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Rethinking Gift Taxation in India: The Need for Clarity and Reform in Trust and Inheritance Structures

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Introduction

India does not have any specific legislation for gift and inheritance related provisions. The provisions relating to taxation of gift are contained in the anti-abuse provisions of the Income-tax Act, 1961 **("IT Act")**. These provisions have always been a focal point of discussion within the Indian tax regime. The taxation of deemed income arising from transfers of assets that are made below the fair market value has been very crucial anti-abuse provisions introduced to protect revenue/ tax base. This seems reasonable, considering the significant revenue loss if the gift tax provisions could be easily circumvented. In the recent case of Buckeye Trust, the Bangalore tribunal **("ITAT")** took a very wide interpretation of provisions of the income tax law to tax the trust, showcasing the existing ambiguity and lack of framework within the gift tax provisions. Although the order has been recalled by the ITAT due to inadvertent errors, this highlights the need for a re-examination of existing provisions related to gift tax, to eliminate any uncertainty and vagueness surrounding trusts and inheritance.

We start this article by explaining the background of the Indian gift taxation system. Further, we delve into factual background of the Buckeye Trust rulingand deep dive into the interpretations and reasoning of the Hon'ble ITAT. Lastly, we discuss the future of gift taxation, calling for reforms to prevent ambiguity and to provide for tax certainty while protecting the tax base and reducing the room for tax litigation on these counts.

Legislative history of Gift Taxation in India

Historically, India introduced inheritance tax in 1953 through the Estate Duty Act, but it was abolished in March 1985 after facing several issues like high administration costs and lack of revenue generation. Gift tax was introduced in the year 1958 and subsequently abolished in 1998. The gift tax on receipt of sum of money was reintroduced in 2004 via the Finance (No. 2) Bill, 2004, under section 56(2)(v) of the IT Act, which taxed receipt of money in excess of INR 25,000 without consideration in the hands of individual/ HUF recipient. The said provision was applicable till 1 April, 2006. The provision was amended in in order to extend the applicability, till 30th September 2009. Subsequently, the Finance (No.2) Act, 2009 introduced section 56(2)(vii) of the IT Act, which was valid until 31st March 2017. The current provision dealing with taxation of gifts is section 56(2)(x) of the IT Act, introduced via the Finance Act, 2017. Under section 56(2)(x) of the IT Act, receipt of various kinds of assets (including immovable property, and property other than movable property) for less than fair market value including inter-alia any sum of money exceeding INR 50,000, is chargeable under the head 'Income from Other Sources. The provision also widened the scope of existing

exceptions by introducing exemptions for receipt of assets by certain trusts, or institution or by way of transaction not regarded as a 'transfer' under section 47 of the IT Act.

This seems like a plausible system that offers a tax haven for inheritance and estate transfers while preventing any notional income that may arise from transfers below the FMV. However, the room for wide interpretation makes the subject litigative and leaves the door open for variety of tax disputes, even though the object of the anti-abuse provisions may be aligned to particular transaction, as highlighted in the present case. Although the provision seems to favour efficient inheritance transfer, strict interpretations complicate its practical application.

Factual Background

The case pertains to settlement of a private discretionary trust, Buckeye Trust **("the Trust")**. The Trust was established on 23rd January 2018 by the settlor, Mr. Anand Nadathur, with Vervain Management Private Limited as the trustee. The Trust received INR 669,27,63,437 in the form of interests in partnership firms and equity/preference shares in companies from the settlor. Issues arose when the Trust filed its return of income declaring 'Nil Income' relying on subclause (X) of proviso 4 to Section 56(2)(x) of the IT Act which exempted receipt of property from an individual by a trust that wascreated or established solely for the benefit of 'relatives' of the individual, from any tax liability in the hands of such trust.

Subsequently, Assessment Officer **("AO")** issued questionnaires seeking information regarding the nature and justifications of investments in the trust. Later, the AO accepted the returned income of the assessee. However, the Principal Commissioner of Income Tax **("PCIT")** invoked revisionaryjurisdiction under section 263 of the IT Act holding the AO's order to be erroneous and prejudicial to the interest of revenue.

Issues

In the present case, the Hon'ble ITAT made two new interpretations that questioned the flexibility of trusts and the overall gift taxation. They are as follows:

1. Partnership interest comes under the definition of 'Property'

As discussed above, apart from receipt of sum of money, section 56(2)(x) of the IT Act also applies to receipt of 'property', either movable or immovable. For this purpose, the term 'property' is defined under explanation (d) of section 56(2)(vii) of the IT Act which inter-alia includes 'shares and securities.' Thus, there is no room for discretionary interpretations. In the present case, out of the hefty total of INR 669,27,63,437 which the Trust received, the preference shares and equity shares amounted to only INR 1.79 crores each. The rest of the amount relates to the interest of the settlor in various partnership firms. Thus, it was critical for the revenue's case to construe the 'partnership interest' within the meaning of 'property' for the purpose of section 56(2)(x) of the IT Act. To support its position, the revenue argued that 'partnership interest' should be included in subclause (ii) of explanation (d) of section 56(2)(vii) of the IT Act i.e., 'shares and securities.' Further, the Hon'ble ITAT did not delve deeply into the concept of interest in a partnership and its transfer but instead differentiated between the term 'shares' and 'securities.' It then adopted a liberal interpretation of 'shares and securities' as 'shares or securities.'

The Hon'ble ITAT did not address the primary distinction between shares and partnership interest. An interest in partnership firms cannot be equated with 'shares', as a 'share' is defined under Companies Act, 2013, as 'a share in the share capital of a company'. In contrast, an interest in partnership comes with a plethora of additional restrictions. Section 29 of the Partnership Act, 1932, outlines the rights of a transferee of a partner's interest, stating that the transferee is only entitled to the share of profits of the transferring partner and is not allowed to inspect the books of accounts or interfere with the conduct of business. Therefore, one may argue that 'share' and 'partnership interest' are distinct and not same thing. Further, it may be trite to refer to the distinction in shares and partnership interest in section 115UB of the IT Act, which addresses the taxation on income of investment funds and its unit holders. Under this provision, the definition of 'unit' separately includes both the terms 'share' and 'partnership interest'. Therefore, it may be safe to argue that if the intention of the legislature had been to include 'partnership interest' within the scope of 'share', it would not have been mentioned separately.

However, some might argue that the reasoning for distinction between partnership interest and shares is invalid as in the present facts, the settlor had retired and the assessee had been made the owner of partnership firms. The ITAT also cited the Supreme Court's judgement of Mansukh Dyeing **[2023] 151 taxmann.com 306 (SC)**,where a firm revalued itself and credited the increased value to the accounts of partners. However, applicability of section 45(4) of the IT Act should not have been discussed, as neither of the parties raised it as an issue. Having said that, in the present case, there is no revaluation or transfer of assets by the firm. Instead, this is a case reconstitution which was not taxable under Section 45(4) of the IT Act as per the applicable law prior to amendment via Finance Act, 2021. Various High Courts, in their interpretations of section 45(4) have held that retirement of partner does not give rise to a tax liability unless there is a dissolution of the firm and distribution of capital assets to the retiring partner as part of such dissolution.

Nevertheless, for the sake of arguments, even if it is assumed that 'partnership interest' falls within the meaning of 'property', there should not be any tax implications in the hands of the trust as long as the trust can be said to be set up 'solely for the benefit of a relative' under subclause (X) of proviso 4 to Section 56(2)(x) of the IT Act. This leads us to the next interpretation made by the ITAT.

2. Pre-emptive taxation

The ITAT rejected the contention that the transactions were outside the purview of Section 56(2)(x) of the IT Act. The ITAT affirmed the PCIT's view that the benefits of the Trust were not restricted to relatives, citing clause 6.1 of the trust-deed, which allowed the trustee to add any persons or class of persons or charity as beneficiaries in the future. According to this interpretation, a trust can be taxed upfront even if the trustees have the freedom to add non relatives at a future date.

In the present case, since all the existing beneficiaries were relatives of the settlor, relaxation from the purview of subclause (X) of proviso 4 to Section 56(2)(x) of the IT Act should have been squarely applicable. However, ITAT's interpretation, based solely on the power of the Trustees to add non relatives in future without any actual exercise of such power, seems to lack justification. One may note that adopting such clause or power to add charity is a standard practice in trust structures to tackle any unforeseeable situations which defeats the vary purpose of asset protection by creation of trust. For instance, where a trust is set up for the benefit of a daughter and her children. In the event of her demise without having any children, the trust would come to an end, as neither is there any beneficiary left nor does the trust-deed provide for the Trustees to have the potential to add any other person. This could lead to an extreme interpretation resulting in taxation impact purely based on the restrictions on the power of trustees to add charity as the class of beneficiaries in a trust. The principles of interpretation of statutes would suggest that when actions undertaken arewithin the scope of existing laws, extreme interpretations should be avoided.

Further, it may trite to note that both 'trust' and 'will' serve as mechanisms to transfer generational assets. However, it is unfair and questionable that addition of any close relative, other than those defined as 'relatives' in a trust, results in taxation of the entire settlement in the hands of the trust. Whereas, in contrast, if the same assets are transferred via a will to the same close relative or any other person, there are no tax consequences. This disparity in the treatment of these two modes of transfer of generational wealth raises doubts about the legislative intent behind the strict restrictions on the class of beneficiaries in a trust.

The Way Forward

After significant concerns were raised against the order, the ITAT recalled it on 7th January 2025 under section 254(2) of the IT Act citing errors apparent from record and scheduled a fresh hearing for 19th February 2025. This is a positive step because it indicates that the ITAT is likely to revise and perhaps modify its position and interpretation. It would be interesting to see how, the issue unfolds, as the recall is a welcome move, appreciated by the stakeholders. However, the revenue is likely to challenge the recall order, citing the Supreme Court's judgment in the case of Reliance Telecom Ltd. **[2021] 133 taxmann.com 41 (SC)**, where it was held that the ITAT does not have the authority to recall its order, as the power under Section 254(2) is limited to amending or rectifying mistakes apparent from the record.

But for the recall, the observation of the ITAT to interpret the power to add any third party or charity beneficiaries, raises wide concerns on the structuring of transmission of assets via private discretionary trusts. Currently, there is no

clear guideline or framework addressing situations where a lack of consideration in a receipt falls under the purview of gift taxation u/s 56(2)(x) of the IT Act. To address this issue, it is important to identify specific circumstances where consideration may not be required, particularly in cases of transfer to a non relative.

A clear and efficient inheritance system for close blood relations, other than those defined as 'relatives', could provide a more effective approach to improve India's existing gift taxation framework, rather than continuously adjusting and expanding the provisions to impose taxes. Under this system, in addition to 'relatives' and 'third party/ non-relatives', it may be advisable to have a defined category of extended blood relatives viz niece, nephew, cousins etc, the gift of assets to whom could be subject to a flat inheritance tax. A flat inheritance tax could be imposed on such trusts settled in favour of such extended blood relatives, rather than subjecting them to regular tax brackets. Such a tax should be imposed only in case of actual addition of extended blood relatives being added to the class of beneficiaries, rather than on the mere potential to add them as beneficiaries in the future. The government may also mull over the differential treatment of 'will' over 'trust', and levy flat inheritance tax on the transfer of assets to extended blood relatives, similar to the trust taxation of extended blood relatives.

Appropriate standard deductions, reasonable tax rates, and threshold limits can be applied to such cases of inheritances by extended relatives. For instance, in the UK, inheritance tax is not applicable if the estate value is below the threshold limit of £ 325,000. Such an organised system would bring clarity, certainty, and reduce anxiety in the succession process, mainly in cases where high net worth individuals and significant assets are involved.

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