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Tax Flash News

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Receipt of partnership interest without paying a consideration taxable as other income

Executive summary

Navigating the tax implications of private discretionary trusts, particularly those established for family succession planning, demands a detailed analysis of trust deeds, relevant trust laws, and applicable tax provisions.

The recent decision of Bangalore Bench of the Tribunal in the case of *Buckeye Trust*[1] delves into the intricate application of tax laws concerning the receipt of investments by a private discretionary trust.

The Tribunal concluded that a partner's interest in a partnership firm is analogous to shares under tax law and that receiving such an interest without paying consideration is taxable as other income. Furthermore, the trust's ability to include non-relatives as beneficiaries in future led to the denial of the exemption claimed under section 56(2)(x) of the Income-tax Act, 1961 ('the Act').

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[1] *Buckeye Trust* v. *PCIT* (ITA No. 1051/Bang/2024)

Facts of the case

The taxpayer was a private discretionary trust whose beneficiaries were relatives of the settlor.

The settlor transferred certain investments to the trust out of natural love and affection.

These investments included interests in partnership firms and unlisted shares.

The trust filed a nil income tax return, which the tax officer initially accepted.

Subsequently, the Principal Commissioner of Income-tax (PCIT) invoked revisionary powers[2], asserting that the tax officer's order was erroneous and prejudicial to the Revenue's interest. The PCIT noted that the trust deed allowed for the inclusion of non-relative beneficiaries, potentially disqualifying the trust from the exemption under section 56(2)(x).

Key provisions of section 56(2)(x)

- Section 56(2)(x) *inter alia* provides that where a person receives any property without paying any consideration, then its fair market value (FMV) is taxable in the hands of the recipient of property as 'income from other sources.'
- In this regard, 'property' has been defined to include 'shares and securities.'
- However, the transaction is excluded from the purview of section 56(2)(x) if the transferee is a 'relative' of the transferor as prescribed in the section.

The Revenue argued that the trust received investments without any consideration, making it taxable as 'income from other sources.'

Taxpayer's Contentions

The trust is not a 'person' under the Act.[3] The investments were received from an individual by a trust established exclusively for the settlor's relatives, qualifying for the exclusion under section 56(2)(x).

The trust received the investments in a fiduciary capacity, creating a legal obligation to use them for the beneficiaries' benefit. This obligation constitutes a promise by the trustee to the settlor which itself is a consideration as per the Indian Contract Act, 1872.

[2] Section 263 of the Act

[3] As defined in section 2(31) of the Act

Interest in partnership firms does not qualify as 'property' for the purposes of section 56(2)(x).

The provisions of section 56(2)(x) should not apply to genuine transactions of private trusts.

Revenue's Contentions

The trust deed allowed for the inclusion of beneficiaries beyond relatives, violating the conditions of section 56(2)(x).

The tax officer failed to scrutinise the valuation of the transferred partnership interest and unlisted shares.

The order lacked adequate inquiry and was prejudicial to the Revenue's interests.

Decision

The Tribunal upheld the PCIT's invocation of revisionary powers, concluding that the tax officer's order was erroneous and prejudicial to the Revenue's interest. The tax officer did not conduct sufficient inquiries into the taxability of the receipt and the applicability of section 56(2)(x).

The trust deed's provisions, allowing non-relative beneficiaries, disqualified the trust from the exemption.

The taxpayer's argument, that there was a consideration involved for investments received by it, was rejected. The taxpayer has been made the owner of the partnership firm without paying any consideration.

The taxpayer's argument that the funds were received in a fiduciary capacity was rejected. The Act contains specific provisions for private discretionary trusts, and the taxpayer's interpretation would render those provisions ineffective.

The taxpayer's use of intermediaries to transfer partnership firm assets circumvented section 45(4) of the Act, which deals with capital gains in the case of partnership reconstitution. The tax officer has failed to analyse the applicability of that section as well.

<u>Equating partnership interest with shares</u>

While partnership interest is not explicitly classified as 'property,' it can be equated with shares for the following reasons:

The term 'shares' in the Act is not restricted to shares of a company but broadly encompasses ownership stakes, aligning with the nature of partnership interests.

A contextual interpretation supports this equivalence.

Judicial precedents have recognized partnership interests as valuable rights akin to shares, encompassing ownership, profit-sharing, and management participation.

Our comments

The Tribunal's decision underscores the importance of reviewing trust deeds for private family trusts. Even if the initial beneficiaries are relatives, the potential inclusion of non-relatives can jeopardise exemptions under section 56(2)(x) as per this decision.

The Tribunal did not accept the taxpayer's argument that a promise/obligation of the trust to use the funds only for the beneficiaries' benefit is a consideration. Rather, the Tribunal seems to have laid emphasis on the monetary consideration.

The decision also raises critical questions about the inclusion of partnership interests under the scope of 'shares' and the applicability of the principle of *noscitur a sociis*. Future judicial interpretations will be pivotal in resolving these issues.

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