

# ***Income earned by a fund set up as a revocable trust to be taxed only in the hands of the beneficiaries as per the provisions of sections 61 to 63***

November 5, 2014

## ***In brief***

In a recent decision, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of **India Advantage Fund-VII** [ITA No. 178/Bang/2012] (the fund or the trust) held that in the case of a revocable trust, income had to be taxed in the hands of the beneficiaries of the trust and not in the hands of the trustee in the capacity of a representative taxpayer.

It also held that for a trust to be a determinate trust, it would be sufficient if the trust deed laid down that the beneficiaries would be the persons who had made, or had agreed to make, contributions to the trust in accordance with the contribution agreement, and their shares were capable of being determined based on the provisions of the trust deed.

Lastly, it held that the fund could not be regarded as an Association of Persons (AoP) as the beneficiaries had not set up the trust; they had not come together with the object of carrying on investment in a mezzanine fund, which was the object of the trust; and there was no *inter se* agreement between the beneficiaries of the fund.

## ***In detail***

### ***Issues before the Tribunal***

- Whether the trust was a revocable trust?
- Whether the trust was a determinate trust?
- Whether the trust could be regarded as an AoP?

### ***Tribunal's ruling***

#### ***Revocability of the Trust***

The Tribunal held that sections 61 to 63 of the Income-tax Act 1961 (the Act), would apply, on the following reasoning:

- the contribution agreement had to be read along with the trust deed

as well as the investment management agreement and the offer document.

- the prospectus inviting contributions from the contributors clearly laid down that in certain circumstances, 75 per cent of the contributors could revoke their contributions to the fund at any point in time, and the trustees should then terminate the fund.
- though the power of the transferor/ beneficiary to revoke the transfer was not in the instrument of transfer, but by virtue of power conferred in the document by which the

investment manager was appointed by the trust by virtue of powers conferred under the trust deed, would be sufficient to conclude that the transferor/ beneficiary had deemed power of revocation.

The Tribunal also held that:

- As per section 61 of the Act, it was not necessary that the power of revocation should be at the instance of the transferor/ beneficiary, but could be at the instance of any person either settlor, trustee, transferee or the beneficiaries. The power of revocation under the trust

deed was a general power of revocation, and the same would be sufficient for construing the transfer in the present case as a revocable transfer.

- Section 61 read with section 63 of the Act, which mandated that income arising to a person by virtue of a revocable transfer of assets should be chargeable to income-tax as the income of the transferor, would apply in the present case.
- Even if a settlement on the face of it was stated to be irrevocable, if the same provided for the direct or indirect re-transfer of income or assets of the settlement to the settlor or gave the settlor a right to resume power directly/ indirectly over such income or assets, the settlement would be deemed to be revocable.

#### *Determinate status of the trust*

The Tribunal held that it was a determinate trust, and that the provisions of section 164(1) of the Act did not apply, on the following facts:

- The trust deed clearly laid down that beneficiaries meant the persons, each of whom had made or agreed to make, contributions to the trust in accordance with the contribution agreement.
- The trust deed clearly specified the manner in which the income had to be distributed.

The Tribunal also held that:

- It was enough if the shares were capable of being determined based on the provisions of the trust deed, and it was not necessary that the beneficiaries should be specifically named in the trust deed.

- The beneficiaries as well as their shares must be capable of being definitely pin pointed and ascertained on the date of the trust deed itself, without leaving these to be decided upon at a future date by a person other than the author.
- Even if the trust deed authorised addition of further contributors to the trust at different points in time in addition to the initial contributors, the same would not make the beneficiaries unknown or their shares indeterminate.

#### *Trust being regarded as an AoP*

The Tribunal held that the trust was not an AoP, on the following reasoning:

- the beneficiaries had not set up the trust;
- the beneficiaries contributed money to the trust under separate agreements, and there was no *inter se* arrangement between either of the beneficiaries;
- it could not be said that two or more beneficiaries joined in for a common purpose or common action;
- therefore, they could not be regarded as an AoP.

The fact that the trust had its PAN under the status of an AoP was irrelevant.

The fact that the trust filed the return of income as an AoP/ BoI was irrelevant.

#### *Other points discussed by the Tribunal*

The Tribunal also held that once the choice was made by the department to tax either the trust or the beneficiaries, it was no more open to the department to go behind and assess the other at the same time.

#### *The takeaway*

This is a welcome decision in the area of taxation of trusts, and should be very relevant and useful to the domestic alternative asset management industry. While the Tribunal has not dealt with Circular No. 13/2014, dated July 28, 2014, issued by Central Board of Direct Taxes, in the context of taxation of the trusts (other than holding that the circular was not applicable to the facts of the present case), the position laid down in the decision should have a persuasive value even while interpreting the Circular.

Having said this, the decision has not explicitly dealt with the conflict between section 61 and section 161 of the Act, and their overriding effect.

In any case, we think that the Government should extend the benefit of the provisions of section 10(23FB) of the Act, to all forms of alternative funds. This could be a step in reducing litigation.

#### *Let's talk*

For a deeper discussion of how this issue might affect your business, please contact:

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