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Tax Flash News

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Surcharge on private discretionary trusts follows slab-based rates, not the highest rate

Executive summary

Private discretionary trusts are subject to tax at the maximum marginal rate (MMR), which corresponds to the tax rate on the highest income slab applicable to individuals, etc. under the relevant Finance Act.

A key area of dispute has been whether the surcharge should also be imposed at the highest rate of 37 per cent, regardless of quantum of income, or whether it should be applied in accordance with slab-based thresholds as specified in the Finance Act.

The Mumbai Special Bench of the Tribunal in the case of *Araadhya Jain Trust*[1], held that surcharge on tax computed at MMR must be levied based on the slab-wise rates provided in the Finance Act, and not automatically at the highest rate.

[1] *Araadhya Jain Trust* v. *ITO* (ITA No. 4272/Mum/2024). Source: Taxsutra

Facts of the case

The taxpayer is a private discretionary trust, meaning that its trustees have full discretion over the distribution of income and capital among beneficiaries. Neither the beneficiaries nor their respective shares are determinable.

For AY 2023–24, the trust reported an income of INR 4.85 lakhs and paid tax at the MMR.

While processing the return, the Centralised Processing Centre (CPC) applied surcharge at the highest rate of 37 per cent.

The trust challenged this, asserting that since its income was below INR 50 lakhs, no surcharge was applicable, per the slab-based provisions in the Finance Act, 2023.

The CIT(A) upheld the CPC's position, prompting the taxpayer to appeal before the Tribunal.

Due to conflicting decisions on similar issues, including for the trust's own AY 2022–23 appeal, a Special Bench was constituted. Multiple trusts with pending similar disputes were allowed to intervene in support of the lead appellant.

Legal provisions

A private discretionary trust is taxed at MMR, as per sections 164/ 167B of the Income-tax Act, 1961 (IT Act) read with section 2(3) of the Finance Act, 2023 (FA 2023).

MMR is defined in section 2(29C) of the IT Act to mean income-tax rate (including surcharge on income-tax, if any) applicable in relation to the highest slab of income in the case of an individual, AOP[2], BOI[3] as specified in the relevant Finance Act.

The Finance Act (Section 2(1) read with the First Schedule) prescribes rates of tax and surcharge, with the surcharge applied based on income slabs.

However, section 2(1) is subject to section 2(3) of the Finance Act which provides that in case of a private discretionary trust, tax is to be charged at MMR.

Taxpayer's contentions

The definition of MMR must be read along with section 2(1) and the First Schedule of the Finance Act. The computation of surcharge is solely governed by the Finance Act, not by the definition of MMR.

[2] Association of Persons

[3] Body of Individuals

While the base tax is to be charged at MMR, the surcharge should follow the slab-based structure under the Finance Act. Section 2(3) of the FA only modifies the tax rate, not the surcharge mechanism.

The words 'including surcharge on income-tax, if any' in the definition of MMR are placed in round brackets within the definition clause and should be interpreted as connoting extra information separate from the main context of the definition itself.[4]

The phrase 'if any' in the definition of MMR implies that surcharge is not inherently included in MMR and should only be levied if applicable under the Finance Act.

Interpreting MMR to include a flat 37 per cent surcharge leads to absurdity, especially for low-income trusts. Budget documents and circulars support the view that surcharge targets high-income taxpayers and should not burden small trusts.

The phrase 'unless the context otherwise requires' in section 2 of the IT Act means definitions should be interpreted based on context. If a literal interpretation leads to absurd results, a contextual interpretation must be adopted.[5]

When there are conflicting interpretations, the one favouring the taxpayer should be preferred, especially regarding charging provisions.

Nature of surcharge

Surcharge is an amount added to the income-tax. Relying on the decision in *K. Srinivasan*[6], the taxpayer argued that there is a distinction between 'rates of income tax' and 'surcharge' as elaborated below:

- The First Schedule to the Finance Act speaks of 'rates of income tax' and 'surcharge' and not 'rates of surcharge.'
- Article 271 of the Constitution of India recognises surcharge' as a separate category and its collection is treated differently than the income tax levied at the specified rates.

4 Fuerst Day Lawson Ltd v. Jindal Exports Ltd (2011) 8 SCC 333

[5] *CIT* v. *J.H. Gotla* [1985] 156 ITR 323 (SC)

[6] *CIT* v. *K. Srinivasan* [1972] 83 ITR 346 (SC)

Revenue's contentions

The Revenue cited the Memorandum to the Finance (No. 2) Bill, 1980, arguing that MMR was designed to include both tax and surcharge at the highest slab rates to prevent tax avoidance.

Allowing slab-wise surcharge for trusts would undermine the anti-abuse objective of MMR provisions.

The phrase 'if any' should be interpreted as referring to whether surcharge is in force for the year—not whether slab-based rates apply.

Tribunal decision

Surcharge must be computed in accordance with the slab-based thresholds specified in the FA, and not automatically at 37 per cent.

Though there is no conflict between the definition of MMR in section 2(29C) and section 2 of the FA, even if there's perceived conflict, a harmonious reading avoiding absurdity must prevail.

The definition of MMR under section 2(29C) must be read in conjunction with (and not *de hors*) the surcharge computation mechanism in the Finance Act (section 2(1) and the First Schedule to the FA), where surcharge is a separate levy applied after computing base tax.

The First Schedule distinguishes between income-tax rates and surcharge, reaffirming that surcharge is a distinct and conditional levy.

The term 'slab' in the context of income tax refers to levels of income, not the tax. Although the FA and section 2(29C) of the IT Act don't explicitly define 'slab,' press note[7] and circulars[8] clarify that it denotes income categories.

Revenue's interpretation would render the slab system redundant, and lead to unjust outcomes, violating principles of equity and proportionality in taxation.

Surcharge must be authorized by law (per Article 265 of the Constitution) and thus, does not require any further clarification with the use of words 'if any' to mean whether the FA of a particular year provides for the levy of surcharge or not, as argued by the Revenue.

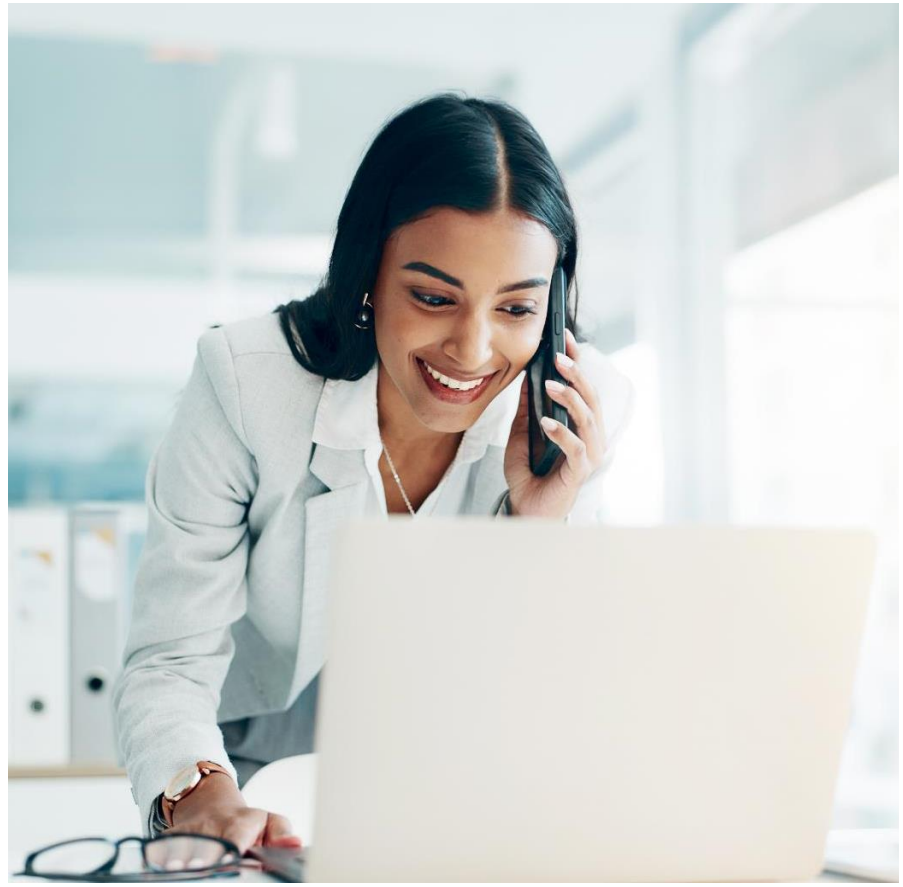
[7] Press Note dated 1 December 1965 issued by the GoI

[8] Circular No. 2/2018 containing explanatory notes to the provisions of Finance Act, 2017

Our comments

The decision ensures equitable treatment of discretionary trusts and avoids irrational tax burdens on trusts with modest incomes.

This ruling also emphasises the need for a harmonious and contextual interpretation of tax laws, especially when multiple provisions intersect.



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