatives the beneficiaries in specific trusts may seek a "throw-back relief" in respect of the income received by them from time to time. That is to say, the income received by them may have to be made liable to tax at the rate appropriate to them in the manner and during the period in which the income had actually accrued or arisen in the case of the trust. Any manipulation of the rate of tax applicable to the beneficiaries, e.g., by arranging distribution of income in a year in which the rest of the income of the beneficiaries is lean, will necessitate a similar "throw-back" of realisations, and their aggregation with the other income in the years in which the trust itself earned the income, as in the USA. The second and third courses lack, therefore, the element of finality, which is essential for effective administration : the assessment of several beneficiaries may have to be disturbed for more than one year, either at the beneficiaries' request or on the initiative

of the revenue authorities. Such a scheme of assessment will call for maintenance of elaborate details of the income earned by a trust and the distributions made by it in the different years, so that correlation between the two will be facilitated.

Even the adoption of the last course may not do away with the need for the Revenue's keeping a record of allocations or applications of income made by the trustee to the extent necessary to give a finding on the portion of the beneficiaries' income that can be taken to have borne tax at the maximum rate in the hands of the trustee. There may also be situations where the assessment year to which the income will have to be ascribed may have to be ascertained on the basis of the available surplus after tax each year in the trust. Such a situation may arise, for instance, in a case in which the beneficiary has income from sources other than the trust, and there is ground for believing that payments are being deferred by the trust to keep down the level of the beneficiary's total income and consequently, the average tax rate applicable to the other income. The maintenance of records required to check such tax manoeuvres will not, however, disturb or delay the assessments of the trust or even of the beneficiaries : all that may be needed is the computation of the income or the value of the benefits to which each of the beneficiaries of the trust is entitled in the order of assessment in the case of the trust itself, like the apportionment of the partners' shares in a firm's income. While this procedure will take care of payment-postponement tactics in specific trusts, the solution in the case of a discretionary trust is to give the Revenue the option to correlate the payments to the year or years in which surplus income large enough to cover them emerged in the trust, or take the payments as the beneficiary's income in the accounting year in which they were made, whichever may be more beneficial to the Revenue.

As for the wealth tax, it may be levied on the trust at three per cent of the market value of the assets held by it[11], providing for exemption only in the case of a specific trust, if its wealth is less than the maximum not liable to tax and none of its beneficiaries is also likely to have wealth tax liability even if the value of his interests in different trusts are added to wealth directly held by him. Each of the beneficiaries should be required to file a statement of his wealth, together with parti-

culars of every trust in which he is a beneficiary and the value of his interest in each of the trusts as worked out and certified by a Chartered Accountant or a Government approved or empanelled valuer. Where there is more than one beneficiary and the sum of the values of all the beneficiaries' interests in a trust falls below the value of the wealth of the trust as a whole, the Wealth-tax Act provides for the assessment of the difference to tax in the case of the trust itself at 3 per cent or at the rates specified in Part I of Schedule 1, whichever would be more beneficial to the Revenue. In view of the difficulties and delays involved in evaluating individual interests and arriving at the balance to be covered by an assessment in the hands of the trustees, it is advisable to tax the trust, and give proportionate credit to the individual beneficiaries for the tax paid by the trust, if they file the actuarial valuation of their respective interests. Every beneficiary will be assessable to tax on his wealth including his interest in the trust, if it exceeds the maximum not liable to tax. But he may be given appropriate credit for the tax on his interest in the trust, as actually paid by the trust, subject to the condition that such credit does not entitle him to any refund of the tax paid by the trust, with reference to the value of his interest and the marginal rate of tax relevant to his wealth. If a beneficiary is a minor in a specific or accumulation trust, his income and wealth should be added to the income and wealth of either of his parents having the larger wealth, even if no part of the wealth was transferred to the minor by either of the parents. Such a provision will take care of cross transfers and gifts made to minors in consideration of any obligation to the parents. The analogous provision in regard to partnership concerns in which minors are given a beneficial interest should serve as a precedent in this connection. While a small specific trust, none of the beneficiaries of which has wealth that may be liable to the wealth tax, may be exempted from the tax, the Revenue should be free to assess the trust at the appropriate marginal rate, if the net wealth held in trust attracts the wealth tax at more than 3 per cent. So far as discretionary trusts are concerned, the existing provision of section 21(4) of the Wealth-tax Act may continue to govern them without any relief on the lines suggested for specific trusts which do not avoid or help anyone to avoid the tax.

A plain and simple trust which strictly follows the investment pattern prescribed for provident and other tax exempt funds, and which does not dabble in business or professional activities, can be allowed to pay tax at the marginal rate appropriate to its total income or taxed at a rate lower than that applicable to the other trusts. This relaxation should be confined, however, to a trust with a specified class of beneficiaries who deserve a special tax concession, e.g., orphaned minors, lunatics, mentally retarded persons, persons who are physically so handicapped that they are incapable of profitable employment, old people past the age of 70, or those who are suffering from incurable diseases or other serious disabilities. If such a guileless trust has more than one beneficiary of this category it may be given a tax remission equal to the difference between the tax raised against it on the basis of the total income derived by it and the sum of the taxes that may be demanded from the beneficiaries if the entire income had been disbursed to them according to the terms of the trust instrument. If any of the beneficiaries has any other independent income, additional demand can be raised in his own assessment, including the trust income in his total income only for rate purposes.

Residence of a trust

If a trust is to be assessed to tax *qua* trust, specific tests will have to be prescribed in the Income-tax and Wealth-tax Acts for determining its "residential status" as a taxpayer : without a statutory clarification on a trust's residence, there is likely to be avoidable litigation, for tax jurisdiction over income and wealth abroad depends on it. While every taxpayer is charged to tax on his income and wealth in India, it is only a person who is ordinarily resident in the country that is liable to pay tax on outside income and wealth. A company is said to be a resident in India in a year if it is an Indian company or, during the year, the control and management of its affairs is situated wholly in India. Likewise, a Hindu undivided family, a firm, an association of persons or any other person is taken as resident in India in a year unless, during the year, the control and management of its affairs is situated wholly outside India. If a trust is treated as a taxable entity, its residence will have to be determined on the same principles. It can be taken

to be resident in India if its managing trustees, or the majority of the trustees who administer it, are resident in India.[12] Beneficiaries who have merely the right to proceed against the executors and trustees for claiming the income from certain shares in companies in India cannot be said to have any assets in India chargeable to the wealth tax, where the testator, the beneficiaries and all the trustees are non-residents.[13] It should be possible, however, to tax the registered "owners" of the shares in such cases on the income from the shares in the status of a body of individuals or an association of persons, depending on the facts of the case.

A trust set up outside India by any person ordinarily resident in this country should also be held to be resident, if the spouse or the minor child of the author is one of its direct or indirect beneficiaries, irrespective of whether the benefits are immediately enjoyed or put off to a remote contingency. Since there can be no trust without some property, the decisive factors for levying tax will obviously be the situs and the nature of the property. The trust can reasonably be treated as a resident even where the managing trustees or majority of the trustees are resident abroad, if most of the trust properties lie in India and the trustees are required to supervise or manage the estate or conduct any part of the trust affairs in India. While immovable properties are subject to the exclusive jurisdiction of the country in which they are located, tax jurisdiction of the country where the taxpayer resides can be extended to reach his movables outside the country. Tax treaties under section 90 of the Income-tax Act and the provision for unilateral relief for double taxation under section 91 of the Act[14] will temper any liability that may be raised against the trust both in India and the country in which any assets are held, but that will not dispense with the need in India for a suitable provision like the one in section 25(1) of the UK Finance Act of 1965.[15] It is obvious, in this context, that a genuine overseas trust should be distinguished from a trust seeking refuge in a tax haven.

Other counter- measures needed

While many of the methods of tax avoidance outlined in Chapter 7, particularly those directed against the income tax, may be rendered pointless if all private trusts saving those

which are excepted by the special provisions, e.g., trusts for the mentally unbalanced or retarded, are taxed at the maximum marginal rate applicable to an individual or an association of persons, there will still remain a few devices requiring special curative amendments. A few of the important amendments that are called for are indicated below :

(i) Cross trusts

Since courts have found difficulty in holding that there are "cross trusts" where reciprocity is not immediately apparent, there should be provisions in the direct taxes statutes enabling the Revenue to take an overall view of family settlements. If a series of transactions appear to be connected and the settlors and beneficiaries are related to each other or have close business association, there should be no further need for proof of concerted attempt to avoid tax. The Revenue should have the right to draw the inference that if any member of the family of the donor benefited through any settlements made by any member of the families of the donees within a specified period, say five or six years from the date of the donation, all the settlements in question are parts of a single deal. The consequence of such a rebuttable presumption will be inclusion of the settled income and assets in the transferor's assessments to the income tax and wealth tax, subject to his right to lead evidence to vindicate his stand.

(ii) Treatment of unauthorised benefits

The existing law is unsatisfactory where the trust resources are scooped out without the necessary powers by the author or the trustees or even a nominee of the beneficiary. While it may be irrational to punish a beneficiary for the trustee's malpractices, there is no justification for not amending the law to make it clear that a trust will be taken to be revocable if its author yields to the temptation to make off with any benefits without the necessary sanction in the trust instrument, or utilises the trust funds in the form of loans to or deposits with concerns in which he is interested,[16] other than public companies in which he does not directly or indirectly control more than 5 per cent of the equities. Alternatively, tax may be levied at 10 per cent more than the maximum rate applicable to an in-

dividual in respect of so much of the income of the trust as is attributable to such misuse of the trust capital. This may be the preferable course if the trust itself is assessed to tax at the maximum rate applicable to an individual. The Revenue is not bothered about the remedies available to the beneficiary : he may not consider them worth his while. What the Revenue is concerned with is the tax on the benefit that the author or trustee has managed to scrape away. A charitable or religious trust is taxed on such income under section 13(1)(c) of the Income-tax Act. In a private trust, it may be equitable to make the trust or the person in whose favour a benefit has been misapplied, pay tax on it at 10 per cent more than the maximum rate. The misapplication tantamounts to tax "avoision",[17] falling in the grey area between tax avoidance and evasion, and merits a deterrent levy, over and above the maximum rate of tax. A penalty as such may not be supported by the courts which insist on *mens rea*[18] being established where evasion is alleged by the Revenue; and this leaves the legislature with no option but to charge additional tax in such a case.

Any payment by a close company by way of advance or loan to a shareholder who has a substantial interest in the company is deemed to be a dividend.[19] There is need for a similar provision for the treatment of the resources of a private trust which the beneficiaries or their nominees are allowed to exploit, directly or deviously, through contracts, covenants, or other financial arrangements. As stressed earlier, even if the trust is made to pay tax on its full income, the income received or receivable by the beneficiaries will still have to be worked out to arrive at the rate of tax chargeable against the rest of their income. The value of the benefit enjoyed by any one on the sly, without sanction in the trust deed, may have to be indicated in the order of assessment in the case of the trust to facilitate appropriate tax procedings against the interloper, without prejudice to its being taken into account, simultaneously, as a part of the income of the trust.

(iii) Trusts in favour of natural children, premarital transfers of assets between a couple and settlements made in favour of persons not legally wedded

The provision in the tax laws for the removal of the undesi-

rable distinctions in the matter of aggregation of income and assets of minor children, etc., may have to be comprehensive in its scope : the income from assets transferred by a taxpayer, either directly or through a trust, to a minor child or any member of the opposite sex, without adequate consideration, may be required to be included in his or her own total income for income tax purposes even if the transfer has been subjected to the gift tax. The value of the transferred property may be aggregated likewise with the transferor's wealth for wealth tax purposes.

The term "children" has been defined to include illegitimate children in section 27(7) of the Estate Duty Act, though, unaccountably, those who live together without a valid contract of marriage or those whose relationship is not approved in law are not covered by the expression "relatives" in that section, while dealing with dispositions in favour of relatives as gifts for estate duty purposes. The object is not to visit the sins of the parents on the children or subject any category of taxpayers to a discriminatory liability. but ensure that the concerned parent who has made a settlement or other arrangement in the nature of trust does not get away with a tax benefit to which he will not be entitled if he strictly abides by his personal law. Gift tax is payable in any case, without reference to the relationship or the legitimacy of the donee, whenever property is transferred to him or her, in trust. What may escape are the income and wealth taxes and the estate duty unless the revenue laws are suitably amended. In effect, the proposed provision may entail income tax and wealth tax liability, in respect of gifted property, for the donor during his life-time without affecting the donees adversely in any manner. It will also obviate the need for any embarrassing and fruitless enquiry about the relationship between the transferor and the transferee, while protecting the Revenue from income-splitting tactics.

Pre- and post-marriage financial arrangements will get uniform tax treatment if income from transferred assets is taxed to the transferor, without reference to the period or motive of the transfer or the relationship between the transferor and transferee, during his life-time.

(*iv*) *Estate duty liability in respect of property held in discretionary trusts*

In the absence of a capital transfer tax as in the UK, estate duty may have to be raised on the death of persons qualified to receive any benefits from a discretionary trust with reference to the same proportion of the trust assets that the benefits actually received by the deceased during a prescribed period before his death bore to the total income of the trust during that period. Additionally, as in the case of the wealth tax, the Revenue may also be given the option to levy the estate duty at a fixed rate on the death of any person eligible for apportionment of a benefit in the trust: the rate may be the maximum prescribed in the Act, divided by the number of persons entitled to consideration by the trustees while exercising their discretion.

(*v*) *Release of life-interest less than two years before death*

Release of life-interest in favour of persons entitled to the remainder has been held to be a disposition of the nature of a settlement within the meaning of s. 21(1)(a) of the Finance Act, 1936, in the UK[20]. Since it is reasonable to subject all such acceleration to the estate duty, when it is effected by the deceased less than two years before his death, amendment to the Estate Duty Act on the lines of the provisions made in ss. 2(xxiv)(c) and 4(1)(e) of the Gift-tax Act seems to be required.

Need to vest Revenue with general power to ignore financial arrangements designed to avoid tax

Besides amendments to remove the deficiency in law set out above, a provision on the lines of section 64 of the Income-tax Act (41 of 1974) of Mauritius may be useful in tackling some of the cases in which the revenue has grounds for concluding that the apparent is not the real state of affairs. An "arrangement" can be ignored for income tax purposes in Mauritius, having regard to—

(*a*) whether it might reasonably be expected to have been entered into and implemented in that particular way if tax avoidance had not been its purpose or one of its purposes ;

(*b*) whether the rights and obligations arising under it might reasonably be expected to have been created under an arrangement not having tax avoidance as its purpose or one of its purposes;

(*c*) the extent to which the emphasis in it is substantial on income factors;

(*d*) the overall effect on the practical carrying on of an existing business or other income-earning activity to which it relates;

(*e*) the dependence on the taxpayer of the earning or accruing of income under it;

(*f*) the extent of control over the earning and disposition of income under it in practice, exercised by the taxpayer;

(*g*) any advantage or disadvantage accruing to the taxpayer from it;

(*h*) the income tax and other implications of other courses of action open to the taxpayer at the time he entered into it; and

(*i*) any other relevant considerations.

Where an arrangement is voided, the net income of a taxpayer who is a party to it is required to be adjusted as the Commissioner considers appropriate, so as to counteract the tax advantage obtained by the taxpayer, having regard *inter alia*, to the income that, in his opinion, would in all likelihood, have been derived by the taxpayer had the arrangement not been entered into. The Commissioner is competent to make any consequential adjustments that may be necessary in the income of any third party involved in the arrangement. For the purpose of these provisions, the Mauritius Act defines an "arrangement" to mean an agreement, plan or understanding, whether enforceable or unenforceable, and includes any step or transaction by which it is carried into effect. Since most modern trusts are mere business arrangements neatly tied up through instruments drafted with an eye to the settlor's tax liabilities, there can be no reasonable objection to arming the Revenue with the powers to unravel the skeïn.[21]

The only objection to such a provision in India may be that it is of a sweeping character, vesting the executive with excessive powers. But the objection may not be sustainable if the Commissioner's order is made appealable, like other orders passed by him, e.g., under section 263 of the Indian Income-tax Act, which permits him to revise the orders of the Income Tax Officer which are prejudicial to the Revenue. There is certainly a risk of the proceedings getting bogged down in protracted litigation but it will be an improvement on the existing situation in which tax avoidance has been raised to the level of a virtue. The alternative is to clutter the revenue Acts with countless *ad hoc* amendments, catching up every exercise of individual ingenuity, like plucking each weed with forceps in a garden.

Statutory registration of private trusts and provisions for ensuring flow of information

Since the marginal rate of tax applicable to the rest of the income or wealth of a beneficiary cannot be correctly computed without considering his share of the income or wealth of the trust in which he has an interest, it is evident that it is essential to have a true copy of the instrument of trust in the income and wealth tax records of every beneficiary and also to get its implications examined thoroughly in the tax assessment of the trust.

There should be a statutory obligation for the registration of all private trusts including private religious trusts, *debuttar* estates, *waqf*s and other pious or quasi-charitable endowments, with the designated authority in trust circles which should be constituted as a distinct jurisdiction in the direct taxes establishment in every State.[22] The formation of separate jurisdiction for private trusts will not merely be conducive to uniformity in the tax treatment of the trusts but also facilitate the collection and compilation of the necessary intelligence and statistical data about them. Concentration of the trusts in the hands of a few tax officials may make it possible to tackle them effectively. An idea of the scale of tax avoidance and the revenue entailed can be gathered and measures for preventing the leakage of revenue can be taken only if full and dependable information is systematically supplied to the concerned agencies.

The responsibility should be cast on the authors of the

non-testamentary trusts, and the trustees in regard to testamentary trusts, to have the assets valued and the trusts registered with the notified income tax authorities. All trusts holding properties in India with non-residents as beneficiaries, should be required to withhold the income tax and wealth tax at the appropriate rates each year and file statements of the taxes so deducted before the income tax authorities unless the trusts are themselves assessed to the income and wealth taxes.

In Sri Lanka, the Inland Revenue Act requires that every trust shall, on or before the 30th day respectively of July, October and January of a year of assessment and on or before the 30th day of April immediately succeeding the year of assessment, give the beneficiary concerned, a notice stating the amount of income or wealth earned or held by the trust for his benefit. It is desirable to incorporate a similar provision in the Income-tax Act in India, supplemented with the requirement that every trustee should also endorse a copy of his letter to the beneficiaries to the concerned revenue authorities, for more often than not, it is the Revenue which is in the dark about a trust, not the beneficiaries, especially if the trust is created for avoidance of tax. If the Revenue is posted with prompt information about all trusts that are set up, *inter vivos* or through wills, there can be no difficulty in keeping track of them and taking appropriate action in the cases of the beneficiaries as well as the trust.

Sections 443 and 453 of CTA 1970 in the UK vest the Inspectors with powers to require any party to a settlement to furnish them with the particulars necessary for the purposes of the tax legislation on settlements. Domestic and foreign settlements, banks and even solicitors are compelled to comply with the requisition.[23] Such a provision will be very useful in India, where some of the banks decline to furnish even statistical data of a general nature,[24] taking cover behind "privilege".

Since trust accounting and accounting for income tax purposes may be at variance, every trust will have to be asked to file income as well as wealth returns, furnishing details of all transactions with beneficiaries, settlor and trustees and persons related to or connected with them. A statement reconciling trust income with income returned for income tax purposes will also be required, besides particulars of all other trusts with

which either the trustees or beneficiaries are concerned either as beneficiaries or as trustees or as authors. The powers, if any, exercised by the beneficiaries of the trust with reference to the terms of the trust, e.g., powers of appointment and disposal of life interest, should also be specified in the form of return. The trust is in a better position to monitor action and comply with the assessment proceedings than the individual beneficiaries.

The filing of a photo-copy or a true copy of the trust deed and annual audited accounts, with a certificate of allocation of the different beneficiaries' respective shares in the trust's income and wealth, should be made compulsory for the trustees. The beneficiaries should also be required to declare in their own individual assessments (a) the exact amounts actually received by them from various trusts and the other benefits enjoyed by them in any trust, (b) the amounts apportioned to them by the trustees/auditors as their entitlement in the trust's income/wealth, but not received by them, and (c) their interests in other trusts, from which they have derived no tangible or intangible benefits.

A deterrent penalty ranging from 10 per cent to 50 per cent of the tax payable by the trust should be levied on the beneficiaries and trustees jointly and severally, if there is no compliance with the above requirements, including registration with the notified authorities. Where an individual trustee or beneficiary is guilty of deliberate default or delay, the penalty may be a fixed amount for every day of default, with the prospect of prosecution and a prison sentence, in the event of conviction, if penalty is of no avail in securing compliance. The responsibility for cooperation with the Revenue should be collective in the case of a trust since the settlor, the trustee and the beneficiary have in most cases, a common purpose, *viz.*, promoting the beneficiary's interests in the trust. They cannot therefore, disclaim their obligation on any technical pretexts.

NOTES

1. See Chapter 3. As long as a trust exists the beneficiaries' right to the assets held in trust and the income derived from them depends on the terms of the trust instrument. The trustees are in possession of the assets and in control of the income and are accountable accor-

dingly for the income and wealth taxes. To the extent that the beneficiaries are given a vested interest in the assets and a right to a part of the income or the whole income, the trustees' tax liability is required to be determined with reference to the aggregate liability of the beneficiaries. The trustees bear the income tax on the balance of the income, if any, to which the beneficiaries may not be entitled in the accounting or income year and the wealth tax on the difference between the market value of the wealth, in trust and the aggregate value of the beneficiaries' interests in the wealth at the close of the year. It is possible that the beneficiaries of a particular trust may have a specific share in all the income that accrues to or arises in a trust but this is not a requirement of either the Indian Trusts Act or the Income-tax and Wealth-tax Acts. In this connection, see Arundhati Balkrishna v CIT (1976) 102 ITR 356 (Guj); Reid's Trustees v IR 14 TC 512, 523; Aikin v Macdonald's Trustees 3 TC 306; IR v Dewar 16 TC 84, 94 (HL); Hotz Trust v CIT (1930) 5 ITC 8, 16; IR v Blackwell Minors' Trustees (1924) 10 TC 235.

2. See Chapter 5 on the incompleteness and vagueness of the statutory provisions regarding the tax treatment of trusts, Chapter 6 on the pronounced bias in favour of trusts as against other media for carrying on a business or holding investments and Chapter 7 on some of the methods of tax avoidance that have come to notice in the recent years.
3. A Hindu deity is an "artificial juridical person", caught by s. 2(3)(vii) of the Income-tax Act. Endowments to Him are accordingly within the ambit of the Act. There is no lack of tax-planning for these endowments, e.g., Pravinchandra C. Parekh, 1981, *Tax-Planning through Artificial Juridical Persons (Private Family Gods, Idols, Deities)*.
4. Thiagesar Dharma Vanikam v CIT (1963) 50 ITR 798, 807 (Mad).
5. Deccan Wine and General Stores v CIT (1977) 106 ITR 111 (AP); CIT v Harivadan Tribhuvan Das (1977) 106 ITR 494 (Guj); CIT v Indira Balakrishna (1960) 39 ITR 546 (SC); N.V. Shanmugam and Co. v CIT (1971) 81 ITR 310 (SC).
6. See n. 16, Chapter 3.
7. The American approach is similar, *vide* s. 641(b) of the Internal Revenue Code. Also see s. 104(2) of the Income-tax Act in Canada. The trustees of a trust in India are treated like an association of persons or a body of individuals, depending on the facts of the case, where they have to be assessed on the income or wealth of the trusts not immediately belonging or attributable to any particular beneficiary. See also Chapter 3.
8. Report of Committee chaired by J.E. Meade (1978), *The Structure and Reform of Direct Taxation*, The Institute of Fiscal Studies, London, George Allen and Unwin, p. 461.
9. A non-industrial domestic company in which the public are not

substantially interested has to pay income tax at 65 per cent of its total income and surcharge at 5 percent thereon for its assessment for 1984-85. The maximum rate applicable to income exceeding Rs. 1,00,000 in the case of an individual is income tax at 60 per cent plus surcharge at 12.5 per cent thereon.

10. The rate of tax has been taken at 60 per cent only for purposes of illustration. The rates actually applicable to a close company are higher—60 per cent tax plus 5 per cent surcharge thereon if it is industrial and 65 per cent tax plus 5 per cent surcharge thereon if it is non-industrial.

11. The Meade Committee has suggested that where income is distributed, the trust capital can be attributed to the beneficiaries in the same proportion as the share of income which each has received and the wealth tax payable (if any) can be calculated by treating the attributed amount as the top-slice of the beneficiary's wealth. According to the Committee, the tax should be payable by the trust and not the beneficiary; and this arrangement could apply both where the beneficiary has an interest in possession in the trust and where the income he receives is paid at the discretion of the trustees. [Report of Committee chaired by J.E. Meade (1978), *The Structure and Reform of Direct Taxation*, The Institute of Fiscal Studies, London, George Allen and Unwin, p. 409].

    This approach may not be satisfactory where the object of creating a trust is to split income and wealth in order to reduce tax liability. In a discretionary trust, for example, distribution of income can be so made as to benefit only those who have little or no wealth, apart from their interest in the trust, while those who have large wealth may be content if they are let alone without any payment, for the time being.

    The Meade Committee has pointed out that where some income or part of the income is accumulated, some relatively arbitrary charge on the slice of the trust capital corresponding to the fraction of income accumulated may be attributed to the settlor but the tax that is raised, realised from the trust. Provisions to give effect to these suggestions are not likely to simplify the existing law in India.

12. The residence of the majority of the trustees of a trust not engaged in a business will be the residence of a trust in Canada : Theobodean Family Trust v The Queen (1978) CTC 539 (FCTD), quoted at p. 568, James G. Carphin, *Constituting an inter vivos Trust*, 1981 Conference Report—Report of the Proceedings of the 33rd Tax Conference, Canadian Tax Foundation.

13. A & F Harvey Ltd., v CWT (1977) 107 ITR 326 (Mad).

14. S. 90 enables the Government of India to enter into agreement with the Government of any country outside India for the granting of relief in respect of income on which income tax has been paid in India as also in that country, and for avoidance of double taxation in both the

countries. A treaty between two countries prevails over the laws of both the countries so far as its terms are concerned. India has comprehensive agreements for double tax avoidance with Austria, Belgium, Denmark, Federal Republic of Germany, Finland, France, Greece, Japan, Malaysia, Norway, Singapore, Sri Lanka, Sweden, Tanzania, the United Arab Republic and the UK. India's agreement with Pakistan is no longer operative. There are agreements limited in scope to shipping or aircraft profits with several other countries, including the USA. None of the treaties specifically mentions tax treatment of trusts. However, the amount of tax attributable to the tax law of a particular country is that which is ultimately imposed on the taxpayer : O. A. P. Andiappan v CIT (1971) 82 ITR 876 (SC). If, therefore, a trust is taxed on the same income, say, in the UK as well as India, it will be able to claim appropriate relief in terms of the treaty between the two countries.

S. 91 grants unilateral relief to a resident assessee who has paid tax on his income in another country with which India has no tax treaty, subject to the condition that the income is not deemed to accrue in India under any provision of the Act. The relief is in the form of a deduction, from the tax payable in India, of a sum calculated on the doubly taxed income at the Indian rate of tax or the rate of tax in the foreign country, whichever is lower, or at the Indian rate of tax, if both the rates are equal.

15. Section 25(1) of the UK Finance Act of 1965 is reproduced below :

"(1) In relation to settled property, the trustees of the settlement shall for the purposes of this part of the Act be treated as being a single and continuing body of persons (distinct from the persons who may from time to time be trustees), and that body shall be treated as being resident and ordinarily resident in the United Kingdom unless the general adminsitration of the trusts is ordinarily carried on outside the United Kingdom and the trustees or a majority of them for the time being are not resident or ordinarily resident in the United Kingdom :

"Provided that a person carrying on business which consists of or includes the management of trusts, and acting as trustee of a trust in the course of that business, shall be treated in relation to that as not resident in the United Kingdom if the whole of the settled property consists of or derives from property provided by a person not at the time (or, in the case of a trust arising under a testamentary disposition or on an intestacy or partial intestacy, at his death) domiciled, resident or ordinarily resident in the United Kingdom."

The Tax Reform Act of 1976 has made the creation of a foreign trust unattractive in the USA. The income of a foreign trust with one or more US beneficiaries is taxed to its US grantor for his life (I RC 679). The US beneficiary has to pay tax at a higher rate on the

accumulated capital gains, if any, distributed to him, as though it has been converted into ordinary income, if it does not suffer tax in the hands of the grantor (IRC 643 and 667). The taxes due from a foreign accumulation trust under throw-back rules bear a non-deductible interest at 6 per cent per year, where the income of the trust has not been treated as the grantor's (IRC 667 and 668).

In Canada, a non-resident trust is subject to FAPI rules under which a Canadian taxpayer has to include his share in all "foreign accrual property income" (FAPI) of any "controlled foreign affiliate" in his income for tax purposes. A foreign trust is deemed to be a controlled foreign affiliate if a Canadian resident has a beneficial interest in it to the extent of at least 10 per cent. A non-resident trust which has a Canadian beneficiary or which has acquired property either from the beneficiary or any person related to him who had been resident in Canada for more than 5 years is treated as a resident of Canada if the distribution of its income or capital is subject to the discretion of the trustees.

The Foreign Tax Law in Germany (Aubensteuergesetz-AStG) has a special rule which attributes the income and assets of a non-resident family foundation established by a resident of the Federal Republic to the resident, vide, *Recourse to Tax Havens: Use and Abuse*, (1980). IFA, Proceedings of a Seminar held in Paris in 1980 during the 34th Congress of the International Fiscal Association, Kluwer.

16. In the UK, s. 451 of the Income and Corporation Taxes Act 1970 provides that where either the trustee of a settlement or a body corporate connected with the settlement pays any capital sum, makes a loan or repays a loan to the settlor or spouse, such amount should be treated as the income of the settlor to the extent that it falls within the amount of income available in the settlement upto the end of that or subsequent tax-years. See also IR v De Vigier (H/L 1964) 42 TC 25; McCrone v IR (1967) 44 TC 142; in re. Pott's Executors 32 TC 211; Bates v IR (H/L 1966) 44 TC 225.
17. The word, which has been in circulation for the last few years, reflects the gradual blurring of the distinction between "legal avoidance" and evasion.
18. Anantharam Veerasingaiah & Co. v CIT (1980) 123 ITR 457 (SC); CIT v Anwar Ali (1970) 76 ITR 696 (SC).
19. S. 2(22)(e) of the Income-tax Act.
20. IR v Buchanan (1958) 34 ITR 173 (CA); (1958) 37 TC 365; CWT v Smt Ansuya Sarabhai (1982) 133 ITR 108 (Guj); Palanivelu v Ouseph (1973) 1 MLJ 264 (Mad); CGT v Mrs Jar Merivis Lubimoff (1978) 114 ITR 90 (Bom).
21. IR v Leiner (1964) 41 TC 589; IR v Wachtel (1971) 46 TC 543; IR v Mills (1974) 49 TC 367; Crossland v Hawkins (1961) 39 TC 493; IR v Plummer (1979) 3 All ER 775; Arundhati Balkrishna v CIT (1976) 102 ITR 356 (Guj).

22. In the UK, the corporate trustees and banks file returns of income for the trusts that they administer. Non-professional trustees file returns in the area where they reside.
23. In the UK, every trustee is obliged to return full details of the trust income, including (a) gross income received during the year, (b) annual charges paid, (c) expenses incurred in administering the trust and (d) the distribution of income among the beneficiaries.
24. See n. 11, Chapter 9.