CHAPTER 6:

IMPACT OF TRUSTS ON CORPORATE TAXATION

I. General:

A trust is the creation of law governed by the provisions of the Indian Trust Act, 1882. It is not a unit of assessment. Though for certain purposes a trust is considered as having a quasi-legal personality, like a company; the legal concept of 'trust' is something entirely different and it does not envisage either in law, or in commercial practice, creation of an artificial legal entity. The creation of a trust merely results in the income being diverted by over-riding title in favour of the beneficiaries. The obligation itself is designated as 'Trust' and it is merely the nomenclature given to a particular type of obligation. It is by virtue of this over-riding obligation that the trustee, has been recognised as a 'representative-assessee' in the Income Tax Act, 1961 or Wealth Tax Act, 1957.

It is by virtue of the general principles of contractual obligations that the author of the trust must be competent to contract. In other words, a company being a 'corporate personality' can create a trust. On the other hand, a trust can create a company through its trustees.

1. Legal Aspects

The private trusts, or so to say, private family trusts have been recognised in the Income Tax Act, 1961 as well as the Wealth Tax Act, 1957. For purposes of classification private family trust may be discretionary or non-discretionary as under:

A trust is said to be discretionary:

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1. Section 2(31), Income Tax Act, 1961 defines the units of assessment. It provides, inter alia, for 'an association of persons or a body of individuals, whether incorporated or not'.
a) When the beneficiaries are definite but their shares are indefinite; or

b) when the shares are definite and known but the beneficiaries are unknown (for example, unborn person); or

c) when both the beneficiaries and their shares are unknown and indefinite.

The Income Tax Act also recognises the classification of trust on the basis of 'accumulation trusts' or 'non-accumulation trusts'. In the former case, the trustees are entitled to accumulate the annual income of the trust property, dividing the surplus income amongst the beneficiaries, as per the terms of the trust deed.

Section 160, Income Tax Act, 1961 deals with the assessment of representative assesses. In a leading pronouncement on this subject, N.V. Shanmugham & Co. v. CIT, the Supreme Court enunciated the concept of 'representative assessee', as under:

1. There may be as many assessments on the trustee as there are number of beneficiaries, with definite shares;

2. The assessment of the trustee would be in the same status as that of the beneficiary;

3. The tax payable by the trustee would be the same as payable by each beneficiary.

Though Shanmugham's case related to a partnership business, the general principles of law enunciated by the Supreme Court are

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2. Section 3 of the Indian Trusts Act, 1882 defines 'Trust' as "an obligation annexed to the ownership of property and arising out of confidence reposed in and accepted by the owner or declared and accepted by him for the benefit of another or of another and the owner".

3. (1971) 81 ITR 310 (SC)
equally applicable to any other entity. This leading judgment of the Supreme Court established an important principle of law, which had been overlooked in earlier cases, that the mere fact that there are joint representative assesses - for example, co-trustees or co-receivers - will not make them assessable as an 'association of persons'; representative assesses take their status from the beneficiaries they represent and it is wholly immaterial whether there is one representative assesse or there are two or more of them representing the same beneficial interest or interests. For instance, co-trustees would be assessable in the status of 'individual' where they represent beneficiaries who are assessable separately in the status of 'individual' and, likewise, they would be assessable in the status of 'association of persons' where they represent beneficiaries who constitute an 'association of persons'. As a matter of fact, this very concept principally exists in section 168(1)(b) which expressly enacts that co-executors should be assessed, as if they constituted an association of persons.

4. The Supreme Court enunciated certain norms in order to create the charge on the basis of an 'association of persons', as under:
   a) Generally speaking, there can be no 'association of persons' in business unless the members of the group have joined together of their volition or free will, but if the test governing an association of persons is satisfied, the circumstance that the association emerges as a result of operation of law is immaterial.
   b) only such receiver, manager or trustee fall within section 160 who are appointed by or under any order of a cou or by virtue of law deeming it to be so.

5. Since the tax is to be levied on the representative assessee in like manner and to the same extent as it would be leviable upon the persons beneficially entitled to the income in a case where several persons are beneficially entitled to the income, the assessment on the representative assessee should be at the individual rates of tax applicable separately to the total income of each beneficiary. However, this principle would not apply in the exceptional case where the persons beneficially entitled to the income constitute an association of persons. In such an exceptional case the representative
The Income Tax Officer is empowered by virtue of section 161, either to assess the 'representative assessee' 'in like manner and to the same extent', as it would have been in the case of person represented by him, or he can directly assess or recover the amount of tax from the beneficiary by virtue of section 166. In the case of a discretionary trust, the assessment can be done in the hands of the representative-assessee on the basis of an 'association of persons'. In other words, the concept of co-extensive liability, strictly speaking, loses its nexus in the case of a discretionary trust. At this stage, it is to note that during the stages of consideration of the Income Tax Bill, 1961, it was decided that the provisions to charge the tax at the maximum rate when the income received by a representative assessee is not specifically receivable on behalf of a beneficiary or the shares of the beneficiaries are indeterminate or unknown, may be given up pursuant to the recommendation of the Law Commission's 12th Report.

Section 161 creates a charge in general, whereas section 164 creates the charge in the case of a discretionary trust only. The scheme of section 164 enunciates that in case of beneficiaries whose shares are unknown or indeterminate, tax shall be charged at the

5 contd. assessee would be chargeable at the rate appropriate to the total income received on behalf of all the beneficiaries as constituting a unit of assessment, and consequently the incidence of tax may be higher. But in order to constitute an association of persons the beneficiaries must 'voluntarily' join in a common purpose or common action and the object of the association must be to produce income; it is not enough that the income is received jointly. Thus, where income is merely received from investments, the beneficiaries cannot be said to have joined together to produce income; they cannot be treated as constituting an association of persons.

6. The words 'in like manner and to the same extent' appearing in section 161(1) refer to the concept of co-extensive liability of the trustees vis-a-vis beneficiaries.

7. Non-discretionary trust is not covered under section 164.
maximum marginal rate. But following are the exceptions to such a
maximum charge:

a. Where none of the beneficiaries has any other chargeable
income to tax and is not a beneficiary under any other trust; or

b. Where the relevant income is receivable from the trust
declared by any person by will and such trust is the only trust declared
by him; or

c. Where the relevant income is receivable under a trust
created before March 1, 1970, by a non-testamentary instrument and the
ITO is satisfied that the trust was created 'bonafide' exclusively for
the benefit of the relatives of the family, or members of HUF in

circumstances where the relatives or members were mainly dependent on
the settlor for support and maintenance, or

d. Where the relevant income is receivable by the trustee on
behalf of a provident fund, etc.

Till 1970, section 164 afforded opportunity for reduction of
tax liability by transferring property to trustees and vesting
discretion in them, either to accumulate the income or to apply it at
their choice or the benefit of one, or more than one beneficiaries.
By creating a 'multiplicity' of such 'discretionary trusts', each one
of them derived a comparatively low income and thus the incidence of tax
on the income of the property so transferred to several 'discretionary
trusts' was kept at a low level.

7 contd. Thus neither the rate of 65% nor the rate applicable to an
'association of persons' shall be applicable.


162 (Guj), the Gujarat High Court held that unless the minor
children of the settlers were 'mainly' dependent on the
settlers for their support and maintenance at the time when
the trust was created, the case would not fall within the
purview of section 164(1)(iii).
In such arrangements, it was often found that one or more of the beneficiaries of the trust were persons having high personal incomes, but no part of the trust income being specifically allocable to such beneficiaries under the terms of the trust, such income could not be subjected to tax at the high personal rate which would have been applicable, if their shares had been determinate.

In order to put a curb on the proliferation of such 'discretionary trust' the Finance Act, 1970 subjected such trusts to tax at a flat rate of 65% or at the appropriate rate applicable to 'association of persons', whichever is more beneficial to the revenue.

Thereafter, the words 'or which is of the nature referred to in sub-clause (iia) of clause (24) of section 2' were inserted by virtue of Finance Act, 1972 in sub-sections 2 and 3 of section 164, with the result that voluntary contributions received by a trust created wholly or partly for charitable purposes, not being contributions made with a specific direction that they shall form part of the corpus of the trust shall be assessed to income tax on the basis of 'association of persons' in the hands of the trustees.

Still, the law was not explicit as to the point of time at which determination was to be made as to whether, in the trust in question, the trustees received the trust income or any part thereof on behalf or for the benefit of any one beneficiary or of more than one beneficiary with shares determinate and known. Such provisions were also introduced in the Wealth Tax Act, 1957 where section 21(1) broadly corresponds to section 161(1) of the Income Tax Act, 1961 and section 21(4) corresponds to section 164(1) of the Income Tax Act, 1961.

In the wake of these legislative experiments, another leading
pronouncement came from the Supreme Court in CWT v. Trustees of HEH Nizam's Family (Remainder Wealth) Trust. The Supreme Court laid down an extremely important principle of law that the liability of a trustee cannot be greater than the total liability of the beneficiaries. In many cases the combined value of life interest and remainder-man's interest in the corpus will be less than the total value of the corpus and the difference, which cannot be assessed in the hands of the trustees escapes assessment.

In order to overcome this Supreme Court's decision, a new section 21 (1A) has been inserted by the Finance Act, 1980 with effect from April 1, 1980. By virtue of this amendment:

i. The discretionary trusts will be liable to Wealth Tax at a flat rate of 3% or at the rate applicable to resident individual, citizen of India, whichever is more beneficial to the revenue;

ii. The excess over the value of life interest of beneficiary and the remainderman's interest in the corpus, is subjected to tax at a flat rate of 3% or at the rate applicable to an individual, resident citizen of India, whichever is higher;

iii. Unless the names of beneficiaries and their shares are expressly stated in the trust-deed and ascertainable as on the date of deed, the trust will be treated as a discretionary trust;

iv. In case where none of the beneficiaries has any other wealth chargeable to wealth tax, nor is he a beneficiary under any...

10. (1977) 108 ITR 555 (SC)

11. Explanation 1 to section 21(4) states:

"For the purposes of this sub-section, the shares of the persons on whose behalf or for whose benefit any such asset are held shall be deemed to be indeterminate or unknown unless the shares of the persons on whose behalf or for whose benefit such assets are held on the relevant valuation date are expressly stated in the order of the court or instrument of trust or deed of wakf, as the case may be, and are ascertainable as such on the date of such order, instrument or deed."
other private trust, the wealth tax leviable will be at the rate applicable to the individual, resident citizen.

Similar to section 164A, Income Tax Act, 1961 a new section 21(4A) has been inserted by the Finance Act, 1981 to the Wealth Tax Act, 1957. By this amendment, oral trusts will be subjected to tax at a flat rate of 3% or at the rate applicable to an individual, resident citizen of India, whichever course would be more beneficial to the revenue. However, such oral trusts shall be deemed to be a trust declared by a duly executed deed in writing, if a statement in writing, signed by the trustee setting out the objects of the trust, names of trustees and beneficiaries and details of trust property is furnished to the WTO before June 1, 1981 or within 3 months from the date of oral declaration.

Another very important principle laid down in the Supreme Court's decision in CWT v. Trustees of HEM Nizam's Family (Remainder Wealth) Trust was that whether in a trust the individual shares of the beneficiaries were indeterminate or unknown, has to be ascertained independently for each assessment year. Following this Supreme Court's judgment, the Bombay High Court has held in CWT v. Hasnate Burhaniyah Fidaivah Wakf as under:

"It is now too late in the day of dispute that where the beneficiaries under a trust are determinate and can be identified and their shares are known, the proper provision under which an assessment has to be made under the Act would be section 21(1). This is now settled by the decision of the Supreme Court in CWT v. Trustees of HEM Nizam's Family (Remainder Wealth) Trust. The Supreme Court has clearly laid down in that decision that where the beneficiaries are determinate and the shares are known there has to be as many

13. (1977) 108 ITR 555
14. (1983) 14 Taxman 545 (Bom)
assessments of the trustees as there are beneficiaries with determinate and known shares and that the assessment of the trustees would have to be made in the same status as that of the beneficiaries whose interest is sought to be taxed in the hands of the trustee...".

Identical to the provisions of the Wealth Tax Act, the same nature of provisions were inserted in the Income Tax Act. The Finance Act, 1980 inserted Explanation 1 to section 164. The effect of this Explanation is that the determination as to the category of nature of the discretionary trust, and its liability to be to the extent of the maximum marginal rate, is to be made not independently for each assessment year with reference to the circumstances and position obtained in that assessment year, but once for all with reference to the circumstances obtained on the date of the creation of the trust. This Explanation I to section 164, Income Tax Act, 1961, also owes its origin to the implications of the Supreme Court's judgment in CWT v. Trustees of HEH Nizam’s Family (Remainder Wealth) Trust. The implication of this judgment has been that the remainderman is also a beneficiary under the trust and if the constitution or shares of the remainderman are indeterminate, the trust falls under the 'discretionary trust', that is either under section 164(1) of the Income Tax Act, 1961 or section 21(4).

**Explanations 1 to section 164 stated:**

For the purposes of this section —

1. Any income in respect of which the persons mentioned in clause (iii) and clause (iv) of sub section (1) of section 160 are liable as representative assessee or any part thereof shall be deemed as being not specifically receivable on behalf or for the benefit of any one person unless the person whose behalf or for whose benefit such income or such part thereof is receivable during the previous year is expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and is identifiable as such on the date of such order, instrument or deed;

2. The individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is received shall be deemed to be indeterminate or unknown unless the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is receivable, are expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and are ascertainable as such on the date of such order, instrument.
of the Wealth Tax Act, 1957. The law implies that at the time of creation of the trust, contingencies shall be enumerated with regard to the beneficiaries as well as the interest of the remainderman.

Thereafter, by virtue of the Finance Act, 1980, with effect from April 1, 1981, such income has been made to bear tax at the 'maximum marginal rate' which expression has, by the same Act, been defined in Explanation 2 to section 164 to mean the rate of income tax including surcharge applicable in relation to the highest slab of income in the case of an association of persons for the relevant year.

Thereafter, the Finance Act, 1983 inserted the words 'or which is of the nature referred to in sub-section (4A) of section 11' in sub-section (2) and sub-section (3) of section 164, with the result that business held under trust, whereof the shares of the beneficiaries are indeterminate or unknown shall be assessed on the basis of an 'association of persons'. This amendment, as a matter of fact, is consequential to the insertion to sub-section (4A) of section 11 by virtue of the same Finance Act, 1983. In other words, the 'tax shall be charged on so much of the relevant income as is not exempt under section 11 or section 12 as if the relevant income not so exempt were the income of an association of persons'. On the other hand, the revenue has also an option of directly assessing the beneficiaries in respect of the income or wealth receivable by the trustees on behalf of such beneficiaries.

15 contd. or deed.
16. Ibid.
17. According to this definition, the maximum marginal rate for assessment years 1981-82 to 1983-84 is 66% and for 1984-85 is 67.5%.
Thereafter, the current Finance Bill, 1984, proposes to insert sub-section (1A) to section 161. While piloting the Bill, the Finance Minister stated in the Parliament as under:

"41. It has come to notice that attempts are being made to split certain large trusts into a number of smaller trusts in such a manner that the income of each such trust is either less than the exemption limit of Rs 15,000 or the income falls for taxation only at the lower rates applicable to the initial slabs of income. As a result, forfeiture of tax exemption in the circumstances mentioned at (a) to (c) of Paragraph 39 above does not have any deterrent effect in such cases".

"42. With a view to ensuring that the income or property of charitable or religious trusts is not used or applied, directly or indirectly for the private benefit of the specified categories of persons and that the trust funds are not invested in contravention of the investment pattern laid down in the Income Tax Act, the Bill seeks to provide that where a charitable or religious trust forfeits tax exemption in the circumstances mentioned at (a) to (c) of paragraph 39 above, the trust shall be charged to tax at the maximum marginal rate that is the rate of income tax (including surcharge) applicable to the highest slab of income in the case of individuals, association of persons, etc."

18. The proposed sub section (1A) states:

"Notwithstanding anything contained in sub-section (1), where any income in respect of which the person mentioned in clause (IV) of sub-section (1) of section 160 is liable as representative assessee consists of or includes, profits and gains of business, tax shall be charged on the whole of the income in respect of which such person is so liable at the maximum marginal rate:

Provided that the provisions of this sub-section shall not apply where such profits and gains are receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him for support and maintenance, and such trust is the only trust so declared by him.

Explanation: For the purposes of this sub-section, 'maximum marginal rate' shall have the meaning assigned to it in Explanation 2 below sub-section (3) of section 164".


20. Clauses (a) to (c) of paragraph 39 states:

"39. Charitable or religious trusts, which may otherwise be eligible for tax exemption, are liable to forfeit this exemption in the following circumstances, namely:

a. where the trust is created after 31st March, 1962, any part of the income of the trust enures under the terms of the trust deed, directly or indirectly, for the benefit of specified categories of persons, such as, the author of the
Furthermore, the Finance Bill 1984 also seeks to tax business profits of private trusts at maximum marginal rate of income tax. It states as under:

"44. Trustees of a private trust are ordinarily not expected to carry on any business because, implicit in the nature of business is the possibility of incurring loss, and, no prudent trustee would risk the trust's property in business venture. However, it has come to notice that taxpayers are increasingly conducting business through the medium of private trusts. Such arrangements are entered into for purposes of tax avoidance, the main object being to avoid payment of the registered firm's tax which would become payable if the business is carried on in partnership".

20 contd. trust, trustee or manager of the trust, substantial contributor to the trust and any relative of such author, trustee, etc;

b. any part of the income or any property of the trust (whenever created) is used or applied during the relevant year, directly or indirectly, for the benefit of specified categories of persons;

c. the trust funds (with certain exceptions) are invested in contravention of the investment pattern for such funds as laid down under the Income Tax Act.

In section 164 of the Income Tax Act, with effect from 1st April 1985 the following insertions are to be made:

The proviso after the proviso in sub-section (1) of section 164 shall be inserted, namely:

"Provided further that where any income in respect of which the person mentioned in clause (iv) of sub-section (1) of section 160 is liable as representative assessee consists of, or includes, profits and gains of business, the preceding proviso shall apply only if such profits and gains are receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him for support and maintenance, and such trust is the only trust so declared by him."

In sub-section (2), the following proviso shall be added, namely:

"Provided that in a case where the whole or any part of the relevant income is not exempt under section 11 or section 12 by virtue of the provisions contained in clause (c) or clause (d) of sub-section (1) of section 13, tax shall be charged on the relevant income or part of relevant income at the maximum marginal rate."

In sub-section (3), after the proviso and before Explanation 1, the following proviso shall be inserted, namely:

"Provided further that where the relevant income consists of, or includes, profits and gains of business, the preceding proviso shall apply only if the income is receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him..."
"45. In order to counteract such attempts at tax avoidance, it is proposed to make a provision in the Income Tax Act that where any income in respect of which any person mentioned in clause (iv) of sub-section (1) of section 160 of the Income Tax Act (i.e., a trustee appointed under a trust declared by a duly executed instrument in writing, whether testamentary or otherwise, including a wakf deed) is liable as representative assessee consists of or includes profits and gains of business, income tax shall be charged on the whole of the income in respect of which such person is so liable at the maximum marginal rate...

"46. It is relevant to mention that under an existing provision in the Income Tax Act, income received by trustees of discretionary trusts is charged to tax at the maximum marginal rate of income tax (a trust is regarded as a 'discretionary trust' if the income or any part thereof is not specifically receivable by the trustee on behalf of or for the benefit of any one person or where the individual shares of the persons on whose behalf or for whose benefit such income or part is receivable are indeterminate or unknown). The Income Tax Act, however, provides that income received by discretionary trusts will not be charged to tax at the maximum marginal rate, but at the the normal rates of tax applicable to individuals, association of persons etc, in cases where any one of the following conditions is fulfilled namely:

1. none of the beneficiaries has any other income chargeable under the Income Tax Act exceeding the exemption limit or is a beneficiary under any other trust;

ii. the trust is declared by a person by will and such trust is the only trust so declared by him;

iii. the trust has been created before 1st March, 1970 by a non-testamentary instrument and the ITO is satisfied that the trust was created bonafide exclusively for the benefit of the relatives of the settlor or where the settlor is a Hindu Undivided Family, exclusively for the benefit of the members of such family, in circumstances where such relatives or members were mainly dependent on the settlor for their support and maintenance;

iv. the trust has been created bonafide by a person carrying on business or profession exclusively for the benefit of his employees.

Provided also that in a case where the whole or any part of the relevant income is not exempt under section 11 or section 12 by virtue of the provisions contained in clause (c) or clause (d) of sub-section (1) of section 13, tax shall be charged on the relevant income or part of relevant income at the maximum marginal rate..."
The Bill seeks to provide that the aforesaid provisions will not apply in a case where the income of a discretionary trust consists of, or includes, profits and gains of business, in such cases, the entire income of the trust would be charged at the maximum marginal rate of tax, except in cases where the profits and gains are receivable under a trust declared by any person by will exclusively for the benefit of any relative dependent on him for support and maintenance, and such trust is the only trust to declared by him. In such cases, the income of the discretionary trust would be charged to tax at normal rates applicable to individuals and not at the maximum marginal rate of income tax.

It is true that the Parliament has been conscious of this acute problem of tax avoidance through the machinations of 'private family trusts' and 'discretionary trusts'. It can be very well said that since 1970 the settlors, trustees and beneficiaries as a composite block on one hand, and the Parliament on the other, had been actively engaged in creating the nuances of law, but it would be too naive to say that with this labyrinth of law, particularly the Finance Act, 1983 and the Finance Bill, 1984 the legislature could really curb the menace of private family trusts or discretionary trusts.

An 'oral trust' has been deemed to be a 'written trust'; income derived from property held under trust wholly for charitable or religious purposes, or which is of the nature referred to in sub-clause (iia) of clause (24) of section 2, shall be charged to tax on the basis of an 'association of persons', to the extent to which it is not exempt under section 11 or section 12.

It is submitted that the words 'not being contributions made with a specific direction that they shall form part of the corpus of the trust or institution' in clause (iia) of clause (24) of section 2 itself

defeats the very purpose of these expeditions legislative measures. In order to really plug this vast conduit of tax avoidance, the most generic solution could be to end with the words itself. Indubitably, the fangs of the Finance Act, 1983 and Finance Bill, 1984 have endeavoured in that direction, but the ways of human ingenuity are infallible.

It is submitted that the following green patches for the prolific litigative syndrome still exist, as under:

a. The Supreme Court clearly laid down in CWT v. Trustees of "HSH Bismar's family (remainder wealth) trust" that whether in a trust the individual shares of the beneficiaries were indeterminate or unknown has to be ascertained independently for each assessment year. Perhaps it would be an uphill task in the case of wealth tax, since the charge of Wealth Tax is with respect to the valuation date. Perhaps the Finance Act, 1980, in order to supersede this Bismar's case could not conceive the conflict with the general principles of law. The very concept of contingent interest correlates to the happening of an event. Could the law conceive such a contingency at the time of inception of the trust, since remainderman is also a beneficiary? It is submitted, therefore, that the only viable alternative is, not to wade through the jungle of the prevailing law, apparently taking pride in the shelter of innocuous growth, but to cut the non-utilitarian legislative growth itself.

b. At the same time, the Revenue has an option of directly assessing the beneficiaries in respect of the income or wealth receivable by the trustees on behalf of such beneficiaries. It is

24. Ibid.
25. Of course, the Madhya Pradesh High Court in Rai Saheb Seth Ghsalal Modi Family Trust v. CIT (1983) 15 Taxman 328 (MP), the ITO assessed the beneficiaries individually by including their share of income in the trust. The court held that "the mere fact that the ITO stated in the assessment orders that they were subject to rectification, it could not be held
common knowledge that the trustees are required to spend for the minor beneficiaries according to their overall advancement according to their needs, which itself creates an outlet as to the legislative experiment to enunciate the guidelines for such 'overall advancement' or 'needs'.

Perhaps it would be appropriate to say that this very legislative plank of revenue having an option of either assessing the trustee or the beneficiary would be hazardous for the tax administration, as the administration itself is likely to be the worst sufferer. By way of an analogy, in CIT v. Murlichar Jhawar & Purna Ginning & Pressing Factory, the ITO assessed the three persons who were parties to a joint venture as individuals and included their share of income from the joint venture in their individual assessments. Thereafter, the ITO assessed the three parties to the joint venture as an unregistered firm. On these facts, the Tribunal held that the ITO had the option to assess the individual parties to the joint venture and he having exercised that option, it was not open to him thereafter to re-assess the same income collectively in the hands of the three parties to the joint venture in the status of an unregistered firm. The Supreme Court upheld the order of the Tribunal. The Supreme Court also negatived the contention that the assessments in the first instance were provisional and, therefore, it could not be said that the ITO had exercised his option.

The Supreme Court held as under:

"...Again the order of the ITO clearly indicates that he was cognizant of the fact that the income of the joint venture was taxable collectively, but he thought that he could in law in the first instance make an 'assessment provisionally' of the three parties separately and then rectify the assessments later. In so holding the ITO may have committed an error of

25 contd. that he did not exercise his option to assess the beneficiaries directly*.

26. (1966) 60 ITR 95 (SC)

27. Ibid, 99.
law, but he does not appear to have laboured under an ignorance of facts...".

c. The gamut of sections 11, 12 and 13 of the Income Tax Act, 1961 have a profound intimacy with the provisions of section 164 of the same Act, as a result of which tax at the 'maximum marginal rate' shall be charged only on that part of the income, which does not get a generous treatment under the gamut. Possibly, it would be too naive to say that these provisions would rather invigorate the machinery of section 164.

It is submitted that the Parliament in its own wisdom exercise the wobbling flexibilities in the name of 'rationalisation of the law', or to put the cloak of 'socio-economic fabric' on the law, whereby the very dynamism of the legislation is being sapped away by inserting a generalized clause after enumerating specific modes. One such glaring example is clause (x) of section 11(5) inserted by virtue of Finance Act, 1983 which enumerates 'investment in immovable property'. The Explanation thereto further gives a clear vent to the tax manoeuvrings, which states as under:

"Explanation - 'Immovable property' does not include any machinery or plant (other than machinery or plant installed in a building for the convenient occupation of the building) even though attached to, or permanently fastened to anything attached to the earth".

It is submitted that as a consequence of the submission made aforementioned by the writer in regard to the omission of the words 'not being contributions made with a specific direction that they shall form part of the corpus of the trust or institution' in section 2(24)(iiia), even this clause (x) of section 11(5) may be omitted.

a. Legal Obligation Vs-a-Vs Customary Obligation

There are certain customary obligations prevalent in the Indian society, by virtue of which certain funds are created. 'Dharmada' is one of such kinds. It is common knowledge that many companies realise
certain amounts on account of 'Dharmada' from its customers on sales of
their farm or raw commodities. The assessee-company do not credit the
amounts so realised by it in its trading account but maintain a separate
account known as 'Dharmada' in which the realization on account of
'Dharmada' are credited and payments made thereout are debited.

The question arises as to whether such funds create a trust
especially when it has been found that such payments were made pursuant
to a custom which obtained in the commercial and trading community.
This very question came up before the Supreme Court in 28
Cotton Mills Pvt Ltd. The assessee-company was a private company
carrying on the business of manufacturing and selling yarn. The Board
of Directors passed a resolution whereby the amounts so accumulated and
to be received in future were declared to form a trust fund to be
utilised for religious and charitable purposes.

The Tribunal held that the trust being void for vagueness and
uncertainty, the realisations partook the nature of trading receipts.
The Supreme Court, dismissing the findings of the Tribunal, held as
under:

"On a parity of reasoning the Dharmada amounts paid by the
customers cannot be regarded as part of price or a surcharge
on price of goods purchased by the customers. The amount of
Dharmada is undoubtedly a payment which a customer is required
to pay in addition to the price of the goods which he
purchases from the assessee but the purchase of the goods by
the customer would be the occasion and not the consideration
for the Dharmada amount taken from the customer... The
Dharmada amount is, therefore, clearly not a part of the price,
but a payment for the specific purpose of being spent on
charitable purposes".

The Supreme Court further observed:

"...further, the fact that the assessee would be having some

28. (1979) 116 ITR 60 (SC)
29. Ibid, 73: The Supreme Court followed its earlier decision on the
point in CIT v. Tollygunge Club Ltd (1977) 107 ITR 776 (SC)
30. Ibid, 74
discretion as regards the manner in which and the time when it should spend the Dharmada amounts for charitable purposes would not detract from the position the assesses held qua such amounts, namely, that it was under an obligation to utilise them exclusively for charitable purposes.

It is submitted that with the recent advancements in law, the legislation has an effect of superseding this Supreme Court's judgment in CIT v. Be Ellis Cotton Mills Pvt. Ltd. Even though the customers might have contributed on their own volition for creating such a fund for charitable purposes, it could have no sanctity of exemption in the eye of law and would be likely to be treated on trading account in the hands of the company. If this customary practice could be allowed to perpetuate, as most of the private companies are actively engaged in it, it boomerangs into one of the best innovations of tax avoidance.

The Finance Minister, while piloting the Finance Bill 1984 before the Parliament enunciated certain strong and viable measures for combating tax avoidance, one of which relates to 'imposition of restrictions on contributions by employers to non-statutory funds'. The Finance Minister stated as under:

"35. Sums contributed by an employer to a recognised provident fund, an approved superannuation fund and an approved gratuity fund are deducted in computing his taxable profits. Expenditure actually incurred on the welfare of employees is also allowed as deduction. Instances have come to notice where certain employers have created irrevocable trusts, ostensibly for the welfare of employees, and transferred to such trusts substantial amounts by way of contribution. Some of these trusts have been set up as discretionary trusts with absolute discretion to the trustees to utilise the trust property in such manner as they may think fit for the benefit of the employees, without any scheme or safeguards for the proper disbursement of these funds. Investment of trust funds has also been left to the complete discretion of the trustees. Such trusts are, therefore, intended to be used as a vehicle for tax avoidance by claiming deduction in respect of such contributions, which may even flow back to the employer in the form of deposit".

31. Ibid
"36. With a view to discouraging the creation of such trusts, the Bill seeks to make a provision that no deduction shall be allowed in the computation of taxable profits in respect of any sums paid by the taxpayer as an employer towards the setting up of, or as contribution to, any fund or trust for any purpose, except where such sum is paid or contributed (within the limits laid down under the relevant provisions) to a recognised provident fund or an approved gratuity fund or an approved superannuation fund or for the purposes of and to the extent required under any other law".

With this view, an amendment has been proposed by virtue of the Finance Act, 1984, in section 40A of the Income Tax Act, inserting subsection (9) which reads as under:

"No deduction shall be allowed in respect of any sum paid by the assessee as an employer towards the setting up of, or as contribution to, any fund or trust for any purpose, except where such sums is so paid, for the purposes and to the extent provided by or under clause (iv) or clause (v) of sub-section (1) of section 36, or, as required by or under any other law for the time being in force".

Though, this proposed amendment relates to the creation of an irrevocable trust out of the company's funds ostensibly for the welfare of the employees, but the principle involved behind it can be equally applicable, by way of analogy, to an irrevocable trust created out of the amounts tendered by the customers, on their own volition, of course, for charitable purposes. It is submitted, therefore, that such amounts may be well considered to be in the nature of trading receipts in the hands of the company, for which the existing law may not be sufficient to meet the sporadic undercurrents of the business culture. It is, therefore, submitted that the following clause (bb) may be inserted in section 13(1):

"In the case of a trust for charitable purposes created by a customary levy from the constituents or customers, whether on their own volition, or for the benefit of such customers or constituents".

32. It is to be noted that the existing clause (bb) stands omitted by virtue of the Finance Act, 1983.
II. Socio-Economic Aspects

It is common knowledge that trust funds are increasingly utilised for investment in equity shares of the companies, thus furthering the business interests of the settlor or his family members. The legislature has been constantly seized of this tendency, which is itself one of the potent factors for the proliferation of 'black money'.

Towards the end of 1963, the Companies Act, 1956 was amended to provide, inter alia, the voting rights in favour of a 'public trustee' in those companies where the shares are being held by the machinations of a trust. The Income Tax Act too, takes enough care of such a situation. Section 13(1)(c) states that if any part of the income of a trust for charitable or religious purposes enures directly or indirectly for the benefit of the author of the trust, substantial contributor to the trust, members of the family thereof, then the exemption enumerated under section 11 shall be forfeited.

Finance Act, 1983 has taken effective measures by virtue of clause (d) to section 13(1) that the income from any shares in a company in which public are not substantially interested, shall not qualify for exemption in the hands of a charitable or religious trust, after 30th November, 1983. But at the same time, the proviso to clause (d) to section 13(1) mollifies the aforementioned provision. The effect of the proviso is that if the trust invests in the shares of any company, including an investment company, then the profits and gains out of such

33. Section 187B read together with section 153A, Companies Act, 1956. This amendment was made on the basis of the study by R.K. Hazari, "The structure of the corporate sector - a study of concentration, ownership and control" (1958), para 10. It pointed out that it will tend to reduce the magnitude of large blocks of tax free wealth and income available for the purpose of controlling companies and would, to that extent, also tend to curb the concentration of economic power.
a business are not at all questionable for the purposes of exemption, even though the trust may make such an investment after 30th Nov., 1983. It would be pertinent to quote the proviso, which is as under:

"Provided that nothing in this clause shall apply in relation to -

i. ...

ii. ...

iii. Any funds representing the profits and gains of business, being profits and gains of any previous year relevant to the assessment year commencing on the 1st day of April, 1984 or any subsequent assessment year...."

As mentioned in the preceding paragraphs, the very dynamism of the legislation is being sapped away by inserting a generalized clause amongst the category of specific clauses. Such examples pouring in through the yearly finance Budgets are too glaring to ignore. It is too late in the day to say that even now our fast-developing economy could sustain such legislative manoeuvrings. It is submitted that clause (iii) of the proviso to section 13(1)(d) deserves no place and, therefore, may be omitted.

II. Techniques of Capital Formation

1. Benami Holdings

With a view to regulate the corporate affairs properly, few important measures were taken under the Companies Act, 1956, way back in 1974. Indubitably, the shareholder's lists should be true and reliable. As a matter of fact, keeping in view the implication of this matter, section 153 of the Companies Act lays down the statutory bar against registration of trusts as shareholders.

34. Section 187 C was inserted by virtue of the companies (Amendment) Act, 1974 which regulates holding of the shares in the benami names.

35. The Gorwala Committee on 'Stock Exchange Regulation' which submitted its report in 1951 clearly mentions that whereas the official members wanted a complete embargo or abolition of 'blank transfers' on the ground that they help tax evasion and unhealthy speculation, thus making shareholders lists inaccurate and unreliable; the non-official members argued that some
It is common knowledge that substantial percentage of 'benami' or 'nominee' holdings are managed by the public financial institutions or the banks, either in the capacity of trustees or mortgagees. The Reserve Bank of India has powers, under section 36(1)(a) of the Banking Companies Act, 1949, to regulate such holdings.

The Finance Bill, 1984 has introduced the concessions regarding the application of the 'convertibility clause' to those units borrowing from the financial institutions and a cut in interest rates for funds borrowed from these institutions for modernisation by the units. It is a welcome move as the process of benami holdings would be discouraged. The threshold for exemption for applying the convertibility clause has been raised from Rs one crore to Rs five crores for borrowings from the institutions. Also the convertibility clause will be applied to non-MRTP Companies only when the holding of all the financial institutions in a company exceed 26% though the application of the clause to MRTP companies remains untouched at 40%. The welcome concession given to entrepreneurs in the application of the convertibility clause is that the 'convertibility clause' will not be applicable to those units being set up in 'no industry' districts.

35 contd. Form of blank transfer was used in all capital markets, its abolition would disrupt the working of the market by reducing the floating stock of shares; moreover the blank transfers were not the only potent instrument for tax evasion.

36. Under Section 19(2) of the Banking Companies Act, 1949, such shareholdings held by the Banks are limited to 30% of the paid-up capital of these companies, or 30% of the paid-up capital and reserves of the bank, whichever is less.

37. The convertibility clause has always been a 'bug bear' for borrowers from the financial institutions, as their fear has been that once the institutions convert their loans into equity their 'say' in the managing of the companies will increase thereby hampering the promoter's freedom of action.
The interaction of section 64 on one hand and the gamut of sections 161 and 164 on the other, is of crucial importance in this connection. The leading pronouncement on this subject remains the Supreme Court's decision in C. R. Nagappa v. CIT where the court held that assessment in the hands of the settlor's minor children of the income from assets settled in trust for the benefit of minors by the settlor, will not affect the validity of the inclusion of the trust income of such minor children in the hands of the settlor under section 64(1)(vii). The Supreme Court observed that section 64 overrides section 161. The Taxation Laws (Amendment) Act, 1975 made the position clear that any income arising directly or indirectly, from assets transferred directly or indirectly, otherwise than for adequate consideration, by a settlor, to the extent to which the income from such assets is for the immediate or deferred benefit of settlor's spouse or minor child (not being a married daughter) or both, is includible in the hands of the settlor. Of course, where income from a trust is made exigible to tax in the hands of the settlor by virtue of the provisions of section 64(1), it cannot be brought to tax in the hands of the beneficiary or trustee again.

Indubitably, the implications of the mischief of section 64 are far-fetched, but even now certain loopholes remain to be plugged. Whereas the income arising to the trustee from the membership of the trustee in a firm carrying on business in which the spouse of the individual and the individual are partners, to the extent that such an income is for "the immediate or deferred benefit" of the spouse shall be included in the total income of the individual. Similarly, the income

38. (1969) 73 ITR 626 (SC)
39. Explanation 1A to section 64(1) Income Tax Act, 1961 inserted by virtue of Finance Act, 1979 w.e.f. 1.4.80.
arising to the trustee from the membership of the trustee in a firm, to the extent that such an income is for the benefit of the minor child, shall be included in the total income of the individual. But strangely enough, the Finance Act, 1979 did not provide the same mechanics in a case where the income is for the benefit of son's wife or son's minor child of such an individual. Though section 64(1)(vi) entitles the revenue for clubbing but the income arising to the trustee from the membership of the trustee in a firm, to the extent that such income is for the benefit of the son's wife or son's minor child, no clubbing is warranted, since there is no provision analogous to Explanation 3 to section 64(1).

It is submitted that Explanation 3 to section 64(1) may be amended as under:

"For the purposes of clauses (iv), (v), (vi) and (vii), where the assets transferred directly or indirectly by an individual to the spouse, minor child, son's wife or son's minor child are invested by the spouse, minor child, son's wife or son's minor child in any business, including a business by the trustees on their behalf, that part of the income arising out of the business to the spouse, minor child, son's wife or son's minor child in any previous year, which bears the same proportion to the income of the spouse, minor child, son's wife or son's minor child from the business as the value of the assets aforesaid as on the first day of the previous year bears to the total investment in the business by the spouse, minor child, son's wife or son's minor child as on the said day, shall be included in the total income of the individual in that previous year."

It is submitted that the Gujarat High Court's decision in K.T. Doctor v. CIT is incorrect, where the court held as under:

"Lifting the veil to ascertain whether a business is in reality and substance is the business of the trust is not permissible in law so far as trusts are concerned. The concept of lifting the veil is permissible only in the case of a company with a view to finding out the real person behind the corporate body, viz., the company."

40. Explanation 2A to section 64(1).

The doctrine of lifting the veil, in its true essence, is not confined to the field of company law. It would be a travesty of the law to say that the substance of the business can be inferred only in those businesses which are of corporate form, thus opening new avenues for tax evasion. The very underlying concept behind the provisions of section 64 embodies the nexus of 'lifting the veil', particularly where the income is diverted through the conduit of a trust.

It is further submitted that in order to circumvent the tax avoidance practices, the renewal of registration of the trusts should be on an annual basis, with respect to the assessment year. This submission gets support from the Supreme Court’s judgment in CWT v. Trustees of HEH Nizam's family (remainder wealth) Trust, wherein the Supreme Court held that whether in a trust the individual shares of the beneficiaries were indeterminate or unknown, has to be ascertained independently for each assessment year. It is, therefore, submitted that a third condition may be inserted in section 12A as under:

"(c) Where the total income of the trust or institution as computed under this Act without giving effect to the provision of section 11 and section 12 exceeds twenty five thousand rupees in any previous year, the person in receipt of the income has made an application for renewal of the registration of the trust or institution in the prescribed form and in the prescribed manner to the commissioner before he furnishes the return of income for the relevant assessment year".

42. (1977) 108 ITR 555 (SC)

Section 12A which was inserted by virtue of the Finance Act, 1972 already lays down two conditions in order to earn exemption under section 11 and section 12.

1. The trust or institution should be registered with the Commissioner at the time when it has been created.

2. The accounts of the trust or institution should be audited if the total income, without giving effect to the provisions of section 11 and section 12 exceeds Rs25,000.