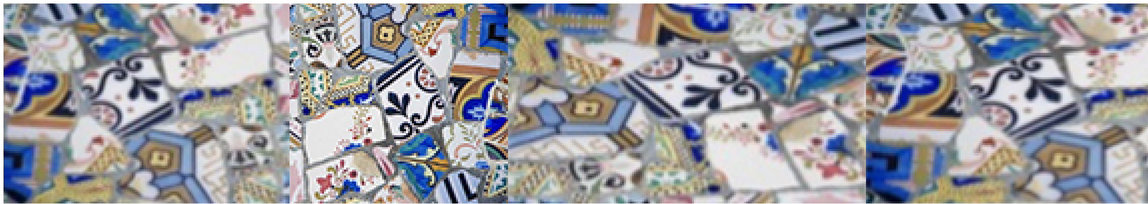

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House Features

Liability In Special Cases - Representative Assessees: Section 164- Where Share Of Beneficiaries Is Indeterminate Or Unknown

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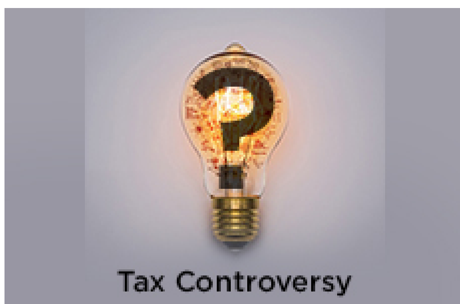

Chapter-X dealing with the computation of income from transactions between associated enterprises having regard to Arm's Length Price (ALP) was inserted by the Finance Act, 2001 w.e.f. 1.4.2002. The Transfer Pricing (TP) regulations came to be introduced in the light of growing cross-border trade and the need to protect tax base and curb tax avoidance/ profit shifting practices of the entities involved in the transactions. →

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Liability In Special Cases - Representative Assessees: Section 164- Where Share Of Beneficiaries Is Indeterminate Or Unknown

Introduction

S.164 is a special provision applicable specifically to private discretionary trusts where the beneficiaries are indeterminate or unknown. It confines itself specifically to defining the rate of tax to be levied in such cases, the total income of the representative assessee - namely, the trustees of the trust - is determined by other provisions of the Act [*CIT v. SAE Head Office, MPEW Trust 271 ITR 159* (*Delhi*)].

Statutory provisions

The statutory provisions are broadly as follows:

S.160 specifies five categories of representative assessees. The trustees of a private trust constitute one such category and are covered by s.160(1) (iv) or (v) of the Act. S. 160 (2), deems all such persons to be assessees. They can thus be assessed or be liable to pay tax in respect of incomes which accrues or arises to the trust, on behalf of the beneficiaries of the trust.

S. 161 defines the extent of such liability. A representative assessee has the same rights and duties under the Act as he would have had, had such income been his personal income. He is assessed on such income in his own name but only in a representative capacity. This means that the tax on such income can only be assessed in his hands and the tax realised from him only in the like manner and to the same extent that it would have been so assessed or realised from the beneficiary or beneficiaries.

What happens however when the income is not receivable on behalf of any one beneficiary or the shares of such beneficiaries are indeterminate or unknown? S.164(1) stipulates that such income shall then be taxable at the maximum marginal rate of tax[1], without any exemption limit [*Surendranath Gangadhara Trust v. CIT 142 ITR 149 (Cal)]*.

[1] S 2(29C)

In the following circumstances, however, the trust would be treated as an AOP[2] and be taxed as such instead of at the maximum marginal rate:

- Where total income of each of the beneficiaries of the trust falls below the exemption limit for an AOP and they are not beneficiaries of any other trust; or,
- Where the trust is the only trust created by the settlor concerned under a will
- Where the trust is not created by will and is the only trust created before 01.03.1970:
    - by the settlor for the exclusive benefit of his relatives mainly dependent upon him for support and maintenance; or
    - where the settlor is an HUF, the trust so created is for the exclusive benefit of its members for their support and maintenance
- Where the trust is a provident or other fund created by a person carrying on a business or profession exclusively for the benefit of the employees of such business or profession; or,
- Where the income is derived from property held under trust for charitable or religious purposes, or is business income falling within the ambit of s. 11(4A) or comprises of voluntary contributions received by the trust which are not exempt u/ss 11 and 12 (But if the denial of exemption u/ss 11 and 12 springs from a violation of s13(1)- that is the use of the property of the trust by the prohibited category of persons- such as its manager, trustees etc.- tax will levied at the maximum marginal rate).

In a major amendment introduced by the Finance Act of 1981, where a trustee receives or is entitled to receive any income on behalf of or for the benefit of any other person under an oral trust, it shall be taxed at the maximum marginal rate, notwithstanding anything to the contrary stipulated under any other provision of the Act. Explanation 1 provides two exceptions to this rule. An oral trust will be treated as a trust created by an instrument in writing if the trustees file a statement duly signed by the trustees, indicating the purpose of the trust, names of the trustees and the beneficiaries and the details of the trust property:

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[2] Slab-wise rates

- In the case of trusts in existence prior to 1st June 1981, by 31st August, 1981
- In all other cases, within three months of the date of declaration of the trust

Where only part of the income of a trust is indeterminate or unknown, the above provisions would apply to it mutatis mutandis in the manner indicated above.

"Indeterminate or unknown"

The statutory provisions appear to show that s.164 is not a self-contained code for the taxation of discretionary trusts. It merely prescribes the tax rate where shares of the beneficiaries are indeterminate or unknown. The liability of the trustee to be taxed as a representative assessee is laid down u/s 160 and 161 and the total income itself is determined by the other provisions of the Act *[CIT v. Kamalini Khatau 209 ITR 101 (SC) and Moti Trust v. CIT 236 ITR 37(SC)]*. Where certain income of a trust was distributed to a beneficiary and the same was also received by him within the previous year, it would constitute part of his total income and be assessable in his hands u/ss 4 and 5 *[CIT v. Kamalini Khatau 209 ITR 101 (SC) and Moti Trust v. CIT 236 ITR 37(SC)]*.

What is determinate or unknown has often been seen to be problematic in the past. In order not to fall within the ambit of s.164, the trust deed must not only specify the names of the beneficiaries but also their respective shares [*Yakub Versey Laljee v.CIT 14 ITR 548 (Bom)*]. Only then can it be said that the beneficiaries are known and determinate.

Sometimes, the beneficiaries for one part of an income may be determinate or known; for another part, they may be indeterminate or unknown. In such a situation, s.164 will be attracted only in respect of the latter and not the former income. [*Official Trustee v. CIT 26 ITR 410(Cal)*].

S.164 would be attracted if the amounts or proportions in which the income is to be distributed is not defined in the trust deed but left to the discretion of the trustees [*Anasuya Muthanna v. CIT 232 ITR 561(Mad)*]. This section would be similarly attracted if the right to receive income by a beneficiary is contingent

in nature [*Ankleshwaria v. CIT 207 ITR 1068 (Guj), Nirmala Bala Sarkar v. CIT 74 ITR 268 (Cal)*].

In all these cases, the shares of the beneficiaries would be indeterminate. It would likewise be indeterminate if the trust is to accumulate income for the benefit of a class of beneficiaries who are not ascertainable in a given year [*CIT v. Trustees of Keshav Mohta Family Trust 232 ITR 875 (Cal)*] or if the objects are vague, such as the political advancement of India [*In re: Lokmanya Tilak, 10 ITR 26 (Bom)*]. However, if the trust deed vests power in the trustees to determine the share of the beneficiaries and they exercise such power for any year, the trust shall cease to be a discretionary trust for that year [*CIT v. Devshi Trust 279 ITR 579 (Bom)*].

One important criterion for deciding whether the beneficiaries are known and determinate is whether, in terms of the trust deed, the names of the beneficiaries and their shares are clearly ascertainable on the last day of the relevant previous year. Where however the shares of beneficiaries are indeterminate, a subsequent deed of rectification can specifically indicate how much income each beneficiary would get and the trust would then cease to be a discretionary trust.

Interestingly, in the case of an endowment, the shares of the various dieties were not specified, it was held that each of them could be deemed to be entitled to an equal share [*CIT v. Bhimchandra Ghosh 30 ITR 46* (Cal), *CIT v. Official Trustee 139 ITR 1* (Cal)*]*. On the principle of reasonable construction, this principle would perhaps apply equally to beneficiaries who are private individuals [*CWT v. Chetty 120 ITR 329* (*Mad*)].

It would not make any difference if the number of beneficiaries is very large. In one case they were 24 in all, nonetheless, the beneficiaries were held to be determinate and known [*CIT v. Trustees of H. E. H. the Nizam's Miscellaneous Trust [160 ITR 270* (AP)], *Khan Bahadur M. Habibur Rahman vs Commissioner of Income-Tax, v. CIT 13 ITR 189*(Patna)].

It also does not matter if they vary from year to year [*CWT v. H.E.H. Nizam's Family (Remainder Wealth) Trust 108 ITR 555*(*SC*), *Pandit v. CIT 83 ITR 136* (*Bom*)], or if a title suit to the income is pending in a court of law [*Mahamaya Dassi v.CIT 126 ITR 748*

(*Cal*)], or if one of the beneficiaries dies and his interest devolves upon his legal heirs [*CIT v. Gulabchand Mehtab Bai Kasliwal Family Trust ((2002) 254 ITR 336 (Raj)*)]. These decisions are now subject to Explanation 1 to section 160. Introduced with effect from 1st April 1980-81, this specifies *inter alia* that:

i. an income shall not be deemed to be receivable on behalf of a beneficiary unless the trust deed or the order of the Court specifically mentions his name and he is specifically identifiable on the date of the trust deed/order of the Court; and,
ii. the individual share of such beneficiary shall be deemed to be indeterminate or unknown unless the same is clearly indicated in the trust deed/ court order and is clearly ascertainable on the date of such deed/order.

To be continued

We shall carry on our discussion on liability in special cases in the next issue of Knowledgeware.

Penalty In Case Of Income Represented By Addition/ Disallowance In TP Audit

Chapter-X dealing with the computation of income from transactions between associated enterprises having regard to Arm's Length Price (ALP) was inserted by the Finance Act, 2001 w.e.f. 1.4.2002. The Transfer Pricing (TP) regulations came to be introduced in the light of growing cross-border trade and the need to protect tax base and curb tax avoidance/ profit shifting practices of the entities involved in the transactions.

Under the TP regulations, any income arising from an international transaction i.e. transactions between associated enterprises, called as controlled transaction, is computed having regard to the arm's length price. The rationale for the arm's length principle itself is that, because the market governs most of the transactions in an economy, it is appropriate to treat intra-group transactions as equivalent to those uncontrolled transactions between independent entities.

Section 92 (3) of the Income Tax Act 1961 which deals with TP regulations, contains a provision to avoid base erosion in terms of which the Tax Authority is precluded from making TP adjustments which can lead to

- reduction in the total income or increase in loss; or
- result in allowing higher profit-linked deduction on the total income enhanced by TP adjustment

The TP regulations prescribe six methods, three of which are profit based methods, and require choosing of the most appropriate method to determine that the international transactions are consummated consistent with arm's length principles.

The profit based methods involve use of profit level indicators (PLI) viz. gross profit, operating net profit margins expressed as percentage of operating revenue or cost for comparison and benchmarking thereof with the margins earned by the independent entities under similar conditions and circumstances as in the uncontrolled transactions. The financial results essentially are outcome of the accounting practices employed by the entities which tend to vary and therefore require appropriate suitable adjustments for a meaningful comparison. The functions performed, assets employed and risks borne (FAR) by the entities have a bearing on the financial results and, though the products or services in the controlled transactions may not exactly be same in uncontrolled transaction, similarity between the FAR lie at the core of the comparison. TP regulations therefore

allow for the adjustments in computing PLI for appropriate comparison to remove differences which materially affect the profit margins.

Where the application of the most appropriate method prescribed in section 92C of the Act results in determination of more than one price, then the arm's length price in respect of such international transaction or specified domestic transaction is required to be computed on the basis of the dataset so constructed and in accordance with the provisions of the rule 10CA of Income Tax Rules. The TP benchmarking exercise in such circumstances involves estimation and approximation and is not an exact science.

In the course of TP audit, if the Transfer Pricing Officer does not accept the arm's length price and proceeds to recompute ALP, then upward TP adjustment to the ALP is often mechanically subjected to levy of penalty for furnishing of inaccurate particulars of income.

It has been a matter of dispute as to whether ALP adjustment made by the TPO can be said to attract penalty when a different approach is adopted by him in the TP audit and where it is inherent in transfer pricing that reasonable people can end up drawing different conclusions on the same set of facts.

Recent decision of Honourable High court of Gujarat at Ahmedabad in the case of Shell Global Solutions International B.V. Tax Appeal No. 483 of 2023 Date of Judgement/Order: 26/10/2023 bears vital notice in this context. The facts obtaining in the said case were as follows-

The respondent assessee company was a Foreign Company registered in Netherlands, deriving income from Royalties or fees for technical services. Return of income of Rs.9,19,53,530/- was filed in India. Audit Report under Section 92E relating to international transactions for 3CEB was also filed. The case was selected for scrutiny and was referred to the TPO. On verification of Form 3CEB the TPO made an upward adjustment of Rs.29,43,61,998/- on account of variations in the ALP of service charges. In the quantum proceedings it was contended by the respondent foreign company that the upward TP adjustment was not warranted as application of arm's length principles would result in the erosion of Indian tax base. However, the argument of the assessee could not find favour before the Tribunal and the assessee went in quantum appeal before the High Court.

The AO levied penalty in respect of the TP adjustment made in the TP audit by invoking the explanation 7 to Section 271 (1)(c) . The said provision deems the amount added or disallowed pursuant to upward TP adjustment in the TP audit under section 92C of the Act to represent the income in respect of which particulars have been concealed or inaccurate particulars have been furnished.

Honourable High Court observed that the lower mark-up charged in respect of services rendered by the assessee foreign company to its associated enterprises, did not result in Indian tax base erosion and the TP provisions are not attracted in cases where there is no base erosion, so far as taxes are concerned. Further, it was also observed that the assessee had made adequate disclosure of all the material facts in Form 3CEB, Transfer Pricing Study Report etc. during the course of the transfer pricing assessment proceedings and also in the scrutiny assessment proceedings. The High Court noted that the computation was made under Section 92C in the manner prescribed under that Section, in good faith and with due diligence. Merely because the quantum appeals were admitted and pending it did not ipso facto attract penalty. Transfer Pricing Mechanism adopted and the 'Base Erosion' theory was a debatable issue and therefore on two opinions being available it could not be a case of penalty under Section 271(1)(C) read with Explanation 7.

Honourable High Court referred to the decision in the case of Toyota Kirloskar Motor (P) Ltd. V. Union of India wherein the Court had held that the Explanation 7 to Section 271(1)(c)] cannot be applied blindly in a routine manner to levy penalty on the additions made in the absence of any material to establish the concealing of income or furnishing inaccurate particulars. The Honourable High Court inter alia referred to the decision of Honourable Supreme Court in Reliance Petroproducts Ltd. (322 ITR 158) wherein the Supreme Court had held that 'Merely because the assessee had claimed the expenditure, which claim was not accepted or was not acceptable to the Revenue, that by itself would not, in our opinion, attract the penalty under Section 271(1)(c). If we accept the contention of the Revenue then in case of every Return where the claim made is not accepted by Assessing Officer for any reason, the assessee will invite penalty under Section 271(1)(c).'

Section 271(1)(c) has been omitted by the Finance Act 2016 and in its place section 270A has been inserted which is applicable from 1 April 2017. It seeks to levy penalty on under reporting and misreporting of income. The rigours of the erstwhile deeming fiction appear to have been somewhat relaxed by the subsequent amendments brought in the Act.

Useful reference can be made at this juncture to the aforesaid new provisions.

Section 270A(6)(d) provides that the under – reported income for the purpose of Section 270A shall not include the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer, where the Assessee had a) maintained information and documents as prescribed under section 92D,

b) declared the international transaction under Chapter X, and, c) disclosed all the material facts relating to the transaction. Section 270 A.

Section 270A (7) of the Act prescribes a penalty of 50% of the amount of tax payable on the under-reported income.

Section 270 A (6) (a) provides that under reporting of income shall not include income in respect of which explanation is offered by the assessee and the AO/ CITA/ JT. CIT A/ CIT/ PCIT is satisfied that the explanation is bonafide and assessee has disclosed all the material facts to substantiate the explanation offered. Clauses (b) and (c) refer to determination of under reported income on the basis of estimate and exclude it from the vice of under reporting of income if the conditions specified in those sub clauses are met.

Section 271BA provides that if any person fails to furnish a report from an accountant as required by section 92E, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of INR 1,00,000.

Section 271G provides that if any person who has entered into an international transaction or specified domestic transaction fails to furnish any such information or document as required by sub-section (3) of section 92D, the Assessing Officer or the Commissioner (Appeals) may direct that such person shall pay, by way of penalty, a sum equal to two percent, of the value of the international transaction or specified domestic transaction for each such failure.

It is interesting to note that under the 271(1)(c) regime the requirement was quite subjective, in the sense that, the assessee had to prove, to the satisfaction of the Revenue authorities, that the price charged was computed in accordance with the provisions of s 92C and in good faith and with due diligence. Being so subjective, defending charge of concealment etc. was quite onerous.

As stated above, under the new provisions, the emphasis is on maintenance of prescribed information and documents and disclosure of all material facts. In the new regime levy of penalty is not automatic and certain safeguards are also available to the taxpayer. The ratio laid down by the Apex Court in the case of Reliance Petro Products Ltd. reported in 322 ITR 158 is good law.

Having said this, it must be borne in mind that the provisions dealing with computation of income from international transactions are contained in Chapter X of the Income Tax Act being ‘Special provisions relating to avoidance of tax’. If the pricing of the international transactions is unnaturally arranged so as to avoid tax in India, issue of levy of penalty would assume significance.