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Limit Family Trusts to your Family. Forever.

Snapshot

Private Family Trusts have emerged as being popular instruments for wealth & business succession planning globally due to their multi-faceted utility. And yet, taxation of private trusts in India is such that it has resulted into an ever-lengthening list of tax cases in the past.

Adding to this list, the recent decision of the Hon'ble Bengaluru ITAT in Buckeye Trust's case [Buckeye Trust v. PCIT, (ITA No.1051/Bang/2024 dt. 30-12-2024)] answers some of the essential questions pertaining to trust and gift taxation – Whether on settlement in a family trust with a potential to add non-relatives is subject to gift taxation under head 'other sources'? Whether interest in a partnership firm is subject to gift taxation as such?

Background & Context

Private family trusts are the most effective tools for wealth succession planning, especially for family businesses. This is because trusts provide wealth owners with a means to formalize governance within their family, ringfence their wealth, provide for their family members and see their 'wills' play out during their lives. Despite this commercial significance of family trusts, the taxation of such trusts is plagued with gaps and ambiguity. Buckeye Trust's case[1], decided by the Hon'ble Income-tax Appellate Tribunal (Tribunal), Bengaluru, comes in as a hard reminder of this fact. The present article attempts to explain the case and share a few thoughts on the subject.

The taxpayer was a private discretionary trust (the 'Trust') settled by Mr. AN (the 'Settlor') for the benefit of his family members. M/s. VMPL (the 'Trustee') was appointed as the trustee of the Trust. Mr. AN had settled two categories of assets in this Trust (the 'Trust Funds') – (i) his investment in unlisted shares (equity & preference) of a private company, and (ii) interest in multiple partnership firms (accordingly, the firms were reconstituted such that the Trust was introduced as a partner whereas the Settlor retired from these firms immediately after executing the deed of this Trust). The aggregate settlements amounted to INR 669 crores (approx.).

A nil return was filed for the Trust for the year in which the settlement was made. However, the Income-tax Department (the 'Revenue') contended that the amount of INR 669 crores is liable to be taxed as income in the hands of the Trust under the provisions of section 56(2)(x) of the Income-Tax Act, 1961 (the 'Act') for two reasons – (i) the Trust had received the Trust Fund without any consideration against the settlement and, (ii) the Trust had not been created solely for the benefit of the Settlor's relatives.

[1] *Buckeye Trust v. PCIT, (ITA No.1051/Bang/2024 dt. 30-12-2024)*

Arguments of the Parties & Findings of the Tribunal

Was the Trust created solely for the Settlor's relatives?

In order for Sec. 56(2)(x) to not apply in cases of family trusts, it is required for the trust to be "**created or established solely for the benefit of the relatives**"[2] of the settlor. Accordingly, it was contended on behalf of the taxpayer that the Trust had been created solely for the benefit of the Settlor's relatives as covered by the exceptions to the applicability of Sec. 56(2)(x). All the beneficiaries of the Trust were relatives of the Settlor. However, on a perusal of the deed of Trust, the Tribunal found that under the trust deed the Trustee possessed the power to add any person or charity as a beneficiary to the Trust. The Tribunal held that with such a provision, it was evident that the benefits of the Trust were not restricted to the Settlor's relatives alone.

Would interest in a partnership firm be hit by Sec. 56(2)(x)?

The taxpayer also contended that Sec. 56(2)(x) should not apply to the settlement of his interest in the partnership firms since these fell outside the scope of the list of properties which are covered by Sec. 56(2)(x). The Tribunal tested this contention and held that the definition of "property" covered "shares and securities" and, an interest in partnership firms should squarely fall within the meaning of "shares" as appearing in the said definition. To arrive at this conclusion the Tribunal took note of the following rationale –

a. In the phrase "shares and securities", the word "and" had to be read as "or" in view of the legislative intent. This, the Tribunal supported by referring to a bevy of judicial precedents.

b. Meaning of the term, securities' covers a wide variety of financial assets including shares of a company. If that is the case, then it follows that the legislature intended to give a different and a wider meaning to the term 'shares' which preceded the word 'securities' in the definition.

c. *What is that wider meaning of the term 'shares'*? It was held by the Tribunal that since the term 'shares' is not defined under the Act; we resort to the ordinary meaning of the word. According to the Tribunal, the term shares is not restricted to only shares of a company but is wide enough to mean 'a part or portion of something'.

d. *How would interest in partnership firms be covered by the term shares*? It was held, relying on various judicial precedents, that interest in partnership firm is nothing but a share in the partnership firm which refers to a proportion of ownership and also a right of the partners to participate in the management of the firm.

The Tribunal thus concluded that an interest in partnership firm is also be caught by the tentacles of Sec. 56(2)(x).

Settlement was without consideration?

Sec. 56(2)(x) only applies in cases where the property is received by a person for no consideration or inadequate consideration. The taxpayer contended that the property was received by the Trustee as against a simultaneous fiduciary obligation imposed on it by the law[3]. Assumption of such obligation by the Trustee is sufficient consideration against the receipt of Trust Funds. It was also contended that the Trust cannot enjoy the receipt as an owner via the Trustee. Both these contentions were rejected by the Tribunal.

Basis the aforementioned rationale, the Tribunal held that (a) a settlement in a trust which only has family beneficiaries today but has a potential to have non-family beneficiaries shall attract Sec. 56(2)(x) liability, and (b) interest in partnership firm is a covered property and Sec. 56(2)(x) applies on undervalued receipt of such asset.

[2] *Clause (X) of the first proviso to Sec. 56(2)(x)*

[3] *Refer Sec. 3 of the Indian Trusts Act, 1882 (definition of the term "trust")*

KCM Comments

Impact of this decision

This is a particularly woeful decision for the taxpayer pursuant to the fact that it significantly widens the reach of Sec. 56(2)(x) on two fronts – (i) the current existence of a non-relative as a beneficiary is irrelevant in testing the exception pertaining to trusts but what matters is the mere possibility of non-relatives being added as beneficiaries in the future; (ii) the wider meaning given to "shares" as appearing in Sec. 56(2)(x)(c) is likely to lead to a significant expansion in the list of properties hit by Sec. 56(2)(x)(c).

Hints for drafting Family Trust Deeds

The Tribunal upheld the invocation of Sec. 56(2)(x) because of (inter alia) the power possessed by the Trustee to add 'any person or charity' as a beneficiary of the Trust in future. With this it was concluded that the Trust was not solely for the benefit of the Settlor's relatives. While the counsel for the taxpayer tried to argue that it was never the Settlor's intent to introduced non-relatives in the Trust which is also corroborated by the current facts (i.e., only family members were beneficiaries as on date), it was met by flat rejection by the Tribunal which focused on the language used in the Trust deed.

The moral of Buckeye Trust's story for the professionals is this: ensure that the family trust deeds clearly and explicitly state that power of adding beneficiaries to the trust (if any) shall be limited to addition of only those persons who are relatives of the Settlor as defined u/s 56[4].

Musings on the Tribunal's observations – Trusts and 56(2)(x)

The Tribunal may have answered some questions, but the answers only seem to lead us towards a fresh batch of questions. As explained earlier, due to the power to add any person as beneficiary featuring in the trust deed it has been concluded that Sec. 56(2)(x) should apply on a case where there is a potential for non-relative beneficiaries to be added to the benefits of the private trust. In light of this decision, what would happen if the deed provided that only relatives as defined u/s 56 can be added as beneficiaries but the trustee possesses an unfettered right to amend the deed of trust which he may use to add any person as a beneficiary? In such a case can it be said that such trust is created solely for the benefit of relatives? If yes, how would this be any different from the case in question?

An important contention which although raised by the taxpayer appears to have been summarily rejected by the Tribunal. The fundamental requirement for Sec. 56(2)(x) to apply is inadequacy of consideration flowing from the recipient of property. Where it is a case of settlement in trust, what is the consideration flowing from the recipient i.e., the trustee? *From Keshub Mahindra's case*[5] we find that since the term 'consideration' has not been defined in the Act, reference may be made to Sec. 2(d) of the Indian Contract Act, 1872. We see that the term consideration has been defined widely and covers *a promise to do something as well as a promise to abstain from doing something*, which indicates that one should not confine the scope of this term to only monetary consideration. The Hon'ble Kerala High Court in Smt. K. Nagammal's case[6] as supported this argument. As per the Indian trust law, trust itself has been defined as an obligation which is assumed by the trustee in favour of the settlor to be bound and act as per the deed of trust. One may still question the adequacy of such consideration. However, the Tribunal has concluded that there was a complete absence of consideration in this case since there was no money flowing to the settlor. Based on these arguments, the Tribunal's conclusion appears to be one which some of us may find difficult to digest.

What fascinates one is the laser focus of the Tribunal as well as the arguing counsels on the exemption relating to the trusts[7]. An alternative line of argument may also

[4] *Section 56(2)(x) read with Clause (e) to Explanation u/s 56(2)(vii)*

[5] *Keshub Mahindra v. CGT [1968] 70 ITR 1 (Bom.)*

[6] *CGT vs. Smt. K. Nagammal [1997] 226 ITR 598 (Kerala)*

[7] *Clause (X) of the first proviso to Sec. 56(2)(x)*

be evaluated. Accepting the premise that the exemption relating to trusts is unavailable in this case and that interest in partnership firm is covered property for Sec. 56(2)(x), one may still be able to argue that this is a case of property being transferred/received inter-se among the individual and his relatives only. Hence, it would be outside the purview of Sec. 56(2)(x). This proposition may be countered by the fact that the legal ownership of the trust property passes from the settlor to the trustee and in this case, the trustee was clearly a non-relative since it was a corporate trustee. Thus, it was not a case of inter-se transfer among relatives. To this, we may inquire as to who are the real owners of the property held in trust? It has been held by a plethora of judicial authorities, including the decision of Hon'ble Bombay High Court in *Bai Hamabhai J. K. Mehta's case*[8], that beneficiaries are the real owners of the trust property. If that be the case, one could possibly argue that the beneficiaries were the real recipients of the Trust Funds thereby making this transaction an inter-se transfer among relatives hence not attracting Sec. 56(2)(x).

Musings on the Tribunal's observations – Partnership firm interest and 56(2)(x)

Then there is the observation pertaining to the inclusion of interest in partnership firm as covered property for Sec. 56. We see that the term "shares" has been understood in its widest possible sense by the Tribunal. They say, "*Shares can be used more broadly to mean a part or portion of **something**. For instance, sharing refers to dividing or giving out of **something** among several people.*" But what is this 'something' which has been referred to. Does it mean that Sec. 56 would cover a part of anything, any property? If yes, then does it mean that gifting an entire machine would not lead to Sec. 56 but gifting of a part ownership or 'share' in such machine would attract Sec. 56? This surely is absurd.

Another point which we may ponder upon if we accept the idea that interest in partnership firm is a covered property which attracts Sec. 56(2)(x)(c), is the question of measuring adequacy of consideration for the purpose of Sec. 56(2)(x). This aspect has been left untouched in this case. The valuation mechanism for this purpose is prescribed under Rule 11UA of the Income-Tax Rules, 1962 (the 'Rules'). Interest in partnership firm would fall under the residuary provision housed under Rule 11UA(1)(c)(c) which is reproduced hereunder –

"*the fair market value of **unquoted shares and securities other than equity shares in a company** which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of such valuation.*"

From above, we see that the phrase "shares and securities" is qualified by the word "unquoted". The terms "quoted shares and securities" and "unquoted shares and securities" are defined under Rule 11U(d) and (i), respectively. In summary, the terms are defined to mean a share or security quoted on any recognized stock exchange, and not quoted on any recognized stock exchange, respectively. Hence, the Rules appear to cover only those shares and securities which are capable of being quoted. It is a well-known fact that an interest in partnership firm can never be quoted on any Indian stock exchange and hence, in absence of the valuation mechanism the charge would fail in such case[9].

If we say that the term 'shares' covers only shares in a company, then how do we reconcile this with the proposition that the term securities already include such shares in a company[10]? This is important because it is a fundamental principle of interpreting statutes that as far as possible all words appearing in the law

[8] *Bai Hamabhai J. K. Mehta v. CIT [1948] 16 ITR 115 (Bom.); Mrs. Amy F. Cama v. CIT [1999] 237 ITR 82 (Bom.); Peter Luis Estate v. WTO [1984] 10 ITD 72 (BOM.); Abad Trust vs. ADIT [2018] 171 ITD 50 (Cochin - Trib.); Lord Macnaghten in Heritable Reversionary Co. Ltd. v. Miller [1892] AC 598 (HL) as affirmed by the Supreme Court in CWT v. Trustees of H. E. H. Nizam's Family (Remainder Wealth) Trust [1977] 108 ITR 555 (SC)*

[9] *CIT v. B.C. Srinivasa Setty [1981] 128 ITR 294 (SC)*

[10] *Ordinary meaning of securities would not include shares but Rule 11U(h) defines securities to have the same meaning as that in Sec. 2(h) of the Securities Contracts (Regulation) Act, 1956 (SCRA)*

must be given meaning and the legislature is not assumed to waste words in drafting a statute (whatever may be the reality). To this end, we must evaluate whether shares of all kinds of companies are covered within the scope of the term "securities" as defined in Sec. 2(h) of the SCRA? Interestingly, the answer to this can be No. As per this theory the definition of securities only covers the shares of public companies and not those of private companies[11]. Hence, one may contend that the legislature intended to cover shares of private companies under Sec. 56(2)(x) and that is the reason why they have used the words "shares and securities".

[11] *Refer Dahiben Umedbhai Patel & Ors vs Norman James Hamilton & Ors [1985] 57 COMP CASE 700 (BOM) affirmed by the SC in Bhagwati Developers (P.) Ltd. v. Peerless General Finance & Investment Co. Ltd. [2013] 179 COMP CASE 421 (SC)*

Conclusion

Bringing a shocking conclusion to 2024, Buckeye Trust's case has gathered fame overnight especially among Indian tax professionals. The questions and arguments raised in this article form only a small part of the swarm of questions which would have arisen in the many fertile minds of our country. This decision endorses the precautionary practice of excluding non-relatives as potential beneficiaries in trust deeds, bringing a smile to the faces of professionals like us, who have been hitherto adding such protections – just in case. At the same time, it also pumps immense power into the language of Sec. 56(2)(x) of the Act which may prove to be a litigation-generator for the times to come. All we can do now is to wait and watch how things unfold with the superior judicial fora.

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For further analysis and discussion, you may please reach out to us.

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