Opinion | Should you rush to create a private trust for the benefit of your family?

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There is significant uncertainty even if assets are settled upon a trust

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In the past three or four years, just before the budget, we have seen a rush of anxious clients seeking advice on whether they should set up a private trust for the benefit of their family members. This year has been no different. A discussion with the clients reveals that the anxiety is fuelled by rumours that estate duty is likely to be reintroduced in the forthcoming budget. Should one rush to set up a trust under such circumstances, and is it beneficial?

In the 1980s, family trusts were formed for tax planning, as a family trust is taxable as a separate entity. They were then taxable at separate slab rates, thus providing a tax benefit. However, with the amendments in tax laws, which resulted in discretionary trusts being taxed at maximum marginal rates and specific trusts being taxed at the same rate as the beneficiaries, the income tax arbitrage was eliminated. Further, with the abolition of estate duty in the mid-eighties, there remained no tax benefit in having such family trusts.

For three decades, one saw family trusts being set up only for non-tax reasons, perhaps the right reasons. Businessmen set up family trusts so that income from family businesses could be divided among all the family members, while only certain members were vested with the management of the business; parents set up family trusts for the benefit of children with special needs to provide for them even after the lifetime of the parents; trusts were set up in cases where the income was to go to one set of persons, while the asset was to go to another set of persons; and persons involved in risky businesses or professions set up family trusts to protect some of their assets against any potential liabilities that may arise in future.

The exemption of dividends provided an opportunity for settling shares in a trust, where the income of the trust would be exempt, and which could then be distributed again, tax-free, in the desired manner, to the concerned beneficiaries. However, now even trusts are liable to pay the super-rich tax of 10% on dividends exceeding □10 lakh.

There are various other aspects that one needs to consider when setting up a family trust. The first is that any settlement of assets on the trust or transfer of assets to the trust would not be taxable as the income of the trust if the trust is only for the benefit of specified relatives of the settlor or transferor. If any person, who does not fall within the category of specified relative of the settlor or transferor, as the case may be, is a beneficiary, the entire value of the assets received by the trust would be taxable as income of the trust.

Another important aspect is that there are stamp duty implications on transfer of assets to a trust. On such transfer, the stamp duty concessions applicable to transfers to a relative are not available, and hence, one may end up paying the full amount of stamp duty. This stamp duty has to be paid upfront, and is therefore an immediate cost, in contrast with any future benefits that may arise. Transfers of immovable property may attract a significant amount of stamp duty, since it is payable on the current market value of the property.

One also needs to keep in mind that the settlor or transferor himself would not have access to the income from the assets being settled in trust or transferred to the trust, or else it may be regarded as a revocable transfer, inviting provisions for clubbing of income. Therefore, the settlor or transferor needs to ensure that he retains sufficient assets to generate the income that he needs, and it is only surplus assets which are transferred to the trust.

With regard to the potential advantage if estate duty is reintroduced, one needs to keep in mind that whether assets settled on such a trust will be outside the purview of estate duty would depend upon the provisions of the law that is enacted. The law may provide for taxing past transfers in the recent certain number of years. If that is the case, there may really not be much benefit in settling assets on such a trust today. There is, therefore, a significant amount of uncertainty even if assets are settled upon a trust.

All gifts (including those to relatives) will also necessarily need to be made taxable, if estate duty is introduced, so that estate duty cannot be avoided through gifts. The likelihood of a recently re-elected government with a new finance minister introducing such a significant change in the tax laws needs to be evaluated. Further, the likely threshold limit beyond which estate duty would apply is also not known, neither is it clear which assets would be exempt from estate duty.

Therefore, setting up of a family trust will require a great deal of thought and planning. Rushing to set one up to beat any potential estate duty liability may not be such a good idea, if adequate preparation and groundwork is not done. One may otherwise end up with a trust which does not really serve the purpose of the settlor.

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