SUCCESSION PLANNING VIA PRIVATE TRUSTS – AN OVERVIEW

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Family-run businesses continue to be the norm rather than the exception in India; with most progressing fast on the path to globalisation, succession planning has never been as important as it is today. Succession planning is not only a means to safeguard from potential inheritance tax, but also a method to ensure that legacies remain alive and keep up with changing times with minimum conflict or impact on business.

Succession planning can be a complex exercise in India. Families are often large with multiple factions involved in the business, making deliberations around succession planning prolonged and difficult. The slew of regulations around tax and other regulatory matters, in addition to personal laws, do not ease matters.

Despite these factors, it is imperative to plan for succession. A look back at the history of corporate India reveals the immense disruption due to improper or absent succession planning. Familial ties have been irreparably damaged, wealth accumulated over generations has been squandered, protracted and endless litigation between family members has taken up significant time and effort, draining valuable resources that could have been put to better use, and most importantly, once-leading business houses have taken a huge hit to their finances, glory and reputations.

USE AND LIMITATION OF WILLS

While a Will remains the most oft-used mechanism for passing down wealth through generations, it has its limitations. The chances of a Will being challenged, tying up the family in litigation for years to come, are high. In addition, it is not possible to keep ownership or control of assets in a common pool in a Will, leading to fragmentation of family wealth. Since assets under a Will are transferred only on the demise of the owner, they were subject to estate duty under the Estate Duty Act, 1953 (ED Act), which was abolished in 1985. Although estate duty is currently not on the statute, there have been apprehensions of its reintroduction. While one cannot predict the provisions thereof, a reasonable assumption is that passing of property on the death of the owner would be subject to any such tax.

Such limitations and other concerns, such as ring-fencing assets from legal issues and setting family protocols, has led India Inc. to once again seriously consider succession planning through a private Trust set up for the benefit of family members.

PRIVATE TRUSTS

As the name suggests, a Trust means faith/confidence reposed in someone who acts in a fiduciary capacity for someone else. Essentially, a Trust is a legal arrangement in which a person's property or funds are entrusted to a third party to handle that property or funds on behalf of a beneficiary.

While oral Trusts that were self-regulated have been part of Indian society since time immemorial, the law relating to private Trusts was codified in 1882, as the Indian Trust Act, 1882 (the Trust Act). The Trust Act is applicable to the whole of India, except the State of Jammu and Kashmir and the Andaman and Nicobar Islands. The provisions of the Trust Act should not affect the rules of Mohammedan law with regard to *waqf*, or the mutual relations of the members of an undivided family as determined by any customary or personal law. The provisions of the Trust Act are also not applicable to public or private religious or charitable endowments.

A private Trust is effective for succession planning as the settlor can see its implementation during his lifetime, enabling corrective action to be taken in a timely manner. A Trust demonstrates family cohesiveness to the world and provides effective joint control of family wealth through the Trust deed. Thus, a Trust provides united control and effective participation of all members in the decision-making process, leading to mitigation of disputes and legal battles. It can also ease the path for separation within the family, making it a smooth and defined process.

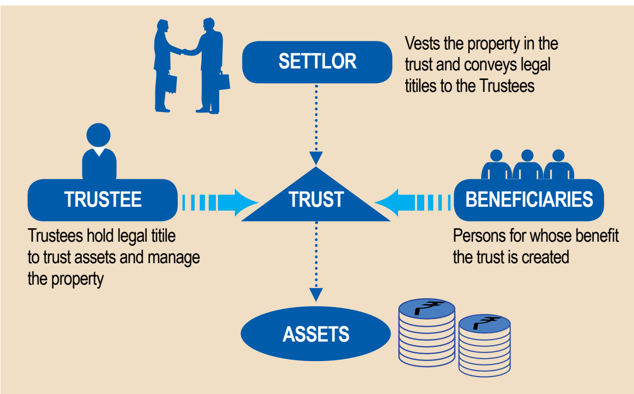
A Trust, as a means of succession planning, is easy to operate and not heavily regulated. The statutory formalities to be complied with are minimal. The Trust Act is an enabling Act and does not contain regulatory provisions. Thus, a Trust provides all types of flexibility. It allows the necessary distribution, accumulates balance and allows ultimate succession, even separation, as planned. As against being regulated by laws, a Trust is governed and regulated by the Trust deed.

Information on private Trusts is not publicly available, unless such Trusts have been registered, providing much-sought-after privacy.

Therefore, for several generations, private Trusts have been a popular means of succession planning, and the spectre of inheritance tax has only given a boost to its use.

A. BASIC STRUCTURE

The basic structure of a private Trust is as follows:



Apart from the settlor, Trustees and beneficiaries, who are the key players in any Trust, there may also be a protector and an advisory board. The protector is essentially a person appointed under the Trust deed, who guides the Trustees in the proper exercise of their administrative and dispositive powers, while ensuring that the wishes of the settlor are fulfilled and the Trust continues to serve the purpose for which it was intended. An advisory board is a body constituted under a Trust deed to provide non-binding advice to the Trustees, often used more as a sounding board.

B. TRUST DEED

A private Trust is usually governed by a Trust deed. A Trust deed, as an instrument, is similar to an agreement and contains clauses similar to an agreement between two parties, in this case, the settlor and Trustee, however, which would have implications for the beneficiaries. Therefore, like any other agreement, a Trust deed usually provides for rules in relation to each of the three parties and is a complete code by itself for operating the relationship within them.

A Trust deed would—apart from information regarding the relevant parties and Trust property—also cover aspects such as:

- Rights, powers (and restrictions thereon), duties, liabilities and disabilities of Trustees, including the procedure for their appointment, removal, resignation or replacement and minimum/maximum number of Trustees
- Rights, obligations and disabilities of beneficiaries, including the powers and procedure for addition and/or removal of beneficiaries, including the person who would be entitled to exercise such powers
- Terms of extinguishment of the Trust
- Alternative dispute resolution, etc.

It is preferable that a Trust deed is in simple language and contains clear instructions, including the process and provisions for amendment thereof.

C. TYPE OF PRIVATE TRUST

Usually, when property is settled into a private Trust for the purpose of succession planning, it is done through an irrevocable transfer, i.e., the settlor does not retain or reserve the power to reassume the Trust property/income or to transfer it back to himself. Thus, once the assets are settled in an irrevocable Trust, the property no longer belongs to the settlor or the transferor, i.e., it belongs to the Trust. Since the settlor has no right left in the Trust property, this typically provides adequate protection to the assets against claims by creditors, or in case of a divorce, etc. Under the erstwhile ED Act, if the settlor reserved any right for himself, including becoming a beneficiary in the Trust, such property may be considered to be passing only on the death of settlor, resulting in a levy of estate duty. This is another reason why irrevocable Trusts are typically used for succession planning, unless some special extenuating circumstances exist.

Based on the distribution pattern adopted by a private Trust, it may be classified as either a specific (also called determinate) or a discretionary Trust. If the Trust deed provides a list of beneficiaries specifying their beneficial interest, it would be a specific Trust. On the other hand, if the Trust deed does not specify any beneficiary's share, but empowers someone (usually the Trustees) to determine such share, it is considered as a discretionary/ indeterminate Trust. Such discretion may be absolute or qualified.

Under the ED Act, in case of a specific Trust, since the interest of each beneficiary was identified, the same was considered as passing to others on the death of such beneficiary, and therefore, subject to estate duty.

However, as no interest was identified in case of a discretionary Trust (based on the decision of the Trustees, each beneficiary's share could be anywhere from 0% to 100%), no estate duty was levied upon the death of any beneficiary, as no property was considered to be passed, making it a commonly used mechanism.

Often—and depending on the requirements—a combination of specific and determinate Trusts (in either case irrevocable) may be used for succession planning and planning around the potential levy of estate duty.

D. KEY ASPECTS OF TAXATION OF A PRIVATE TRUST

In general, moving to a Trust structure is neutral from the point of view of taxation, i.e., neither a tax advantage nor an additional tax burden is imposed by the Income-tax Act, 1961 (IT Act).

1. Settlement of a Trust

Taxation of the settlor

Section 47(iii) contains a specific exemption for any capital gains that may be considered to arise to the settlor on transfer of capital to an irrevocable Trust. Therefore, the settlor should not be liable to any tax on settlement of the irrevocable Trust.

Taxation of beneficiaries

Section 56(2)(x), which was introduced by the Finance Act, 2017, provides for taxation of the value of the property in the hands of the recipient of such property, if received for nil or inadequate consideration. Certain exceptions, including for receipt of property by a Trust created for the benefit of relatives of the transferor of the property have been carved out from the purview of these provisions.

Thus, when assets are settled into a Trust, assuming the beneficiaries are considered as "relatives" of the settlor within the definition prescribed for this purpose under the IT Act, no tax implications would arise u/s. 56(2)(x) of the IT Act. It is important to note the following aspects:

- Fundamentally, for determining taxability u/s. 56(2)(x), the definition of relative is to be tested in relation to the recipient of the property. However, the exception for Trusts requires the relationship to be tested with reference to the giver/settlor. This could give different results, such as in the context of uncle and nephew/niece, and therefore, should be examined closely.
- The argument may be that the provisions of section 56(2)(x) ought not to apply in context of Trusts set up for beneficiaries who do not fall within such definition of "relatives," including corporate beneficiaries, notwithstanding that there is no specific exception carved out; however, its applicability cannot be ruled out. Hence, adequate care is necessary in such cases, e.g., separate Trusts may be set up for relatives and non-relatives.

Taxation of Trustees

The provisions of the aforesaid section 56(2)(x) ought not to apply to the Trustees, as a Trustee receives the property with an obligation to hold it for the benefit of the beneficiaries. This obligation taken over should be good and sufficient consideration for receipt of properties by the Trustees, and therefore, the receipt of property cannot be said to be without/for inadequate consideration.

2. Income earned by a Trust

Broadly, a specific Trust's tax is determined as an aggregate of the tax liability of each of its beneficiaries on their respective shares (unless the Trust earns business income). A discretionary Trust, on the other hand, is generally taxed at the maximum marginal rate applicable to the type of income earned by the Trust.The additional tax on dividends earned from domestic companies (as provided u/s. 115BBDA[1]) would also apply.

Once taxed, the income should not be taxed once again when distributed to the beneficiaries.

3. Distribution of assets/termination of a Trust

There are no specific provisions under the ITA dealing with dissolution of Trust/taxability on distribution of assets of the Trust.

Since a Trust holds property for the benefit of the beneficiaries, when the properties are distributed/handed

1 *Section 115BBDA provides that if an assessee earns dividend income from a domestic company [which is otherwise exempt u/s. 10(34)] in excess of INR 10 lakhs during a financial year, the assessee shall be subject to an additional tax at the rate of 10% on the dividend income earned in excess of Rs. 10 lakhs. The same is applicable to all assessees other than the three specifically exempted categories, none of which are a private trust.*

over to the beneficiaries, it should not result in any income taxable under the ITA for them.

Since the Trust does not receive any consideration at the time of distribution, no capital gain implications ought to arise.

In the past, tax authorities have attempted to treat a Trust as an AOP, and apply the provisions of section 45(4)[2] of the IT Act on dissolution of a Trust. However, the Hon'ble Bombay High Court[3] has held that Trustees cannot be taxable as an AOP, and therefore, the provisions of section 45(4) are not applicable.

Hence, the distribution to the beneficiaries at the time of termination of the Trust or otherwise ought not to result in any tax liability.

E. IMPLICATIONS UNDER OTHER REGULATIONS

Depending on the kind of property settled into a Trust, implications under various other provisions may also arise:

1. Shares of a listed company

It is increasingly popular to settle business assets, in the form of shares of listed companies into a Trust. A family may decide to put part or all of their holding into a single Trust or multiple Trusts, depending on their specific needs.The key consideration is whether this triggers any implications under the regulations framed by the Securities and Exchange Board of India ('SEBI'), notably the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011 (Takeover Code).

Under the Takeover Code, if there is a substantial change in shareholding/voting rights (direct or indirect) or change in control of a listed company, the public shareholders are supposed to get an equal opportunity to exit from the company on the best terms possible through an open offer. Certain exceptions have been carved out, whereby, upon compliance with certain conditions, the open offer obligations would not be applicable[4].

There are arguments that may be taken as to why the Takeover Code ought not to have an implication, especially since there is no change in control. However, in the absence of specific exemptions, especially in the context of transfer to a newly set-up Trust or a Trust, which does not already own shares in the listed company for at least three years, as a matter of precaution, several families approached SEBI for seeking a specific exemption. SEBI has, subject to certain conditions or circumstances being met, generally approved such transfers to a Trust, albeit with safeguards built in.

In December 2017, SEBI released a circular highlighting the guidelines that would need to be adhered to while seeking exemption for settling shares of a listed company into a Trust, which broadly mirrors the principles applied by SEBI in its earlier orders.

2. Immoveable property

Immoveable properties in which family members are residing or those acquired for investment purposes may also be transferred to a Trust. However, typically, stamp duty would be levied on any such settlement of immoveable property, which becomes a major deterrent. Often, residential property is gifted to individual members, since in states such as Maharashtra, the stamp duty on gifts to specified relatives is minimal; such exception is not available for transfer to a Trust even if the beneficiaries are such specified relatives.

As there is no stamp duty on assets transferred through a Will, it becomes a more commonly used means of migrating large immovable properties held by individuals. However, this could lead to a potential estate duty liability, as it would only pass on on the demise of the owner. Thus, apart from the concerns around the ownership of the property or any friction between family members, the trade-off between immediate stamp duty outflow and potential future estate duty outflow would need to be considered.

In case properties are not held directly by individuals but through entities, the ownership of the entity itself may be transferred to the Trust. In such case, stamp duty implications, if any, are likely to be significantly lower than that which would have arisen on transfer of the immovable property itself.

Family wealth may include intangible rights in the properties, such as development or tenancy rights, which are not transferable without the approval of landlord/owner

2 *U/s. 45(4), the distribution of assets by, inter alia, an AOP would be charged to tax as capital gains, by taking the fair market value of the assets as the full value of the consideration.*
3 *L.R. Patel Family Trust vs. Income Tax Officer [2003] 129 Taxman 720 (Bombay).*
4 *For example, if the trust is named as a promoter in the last three years' shareholding pattern of a listed entity, exemption may be claimed for transferring shares by another promoter to such trust.*

of the property. Depending on how such rights are held and whether such approval is forthcoming, a decision may need to be taken if they ought to be settled into the Trust.

3. Assets located overseas

Increasingly, many families hold assets overseas, be it in the form of shares (strategic or portfolio investments) or immoveable property. For any such assets to be transferred to a Trust, or if any of the family members are non-residents, not only would the provisions of the Foreign Exchange Management Act, 1999 need to be considered, but also the laws of the country where the assets are located.

4. Business assets

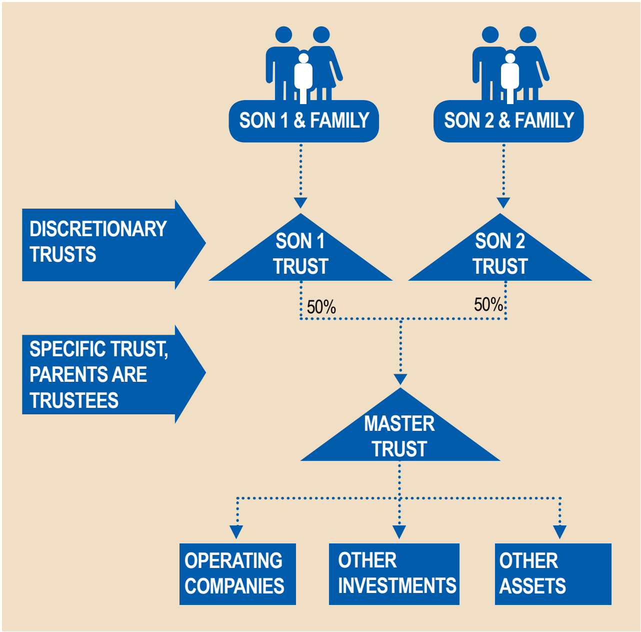
In the current environment, considering the size of business and other factors, it is usually not possible or advisable to carry on business from a Trust. Therefore, it is inevitable that the business is continued or transferred to a company or other entity.

If the business is carried on through a company, whether wholly owned by the family or not, the securities in such company will be transferred to a Trust. In case the business is housed in non-company entities (such as a partnership firm or Limited Liability Partnership firm), it may be necessary to make the Trust (through its Trustees) a partner in such an entity. However, it would be advisable that in case a partnership firm is conducting the business, a separate Trust is set up to ring-fence and protect other properties, since partnership firms have unlimited liability for its partners.

F. EXAMPLES OF TRUST STRUCTURES

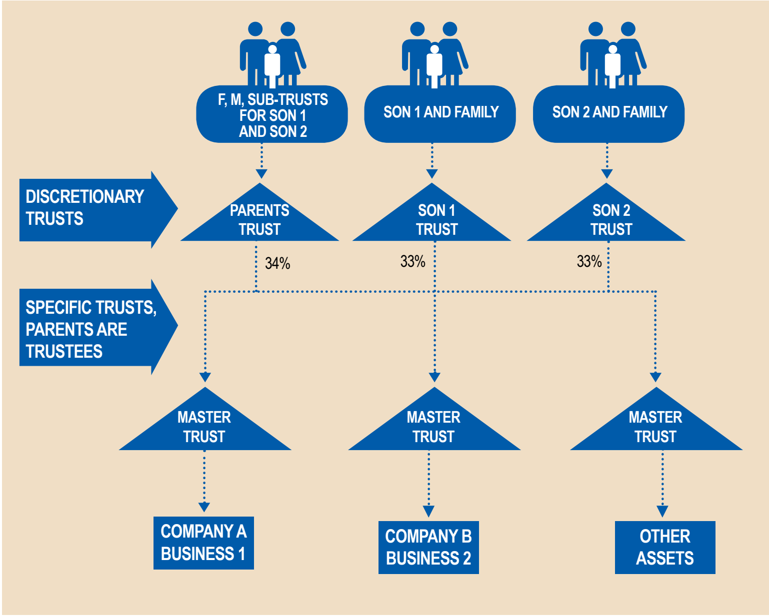
Depending on the requirements, a Trust structure may be set up in multiple ways. No one-size-fits-all approach would work.

If it is a nuclear family, setting up a single Trust may suffice. On the other hand, multiple factions within the family would require multiple Trusts to be set up. For example, a family of two brothers owned their business in a company. Their father created the business, and with his wife (the mother), owned 100% shares in the company. The parents settled their entire holding in the company to a master Trust, wherein they were the Trustees, thereby retaining control with them. The beneficiaries were two separate Trusts (often referred to as baby or sub-Trusts) set up for each of their sons and their respective families. This is depicted here as a base structure:



Another variation could be with multiple master Trusts. In this example, a family of father and two sons owned two businesses. They decided to have:

- Two master Trusts for holding the two businesses through existing companies
- One master Trust for owning other assets
- Three baby Trusts for each segment of the family



Clearly, the facts of each case, combined with the requirements of all stakeholders will need to be considered while establishing any Trust structure.

G. MIGRATION

Any succession plan would fail unless it is implemented properly, through appropriate migration of assets to the structure. Not all assets would be directly owned by the settlor, which can easily be settled into the Trust. In some cases, they may be owned by companies, partnership firms, LLP, even Hindu Undivided Families. In such case, the existing structure would first need to be unwound before the properties are introduced into the Trust.

To do so, especially to unwind a structure, various methods may be used, e.g.:

- Settlement into a Trust
- Gift of assets
- Sale of assets/business/shares
- Family arrangement/settlement
- Primary infusion
- Mergers/demergers

Any migration strategy would typically be a combination of the above. Each of the above modes of transfers could have implications under various statutes, which would need to be examined closely, e.g.:

- Income tax
- Stamp duty
- SEBI
- FEMA
- Laws of foreign jurisdictions

Further, one would also need to consider the potential levy of inheritance tax/estate duty, and plan appropriately, considering that there is no law in place currently, not even in draft form; one can only draw an analogy from the erstwhile ED Act or even from laws of foreign countries.

TO CONCLUDE

Succession planning through the use of Trusts has been in use in India since several generations and is not a new concept. However, with the various complications of business, the multitude of laws that today surround any kind of action, the glare that any business house comes under, and the uncertainty surrounding the reintroduction of inheritance tax, makes it an exciting subject. The intent is to capture a flavour of Trust structures; however, various nuances would need to be considered before embarking on such a journey. ■

▼ARTICLE TAXATION ASPECTS OF SUCCESSION *continued from Page 28*

be the way the law makers seem to view this. In the proviso to section 56(2)(x), the law provides a clause granting exemption from this taxing provision in respect of any sum of money or any property received "from an individual by a trust created or established solely for the benefit of relative of the individual". Now, is this exemption inserted out of abundant caution or is it an exemption to relieve the trusts created for relatives from the rigours of this section is a vexed question. If I am right in the view expressed earlier, receipt by a trustee can never be subjected to this tax since his obligation is an adequate consideration. However, another view of the matter is that but for this exemption, even trusts created for relatives would be subjected to the rigours of this taxing provision.

Be that as it may. While one is planning his affairs, one may have to go by the conservative interpretation that but for the exemption, every trust would be chargeable to tax under this provision. Consequently, this provision may have to be kept in view while making the succession plans. It may be stated here that the amounts received under a Will or by way of inheritance are exempt from the purview of section 56(2)(x) and hence, if there is a testamentary trust (i.e. a trust created through a Will), then, this section will not be applicable in any case, whether all the beneficiaries of the trust are relatives of the testator or not. If one ignores a possibility of resurrection of estate duty law, then, this seems to be an efficient mode of planning succession so as to achieve the objective of segregating the control of the assets from the economic benefits thereof and pass on only the economic benefits to the legatees and not the control over the asset which can be retained with the desired trustee or trustees.

THE WAY FORWARD

If you have crossed fifty, and if you are not enjoying life, i.e. not lavishly spending the wealth you have created, prepare a 'Will', whether you have a 'will' to give away everything or not, because it is His 'will' that will ultimately prevail and if the affairs are not well planned, the 'will' of the devil will ruin the empire created by you in future. If you are just worried about the tax on your estate, then, forget everything, start spending your every rupee, enjoy life. Remember that punch line from the film "Anand" – "*Jab tak zinda hoon, tab tak mara nahin. Aur jab mar gaya, to saala mei hi nahin*". ■