

# Trusts

## Chapter 112

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### Synopsis

<i>Particulars</i>	<i>Page No.</i>
1. Hague Convention on the law applicable to trusts and recognition .....	1012
2. Types of Offshore Trusts and their Uses .....	1017
3. Taxation of Offshore trust and its beneficiaries.....	1018

## 1. Hague Convention on the law applicable to trusts and recognition

### Introduction

The Hague Convention aims to “establish common provisions on the law applicable to trusts and to deal with the **most important issues concerning the recognition of trusts**,”<sup>1</sup> and to do so for legal systems which may have (i) highly developed law of trusts, (ii) wholly without the trust, or (iii) may have devices analogous to the trust in function or structure.<sup>2</sup> It must be pointed out that India is neither a signatory nor has ratified this Convention.

The Convention describes the trust as the legal relationship created *inter vivos* or on death, by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.

1 Preamble (not reproduced in the 1987 Act)

2 For an account of these devices, which include the *fiducie* in the law of Quebec, and the Liechtenstein trust, see Lipstein, in International Encyclopedia of Comparative Law, Vol. III, Chap. 23.

Per the Convention, any trust by whatever name called, shall have the following characteristics:-

- a) the assets constitute a separate fund and are not a part of the trustee's own estate;
- b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
- c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.

It applies only to trusts created voluntarily and evidences in writing.<sup>3</sup> Trusts created by judicial decisions are not included, but Contracting States are free to extend the provisions of the Convention to such trusts.<sup>4</sup>

The Convention applies to trusts regardless of the date on which they were created. However, a Contracting State may reserve the right not to apply the Convention to trusts created before the date on which, in relation to that State, the Convention enters into force.<sup>5</sup>

### ***Preliminary Issues***

A distinction must be drawn between questions relating to the settlement, will or other instrument which operates *inter alia* to vest property in trustees and questions relating to the validity and operation of the trust provisions contained therein. The Convention does not apply to preliminary issues relating to the validity of wills or of other acts by virtue of which assets are transferred to the trustee.<sup>6</sup>

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3 Article 3

4 Article 20

5 Article 22

6 Article 4

### *Governing Law*

Articles 6 & 7 of the Hague Convention contain two rules as to the governing law of a trust. The primary rule<sup>7</sup> is that a trust is governed by the law chosen by the settlor, as long as that choice is not opposed to public policy. The choice must be express or be implied in the terms of the instrument creating or the writing evidencing the trust interpreted, if necessary, in the light of the circumstances of the case. A testator or settlor resident in India is free to set up a trust governed by some foreign law. If the settlor makes no choice of the governing law, or if he selects some law which does not provide for trusts or the category of trust involved<sup>8</sup>, the secondary rule applies, which is that the trust is governed by the law with which it is most closely connected.<sup>9</sup> The same rule appears to apply at common law. It must be noted that the choice of law would not be applicable to tax matters which would be governed by the respective jurisdiction where the settlor, beneficiaries, property or trustee, as applicable,

The ascertainment of the law with which the trust is most closely connected involves making reference in particular to four factors:

- (a) the place of administration of the trust designated by the settlor;
- (b) the situs of the assets of the trust;
- (c) the place of residence or business of the trustee; and
- (d) the objects of the trust and the places where they are to be fulfilled.<sup>10</sup>

There is among these factors “a certain implicit hierarchy,” but also a considerable overlap for (a) and (c) will usually coincide. Although not expressly stated in the Hague Convention, it is clear from other provisions of the Convention<sup>11</sup> that these factors are to be considered as at the moment of creation of the trust. These will include domicile of the settlor, especially if the trust is created by a

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7 Article 6

8 Article 6(2)

9 Article 7(1)

10 Article 7(2)

11 Article 10

will or a marriage settlement, and the place of execution of the trust deed. The weight to be given to all these factors, whether or not listed in Article 7, must vary with the circumstances.

The rules as to choice of governing law, especially those giving freedom of choice to the settlor, are qualified by two further provisions in the Hague Convention. Article 13 provides that no State is bound to recognise a trust, the significant elements of which, except for the choice of the applicable law, the place of administration and the habitual residence of the trustee, are more closely connected with States which do not have the institution of trust or the category of trust involved. Article 18 allows the provisions of the Convention to be disregarded when their application would be manifestly incompatible with public policy.

#### *Scope of application of governing law*

The law identified by Article 6 or 7 of the Convention governs the validity of the trust, its construction, its effects and the administration of the trust.<sup>12</sup> In particular, it governs (a) the appointment, resignation and removal of the trustees, the capacity to act as a trustee, and the devolution of trustee; (c) the right of trustees to delegate in whole or in part discharge of their duties or the exercise of their powers; (d) the power of trustees to administer or to dispose of trust assets, to create security interests in the trust assets, or to acquire new assets; (e) the powers of investments of trustees; (f) restrictions upon the duration of the trust, and upon the power to accumulate the income of the trust; (g) the relationship between the trustees and the beneficiaries including the personal liability of the trustees to the beneficiaries; (h) the variation or termination of the trust; (i) the distribution of the trust assets; and (j) the duty of trustees to account for their administration.<sup>13</sup>

#### *Recognition of trusts*

Article 11 of the Convention provides that recognition implies, as a minimum, that the trust property constitutes a separate fund, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity. Further, in so far as the law applicable to the trust requires or provides, recognition implies

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<sup>12</sup> Article 8(1)

<sup>13</sup> Article 8(2)

in particular (a) that personal creditors of the trustee can have no recourse against the trust assets; (b) that the trust assets do not form part of the trustee's estate upon his insolvency or bankruptcy; (c) that the trust assets do not form part of the matrimonial property of the trustee or his spouse nor part of the trustee's estate upon his demise; (d) that the trust assets may be recovered when the trustee, in breach of trust, has mingled trust assets with his own property or has alienated trust assets. However, the rights and obligations of any third-party holder of the assets remain subject to the law determined by the choice of law rules of the forum.<sup>14</sup> These provisions, like the description of the trust in Article 2, concentrate on the position of the trustee, and deal less than satisfactorily with that of beneficiaries. In particular a beneficiary's right to trace trust assets is restricted, especially where the relevant assets are situated in a country, the law of which does not have the concept of the trust.

An important practical aspect of the recognition of trusts is that inclusion of trusts in registers of title, a matter of some difficulty in civil law countries. Article 12 seeks to facilitate such registration, but only in so far as this is not prohibited by or inconsistent with the law of the State where the registration is sought.

The effect of Article 11 and of the Hague Convention as a whole is qualified by the savings for mandatory rules in Articles 15 & 16, of which says that the Convention does not prevent the application of provisions of the law designated by the conflict rules of the forum, in so far as they do not derogate from the Convention.<sup>15</sup> However, it does provide that if the recognition of a trust is prevented by application of Article 15(1), the court shall try to give effect to the objects of the trust by other means.<sup>16</sup> Article 16 similarly protects the mandatory rules of the forum. Article 18 further provides that the provisions of the Convention may be disregarded when their application would be manifestly incompatible with public policy (*ordre public*).

### *Change in governing law*

The law applicable to the validity of the trust determines whether law, or the law governing a severable aspect of the trust, may be replaced by another law.<sup>17</sup>

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<sup>14</sup> Article 11(2)(3)

<sup>15</sup> Article 15(1)

<sup>16</sup> Article 15(2)

<sup>17</sup> Article 10

Even though India is not a signatory to the Hague Convention (or ratified it), most of the principles provided in the Hague Convention are already covered in the Indian Trusts Act, 1882. India gives due recognition to offshore trusts and also does not place restrictions on Indian trusts having non-resident trustees, non-resident beneficiaries and *vice-versa*.

## 2. Types of Offshore Trusts and their Uses

A person competent to contract, upon fulfillment of the conditions enumerated above, may form any of the following types of Trust:

- 1) *Bare Trust*: A trust where the beneficiary is absolutely entitled to the assets and the trustee is obliged simply to pay them over to the beneficiary.
- 2) *Constructive Trust*: It is imposed by law as an equitable remedy. It generally occurs due to some wrong doing.
- 3) *Resulting Trust*: It is a form of implied trust which occurs where a trust fails, wholly or in part, as a result of which the settlor becomes entitled to the assets.
- 4) *Discretionary Trust*: It is an arrangement where the trustee may choose, from time to time, who (if anyone) among the beneficiaries is to benefit from the trust, and to what extent. Such trusts are essentially used for asset protection.
- 5) *Fixed Trust*: The entitlement of the beneficiaries is fixed by the settlor. The trustee has little or no discretion. Such trusts are used by families which have members with disability in their family.
- 6) *Hybrid Trust*: It combines elements of both fixed and discretionary trusts. The trustee must pay a certain amount of the trust property to each beneficiary fixed by the settlor. But the trustee has the discretion as to how any remaining trust property, once these fixed amounts have been paid out, is to be paid to the beneficiaries.
- 7) *Express Trust*: It arises where a settlor deliberately and consciously decides to create a trust, over his or her assets, either now or upon his death.
- 8) *Implied Trust*: It is created where some of the legal requirements for an express trust are not met, but an intention on behalf of the parties to create a trust can be presumed to exist.

- 9) *Inter vivos Trust*: A settlor who is living at the time the trust is established creates an *inter vivos* trust. An *inter vivos* trust can be created in any of the trust forms above.
- 10) *Testamentary Trust*: A trust created in an individual's Will.
- 11) *Irrevocable Trust*: It is the one that will not come to an end until the terms of the trust have been fulfilled.
- 12) *Revocable Trust*: A trust of this kind can be revoked (cancelled) by its settlor at any time.
- 13) *Purpose Trust*: A trust which is created specifically for a purpose. Such trust may or may not have any beneficiaries.

#### **REITs: Real Estate Investment Trusts**

A REIT is an entity which pools in money and invests in real estate assets. It provides a similar structure for investment in real estate as mutual funds provide for investment in stocks. A REIT can be publicly or privately held and is generally listed on a stock exchange. Assets of such a trust are managed by a fund manager.

Even though REITs are not currently active in India, there were draft guidelines and regulations which were issued in this regard.

### **3. Taxation of Offshore trust and its beneficiaries**

The residency of an offshore trust is determined by the trust law under which the trust comes into existence. However, this residency criterion is restricted to only the non-tax attributes of the trust.

For the purposes of the Indian income tax laws (ITA), the trustee derives its status from the beneficiaries. Accordingly, in a case where all the beneficiaries of an offshore trust (specific/determinate or discretionary) are Indian residents then, to that extent, the trust would effectively be an Indian resident for income tax purposes, *i.e.* the income of trust will become subject to tax in India. This may lead to the offshore trustee being considered as a representative assessee of the Indian beneficiaries of the trust and accordingly subject to Indian tax and reporting obligations on behalf of the beneficiaries.

That being said, if the offshore trust has a mix of resident and non-resident beneficiaries, then the Indian beneficiaries may only be

taxed on the receipt of distributions from the trust and the trustee may not be subject to Indian tax and reporting obligations.

Apart from the beneficiaries test, an offshore trust could also be considered to be a tax resident of India, if India is considered to be the place of management and control for such trust, even if such management and control is partly done from India. It may be noted that in such a case, the trust may be treated as an association of persons, which is a separate taxable entity under the ITA and subject to tax in India on its worldwide income. Hence, if the trustee of the offshore discretionary trust is situated in India or if any Indian person is controlling and managing the trust from India, wholly or partly, there is a possibility of the same being considered as a tax resident of India.

The abovementioned would be applicable in a case where the offshore trust has been set up as an irrevocable trust. For an offshore trust which has been set up as a revocable trust by an Indian settlor, the story would be somewhat different altogether.

A revocable trust tantamount to being a revocable transfer under the Indian tax provisions if it contains any provision for the re-transfer directly or indirectly of the whole or any part of the income or assets to the transferor or it in any way gives the transferor a right to re-assume power directly or indirectly over the whole or any part of the income or assets. Thus, where a settlement is made in a manner that the settlor is entitled to recover his contributions over a specified period and is entitled to the income from their contributions, the settlement of the trust will be disregarded for the purposes of tax, and the income thereof taxed as though it had directly arisen to the contributors.

Under the current laws, the Indian resident beneficiaries are required to report their interest in an offshore trust in the information return filed along with the income tax return.

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