TAXATION ASPECTS OF SUCCESSION

YOGESH A. THAR
Chartered Accountant

In the process of making a 'living', we often forget to 'live'. We start realising this fact, only when the time is near for 'leaving'. We then start the exercise of 'leaving' all that we have gathered, for the benefit of our kith and kin such that there is least tax leakage and they inherit maximum possible of what we 'leave' at the time of 'leaving' which we ourselves did not enjoy while we were 'living'.

This takes us into the area of tax planning for succession. This was more prevalent in the days India had estate duty law, which got abolished in 1986 on the ground that the yield from the estate duty was much lower than the cost of administering that law. This was despite the fact that the maximum marginal rate of estate duty was as high as 85%! There is, however, a fear that the draconian law may get resurrected on some pretext or the other in the near future. While it is bad news for each one of us, it is also good news for some of us who are engaged in tax practice!!

But before moving into that unknown terrain, let us have a look at the basic aspects of taxation of the income and the estate of a deceased.

SECTION 159

When a person dies, the assessment of his income pertaining to the period prior to his death would be pending. Courts held in the past that an assessment cannot be made on a dead person and, if so made, would be a nullity in the eyes of law[1] . At the same time, however, it would be unjustifiable to say that upon death of a person, the tax department cannot collect taxes on the income that he had earned prior to death and in respect of which assessments are pending, or even filing of the return may be pending for the last one or two assessment year(s). In order to overcome this conundrum, section 159 was inserted in the Income-tax Act, 1961 ("the Act") to enable assessment of income of a person who was alive during the relevant financial year but had died before filing the return of income or before the income was assessed.

This section provides that when a person dies, his legal representatives shall be liable to pay any tax or other sum which the deceased would have been liable to pay if he had not died "in the like manner and to the same extent" as the deceased. Thus, there would be separate assessments of income in the hands of the legal representative which he has earned in his personal capacity and that which the deceased had earned prior to his death. The two cannot be assessed as part of the same return of income of the legal representative. Consequently, therefore, arrears of tax of deceased cannot be adjusted against refund due to the legal representative in his individual capacity[2]. A legal representative is deemed to be an assessee for the purposes of the Act by virtue of section 159(3). The liability of the representative assessee, however, is limited to the extent to which the estate is capable of meeting the liability and it does not extend to the personal assets of the legal representative[3]. If, however, the legal representative has disposed of any assets of the estate or creates charge thereon, then he may become personally liable. In such cases also, the liability will be limited to the extent of the value of the assets disposed of or charged[4]. A legal representative gets assessed in the PAN of the deceased, but in a representative capacity.

SECTION 168

While the above provision deals with taxation of income of the deceased in respect of the period prior to the date of death, questions arise as regards taxing of the income that the estate of the deceased earns after the date of death but prior to the date of distribution of the assets of the deceased amongst the legatees. Section 168 deals with this income. This section essentially provides that the income of the estate of a deceased person shall

1. *Ellis C Reid v. CIT (1930) 5 ITC 100 (Bom), CIT vs. Amarchand N Shroff (1963) 48 ITR 59 (SC).*
2. *Hasmukhlal vs. ITO 251 ITR 511 (MP)*
3. *See section 159(6). Also see: Union of India vs. Sarojini Rajah (Mrs) 97 ITR 37 (Mad.)*
4. *See section 159(4))*

be chargeable to tax in the hands of the executor to the estate of the deceased. The executor shall be assessed in respect of the income of the estate separately from his personal income. Thus, there would be a separate PAN required for filing the return of the executor. Executor shall be so chargeable to tax u/s. 168 upto the date of completion of distribution of the estate in accordance with the will of the deceased. If the estate is partially distributed in a given year, then, the income from the assets so distributed gets excluded from the income of the estate and gets included in the income of the legatee. Legatee is chargeable to tax on income after the date of distribution[5]. Even if the executor is the sole beneficiary, it does not necessarily follow that he receives the income in latter capacity. The executor retains his dual capacity and hence, he must be assessed as an Executor till the administration of the estate is not completed except to the extent of the estate applied to his personal benefit in the course of administration of the estate[6].

This section applies only in case of testamentary succession, i.e. when the deceased has left behind a Will. In cases of intestate succession, the income from the assets earned after the date of death becomes assessable in the hands of the legal heirs as "tenants-in-common" till the assets of the deceased are distributed by metes and bounds[7].

The section provides that the executor is assessable in the status of "individual". If, however, there are more executors than one, then, the assessment will be as if the executors were an AOP. However, the Madhya Pradesh High Court has held, in the case of ***CIT vs. G. B. J. Seth and Anr (1982) 133 ITR 192 (MP)***, that though the assessment is on the executor or executors, for all practical purposes it is the assessment of the deceased. The Court has held that the status of AOP is for statistical purposes and that notwithstanding the status of the assesse being an AOP, the executors were entitled to claim set-off on account of the balance of brought forward losses incurred by the deceased prior to his death.

INHERITANCE – EXTENT OF TAX EXPOSURE

A transfer of a capital asset under a gift or a will is not regarded as "transfer" for the purposes of capital gains. Referring to this clause, the learned author, Arvind P. Datar, in his treatise, "*Kanga and Palkhivala's The Law and Practice of Income-tax", Tenth Edn., on page 1206*, has said that "*However, these clauses expressly grant exemption where none is needed*". Indeed, wealth transmitted under a Will is not a 'transfer' but a 'transmission'. Also, there is no consideration for the same.

Hence, the question of capital gains tax can never arise. The section does not deal with transfer under intestate succession, it refers only to a transfer under a will. Yet, for the reasons aforesaid, there can be no capital gains on such transmission.

For the recipient, amounts or property received by way of inheritance is a capital receipt and not "income". Ordinarily, therefore, such receipt is not chargeable to tax. Section 56(2)(x), however, charges to tax money or value of certain properties received by a person without consideration or for inadequate consideration. Proviso thereto exempts, *inter alia*, money or property received "under a will or by way of inheritance". There is thus no tax in the hands of the recipient under this section.

In an interesting decision of the Mumbai Bench of the Income Tax Appellate Tribunal, in the case of *Purvez A. Poonawalla [ITA No. 6476/Mum/2009 for AY 2006-07],* it was held that sum received by the taxpayer from the legal heir of a deceased in consideration of the taxpayer giving up his right to contest the Will of the deceased is not chargeable to tax under the then prevailing section 56(2)(vii), which corresponds to present section 56(2)(x) in principle.

Section 49 provides that when a capital asset becomes the property of an assessee, *inter alia*, under a Will [section. 49(1)(ii)] or inheritance [section 49(1)(iii)(a)], the cost of acquisition of the asset shall be the cost to the previous owner. Correspondingly, section 2(42A) provides (in clause (i)(b) of Explanation 1) that in computing the period of holding the asset by an assessee who had acquired the property under a will or inheritance, the period of holding by the previous owner shall be counted. The asset will qualify as a long-term capital asset or a short term capital asset accordingly.

Expenses incurred in connection with obtaining probate are held to be not allowable expenses in an early decision of the Privy Council in the case of *P.C. Mullick vs. CIT (6 ITR 206)(PC)*.

5. CIT vs. Ghosh (Mrs.) 159 ITR 124 (Cal)
6. CIT vs. Bakshi Sampuran Singh (1982) 133 ITR 650 (P&H).
7. CIT vs. P. Dhanlakshmi and Ors (1995) 215 ITR 662 (Mad).

LEAVING A 'WILL' – PROS AND CONS

'Will' is a document by which a person directs his or her estate to be distributed upon his death. It is also termed as "testament". Organising succession through a 'Will' is certainly a preferred option as compared to leaving no such written document from the point of view of certainty. A Will becomes operative upon the death of the testator and hence, unlike a gift given during the life time, the person is in full ownership and control of his wealth till the time of his death. Wealth inherited under a will is not subject to stamp duty. A Will can be amended at any time during the lifetime of the testator.

While these are the pros of writing a 'Will', in today's day and age, one encounters some challenges in implementation of wills in the form of some claimants emerging from the blue and throwing spanner in the works to scuttle smooth and easy succession of the estate. Besides, under a Will simpliciter, it is not possible to segregate the economic interest of the legatee from controlling interest in a particular asset. Say, for example, the testator desires to give the benefit of the income from the shares held by him in a company that he controls to his son, but is not desirous of handing over control of such shares to him as such control gives him voting power qua the company. In such a case, simply writing a Will in favour of the son for bequeathing the shares will not solve the problem. Finally, the fear of estate duty that we talked about earlier looms large and if property worth significant value is transmitted under a Will, and if on the date of death, estate duty law is resurrected, then there would be a sure liability to estate duty.

PLANNING SUCCESSION THROUGH TRUSTS

The above cons of a 'Will' bring to table the option of planning succession by creation of trusts. A trust is a structure involving three persons, namely, a Settlor (or author); a Trustee; and a Beneficiary. The settlor is the creator of a trust who settles his asset into the trust and hands it over to the trustee (who becomes the legal owner) to be held for the benefit of the beneficiary. Thus, the segregation of controlling interest and beneficial interest happens whereby the control remains with the trustee while the economic interest travels to the beneficiary.

A trust structure may get created during the lifetime of the testator or may be incorporated in the will so as to create a trust under the Will. However, creating the trust under a Will may not address the issue of the Will being challenged by some claimant. It also does not address the issue of attracting estate duty on death, if such duty is re-introduced. So, a trust created during the lifetime of the deceased would be a preferred option from that point of view.

When a person creates a trust, he divests himself of the property which, upon creation of the trust, vests in the trustee. Hence, at the time of his death, he is no more the owner of that property and consequently is not liable to estate duty, if such duty becomes applicable. He can appoint a third party as a trustee or he may himself be a trustee during his lifetime. He may plan a successor to the trustee as part of the trust deed itself. If he continues to be sole or one of the trustees, he retains control over the assets settled in the trust, but in a different capacity, namely, as a trustee of the named beneficiary. The trustee carries an obligation to hold the property for and on behalf of the beneficiary and hence he does not own economic interest in the property so held by him and thereby such property so held by him as trustee has no economic value. In absence of any value, there can be no estate duty exposure even if he is himself the trustee.

Care, however, will have to be taken while choosing the beneficiaries in as much as section 56 of the Indian Trusts Act, 1882 empowers a beneficiary who is competent to contract to require the trustee to transfer the property to him at any time if he is the sole beneficiary without waiting for the period mentioned in the trust deed. If there are more than one beneficiaries, they can so compel the trustee if all of them are of the same mind. It may therefore be better to have in the list of beneficiaries a minor and he gets absolute interest in the trust only on his attaining majority. It may also be better to plant a person as one of the beneficiaries who enjoys complete confidence of the settlor so that the wishes of the settlor are not vitiated by the 'not so matured' beneficiaries coming together. It would also be advisable that the trust be a discretionary trust rather than a specific trust so that none of the beneficiaries have any identified interest in the trust property.

SPECIFIC TRUST VS. DISCRETIONARY TRUST

A Specific Trust is a trust where the beneficiaries are all known and their shares in the income and assets of the trust are defined by the settlor in the trust deed. On the other hand, if either the beneficiaries are not identified or their shares are not defined by the settlor, the trust would be a discretionary trust. The distribution of assets and income is left to the discretion of the trustee. A beneficiary of a discretionary trust does not have any identified interest in the income. He only has a hope of receiving something if the trustee so decides.

Taxation of income of a specific trust is governed by section 161 of the Income-tax Act, 1961, ("the Act") while the rules for taxation of a discretionary trusts are contained in section 164 of the Act. For tax purposes, a trustee or the trustees is a "representative assessee". Trustee of a specific trust is taxed "in the like manner and to the same extent" as the beneficiaries. In other words, theoretically, there can be as many assessments on the trustees as the number of beneficiaries. However, there is only one assessment, but the income is computed as if the shares of the beneficiaries are taxed. Section 166 provides an option to the assessing officer to either tax the trustee or the beneficiaries separately on their shares of income from a specific trust. In practice, we often find it simpler that the beneficiaries of specific trusts offer their respective share of income from a specific trust in their respective returns of income and get assessed.

On the other hand, trustees of a discretionary trust are taxed at the trust level in view of the provisions of section 164. This section provides that the income of a discretionary trust is taxable at maximum marginal rate. Only in cases where all the beneficiaries are persons having income below taxable limits, then the trust may be taxed at the slab rates applicable to an AOP. Also, a testamentary trust, i.e. trust created through a will, enjoys this exception provided it is the only trust so created under the will. If a discretionary trust has business income, then such trust (barring a testamentary trust) is taxed at maximum marginal rates. In cases where the income of a discretionary trust is distributed by the trustees to the beneficiaries during the year in which is earned, then, as held by the Supreme Court in the case of ***CIT vs. Kamalini Khatau (1994) (209 ITR 101) (SC),*** the beneficiaries can be taxed directly on such income instead of the trustees being taxed.

Status in which a trust is generally assessable is as an "individual" and not as an AOP. It is only in cases where the beneficiaries have come together voluntarily to form a trust, then, they may be assessed as an AOP[8]. Such would never be the case where a settlor settles a trust for the beneficiaries as part of his succession planning.

REVOCABLE VS. IRREVOCABLE TRUSTS

Trust may be revocable or irrevocable. It is revocable when the settlor retains with himself the right to revoke the trust after having created it. In substance, therefore, he remains to be the effective owner of the property settled. It is irrevocable if he retains no right to revoke it once it is created by him.

Sections 61 and 63 of the Act deal with taxation of revocable trusts. Section 63, by a fiction of law, deems certain instances where the trust shall be deemed to be revocable. These cases are where the trust contains any provisions for re-transfer directly or indirectly of the part or the whole of the income or assets of the trust to the transferor or it gives right to the transferor to re-assume power directly or indirectly over part or whole of the income or assets of the trust. Tax implication of such revocable or deemed revocable trusts is that the income that arises to the trust by virtue of such revocable or deemed revocable transfer is taxable in the hands of the transferor and not in the hands of the trust or the beneficiaries. Thus, in cases where the settlor is himself a beneficiary, such trusts are deemed to be revocable trusts even though the trust deed may say that the trust is irrevocable. In such cases, the income of the trust that arise by virtue of the assets transferred to the trust by the settlor who is also the beneficiary (or one of the beneficiaries), becomes taxable in the hands of the settlor and not in the hands of the trustee or the other beneficiaries, if any.

CREATION OF A TRUST – APPLICATION OF SECTION 56(2)(X)

As noted earlier, section 56(2)(x) charges to tax money or value of certain properties received by a person without consideration or for inadequate consideration. Having regard to the legal position that when a trustee of a trust receives any property from a settlor, he receives it with an obligation to hold it for the benefit of the beneficiary and not for his absolute enjoyment. The obligation so cast on the trustee can be viewed as the consideration and an adequate consideration for his receiving legal ownership of the property. In this view of the matter, receipt by a trustee of a trust of an asset settled by the settlor in trust for another beneficiary cannot give rise to a taxable event in the hands of the trustee. But that does not seem to

continued on page 34 ►

8 *See CIT vs. Shri Krishna Bhandar Trust (1993) 201 ITR 989 (Cal); CWT vs. Trustees of HEH Nizam's Family Trust (1977) 108 ITR 555 (SC); CIT vs. Marsons Beneficiary Trust (1991) 188 ITR 224 (Bom); CIT vs. SAE Head Office Monthly Paid Employees Welfare Trust (2004) 271 ITR 159 (Del).*