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Article

Situs of application of income vis-à-vis the expenditure made abroad for charitable purpose in India

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The Income-tax Act, 1961 ("the Act") provides for various benefits to a trust formed for charitable or religious purposes. Section 11 of the Act exempts the income derived from property held under trust for charitable purposes from taxation, *inter alia*, to the extent to which such income is applied for such purposes 'in India'. The phrase 'applied for charitable purposes in India' has been a subject matter of litigation in the recent past. Does the phrase necessitate the expenditure to be incurred in India, or does it only require the expenditure to result in promotion of charitable purpose in India, irrespective of the country in which the expenditure is incurred?

In order to interpret and appreciate the mandate of section 11, it is imperative to highlight the position as was under the Indian Income-tax Act, 1922 ("1922 Act"). Section 4(3)(i) of the 1922 Act corresponded to section 11 of the Act. Prior to the Indian Income-tax (Amendment) Act, 1953 (made applicable with retrospective effect from 01.04.1952), Section 4(3)(i) of the 1922 Act granted exemption to trusts without any qualification of applying the income for charitable purposes in India alone. The section, at that time, read as under:

> *"4. Application of Act. …(3) Any income, profits or gains falling within the following classes shall not be included in the total income of the person receiving them:*
> *….(i) any income derived from property held under trust or other legal obligation wholly for religious or charitable purposes, ….., the income applied, or finally set apart for application, thereto."*

Thus, the statute provided a blanket exemption to all the income derived from property held under trust, irrespective of the country in which the charitable purpose is undertaken. Vide the amendment act of 1953, section 4(3)(i) of the 1922 Act stood as under:

> *"4. Application of Act. ... (3) Any income, profits or gains falling within the following classes shall not be included in the total income of the person receiving them:*
> *(i) Subject to the provisions of clause (c) of sub-section (1) of section 16, any income derived from property held under trust or other legal obligation wholly for religious or charitable purposes, in so far as such income is applied or accumulated for application to such religious or charitable purposes <u>as relate to anything done within the taxable territories</u>, ….:*
> *Provided that such income shall be included in the total income—*
> *(a) if it is applied to religious or charitable purposes without the taxable territories, but in the following cases, namely: …."*

The amendment sought to restrict the amount of exemption to the things done within India. In other words, exemption was not extended to 'things done' outside India. The phrase 'things done' referred to charitable purpose and not the place where the expenditure was incurred. The position of law, both, before 01.04.1952 and thereafter, so far as section 4(3)(i) of the 1922 Act is concerned, has been noticed and contrasted by Subba Rao, J., in ***Nizam's Religious Endowment Trust***[1] in following words:

> *"Under the said clause, trust income, irrespective of the fact whether the said purposes were within or without the taxable territories, was exempt from tax in so far as the said income was applied or finally set apart for the said purposes.* ***Presumably, as the State did not like to forgo the revenue in favour of a charity outside the country****, the amended clause described with precision the class or kind of income that is exempt thereunder so as to exclude therefrom income applied or accumulated for religious or charitable purposes without the taxable territories."*

A careful perusal of the law prior to 1954, the amendment made in 1954 and the above observation of the Supreme Court, would clearly show that the phrase "as relate to anything done within the taxable territories" relates to the charitable purpose being within the taxable territories of India, and that it was immaterial where the income was actually spent in India or not.

The 1961 Act, enacted by repealing the 1922 Act, couched the condition of 'application to such charitable purposes as relate to anything done *within the taxable territories*' with 'application to such charitable purposes *in India*'. There seems to be no intention of the law makers to alter this condition for granting the exemption. Strangely, the question of whether the phrase 'in India' qualifies 'application of income' or 'charitable purposes' has been a subject of contrary interpretation by Courts.

The Mumbai Tribunal in ***Gem & Jewellery Export Promotion Council***[2] held that there was no doubt that the requirement under section 11 of the Act is for application of income for 'purposes' in India and it does not restrict the application of income within the 'territory' of India.

The Delhi Tribunal relied on the reasoning given by the Mumbai Tribunal, while dealing with a similar issue in the case of ***NASSCOM***[3]. It held that the application of income need not be in India, but the application should result and should be for charitable and religious purpose in India. However, on appeal, the Delhi High Court in ***NASSCOM***[4] held that the words 'in India' appearing in section 11(1)(a) of the Act qualifies the verb 'applied' appearing in the section and not the phrase 'such purposes'.

The author believes that the judgment of the Delhi High Court seems to not lay down the correct law, for more than one reasons. *Firstly*, going by the intention of the Legislature, the Court implied that the law did not intend to forgo the revenue in favour of a charity outside the country. Though the principle is unquestionable, but the mere incurrence of expenditure in foreign currency would not imply carrying on a charitable activity outside India. To illustrate, where a hospital imports medical equipment by remitting foreign currency, the expenditure does not result in application of income outside India. *Secondly*, the Court observed that if it was accepted that it was only the place of purpose which is relevant for section 11(1)(a), then section 11(1)(c) would be rendered redundant. In this regard, it is highlighted that section 11(1)(c) provides for exemption in the cases where the object of the trust is international welfare in which India is interested, i.e. where the charitable purpose itself lies outside India. Contrary to the observation of the High Court, the exemption in section 11(1)(c) of the Act strengthens the argument that the intention of the Legislature to grant exemption

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[1] *H.E.H. Nizam's Religious Endowment Trust* v. *CIT*, [1966] 59 ITR 582.

[2] *Gem & Jewellery Export Promotion Council* v. *Sixth ITO*, [1999] 68 ITD 95 (Mum.).

[3] *National Association of Software & Services Companies* v. *DDIT (Exemptions)*, [2010] 130 TTJ 377 (Delhi).

[4] *DIT (Exemption)* v. *National Association of Software and Services Companies*, [2012] 345 ITR 362 (Delhi).

under section 11(1)(a) is with respect to those cases where the purpose lies in India; where the charitable purpose lies outside India, exemption is granted under Section 11(1)(c) of the Act.

The Bangalore Tribunal in ***Ohio University Christ College***[5] has also concluded that, merely because the payments are made outside India, it cannot be said that the charitable activities were also conducted outside the country. The Tribunal has however not referred to the judgment of the Delhi High Court.

Considering the discussion in the foregoing paragraphs, it can be said that the mandate under section 11(1)(a) is only to apply the income in India for charitable purposes, while the actual expenditure could in fact be outside India. Therefore, if the expenditure is incurred outside India for the charitable purpose in India, then the exemption under section 11(1)(a) should not be denied.

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Statute update

Taxation Laws (Amendment) Bill, 2019 receives Presidential assent

The Taxation Laws (Amendment) Bill, 2019 received Presidential Assent on December 11, 2019. In addition to the various changes proposed in the Bill vis-a-vis the Ordinance, a further amendment was moved to the effect that reduced rate of MAT at 15% would be available to corporate assessees from the current year that is previous year relevant to assessment year 2020-21 rather than from the following year.

Ratio Decidendi

Manufacturing and trading transactions not closely linked if they are not inter-dependent

The assessee engaged in trading of spare parts commenced manufacturing and sought to club transaction to determine ALP under TNMM. The department contended that the two transactions were not closely linked, and ALP had to be determined separately. Following the principles laid down in Punjab & Haryana High Court decision in the case of *Knorr Bremse,* the ITAT held that transactions of production and distribution segments cannot be clubbed because it is neither a case of package deal nor the two sets of transactions are structured in such a manner that the assessee has no option to accept one and reject the other nor they are so inextricably linked that one cannot survive without

[5] *DDIT (Exemptions)* v. *Ohio University Christ College*, [2017] 83 taxmann.com 11 (Bangalore-Trib.).

the other. In the facts of the assessee, it did not sell spare parts to AEs whereas the manufacturing segment exported diesel engines only to AEs. Thus, reiterating that Rule 10A(d) contains a caveat that only closely linked transactions can be aggregated, the ITAT upheld the transfer pricing addition based on the ALP worked out separately for the manufacturing segment.[*Man and Diesel Turbo India P Ltd* v. *ACIT*, ITA 1049/Pun/2017, ITAT Pune Order, dated 9-12-2019]

Transfer pricing provisions not to apply when there is no possibility of income accruing

The assessee had provided a loan to its Chinese AE and in the year under consideration the AE had applied to Chinese authority's permission to repay the loan. As per Chinese laws, no interest could accrue once such application was made. Thus, the assessee contended that when there was no possibility of income accruing to the assessee, ALP cannot be determined, and no income can be imputed to the assessee. The ITAT agreed with the arguments put forth by the assessee and further stated that as per the DTAA, in order for India to tax interest such income must arise within India or in China. Since, in the instant case, income did not arise in the first place, India would have no right to tax such income. [*Aricent Technologies Holdings Ltd* v. *DCIT*, ITA No. 1308/Del/2015, ITAT Delhi Order, dated 20-11-2019]

Internal comparables to be given preference over external comparables as per Rule 10B(1)(e)

At issue was the choice of appropriate comparables since the assessee sought to demonstrate the ALP under Transactional Net Margin Method (TNMM) of exports made to associated enterprises (AEs) by using internal comparables that is uncontrolled transactions between itself and non-AEs whereas the department urged the use of external comparables. The ITAT held that Rule 10B(1)(e) which states: *the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;* should be read as (i) net profit margin realised by an assessee from comparable uncontrolled transaction or (ii) net profit margin realised by an uncontrolled enterprise from comparable uncontrolled transactions. Thus, if internal comparable are available, it would be a better to adopt the same since factors like inputs, assets employed etc would remain the same. External comparables should be preferred only if products and services were different or there are differences in geographical location, timing of transaction and so on. [*DCIT* v. *Carraro India P Ltd*, ITA N0. 1719/Pun/2018, ITAT, ITAT Pune Order, dated 28-11-2019]

Where main transaction is at ALP, incidental benefits need not be benchmarked separately

The assessee as part of global banking group received certain marketing support to its AE and provided similar services and correspondent banking services to its AE. The department contended that the assessee had not been adequately compensated for its efforts. It did not accept the argument of the assessee that since reciprocal services were being provided there was no requirement to add a mark up on costs. The ITAT noted that in the facts of the case, the assessee had earned more income due to the marketing efforts of its AEs than expenditure incurred by it to provide services to AEs. Moreover, all such expenses, incomes were shown to be at ALP. Thus, the ITAT held that if the main transaction has been benchmarked, then incidental benefit cannot be a separate transaction and since there were reciprocal services no mark-up was required. [*ADIT* v. *The Hongkong and Shanghai Banking Corporation Ltd*, ITA 3857/Mum/2006 & Ors., ITAT Mumbai Order, dated 27-11-2019]

Assessment order passed without complying with DRP directions, though rectified later, is invalid

The DRP had directed the Transfer Pricing Officer (TPO) to compute working capital adjustment resulting in Nil transfer pricing adjustment. Since the TPO did not pass order within time, the AO proceeded to complete the assessment under Section 143(3) to avoid bar of limitation. Later after the TPO passed the order, the AO passed an order under Section 154 to rectify his 'mistake' and gave effect to the directions of DRP. The ITAT held that every direction of the DRP was binding on the AO and the assessment order passed as per the draft assessment order of the TPO without giving effect to directions of DRP was invalid. It was held that since the AO was aware of the DRP directions, he had not committed any 'mistake' which could be rectified by order under Section 154. [*Global One India P Ltd* v. *DCIT*, 2019 (12) TMI 503, ITAT Delhi Order, dated 10-12-2019]

Trustee in representative capacity eligible for treaty benefit available to non-resident

The department sought to tax the capital gains earned by a fund which was a transparent entity, at the hands of the trustee. The investors in the fund established in Netherlands were taxable persons as per the domestic law of Netherlands. The department contended that the fund which received the income was a transparent entity and the fund which operated through a trust (a tax resident of Netherlands) would be taxable as an Association of Persons. It argued that the fact that the beneficiaries were taxed in Netherlands was not material and that since the fund was a transparent entity, it would not claim any benefit under the India Netherlands DTAA. The assessee placed reliance on Article 13(5) of the treaty which provides that if a person does not hold 10% or more share in any Indian company then the capital gains would not be taxable in India. The ITAT agreed with the contention of the assessee and held that benefit of treaty claimed by the beneficiaries of the fund as tax residents of Netherlands have to be extended to the trustee who was sought to be taxed as a representative of the beneficiary investors. [*ING Bewaar Maatschappij I BV* v. *DCIT (IT)*, ITA NO. 7119/Mum/2014, Order of ITAT Mumbai Order, dated 27-11-2019]

Expenses on telecast of founder's address eligible for deduction where no personal benefit is derived

The revenue department contended that expenses incurred on telecast of public address by the founder of the trust engaged in imparting spiritual education would not be eligible for deduction since it benefitted the founder, and barred in terms of Section 13(1)(c) of the Act. The assessee however contended that the telecast of programmes was for the purpose of imparting spiritual education and no personal benefit accrued to the founder of the trust. The High Court held that the order of the Tribunal based on the reasoning of absence of personal benefit and restricting the disallowance to 1/3rd was reasonable. [*CIT* v. *Bhagwan Shree Laxmi Narain*, [2019] 111 taxmann.com 479 (Delhi)]

Where assessee responds to SCN, plea of ambiguous SCN cannot be raised later

The assessee had sold business assets and addition was made to income in the revisionary order under Section 263, stating that the assessee had not recorded the value of sale of closing stock. The addition was sustained since assessee did not produce evidence that consideration for business assets included closing stock. Penalty was also imposed on the assessee under Section 271(1)(c). The assessee argued against the imposition of penalty contending that the AO has not struck off the limb not relevant to the imposition of penalty. However, the ITAT held that where the assessee could not rebut the factual position, penalty was warranted and in the instant case since the assessee had responded to the penalty notices, he was aware of the charges and could not raise the plea of ambiguity in the notice. [*Muthukumaran Rangarajan* v. *ITO*, ITA 1841, 1842/Chny/2019, ITAT Chennai Order, dated 4-12-2019]

Acquisition of property by way of perpetual lease satisfies 'purchase' for purposes of Section 54F

Referring to the definition of transfer in Section 2(47)(vi) and to Section 269UA, the ITAT held that where a person acquired a residential house on perpetual lease, he would be eligible for relief from taxation of capital gains as per Section 54F. The said section requires an assessee to 'purchase' a new house within a period of two years from date of transfer. Section 2(47)(vi) defines transfer to include a transaction which has the effect of transferring or enabling the enjoyment of immovable property. In terms of the perpetual lease, the assessee could transfer the right to a third party and also enjoy possession. Section 269UA (not applicable to transfers after 1-7-2002) provides that lease period of not less than 12 years would qualify as transfer. Thus, the ITAT held that acquisition of property by way of perpetual lease would be eligible for benefit under Section 54F. [*N Ramaswamy* v. *ITO*, ITA 925/Chny/2019, ITAT Chennai Order, dated 6-12-2019]

Indirect utilisation of loan for industrial purpose would also qualify for exemption under Section 10(15)(iv)(f)

The assessee was aggrieved by disallowance of interest paid on foreign currency loan on which no tax has been deducted since the assessee claimed that the interest income was exempt from tax in terms of Section 10(15)(iv)(f) of the Act. The said section provides that interest paid on loan agreement approved by the government, having regard to the need for industrial development in India would be exempt from tax. The revenue department argued that the loan was not directly employed in industrial development and was used to repay an earlier loan to a resident and hence it did not qualify for exemption. On facts, the assessee also stated that the loan repaid by it was a working capital loan. The ITAT held that the word 'with regard to the need for industrial development' is wide enough to cover indirect use and it was not necessary to prove direct use. [*CIT* v. *Seven Seas Distillery P Ltd*, Tax case (Appeal) No. 2025 of 2008, High Court of Madras Order, dated 3-12-2019]

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