Private Trusts in Indian Family Businesses

Legal, Tax, and Regulatory Insights

Introduction

India has long maintained a family-run economy, wherein families operate large, medium, and small enterprises with notable success. These businesses not only generate substantial employment but also yield considerable returns for stakeholders. Many such corporations are publicly listed, thereby enabling the general public to participate in their profits.

Over the past few decades, families have accumulated significant wealth, rendering succession planning a critical issue for family patriarchs. In many instances, the protection of wealth takes precedence over the pursuit of higher profits. Consequently, succession planning encompasses both the economic transfer of family assets (including financial and business assets) and the management transition-whether to family members or professional managers.

Effective estate and wealth planning ensures that families maintain control over their enterprises while facilitating a seamless leadership transition across generations. It strikes a judicious balance between the operational needs of the business and the interests of the family members. Moreover, astute wealth planning for high-net-worth individuals can prevent protracted and expensive legal disputes among heirs, particularly when they are situated in multiple jurisdictions. Various legal structures afford differing levels of control over the use and purpose of wealth, with the private family trust being one of the most prevalently employed mechanisms for managing personal assets-including both tangible and intellectual property-and for succession planning.

This insight focuses on estate and wealth succession through the mechanism of a Private Trust.

Private Trust

A private trust is governed by the provisions of the Indian Trust Act, 1882 ("Trust Act"). In contrast, trusts of a public character are regulated by the relevant State Public Trust Act (for example, the Bombay Public Trust Act, 1950, or the Punjab Trust Act, 1950). Under the Trust Act, a trust is defined as "an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared or accepted by him, for the benefit of another, or of another and the owner."

IN A TRUST ARRANGEMENT:

- The individual who reposes or declares the confidence (commonly referred to as the "settlor") is the author of the trust.
- The individual who accepts the confidence is the trustee.
- The person for whose benefit the confidence is accepted is the beneficiary.
- The subject matter of the trust is termed the "trust property."
- The beneficiary's "beneficial interest" or "interest" is the right against the trustee as the owner of the trust property.
- The document by which the trust is declared is known as the "instrument of trust" (commonly referred to as the "trust deed" or "indenture of trust").

A PRIVATE TRUST OFFERS SEVERAL ADVANTAGES:

- It provides an efficient mechanism for managing and transferring family assets by establishing a clear legal framework.
- It circumvents the probate process, thereby avoiding potential frivolous claims and judicial delays.
- It safeguards the interests of family members, including those with special needs or disabilities.
- It permits the attachment of conditions to gifts (e.g., reaching a certain age or fulfilling specific wishes of the settlor).
- It minimizes the risk of family disputes over property.
- It facilitates the structuring of business succession-potentially balancing merit and family control-and can support philanthropic endeavors.

Additionally, a trust structure may incorporate a Protector and/or a Trust Advisor. The Protector, typically a trusted individual known to the family, advises the trustee in various circumstances, ensuring that the family's perspectives are duly represented, particularly when the trustee is a non-family member, institution, or private trust company. Notwithstanding, ultimate decision-making authority generally rests with the trustee or, in certain cases, with the settlor, contingent upon the trust's structure.

Trusts may be established either through non-testamentary documents or by means of testamentary instruments such as wills. A trust designed to hold immovable property must be executed by a duly registered trust deed, whereas a trust intended solely for movable property may be constituted via a document (registered or otherwise) or even by an oral agreement accompanied by the necessary delivery of property and instructions to the trustee.

Any individual competent to contract may create a trust for any lawful purpose, choosing among various forms:

Revocable: A trust that the settlor may cancel at any time during his lifetime;

Irrevocable: A trust that remains in effect until its term or purpose is fulfilled;

Discretionary: An arrangement in which the trustee has the discretion to decide which, if any, of the beneficiaries will benefit and to what extent;

Determinate: A trust wherein the beneficiaries' entitlements are fixed by the settlor at the time of establishment or determined by a specified formula, leaving little or no discretion to the trustees; and

Combination Trusts: Trusts that integrate elements of the above types.

For succession planning, a Private (non-testamentary) Trust-whether specific or discretionary in nature-is typically employed during the lifetime of the settlor. Key considerations when structuring such a trust include:

- An unequivocal expression of intent by the settlor to create a trust.
- A clear and precise definition of the trust's objectives, enabling the trustee to execute the settlor's intentions without ambiguity.
- A detailed specification of the beneficiaries.
- An irrevocable transfer of identifiable property, ensuring that the settlor relinquishes ownership and any beneficial enjoyment of the property's income.
- A comprehensive delineation of the trustee's powers and responsibilities, which may include managing daily operations, distributing income, amending the trust deed, adjusting beneficiary designations, contributing to charitable causes, or modifying the trust's term.

Prior to implementing estate and wealth planning, it is imperative to consider various tax, commercial, and regulatory implications to safeguard the transferred assets' value for future generations. These considerations are discussed in the following sections.

1. Income Tax

1.1 Taxation of Private Trusts

The taxation of private trusts is inherently complex. Despite numerous rulings, including those from the Supreme Court, several issues remain unsettled. Under the Income-tax Act, 1961 ("Act"), a private trust is not regarded as a separate taxable entity. Section 2(31) of the Act, which defines "person," excludes trusts from its purview, meaning that a trust is not classified as an assessee.

In a trust arrangement, the trustee is the legal owner while the beneficiary holds the beneficial ownership. Under the Act, both parties are considered assessees, and the trustee is taxed in a representative capacity, mirroring the tax liability of the beneficiary. For instance, in CIT v. Food Corpn. of India, Contributory Provident Fund Trust [2009] 177 Taxman 224/318 ITR 318, the Hon'ble Delhi High Court determined that a trust with individual beneficiaries should be treated analogously to an individual with respect to Section 194A of the Act. Provisions related to trust taxation are detailed in Sections 161–164 of the Act.

Irrevocable Determinate (Specific) Trust:

In this configuration, beneficiaries are clearly identifiable and their respective shares are fixed. A trustee acting as a representative assessee is taxed in the same manner and to the same extent as would be applicable directly to the beneficiary. It is not mandatory for the trust deed to enumerate every beneficiary by name; rather, it must unambiguously outline the method for calculating each beneficiary's interest. Judicial authorities, including the Authority of Advance Ruling in In re Companies Incorporated in Mauritius [1996] 89 Taxman 125/[1997] 224 ITR 473, and decisions from the Hon'ble High Courts of Madras and other forums, have affirmed that such clarity in the trust deed is sufficient to render the trust determinate.

Irrevocable Discretionary Trust:

In a discretionary trust, the income is not allocated to any one beneficiary, and individual shares remain indeterminate. Trustees possess the discretion to distribute portions of the trust's income as they see fit, subject to the guidance provided in the trust deed. In such cases, the tax is generally levied at the maximum marginal rate.

Revocable Trust:

A transfer is deemed revocable under the Act if it contains provisions allowing for the re-transfer of income or assets back to the transferor, or if it grants the transferor the power to reassume control over such assets. In such instances, the trust is disregarded for tax purposes, and income is taxed as if it were directly earned by the settlor. Accordingly, income arising from a revocable trust is taxable solely in the settlor's hands.

1.2 Taxation of the Settlor

Trusts facilitate "split ownership," where the trustee is the legal owner and the beneficiary is the beneficial owner. When assets are transferred to a private trust, ownership passes from the settlor to the trustee. The tax implications of this transfer depend on whether the trust is revocable or irrevocable. Section 47(iii) of the Act exempts the settlor from capital gains tax on transfers to an "irrecoverable" trust. Conversely, if the trust is revocable, the exemption does not apply; the transfer becomes subject to capital gains tax, and clubbing provisions may further render the income taxable in the settlor's hands. Section 47(iii) also covers transfers under a will, suggesting that testamentary trusts may also benefit from the exemption.

1.3 Taxation of Beneficiaries under Section 56(2)(x)

When property is settled in a trust, it is treated as a gift under Section 56(2)(x) of the Act, which mandates that any property received without adequate consideration is considered income of the recipient. However, this section includes exceptions, notably when the trust is established solely for the benefit of the settlor's relatives. It should be noted that this exemption may not apply if the settlor is also a beneficiary; further clarification on this point may be warranted.

1.4 General Anti-Avoidance Rule (GAAR)

One significant advantage of establishing a private trust is that the settlor may indirectly exercise influence over the trust's decisions through the trust deed, despite not retaining direct control over the assets. Consequently, the creation of a private irrevocable trust for asset protection or family reorganization may attract scrutiny from tax authorities. Nonetheless, CBDT FAQ No. 3 of Circular 7 dated 27 July 2017 clarifies that the choice of entity for such arrangements is at the discretion of the assessee and does not, in itself, invoke GAAR.

2. Stamp Duty

Stamp duty is imposed under the Indian Stamp Act, 1899. Although this Act is central legislation, individual states may adopt it with modifications. Since stamp duty is levied on the instrument of transfer, the location of the transfer is a critical determinant in the calculation of the duty.

3. SEBI Takeover Code Regulation

The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 apply when a share acquisition exceeds 25% of a company's share capital. Under these regulations, the acquirer must make an open offer to existing shareholders for at least 26% of the shares, at a price determined by a prescribed formula. However, certain exemptions exist-such as "inter se transfers between promoters." Promoters may also apply to SEBI for an exemption from the open offer requirement by submitting an application under Rule 11, as opposed to solely relying on the exemption provided in Rule 10. Precedents indicate that SEBI may grant such exemptions subject to conditions, including no material change in ownership, control, or voting rights, and the obligation to notify relevant stock exchanges regarding any changes.

4. Foreign Exchange Regulations

In today's globalized environment, it is not uncommon for Indian residents to hold assets abroad and for foreign residents to own assets in India. An overseas trust may be established by a resident who owns a foreign asset for the benefit of either resident or non-resident beneficiaries. Similarly, a trust in India may include non-resident beneficiaries. It is imperative that if a resident is a beneficiary of an overseas trust, the interest must be disclosed in the Indian income tax return; failure to do so may invoke the provisions of the Black Money Law. Although FEMA does not specifically regulate trusts, asset transfers under a trust are generally classified as "capital account transactions" under Section 2(e) of FEMA. However, further clarification from the Reserve Bank of India on this matter would be beneficial.

5. Estate Duty/Inheritance Tax

Estate duty, once levied on the transfer of assets upon an individual's death, was abolished in India in 1985. At its peak, the duty could reach rates as high as 85% of the inherited asset's value. Since its abolition, neither estate duty nor inheritance tax has been imposed. While there has been ongoing speculation regarding the potential reintroduction of estate duty, current economic and business conditions suggest that any reintroduced rates would likely be lower than those of the past. Additionally, wealth tax has also not been applicable for several years.

Conclusion

In conclusion, effective succession planning is essential for the preservation and smooth transition of family wealth. Unplanned succession may lead to both the dilution of wealth and the emergence of familial conflicts. The trust mechanism, as outlined above, represents a robust and well-established method for safeguarding assets, ensuring flexibility, and facilitating an orderly transfer of wealth to subsequent generations.