

Use of Trusts in Succession Planning



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Trust vehicles, which were earlier used purely as testamentary vehicles for distribution of assets on the demise of the testator, are now being advantageously used for managing and investing assets, securing the interests of the beneficiaries by providing asset protection and ensuring distribution of income and assets as per the desires of the settlor.

The Indian Trusts Act, 1882 defines a trust as being a legal obligation annexed to the ownership of property and arising out of a confidence reposed in the trustee by the settlor, for the benefit of the beneficiaries as identified by the settlor including / excluding the settlor himself. The person who reposes or declares the confidence is called the “author¹ of the trust”; the person who accepts the confidence is called the “trustee”. The person for whose benefit the confidence is accepted

is called the “beneficiary” and the subject matter of the trust is called “trust property”; the “beneficial interest” or “interest” of the beneficiary is the right against the trustee as owner of the trust property; and the instrument, if any, by which the trust is declared is called the “instrument of trust”.

The property in case of a trust is not transferred directly to the transferee but is put in control of the trustee for the benefit of the transferee. The trustee, depending upon the nature of the trust, either transfers the property or its earnings to the transferee at the happening of certain events or applies the property and /or its gains for the benefit of such a transferee.

SETTING UP A TRUST

A trust can be set up either as:

- (i) Revocable: A trust that can be revoked (cancelled) by its settlor at any time; or
- (ii) Irrevocable: A trust will not come to an end until the terms of the trust have been fulfilled; and either as a
- (iii) Discretionary: An arrangement where the trustee may choose, from time to time, who (if anyone) among the beneficiaries is to benefit from the trust, and to what extent; or
- (iv) Determinate: The entitlement of the beneficiaries is fixed by the settlor, the trustees having little or no discretion.
- (v) Combination Trusts viz: of (i) - (iii)/(iv), (ii)-(iii)/(iv)

A settlor may set up a revocable trust in order to exercise control over the assets and distributions of income and capital from the trust or an irrevocable discretionary trust in order to safeguard the assets against the claims of the creditors (actual and/or potential) of the settlor and/or the beneficiaries or multiple trusts to achieve various objectives. Indian trust law does not lay down restrictions with respect to a trust being set up with hybrid characteristics i.e. having

both, determinate and discretionary features for different classes of assets in the same trust or provide a specific format for the trust instrument. This flexibility allows a trust structure to be devised to suit the specific needs and requirements of the settlor and eliminates the need to create multiple trusts.

Unlike most common law jurisdictions, Indian trust law does not recognize duality of ownership viz: legal and equitable. The trustee is the legal and beneficial owner of the trust property and the beneficiaries merely have a beneficial interest in such property. Private trusts in India (of a non-religious character) set up for the maintenance and support of the settlor's family members, are also subject to the rule against perpetuity. This rule prescribes that a trust can be in existence for a period of 18 years from the date of death of the last existing beneficiary².

Reasons for Setting up of Trusts

In India, trusts are also being increasingly used for succession planning and asset distribution, since they are considered to be one of the preferred modes of managing and passing on the family assets in the most efficient manner. Creating a legal framework for the family assets, bypassing probate process, safe-guarding interests of family members including maintenance of members with special needs/disabilities, attaching conditions to gifts (be it on attaining a particular age or fulfillment of the settlor's wishes) and avoiding family disputes over the property being some of the prime considerations while designing a trust.

With large business houses in India being family-owned and controlled, a trust can serve as a bankruptcy remote protecting assets from creditor's (actual and potential) claims, provided the assets have been transferred two years prior to the bankruptcy being declared³. With managing and advisory committees being set up under the directions of the settlor, to monitor and advise

the trustees on application and management of the trust assets, Indian trusts are being used as tools to bring a relatively large pool of assets/ investments under one umbrella, which has more scope to perform well than a series of smaller pools. Exploiting offshore business opportunities, acquisition of interests and cross-border movement of family members have also triggered the need to create trust and like structures viz: onshore, offshore or hybrid.

The primary issues in setting up such an offshore/ hybrid structure arise in terms of Indian foreign exchange control compliances [Foreign Exchange and Management Act (FEMA)] and integrating that with the choice of appropriate jurisdiction.

Offshore trust, in an Indian context, means a trust formed outside India. While an Indian resident can remit funds abroad⁴ from India to set up an offshore trust, a settlement/ transfer of his offshore asset, being a capital account transaction, into an onshore/ offshore will require a prior approval from the regulatory authority viz: Reserve Bank of India (RBI)⁵. Restrictions have also been laid down in respect of transfer of certain classes of assets to an offshore trust viz: a non-resident (not being a non-resident Indian) is not permitted to own immovable property in India⁶. With respect to shares, restrictions may range from the quantum of equity being transferred in a listed company, which may trigger off the takeover code, to the extent of holding that a foreign transferee may acquire in the Indian company, which will be subject to sectoral caps as prescribed under FEMA⁷.

Apart from the regulatory considerations (as discussed hereinabove) and tax implications (discussed below), other important factors affecting the objectives for setting up a trust such as (i) the applicable statute of limitations governing fraudulent transfers; (ii) enforceability of asset protection trusts; (iii) credibility of the banking and administrative

services network, etc. also need to be taken into consideration. For example, if the trust is being set up with asset protection as its main objective, a jurisdiction with nil or reasonable limitation period would be most apt than one which may provide a high creditor protection period. Further, a trust created specifically for asset protection may not serve the purpose if the jurisdiction in which the trust has been set up does not recognize or adequately enforce asset protection laws against claims made by creditors.

Various permutations and combinations while charting out a structure for the flow of family assets can be explored, wherein onshore and offshore trusts (testamentary or inter vivos) can be created for separate assets, while certain assets can be passed on under a will. Provisions can also be made for allotting a portion of the assets to philanthropic purposes.

Having regard to both, clerical and tax implications, the best time to set up a trust is probably “as soon as possible”. There are quite a few advantages that can be availed of if the timing of setting up the trust and transferring the property. For eg.: in case of existing family assets (i) future earnings on those assets could be subject to lower tax; (ii) future capital gains tax on those assets could also be incurred at a lower tax rate; (iii) stamp duty and capital gains tax in respect of the assets being transferred into the family trust at its commencement are likely to be less than later on when these assets might have considerably increased in value; and (iv) in practice, the smaller number of individual holdings likely to be involved in such an early transfer would also be an administrative advantage. As managing a trust involves a learning curve, it is probably better to start off with a small operation than with a large one.

More generally in respect of assets acquired in the future, get the advantage of being in the trust as from the date of their acquisition. This applies both

to assets being built up gradually out of savings and to large one-off items such as inheritances, lottery winnings, damages, awards, etc. It applies equally to assets being acquired for their income potential and to those with capital growth prospects.

Assets acquired directly by a trust do not involve the stamp duty and capital gains



A trust is cancelled or extinguished in the following situations :

- (i) when its purpose is completely fulfilled;**
- (ii) when its purpose becomes unlawful;**
- (iii) when the fulfillment of its purpose becomes impossible by destruction of the trust property or otherwise; and**
- (iv) when the trust, being revocable, is expressly revoked.**

tax liabilities applying to assets which are acquired by another party in the first instance and then transferred to the trust only later on. Further, if the tax rules affecting trusts are ever changed by the authorities, then existing trusts may be able to keep some privileges not available to new trusts set up, or to assets acquired, after the date of the change. Also, assets transferred out of an individual's name well before any bankruptcy occurs cannot be clawed back by creditors.

Stamp Duty Of Trust

Stamp duty becomes payable on the settled property in a trust deed. The Trust Deed is required to be compulsorily registered if the Settlor has transferred any immovable property to the Trust. Under most State laws, public/charitable/ religious trusts are required to be registered.

Cancellation and Revocation of a Trust

A trust is cancelled or extinguished in the following situations: (i) when its purpose is completely fulfilled; (ii) when its purpose becomes unlawful; (iii) when the fulfillment of its purpose becomes impossible by destruction of the trust property or otherwise; and (iv) when the trust, being revocable, is expressly revoked.

A trust is revoked at the pleasure of the testator. A trust otherwise created can be revoked only (i) by consent of all the Beneficiaries (competent to contract); (ii) where the Trust has been declared by a non-testamentary instrument or by word of mouth - in exercise of a power of revocation expressly reserved to the settlor of the trust; or (iii) where the Trust is for the payment of the debts of its settlor and has been communicated to the creditors, by the settlor of the Trust.

Anti-Money Laundering

The legislation presently governing the prevention of money laundering in India is the Prevention of Money Laundering Act, 2002. This Act provides that whosoever directly or indirectly attempts to indulge/ knowingly assists/ is a party/ is actually involved in any process or activity connected with the proceeds of crime (i.e. property/ value of such property derived or obtained, directly or indirectly as a result of criminal activity) and projecting it as untainted property shall be guilty of offence of money laundering. The Act covers property of every description: corporeal, incorporeal, movable, immovable, tangible, intangible and includes deeds

and instruments evidencing title to, or interest in, such property or assets, wherever located and its transfer in the form of sale, purchase, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien. Any person committing an offence of money-laundering shall be punishable with rigorous imprisonment for 3 years extendable to 7 or 10 years and shall also be liable to fine which may extend to Rs. 500,000/-. Any property from the proceeds of crime under the Act may result into attachment of such property.

Taxation of Private Trusts in India

Trusts in India are fiscally transparent entities and the income of the trust is effectively taxed in hands of its beneficiaries. However, as envisaged under Chapter XV of the Income Tax Act, 1961 ("ITA"), the obligation to pay tax is on the trustee who does so in the capacity of a representative assessee⁸. The scope of this obligation extends to all income received by the trustee for the benefit of or on behalf of the beneficiaries to the trust. The trustee would be assessed to tax to the same extent that would be recoverable and levied upon the beneficiary⁹. Hence, the aggregate liability of the trustee cannot be greater than the aggregate liability of the beneficiaries¹⁰. At the same time, the trustee is entitled to recover the tax amount from the beneficiary¹¹.

The tax authority also retains the option of directly assessing the beneficiary to the trust in respect of its taxable income.¹² However, the taxation of the trustee as a representative assessee is primarily a matter of fiscal convenience and expediency. Therefore, the tax is imposed on the person who receives the income (that is, at the earliest point) although he may not be entitled to the ownership and enjoyment thereof.¹³

The assessment of the trustee as a representative assessee is distinct from the assessment of his personal income. The income received by the trustee is taxed in a manner as if such income

was directly received by the beneficiary. Therefore, the applicable rate of tax would depend on the type of income received on behalf of the beneficiary as well as the legal status of the beneficiary. If the beneficiaries are individuals, then the income received by the trustee would be taxed in accordance with the prescribed slabs applicable to the taxation of income received by an individual.¹⁴ But, if the beneficiary is a company, then such income would be taxed at the fixed rate applicable to companies.

If the income of the trust includes profits and gains of business or profession, then such income would be taxed in the hands of the trustee at the maximum marginal rate¹⁵. Likewise, any income received by a trustee under an oral trust (as opposed to a written trust) would be also be taxed at the maximum marginal rate. However, if the income arises from property contributed by the beneficiaries through a revocable transfer, such income would be taxable in the hands of the beneficiaries.¹⁶

With respect to discretionary trusts, where the income received by the trustee does not accrue to the benefit of a specific person or where the individual shares of the beneficiaries are indeterminate, such income would be taxable at the maximum marginal rate.¹⁷ However, this is subject to certain exceptions, for instance in the case of discretionary trusts declared by the last will of a testator, in which case the income would be taxable as if it accrued to an association of persons.

Therefore, while the manner in which the trust is organized would determine the applicable rates of tax, a trust, as such, is a pass-through entity, and although the income generated through the trust is taxable in the hands of the trustee, the burden of tax is effectively borne by the beneficiaries to the trust.

To conclude trust vehicles, which were earlier essentially being used purely as testamentary vehicles for distribution of assets on the demise of

the testator, are now being advantageously used for managing and investing assets, securing the interests of the beneficiaries by providing asset protection and ensuring distribution of income and assets as per the desires of the settlor. This can only be effectively achieved if the structure devised harmonises the strategic objectives of the settlor with the tax, regulatory and other aspects governing such trust structure.

¹ Commonly referred to as a 'settlor'
² Ajit Kumar Mitra v. Tarubala ILR 63 Cal 209
³ Section 53 of the Provincial Insolvency Act, 1920/ Section 55 of Presidency Towns Insolvency Act, 1909
⁴ Liberalised Remittance Scheme under which an Indian resident can remit upto USD 200,000 for any permitted current or capital account transactions or a combination of both
⁵ FEMA (Permissible Capital Account Transactions) Regulations, 2000
⁶ FEMA (Acquisition and transfer of immovable property in India) Regulations, 2000
⁷ FEMA (Transfer or issue of any security by a person resident outside India) Regulations, 2000
⁸ Section 160(1)(iv), ITA
⁹ Section 161(1), ITA
¹⁰ CWT v. Trustees of H.E.H Nizam's Family Trust, 108 ITR 555
¹¹ Section 162(1), ITA
¹² Section 166, ITA
¹³ CIT v. Fertilizers & Chemicals (Travancore) Ltd, (1987) 166 ITR 823 (Ker)
¹⁴ The rates range from around 10% in respect of income between Rs. 1,10,000 to around 30% in respect of income exceeding Rs. 2,50,000
¹⁵ Maximum marginal rate' means the rate of income tax (including surcharge) applicable in relation to the highest slab of income in the case of an individual, association of persons or, as the case may be body of individuals as specified in the Finance Act of the relevant year.
¹⁶ Section 61, ITA
¹⁷ Section 164(1), ITA