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Taxation of Offshore Discretionary Trust – *The Legal Position Instituted by the Supreme Court*

INTRODUCTION

Recently the Apex Court in the matter of Estate of Late HMM Vikramsinhji of Gondal, has explained and adjudicated in the matter of Discretionary Trust and has reiterated the primary basis for difference in taxation of discretionary trusts versus determinate (or specific) trusts in respect of an offshore trust.

What is a discretionary trust?

A Discretionary trust is one where the specific shares of the beneficiaries are not known. That is, the trustee has the discretion to decide, from time to time, who (if anyone) among the beneficiaries is to benefit from the trust, and to what extent. In a determinate trust, the entitlement of the beneficiaries is fixed by the settlor, the trustees having no discretion in determining the amount of distributions to be made to the beneficiaries. The Income Tax Act, 1961, governs the taxation aspect and as per the existing statutory position the income of a discretionary trust is taxed in the hands of the trustee while the income of a determinate trust may be taxed either in the hands of the beneficiary or of the trustee in his capacity as the representative assessee. If it is the latter, the taxation in the hands of a trustee must be in the same manner and to the same extent that it would have been levied on the beneficiary. That is, the trustee would generally be able to avail all the benefits/deductions, etc. available to the beneficiary with respect to that beneficiary's share of income.

THE DISPUTE

In order to determine whether the income was taxable to income tax in the hands of the Taxpayer, the key question to be decided was the nature of the trusts as distinct from the terms of the trust deeds. In the trust deeds in question, the interpretation of two clauses was in dispute.

Clause 3(2) provided that the Trustees shall hold the Trust Fund and income upon trust for the

Beneficiaries for their advancement and maintenance and education at the discretion of the Trustees or of any other persons as the Maharaja shall appoint at any time during the specific period provided always that such power of appointment shall not be capable of being exercised: (a) by anyone other than the Settlor or his elder son or younger son; or (b) in favour of the person making the appointment save with the consent of the Trustees (being at least two in number or a trust corporation) such consent to be testified by their being parties to the deed of appointment and executing it.

Clause 4 provided that, subject to Clause 3, the Trustees shall hold the Trust Fund and income upon trust under certain terms, being that: (a) income of the Trust Fund accruing during the life of the Settlor shall belong and be paid to the Settlor; and (b) subject to the above, income of the Trust Fund accruing during the life of the elder son shall belong and be paid to the elder son. There were similar additional conditions regarding the younger son and descendants of the elder and younger sons.

CONTROVERSY

The trusts were discretionary in nature and income of these trusts was liable to tax in the hands of the trustees alone and not the beneficiaries and that the statement of funds and income account of the trusts indicated that the trustee retained the net income of the trusts and brought it forward from year to year. The trustee had clearly exercised discretion and not disbursed any amount to the Beneficiaries. More over the trust deeds did not prescribe any time limit within which an additional trustee had to be appointed. The trust had already come into existence with the appointment of the foreign national as the sole trustee. Creation of the trust did not depend on appointment of additional trustees under Clause 3



and also that the Income of the UK trusts was not received or earned in India. Neither did it arise or accrue in India since the Beneficiaries' right to receive had not been established.

JUDGEMENT

The Supreme Court upheld the decision of the Gujarat High Court that the trusts were discretionary. The Gujarat High Court had noted that the Settlement Commissions order and the Supreme Courts decision were not binding on the present appeals due to different facts. In contrast to the previous round of litigation, the Taxpayer here did not admit to having received the income; he did not receive the income and he had not shown the income as taxable in his returns.



The Gujarat High Courts reasoning (as listed below) was upheld by the Supreme Court:

- The UK trusts were discretionary trusts. The trusts' income should not be includible in the Taxpayers income for levying income tax since the trusts' income was retained in the trusts and not disbursed to the beneficiaries;
- Mere failure of the Settlor or the Taxpayer to appoint additional trustees did not change the essential nature of the trusts as discernible from the terms of the trust deeds;
- For the same reasons, the value of the trusts' assets could not be includible in the estate of the deceased Settlor for the purpose of wealth tax.

CONCLUSION

This judgement highlights that both trustees and beneficiaries must take steps to clearly identify the nature of the distributions. Trustees must keep separate accounts for income and capital, clearly record when amounts are disbursed from the corpus and the purpose of the distribution. Similarly, it may also be helpful for beneficiaries to keep separate accounts for receiving income and capital disbursements from the trust, and in communications with the trustee to clearly indicate the right under which the beneficiaries claim the funds. The vital takeaways from this judgement of Apex Court are –

Supreme Court reiterates the principle that income of a discretionary trust cannot be taxed in the hands of a beneficiary unless distributed to the beneficiary.

Where trustees have clearly retained the income of the trust and brought it forward year to year without disbursing it to the beneficiaries, the trust is discretionary.

Fallout of this judgment (although not raised in this dispute) is the uncertainty it creates on the taxability of capital/corpus distributions to beneficiaries.

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