Taxation of Trust – Part 4

SUCCESSION PLANNING SERIES #28

Special provisions for discretionary trusts

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A discretionary trust is a trust wherein the share of the beneficiary is not identified as on the date of the trust deed. Such trusts are also known as Indeterminate trust.

Generally, the provisions relating to taxation of income of private trusts is governed by the provisions of Section 161 of the Income tax Act, 1961 ('the Act') which provides that every representative assessee (i.e., the trustee) shall be assessed in respect of income of the trust **in the like manner and to the same extent** as that of the beneficiaries and such assessment shall be deemed to be made upon him in his **representative capacity** only.

However, in case the trust is a discretionary trust, the provisions of Section 164 would apply which provides that tax shall be charged on the representative assessee (i.e., the trustee) at the Maximum Marginal Rate ('MMR'). Further, Section 166 of the Act provides the Assessing Officer an option to directly assess the beneficiaries in respect of the income received by trustees on their behalf.

The MMR tax rate is 30% plus highest rate of surcharge plus Health & Education cess. However, there are certain exceptions to the above MMR taxability *(refer next slide).*

Exceptions from MMR taxability

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The income of the discretionary trust shall be taxed at the rates applicable to **Association of Persons** ('AOP') in the following scenarios:

Where none of the beneficiaries have income (other than trust income) exceeding the basic exemption limit applicable to an AOP (i.e., Rs. 250,000),	Where the trust is declared by a person under a Will and such trust is the only trust declared by him provided income of the trust does not include business income
Where none of the beneficiaries is a beneficiary in any other trust,	Where the trust is declared by a person under a Will **for the benefit of relative dependent** and such trust is the only trust declared by him (income of the trust can include business income).

Principles w.r.t taxation of discretionary trust (1/2)

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Gujarat High Court in the case of **Niti Trust vs CIT** [1997] (221 ITR 435) upheld the principle that where the total income of a discretionary trust includes income chargeable to tax at special rates, then that portion of the income shall be taxed at special rates only and not at MMR. The relevant extracts from the said judgement is as follows:

"With regard to section 112, it would be noticed that for individual and HUF, the amount of income-tax on long-term capital gain is to be calculated at the rate of 20 per cent. However, a provision is made with respect to a company, another category of the assessee, at the rate of 40 per cent and other than individual or HUF and company, all other cases are covered under clause (c) of sub-section (1) of section 112 and the person falling in this category is to be charged on long-term capital gain at the rate of 30 per cent. ***But once the status of an assessee is determined as an individual, then in that case clause (a) of sub-section (1) of section 112 will be made applicable****. The Assessing Officer, without making a reference to the judgment, on facts, has come to a decision, which is correct, in our view, and there is no question of apparent error in view of the settled legal position."*

Madras High Court in the case of **CIT vs Saroja Raman & T.G. Ranjini Trust** [1999] 104 TAXMAN 163 held that *"**If the beneficiary is one, and it is known that the trustees received the income for that beneficiary alone and do not have the discretion to use the receipts for any purpose other than the benefit of the beneficiary, section 164 is clearly not attracted**. It is the obligation under which the money received as income is held that is material, and not the extent to which the beneficiary has control over that income. The discretion that the trustees may have discretion in deciding the time at which and the extent to which the income so received should be disbursed to the beneficiary does not in any manner affect their obligation to apply the income so received on behalf of or for the benefit of the beneficiary, solely for the benefit of such beneficiary. So long as that obligation is clear, the trust is not liable to be taxed at the highest marginal rate".*

Principles w.r.t taxation of discretionary trust (2/2)

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The Apex Court in the case of **CIT vs Smt. Kamalini Khatau** [1994] (209 ITR 101) laid down the following principles with respect to taxation of discretionary trusts:

If a discretionary trust distributes its income to the beneficiaries in the same year in which such income is received, then the tax authorities have an option to assess and recover tax from either trustees or the beneficiaries directly. This is because receipt of such income by the beneficiary, in the same year, would directly fall under the scope of total income (Section 5) and accordingly satisfy the charging section of the Income tax statute (i.e., Section 4).

Section 164 of the Act cannot be read as being a code in itself applicable to and dealing with all matters relating to the taxation of the income of a discretionary trust. The said section has to be read along with Section 161. Further, by virtue of the option given under Section 166, the Assessing Officer has the power to assess the beneficiary directly in respect of income distributed by the trust. Therefore, the argument of the beneficiary that the income earned by them shall be taxed only in the hands of the trustees, stood dismissed.

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- An Introduction to Hindu Succession Act
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