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On

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U.S.A. Tax Effects of a Hindu Undivided Family

A significant number of Indian citizens and persons of Indian origin are U.S. income tax residents. Many are also U.S. residents for purposes of U.S. gift, estate, and generation-skipping transfer taxes. Many of these individuals may be coparceners in Hindu Undivided Family property or may inherit property in a Hindu Undivided Family. The purpose of this article is to explain the basic concepts of Hindu Undivided Family property and to discuss how interests in this type of property may be analyzed under U.S. income and U.S. transfer tax rules. Before advising clients on any specific situation, of course, care must always be taken to engage competent counsel from both India and the United States.

Backdrop

A Hindu Undivided Family ("HUF") is a special feature of Hindu society, which today consists of a common ancestor and all of that common ancestor's lineal descendants together with their spouses and unmarried children. Prior to the amendments to the 1956 Hindu Succession Act in 2005, only sons could be

co-parceners, but since then a HUF includes all family members who are Hindus by religion, i.e. sons and daughters whether married or unmarried.

The Karta is the manager of the family. Traditionally, the Karta was usually the most senior male. In light of the legal changes enacted in 2005, females can now not only be co-parceners but also Kartas. The Karta has the power to transfer for value the joint family property, thus binding all of the coparceners in the property, if such transfer is made for legal necessity or for the benefit of the family (i.e. payment of debts for family business). The HUF can pay valid remuneration to the Karta under a valid *bona fide* agreement for the benefit of the family.

Only joint family property can fund a HUF. Joint family property includes: (i) "Ancestral Property" (as defined below), (ii) property from a partition of a larger HUF, (iii) property that is acquired with HUF assets, and (iv) separate property that is contributed by a member (although the Indian tax benefits of a HUF described below do not apply to such separate property).

Ancestral property includes any property received by a Hindu male from his father, paternal grandfather or paternal great grand father. If a Hindu male dies intestate, then the share received by his son is impressed with the character of HUF property in the son's hands i.e. the wife and children of the son will also have a per capita share in that part of the property. If property is received as a gift or under a Will with a clear direction that it is to be made to the HUF, then it will be so regarded.

Partition

Every coparcener, including sons and daughters (the latter as of 2005) and grandchildren, has a right to ask for partition of the property, which may be a total or partial partition. A total partition occurs when all properties of the family are divided among the members, and upon such a partition, the HUF ceases to exist. As noted below, this partition will only be recognized for Indian tax purposes if all property in the HUF is divided.

Applying U.S. tax concepts to the institution of the HUF provides a fascinating example of the analytical challenges that emerge in a globalized world in which one must cross not only boundaries between nations and municipalities but frontiers of time and tradition.

There are two types of partial partition. The first type of partial partition is property partial partition, which distributes certain property to the family members (or to their smaller HUFs) and retains the balance of the properties in the original HUF. The second type of partial partition is a person partial partition, in which the family distributes certain properties to some family members (or to their smaller HUFs) who no longer remain part of the larger HUF.

The property in a HUF is divided by metes and bounds upon a partition. If there are several branches in a family, each branch takes its share *per stirpes*, according to the stock with respect to such branch. The property is split into equal shares among coparceners, sons and daughters (including any child in the mother's womb), the other parent (if one parent has passed away and the children are partitioning) or the other spouse if both spouses are alive (his or her share equals that of a child at the time of partition between parent and children). Within each branch, the members take per capita but, may, by mutual agreement, take unequally.

All coparceners can, after a total partition, agree to reconstitute the HUF by bringing all the property back into the HUF.

Will/Gift Issues of a HUF

A gift or bequest by a parent to a child to enable the child to establish a new HUF will not automatically cause the property to become joint property: the instrument must specify that it is a gift to the Karta on behalf of the HUF. There is some uncertainty as to whether a lifetime gift to a HUF would be exempted from the income tax imposed by Indian law on gifts to non-relatives because it is unclear whether a HUF qualifying as a "relative" for this purpose.

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Indian Tax Benefits of HUFs

A HUF is treated as a taxpayer separate from the family or the Karta and is eligible for its own tax exemption, separate from the Karta's individual income tax exemption for Indian income tax purposes. The income exemption for individual male taxpayers is Rs 1,60,000 per year, Rs 1,90,000 for female taxpayers, and Rs 2,40,000 for senior taxpayers. In addition, the HUFs, being a separate entity for tax purposes, can claim an exemption of Rs 1,60,000. Also, a HUF can claim other specific exemptions, rebates, and exemptions with respect to capital gains.

If the basis of the property of the HUF is high, it may be beneficial to make a total partition of HUF property. Then, each coparcener can receive the property on behalf of his or her own smaller HUF. If a smaller HUF (i.e. a coparcener's HUF) is in a lower Indian tax bracket, the partition can save Indian tax because it spreads out the income of the larger HUF among the coparceners. A HUF must be fully partitioned in order to take advantage of these income tax benefits; income earned on the property received by a member after partial partition would be combined with the income of the original HUF, as if no partition had taken place.

There are Indian income tax savings if one bequeaths property to a descendant's HUF. If a parent bequeaths property to an adult child as Karta of a new HUF, the child can treat this property as separate from his own property so that the income generated from the property in the new HUF will be taxable to the HUF rather than to the parent or the child.

As a result, the HUF property and the child's individual property will receive separate exemptions and also separate deductions for Indian income tax purposes. In the case of a bequest to the future HUF of a minor child or in the case of inheritance by a minor child by way of intestate succession, there are potential tax benefits. Since the recipient is an individual, income from the property is taxed with the recipient's income, first at his or her parent's income tax level (since the parents will have control while the child is a minor) and, upon maintaining majority, as individual property of the child. Upon marriage, however, at least according to the majority view of the High Courts, the property is treated as Hindu Joint Family Property on behalf of the potential family. The income generated thereafter will be taxable in the hands of the HUF, separate from the individual.

Separate exemptions for Indian wealth tax are also available for

individual property and HUF property. People having assets that are subject to the Indian Wealth Tax under HUF status stand to gain from the extra exemption under the Wealth Tax Act, 1957. A coparcenary interest in HUF property is not subject to the Indian Wealth Tax.

HUFs are most advantageous for individuals with substantial property income. Since two Indian tax returns must be prepared, a HUF makes financial sense only if it would enable a person to reduce tax liabilities on property income. Thus, if an individual wanted to form a HUF with contributions of stock, a HUF would not have much to offer because there is a flat rate of tax on capital gains under the Indian tax laws, and in some instances, no tax at all. (Ex:- When the stock is listed and certain re-investments of long-term net sale proceeds in a residential house.)

United States Income Tax Analysis

A fundamental question for determining the U.S. tax consequences of a HUF is whether a HUF will be treated as a separate entity or whether it would be analogized to a grantor trust under which the person who is viewed as grantor of the property or the person who controls the property (here the Karta) would be considered the owner of the property for United States income tax purposes. Most likely, the IRS will treat a HUF as a separate entity since the Karta cannot be a donor to a HUF and the role of the Karta bears very strong resemblance to the fiduciary responsibilities of a trustee.

Most of the U.S. tax rules that cause a trust to be disregarded (Sections 673-677 and 679 of the Internal Revenue Code(IRC)) apply to the person who is the source or donor of the property to the trust and, therefore by definition, do not apply to the Karta because the Karta can never be the donor of HUF property for which the Karta is responsible. However, under IRC Section 678, if a beneficiary of a trust has the right to vest in himself or herself principal or income of a trust, he or she would be treated as the "owner" of the property for U.S. income tax purposes. However, because the Karta's decisions to make distributions of income, including to himself, must be made in the best interests of the family, we believe that a substantial argument can be made that the Karta does not fall under Section 678 and therefore that the HUF should be treated as a separate entity.

It should be noted that if an Indian citizen or person of Indian origin who is a United States tax resident establishes a HUF with property that person owns in India and any coparceners are also United States tax residents, assuming the analogy of a trust applies, the donor may be continued to be viewed as owner of the HUF property under Internal Revenue Code Section 679, which makes property contributed to a foreign trust by a U.S. person with any U.S. beneficiaries subject to U.S. income tax on the property as if the donor still held the property in the donor's own name. If none of the members of the HUF are U.S.

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residents, then the donor may incur capital gains tax on the unrealized appreciation in the Indian property, under Internal Revenue Code Section 684, which subjects to U.S. capital gains tax transfers of appreciated property by U.S. tax residents to foreign trusts that do not qualify as grantor trusts under Section 679.

If the HUF is treated as a separate entity for U.S. income tax purposes (i.e. not a grantor trust or some other disregarded entity), then the HUF should not be liable to pay U.S. income taxes on such property, even if the Karta is a U.S. income tax resident, because the HUF would be viewed as a non-U.S. entity with non-U.S. source income.

A U.S. coparcener's share of any accumulated income or gains in the HUF that are distributed upon a termination of a HUF could be subject to U.S. income tax under a complex set of rules under which the U.S. coparcener may have to pay an interest charge on the tax that the U.S. coparcener would have paid if the income or gains had been distributed currently. If the Karta has control of any bank accounts in India in connection with the management of the HUF with an aggregate balance of over $10,000, the Karta will have to file annual "FBAR" disclosure reports.

If the HUF is not treated as a separate entity but as property of a U.S. donor or Karta, the Karta must include the income of the HUF in his or her income tax return if he or she is a U.S. tax resident. In this event, the taxes paid to India by the HUF should be viewed as being paid by the U.S. donor or Karta and therefore the donor or Karta should be able to claim a credit against the United States income tax for the income tax paid to India. This situation can be analogized to the grantor of a grantor trust receiving a tax credit for non-U.S. taxes paid by the trust. In that case, the grantor still can receive the credit even though, from perspective of the non-U.S. jurisdiction, the trust paid the foreign taxes rather than the grantor.

United States Estate Tax Analysis

A common cause of estate tax liability in the United States occurs when a deceased transferor retained a power over property the decedent gifted or transferred during life. Such transfers are subject to estate tax under Sections 2036 and Section 2038 of the Internal Revenue Code.

However, those sections will not apply to a deceased U.S. Karta of an existing HUF because the Karta, by definition, did not make a transfer during his or her lifetime, but received this property as an inheritance from another HUF.

The fact that the Karta controls the HUF should not cause estate tax inclusion under Section 2041 of the Code ("powers of appointment") because the Karta does not technically have any individual power over the HUF, but must use the full HUF property in the best interests of the family. However, if the Internal Revenue Service were to successfully argue that the analogy of a HUF to a trust with the Karta having fiduciary duties similar to a Trustee is not correct, a Karta's coparcenary interest may become subject to U.S. estate tax.

In valuing the interest in the HUF for this purpose, discounts may be applied to the Karta's interest for the costs of partition, other expenses, and minority discounts. Other coparceners may also have to include in their estate any portion of a HUF to which they could take title by virtue of a right to compel a partition of the HUF.

However, if coparceners other than the Karta also have an obligation not to partition except in the interests in all coparceners, there is a good argument that the interest should not be subject to estate tax.

***The estates of U.S. decedents who die in 2010 are not subject to Federal estate tax but may be subject to state estate tax. Under current law, estates of U.S. decedents dying in 2011 and afterwards are subject to Federal estate tax.

United States Gift and Generation-Skipping Transfer Tax Analysis

A transfer of property to a HUF during lifetime by a U.S. citizen or domiciliary will be a gift subject to gift tax. The Internal Revenue Service might argue that the partition of a HUF should be considered a gift by the Karta because the Karta thereby gives up control of the HUF property. However, the HUF is always subject to partition and the Karta can only distribute income if it is in the best interests of the initial family. Furthermore, the Karta should not be deemed to have a property interest in any portion of the HUF other than the Karta's own share.

Typically, a United States generation - skipping transfer tax (a "GST tax") is imposed on a transfer that only benefits a grandchild or more remote descendant, if the transfer had at some time, been subject to U.S. gift tax or estate tax.

Conclusion

The institution of the HUF harks back to a time many centuries and even millennia ago, while most of the concepts that undergird current U.S. income, gift, estate and GST tax go back less than a century ago. Applying U.S. tax concepts to the institution of the HUF provides a fascinating example of the analytical challenges that emerge in a globalized world in which one must cross not only boundaries between nations and municipalities but frontiers of time and tradition.

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Well, one hopes that if you're really related to the core of your particular culture, you have profound commitments to it, and that you are aware of how much you can strain it before you do violence to its essential nature.

Chaim Potok

Beyond Thought...

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