

### ***Determinate status of the trust not to be affected if trust deed is capable of identifying the beneficiaries and determining their respective shares***

#### **Background**

The taxation of domestic Venture Capital Funds (VCFs) and Alternative Investment Funds (AIFs) has undergone various changes over the years. Currently, VCFs<sup>1</sup> and Category I/ II AIFs<sup>2</sup> have been granted tax pass through status under the Income-tax Act, 1961 (the Act) in relation to specified income. Such income is directly chargeable to tax in the hands of the beneficiaries/ investors<sup>3</sup>.

In certain cases, the tax pass through status is not available to such Funds (generally set-up as contributory trusts), in which case they are governed by normal trust taxation principles set out under the Act, whereby the trustee of the Funds (set-up as a trust) are assessable in the capacity of a representative assessee. Some of the cases are provided as under:

- Category III AIFs
- Category I/ II AIFs (in past years when tax pass through status was not available)
- VCFs (for non-specified income)
- VCFs (in past years when the tax pass through status was limited to investment income from investments in specified sectors)

In the above cases, it is critical that the Fund (set-up as a trust) qualifies as a determinate trust, so that tax levied in the hands of the trustee is in the like manner and to the same extent as it would be leviable upon the beneficiaries.

In case where the Fund is treated as 'indeterminate trust', it could get taxed under section 164(1) of the Act, which provides for taxation at maximum marginal rate under certain circumstances.

Explanation 1 to section 164 of the Act provides that for a trust to be determinate, (i) the beneficiaries should be expressly stated and identifiable as on the date of the trust deed; and (ii) their individual shares should be expressly stated and ascertainable as on the date of the trust deed.

In this connection, it may be noted that the Authority for Advance Ruling<sup>4</sup> held that if the trust deed sets out expressly the manner in which the beneficiaries are to be ascertained and also the share to which each of them would be entitled without ambiguity, then it cannot be said that the trust is indeterminate.

However, the Central Board of Direct Taxes issued Circular No. 13/2014, dated 28 July, 2014, wherein it had stated that in a situation where the trust deed either does not name the investors or does not specify their beneficial interest, the provisions of section 164(1) of the Act would apply and the entire income should be chargeable to tax at maximum marginal rate in the hands of the trustee in their representative capacity.

#### **In brief**

In a recent decision, the Karnataka High Court in the case of the Trust<sup>5</sup>, upheld the decision of the Bangalore Income-tax Appellate Tribunal and 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.

#### **In detail**

##### *Issue before the Karnataka High Court*

Whether the Tribunal was right in holding the Trust as a determinate trust and not assessing the Trust at the maximum marginal rate as per section 164(1) of the Act?

## **High Court's ruling**

The High Court upheld the decision of the Tribunal on the following principles:

- All that is necessary is that the beneficiaries should be identifiable based on the provisions of the trust deed, and it was not necessary that the beneficiaries should be specifically named in the trust deed. In the present case, 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.
- It is not necessary that the trust deed should actually prescribe the percentage share of the beneficiaries in order for the trust to be determinate. It is enough that the share of the beneficiaries is capable of being determined based on the provision/ formula as on the date of the trust deed and not at the discretion of the trustee. In the present case, the trust deed clearly specified the manner in which the income had to be distributed.
- If the trust deed authorises 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.

The Revenue had also raised other questions before the High Court, but since the above question of law was held in favour of the assessee, other questions did not arise.

## **Key takeaways**

This is a welcome decision in the area of taxation of contributory trusts, and should provide relief to the domestic fund industry.

While Circular No. 13/2014 mentioned above in the context of taxation of the trusts has not been discussed in the present case, this High Court decision would have a binding effect on all tax Tribunals until any other High Court or Supreme Court takes a different view on this matter.

<sup>1</sup> Section 10(23FB) of the Act

<sup>2</sup> Section 10(23FBA) of the Act

<sup>3</sup> Section 115U and Section 115UB of the Act

<sup>4</sup> 224 ITR 473 (AAR)

<sup>5</sup> India Advantage Fund-VII ITA No. 191/2015

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