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Taxability of Charitable Trusts: Balancing Benefits and Ensuring Accountability

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ABSTRACT

Charitable trusts, intrinsic to societal welfare and economic progress, have historically enjoyed tax exemptions under the Income Tax Act. Under the Income Tax Act, the article explores the intricate procedures associated with the registration of charitable trusts, a prerequisite for claiming tax exemptions. It illuminates the spectrum of income exemptions available to these trusts, emphasizing activities aligned with their philanthropic purposes. However, the tax landscape underwent a substantial transformation with the Goods and Services Tax (GST) implementation in 2017, simplifying intricate central and state tax structure. The GST Act outlines specific activities of non-governmental organizations (NGOs) and charitable trusts falling within the realm of business, subjecting them to tax liabilities. Within the tax domain, duly registered charitable entities under the Income Tax Act continue to benefit from tax exemptions on their earnings. Nevertheless, the process of attaining such exemptions now faces heightened scrutiny from tax authorities. This more suitable oversight goal is to make certain that deserving institutions acquire exemption benefits while stopping the misuse of provisions. However, this heightened regulatory oversight and the subsequent rise in administrative complexities and compliance requirements have disproportionately pressured smaller charitable companies, hindering their operational efficiency and competencies. This article offers a comprehensive comparative study of the effectiveness of current legislative frameworks in delivering an appropriate balance between granting earnings tax exemptions and ensuring accountability.

Keywords: Tax Exemption, Taxation, Charitable Trust, Income Tax.

I. INTRODUCTION

The Income Tax Act, enacted in 1961, governs the assessment of income from various sources and includes provisions for tax exemptions. Within the framework of the statute, certain exemptions are explicitly identified, rendering them non-taxable. Charitable trusts fall under one such exemption category, thereby exempting their income from tax assessment. However, it is important to note that an institution cannot simply declare itself as a charitable trust and

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automatically qualify for the exemption. The statute itself outlines specific criteria that must be met in order to be eligible for the exemption. This provision enables the state to scrutinize the authenticity of the organization and effectively pierce the corporate veil.

Charitable trusts are generally institutions that are for the benefit of the general public. They provide the public with beneficial facilities and are not formed for the purpose of carrying out any business or any other commercial activity. Thus, when the purpose of the trust is charitable rather than commercial, it can be defined as a charitable trust. It distinguishes itself by its non-commercial nature, focusing solely on activities that contribute to society.

II. TAX EXEMPTION

Charitable trusts often enjoy certain tax benefits and exemptions due to their altruistic nature. Donors to charitable trusts may be eligible for tax deductions, and the trust itself may be exempt from certain taxes, further incentivizing contributions to charitable causes. The main logic behind giving tax exemptions to the income of charitable trusts and allowing deductions for those who donate money to charitable trusts is to promote more philanthropic activities and encourage charity. In India, the tax exemption of charitable trusts is dealt with Income Tax Act and the Goods and Services Act.

III. INCOME TAX

Section 11,12 and 13 of The Income Tax Act provides a notable exemption for income generated by charitable trusts or societies. This exemption, however, is contingent upon the fulfilment of specific conditions. Notably, the income must be utilized solely for charitable purposes, aligning with the organization's objectives. By adhering to these prerequisites, charitable entities can enjoy this beneficial tax exemption while making a meaningful impact in their respective communities.

(A) What is charitable purpose?

Section 2(15) of the IT Act defines what is charitable or religious purpose. As per the provision, charitable or religious purpose includes, helping the poor, providing education, medical aid, protecting the environment which includes watersheds, forests and wildlife, and the safeguarding of monuments, places, or objects of artistic or historical significance. Additionally, it includes the promotion of any other objective that serves the general public utility. The definitional clause further states that it won't be considered a charitable purpose if it involves conducting business activities. This includes providing services related to business for a fee, regardless of how the money earned is used. Unless the activity is carried out in the

course of the charitable activity, and the total income from these business activities in the past year should not be more than twenty per cent of the total income of the trust or institution in that year.

Even though the proviso of 2(15) clearly defines what is not to be included under the umbrella of "any other objective that serves the general public utility," many organizations claim themselves to be charitable trusts under this broader term. The term "any other objective that serves the general public utility" is used after specific words that describe charitable purposes. Thus, these specific words, followed by a general term, should be given a restrictive meaning as per the principle of *Ejusdem Generis*.

The Latin phrase "*Ejusdem Generis*" simply means "of the same kind." The principle states that when specific words are followed by a general word, the general word should be given a restrictive meaning similar to the category of the specific words. Thus, the term "any other objective that serves the general public utility" should be interpreted to have a restrictive meaning aligned with the purpose of the provision.

In the case of *Assistant Commissioner of Income Tax (Exemptions) v. Ahmedabad Urban Development Authority*³ the Supreme Court clarified that the classification of an activity as "trade, commerce, or business" depends on the cost at which services are availed and the consideration or price at which the organisation provides.. The SC held that an analysis of the nature of activities must be made, and to qualify as a charitable organization engaged in GPU, activities should be intrinsically linked to GPU and conducted in the course of achieving GPU. Charges for services covering costs or consisting of a nominal markup are permissible, but if charges are substantial and significantly higher than costs, the activity may be categorized as "trade, commerce, or business." The SC applied this criterion uniformly to various institutions, including statutory corporations, trade promotional bodies, and private trusts. The SC emphasized that this analysis of income and expenditure must be conducted annually to determine the nature of activities and adherence to section 2(15) of the IT Act. This significant ruling, which introduced a new test allowing nominal additional cost mark-ups for charitable services (offering services at cost plus a small additional charge), could confuse. This is particularly true because certain entities, including the Board of Control for Cricket in India, various clubs, societies, and business chambers, operate in the market, generating substantial income and profits while still claiming charitable status. Charitable organizations also use

³ Assistant Commissioner of Income Tax (Exemptions) v. Ahmedabad Urban Development Authority [Civil Appeal No. 21762 of 2017].

different markups, which are classified as marginal or nominal. The uncertainty about what constitutes a nominal mark-up, as well as the annual examination of financial statements to determine the nominal nature of mark-ups, may lead to disagreements between these organizations and tax authorities, potentially leading to future legal disputes.

In the case of *Travancore Education Society v. Commissioner of Income-tax*, In the case of Travancore Education Society v. Commissioner of Income-tax, the Kerala High Court ruled that when the institution collects additional donation or capitation fee, it should be categorized as commercial rather than for charitable purpose.

(B) Registration

Any trust or institution must register under Section 12AA to claim the exemptions outlined under the act; however, the position of the law changed after 2020, and the trusts that have registered under Section 12AA are now required to re-register under Section 12AB online to claim the exemption.

In the case of *Sree Anjaneya Medical Trust v. Commissioner Of Income Tax*, The court ruled that requesting a report on the activities of the trust at the time of registration is not necessary, and the tax authorities have the right to check only the genuineness of the trust and its activities during the granting of registration. The verification of eligibility for exemption will be conducted at the stage of assessment ⁴.

As per the case of *Commissioner of Income-tax, Kanpur v. Society for Promn. of Edn.*, if a registration application has been filed, the authorities should provide a response within six months, or it is deemed to be allowed.

(C) Income eligible for exemption

Certain incomes received by charitable organizations are exempt from taxation. That is,

- Income generated from the property of charitable organizations (Section 11)
- Voluntary contributions received by charitable organizations (Section 12)

1. Income from property

As per Section 11 of the Income Tax Act, Except in cases of transfer of income, the income generated from the property held under the trust is not taxable.

- a) Income from property wholly for charitable or religious purposes:

Clause a) of Section 11 provides an exemption for income derived from property held under

⁴ Sree Anjaneya Medical Trust vs Commissioner Of Income Tax (2016) 1 KerLJ 599

trust exclusively for charitable or religious purposes. The income that is applied to such purposes in India is exempt. Additionally, if any part of the income is accumulated or set aside for future application for such purposes, it must not exceed fifteen percent of the income from the property.

b) Income from property used only partially for charitable or religious purposes:

This section pertains to income derived from property held under a trust created before the commencement of the Act. As stated in the above clause, the income applied to charitable or religious purposes in India is exempt. If any part of the income is finally set apart for future application, it should not exceed fifteen percent of the income from the property. As per the explanation clause, if a charitable or religious trust allocates 85% or more of its total receipts toward its prescribed objectives within India, it is exempt from taxation on the remaining 15%.

- The unrealized income will be excluded while computing the 85%
- If a trust is unable to spend more than 85% within a year, it can invest as per the modes mentioned in section 11(5) or accumulate for the charitable purpose which should not exceed five years.

In the case of *CIT Vs. Programme for Community Organization*,⁵ the Supreme court held that a charitable trust has the right to accumulate 25% of its income derived from the property held under the trust, not 25% of the income remaining after the application of income for charitable purposes.

c) Income from Property Held under Trust for International Welfare:

Income from property held under a trust created on or after April 1, 1952, for a charitable purpose promoting international welfare in which India is interested. The income applied to such purposes outside India is exempt. Similarly, for trusts created before April 1, 1952, for charitable or religious purposes, income applied outside India is not included in the total income, subject to the Board's direction through a general or special order.

d) Income in the Form of Voluntary Contributions:

Income received as voluntary contributions with a specific direction that they form part of the corpus (core capital) of the trust or institution. The condition here is that such voluntary contributions must be invested or deposited in forms or modes specified in sub-section (5) and maintained specifically for such corpus. These are not considered in an individual's total

⁵ CIT Vs. Programme for Community Organization 248 ITR 1 (SC)(2001)

income, provided they meet the specified conditions.

2. Income from contributions

Section 12 of the IT Act, exempts the voluntary contributions received by the charitable trust. Under the provision,

1) Contributions received by the trust, created wholly for charitable or religious purposes:

Any voluntary contributions received by a trust or institution created wholly for charitable or religious purposes are treated as income derived from the property of the trust thus not included in total income and Section 11 is applicable accordingly.

2) Value of Medical or Educational Services Provided:

The value of any benefit or facility, such as medical or educational services, offered by a charitable or religious trust running a hospital, medical institution, or educational institution to certain specified individuals (mentioned in Section 13) is deemed to be the income of the trust or institution. This deemed income is considered to be derived from property held under trust wholly for charitable or religious purposes during the year in which these services are provided. Even though Section 11 might typically exempt such income, this provision states that income tax will be applicable despite the usual exemptions.

In the case of *Dawn Educational Charitable Trust v. Commissioner of Income-tax*⁶, the court rejected the claim for tax benefits for the educational institution that was running a school for NRI students for commercial purposes in the name of the charitable trust.

3) Donations:

Despite the provisions in Section 11, any donation received by the trust or institution under clause (d) of sub-section (2) of Section 80G, for which the income and expenditure accounts have not been submitted to the prescribed authority, have been utilized for purposes other than earthquake relief in Gujarat, or remain unutilized by the specified date, will be deemed as income of the previous year. Consequently, it will be subject to tax.

Anonymous Donations:

Section 115BBC deals with anonymous donations that are contributions made by a person, where the recipient of such contribution does not keep any record identifying the donor, including their name and address. Anonymous donations are taxable at the rate of 30% if the

⁶ Dawn educational Charitable Trust v. CIT, Kochi [2014 SCC OnLine Ker 2988 : (2015) 370 ITR 724]

donation received exceeds one lakh or 5% of the total donations.

(D) Non-eligibility

Section 13 outlines certain conditions under which the exemptions granted to the trust will not apply,

a) Private religious trust:

Income from the property held by the trust to benefit any particular religion rather than the public is not exempt from tax-paying.

b) Benefittable to any specific religious community or caste:

The income of a trust or institution is not eligible for tax benefits if it directly or indirectly benefits a specific religious community or caste. However, in the case of *International School of Human Resources & Social Welfare Society v. Commissioner of Income-tax*⁷, the court held that, The registration of an educational institution operated by the assessee-society cannot be denied based solely on the minority status granted to it. This status does not imply that the institution is established for the exclusive benefit of a particular religious community.

c) For specific individuals:

If any part of the income or property of a charitable or religious trust is used or applied directly or indirectly for the benefit of any related person, such as the author or founder of the institution, the trustee, or any relatives like a spouse, brother, sister, or lineal ascendant or descendant.

d) Investments and Deposits:

If the investment is not done as per the provisions of Section 11(5) of the Income Tax Act, 1961, the trust cannot claim tax benefits.

If the trust is not eligible for tax exemption due to the outlined conditions or for any other reasons, the income of the trust will be assessed as an association of persons at the maximum marginal rate.

IV. JUDICIAL INTERPRETATION

The strict rule of interpretation applies to taxing statutes. In other words, the statute should be interpreted literally, adhering to the plain meaning of the words used, without making presumptions or assumptions. The primary rationale for employing a strict interpretation rule in taxing statutes is that, since tax laws impose a financial burden on the assessee, the court

⁷ International School of Human Resources & Social Welfare Society v/s Commissioner of Income-tax-1, Patna IT Appeal Nos. 72, 99 & 119 (PAT.) of 2011 of 2012 Decided On, 20 July 2015

cannot adopt a liberal interpretation to create a monetary burden not explicitly stated in the statute.

There are three main stages in a taxing statute: Charging, Assessment, and Recovery. In the context of charging provisions, a strict interpretation is crucial. These provisions clearly define the class of people liable to pay taxes, and the court cannot interpret them to include more persons and impose additional liabilities. This principle is designed for the benefit of the assessee. Even if doubts arise, the benefit of the doubt goes to the assessee.

These interpretation rules also apply to cases involving taxing charitable trusts. If a charitable trust substantially complies with the specified conditions, it is entitled to tax benefits. In the case of *Director of Income-tax, Exemptions, Bangalore v. Envisions*, the ruling favored the assessee. If all the purposes specified by the assessee-trust in Form 10 are towards achieving charitable objectives, the mere fact that more than one purpose is mentioned and detailed plans of expenditure are not provided would not be enough to deny the benefits under section 11(2) to the assessee.

In the case of *Paramount Education Charitable Trust v. Commissioner of Income-tax*,⁸ The court held that the denial of registration under Section 12A to the assessee-trust cannot be justified solely on the basis of its non-registration under the Societies Act when its activities are deemed charitable.

In the case of *Queen's Educational Society v. Commissioner of Income-tax*⁹, the court held that the generation of surplus is not a ground to deny that it is established for charitable purposes. The court deemed the institution to fall within the ambit of charity and not for the purpose of profit. Thus, the court ruled in favour of the assessee as per the interpretation principle.

In the case of *Director of Income-tax (Exemptions), Mumbai v. Shri Vile Parle Kelavani Mandal*¹⁰, the court ruled that the assessee's income from the rental of educational institution premises, when used for educational purposes, cannot be taxed.

In the case of *Shishu Niketan Panchkula Educational Society v. Commissioner of Income Tax*¹¹, the court held that it is not necessary for the institution to carry out any charitable activity at the time of registration. The authorities cannot deny registration on the basis that they have not carried out any charitable activity yet.

⁸ Paramount Charity Trust, Baroda vs Commissioner Of Income Tax, on 27 February, 2018

⁹ Queens Educational Society v. Commissioner of Income-tax 319 ITR 160

¹⁰ DIT (E) v Shri Vile Parle Kelavani Mandal, (2015) 378 ITR 593 (Bom) (HC) DIT (E)

¹¹ Shishu Niketan Panchkula Educational Society vs. CIT, Panchkula [2015] 53 taxmann

V. GOODS AND SERVICE TAX

The Goods and Service Tax Act was introduced in 2017, which applies to all types of goods and services provided. Before the introduction of the GST Act, charitable institutions enjoyed tax exemption under the Income Tax Act. The GST Act defines the term "business" under Section 17 as "any trade, commerce, manufacture, profession, vocation, adventure, wager, or any other similar activity, whether or not it is for a pecuniary benefit". Now the question arises as to whether goods or services offered by charitable trusts should be considered businesses under the GST or if they enjoy exemption from taxation.

(A) Services provided by charitable organizations

GST Act exempts certain services provided by charitable organizations¹². When charitable organizations fulfill the following conditions, the services rendered by them are exempt from tax liability.

- a) The trust should be registered under section 12AA of the income tax act
- b) The services provided should be charitable in nature

Charitable activity:

Not all the services provided by charitable organizations are considered charitable. Under GST, the following activities are considered charitable.

- a) Providing public services such as counselling for drug addicts, terminally ill patients, and people suffering from HIV. Conducting initiatives to promote awareness regarding preventive health, family planning, or HIV infection prevention.
- b) Services or programs promoting religion, spiritual activities, or yoga for which fees are charged from attendees, including fees for residential facilities and voluntary contributions by participants, are exempt from GST.
- c) Providing rehabilitation programs for homeless children, victims of physical or mental torture, prisoners, and elderly rural residents
- d) For the preservation of the environment, and conservation of water, forests, and wildlife

(B) Tax liability for Goods

Goods are not exempt from tax liability. The charitable trust is obligated to pay tax for both selling and buying goods. In other words, whether they are a supplier or a consumer, they have

¹² Notification No.12/2017-Central Tax (Rate) dated 28th June 2017

to pay tax under GST.

(C) Impact of GST

The introduction of GST has placed charitable trusts and NGOs in a position where they must meet the requirements outlined in the GST Act, in addition to those in the Income Tax Act. While this additional compliance requirement helps reduce the misuse of benefits provided, by businesses under the veil of charitable trusts, it also poses challenges for small charitable trusts that are already struggling to raise funds for their activities.

VI. CONCLUSION

While strict interpretation is commonly applied to taxing statutes, it should not be arbitrarily used in a manner inconsistent with the act's objective or legislative intent. Taxing statutes are essentially experimental, adapting to unforeseen contingencies through amendments to prevent taxpayers from exploiting loopholes to avoid tax liability. The judiciary plays a crucial role in interpreting laws effectively to address these issues promptly, especially when the amendment process may take time.

In the case of *State Forum of Bankers Club (Kerala) v. Income-tax Officer*¹³, the court ruled that organizing lectures and seminars for the benefit of bank employees by the assessee-trust did not qualify as a charitable activity. The trust was not entitled to recognition under section 2(15) because the activities primarily benefited employees rather than the public. Therefore, the court's interpretation of taxing statutes aims to prevent individuals from escaping through legal loopholes. Both the judiciary and legislature work collaboratively to provide benefits to charitable trusts through exemptions while ensuring accountability.

¹³ State Forum of Bankers Club (Kerala) v. Income-tax Officer ITA 473/COCH/2014