

# **CAN SALARIES BE PAID TO BOARD MEMBERS & TRUSTEES**

**Published by  
Financial Management Service Foundation**

# 1. CAN SALARIES BE PAID TO BOARD MEMBERS & TRUSTEES

## INTRODUCTION

- 1.1.1 There is lack of clarity regarding remuneration or salaries of Board Members and Trustees of an NGO. There is a common misconception that remuneration or salaries cannot be paid to Board Members and Trustees of an NGO. At the outset, it is clarified that remuneration or salaries can be paid to the Board Members and the Trustees for the actual services rendered as a contractual obligation. The only precaution to be exercised is to ensure that no benefits are extended to the Board Members or the Trustees. A benefit means something which is not due to the recipient.

## THE REASON FOR MISCONCEPTION REGARDING SALARIES TO TRUSTEES

- 1.2.1 The primary reason behind the misconception that remuneration or salaries cannot be paid to Board of Members and Trustees of an NGO is the provisions of Indian Trust Act 1882. Section 50 of this Act provides that Trustees cannot be paid remuneration. However, it may be noted that Indian Trust Act 1882 does not apply to public charitable or religious trust. The provision of Section 50 is provided as under:

*“Trustee may not charge for services. 50. In the absence of express directions to the contrary contained in the instrument of trust or of a contract to the contrary entered into with the bene ficiary or the Court at the time of accepting the trust, a trustee has no right to remuneration for his trouble, skill and loss of time in executing the trust. Nothing in this section applies to any Official Trustee, Administrator General, Public curator, or person holding a certificate of administration.”*

To sum of, the Indian Trust Act 1882 shall not apply and reasonable remuneration can be paid to the Board Members and the Trustees.

## CAN HIGH SALARIES BE PAID

- 1.3.1 We need to understand the quantum of remuneration which can be legally paid and shall not be treated as unreasonable. Let us take an illustration; Chairman of XX Society wants to take a monthly salary of Rs.5 lakhs from the society and the Chairman is devoting his full time for the society and his educational qualifications, experience and credentials are very high. Presently, the society is paying the highest salary of Rs. 2 lakhs per month to some senior employees. The society is registered under Section 12AA (it is the section under which NGOs get tax exemptions). Whether the society can pay a remuneration of Rs.5 lakhs per month to it’s Chairman or not and its implications along with any citations and case laws? The above illustration is discussed as under.

## LEGAL OVERVIEW

- 1.4.1 The law pertaining to remuneration or fees paid to Trustees or Board Members is very enabling and allows reasonable remuneration to the Trustees or the Board Members under Section 13(1)(c) read with Section 13(2)(c). An overview of the law and cases in this regard is provided in **Annexure 1**.

- 1.4.2 Under Income Tax Act any contractual compensation against the services rendered is permissible, however any benefit paid / provided is not permissible. A benefit means something which is not due to a person. As per this understanding, any unreasonable payment over and above what is reasonably due shall be treated as a benefit. This principle will apply to all organizations availing Tax exemptions under the Income Tax Act, 1961. An organization registered under Section 12AA or 10(23C)(v) or (vi) shall also be subject to the same principles.
- 1.4.3 The second issue is whether considerably higher remuneration can be paid to the Chairman or the Managing Trustee over and above the highest paid employee of the organization. In such circumstances, the issue is whether such high remuneration can be justified as reasonable. Again, the available judicial precedence is in favour of the assessee where it has been held that (i) the onus will be on the revenue to establish that the salaries are unreasonable, (ii) the AO just cannot subjectively conclude that the salaries are unreasonable. The seniority and expertise of the Trustees may warrant such high remuneration. An overview of the law and cases in this regard is provided in **Annexure 2**.
- 1.4.4 The Supreme Court in *CIT Vs Kamala Town Trust* [2005] 279 ITR 89 (All) held that Section 13 of the Act, carves out an exception to the general exemption granted under Sections 11 and 12 of the Act, to the income derived by a trust / charitable institution. The onus lies on the Revenue to bring on record cogent material / evidence to establish that the trust / charitable institution is hit by the provisions of Section 13.

## **WILL THE ENTIRE INCOME BE TAXED IF REMUNERATION IS FOUND UNREASONABLE**

- 1.5.1 Further, we have to understand that if for some reason the remuneration paid is deemed to be unreasonable then the issue arises whether the entire income will be taxed or only the portion of unreasonable salary shall be subjected to tax. In this context, there is enough of judicial precedence to opine that the entire income cannot be taxed and only the portion of unreasonable salary shall be subjected to tax. An overview of the law and cases in this regard is provided in **Annexure 3**.

## **CONCLUDING REMARKS**

- 1.6.1 In our considered view, firstly, there is no bar in paying reasonable remuneration. However, there is no objective yardstick available to determine what is reasonable. There is scattered judicial precedence where very high salary to the Trustees have also been treated as reasonable. A salary of Rs. 5,00,000/- per month in today's context can be established as reasonable by drawing parallels from the salary of CEOs of various national level Charities and Educational Institutions. However, it will remain a subject matter of interpretations and therefore, allied controversies and disputes during the Income Tax Assessment cannot be ruled out. Therefore, it is recommended that the salaries of the Board Members and the Trustees should not be unduly high over and above the other employees of the organization, though legally there is no stated bar on the quantum of remuneration.

## REASONABLE REMUNERATION UNDER SECTION 13(1)(C) READ WITH SECTION 13(2)(C)

Under the Income Tax Act, any contractual compensation against services rendered is permissible, however any benefit paid / provided is not permissible. A benefit means something which is not due to a person. Under this understanding, any unreasonable over and above what is reasonably due shall be treated as a benefit. Forfeiture under section 13(1)(c) can be done only if any benefit is provided to the Board Members or interested Functionaries. Section 13(1)(c) does not prohibit payment of remuneration, it gets attracted if any benefit is provided to the interested person. If the Functionary is a salaried employee under an employment contract and therefore, is being paid salary which is a contractual obligation on the part of the Trust then such remuneration is permissible. There has to be a reason or cause of action to infer and conclude that any benefit was provided to the Functionary. A benefit implies payment of anything which is not legally due to a person, therefore, the salaries paid cannot be treated as a benefit. It may also be noted that payment of salary *per se* is not a benefit. To establish that some benefit was passed under section 13(1)(c), it will be incumbent on the AO to have reasons to believe that the remuneration was legally not due to the Employees/Functionaries. Once the legal eligibility of the trustees/board members to receive salary as full time employee is not disputed, then the only option available is to see the reasonableness of the salaries under section 13(2)(c).

It has been held that even if there is some transaction involving the interested person, it is not sufficient to attract section 13, unless some benefit is proved by the revenue, *CIT v. Kamala Town Trust* [2005] 279 ITR 89 (All.). The Allahabad High Court has clearly stated that the onus lies on the revenue to bring on record, cogent material to establish that the Trust/Charitable Institution is hit by the provisions of section 13.

In *DIT(Exemption) v. Parivar Seva Sansthan* [2002] 254 ITR 268 (Delhi), it was held that the revenue cannot infer benefit based on certain transactions relating to Functionaries and reasonable compensation was no bene-fit. In this case the issue of remuneration paid to the Trustee was also deliberated and it was held that reasonable compensation could not be considered as benefit under section 13(1)(c).

In the case of *CIT v. J.K. Charitable Trust* [1991] 59 Taxman 602 (All.), the Trust Deed of assessee-Trust empowered trustees to establish, equip and maintain industrial homes for teaching unemployed person arts like handicrafts and other home industries and to make provision for payment to them daily, weekly or monthly, such wages or remuneration as trustees may determine on basis of place, work or otherwise, it was held to be charitable in nature as advancement of any other public utility.

In *CIT v. Trustees of Dr. Divekar Charity Trust* [1977] 110 ITR 227, it was held that reasonable remuneration paid to the trustees for managing the property and other activities for the purposes of the trust was justified and was applicable towards the purposes of the trust. In this regard, the cases *DIT (Exemption) v. Wardha Charitable Trust* [2002] 120 Taxman 665 (Delhi) and *DIT v. Sikar Charitable Trust* [2002] 120 Taxman 886 (Delhi) are also relevant.

In the case of *Arvind Bhartiya Vidhyalya Samiti v. ACIT* [2008] 173 Taxman 119/115 TTJ 351 (Jaipur), the appellate Tribunal of Jaipur in similar circumstances held that charging of reasonable remuneration could not be considered as benefit passed to the interested person.

In view of the above facts and decided case laws, it is submitted that there is no violation of Sec. 13(1)(c) of the Income Tax Act, 1961.

In the case of *ADIT (Exemption) v. Manav Bharati Child Institute & Child Psychology* [2008] 20 SOT 517 (Delhi) it was held that there is no prohibition in Act to remunerate interested person but such remuneration should be commensurate with services rendered by them and so found, it cannot be said that provisions of section 13(1)(c) are attracted so as to deny benefit of exemption under sections 11 and 12.

In the case of *CIT v. 21st Society of Immaculate Conception* [2000] 241 ITR 193 (Mad.), the Assessing Officer found that the Nuns who were managing the society were donating back certain portion of their salary. It was inferred as since they were being paid more than their needs, section 13(1)(c) was attracted. The Madras High Court observed that the test of reasonableness is not whether the payment was more than their needs, but whether it was commensurate with the services rendered by them.

In the case *Deputy Director of Income-tax (Exemption)-III, Hyderabad v. Gideons International in India* [2016] 65 taxmann.com 95 (Hyderabad Trib.), it was held that where there was a failure by the Assessing Officer to indicate the assessment order that salary paid by the assessee-Society to the Executive Director was unreasonable, no violation of provision of section 13(1)(c) could be alleged and exemption could not be denied. It was held as under:

*“As could be seen from the material placed on record, total salary paid in the initial year of appointment to the Executive Director was Rs. 10.80 lakhs and not Rs. 7.20 lakhs as noted by the Assessing Officer. Therefore, compared to the salary paid in the initial year of appointment the salary paid in the year under consideration could not be excessive or unreasonable. The Assessing Officer has not mentioned any valid reason in the assessment order to indicate that the salary paid to the Executive Director is not commensurate with the responsibilities/duties performed by him. No material brought on record by the Assessing Officer to indicate that the salary paid is unreasonable or excessive.”*

## HIGH SALARIES TO TRUSTEE SECTION 13(1)(C) READ WITH 40A(2)(A)

In the case of *Director of Income-tax (Exemption), Ahmedabad v. N.H. Kapadia Education Trust* [2012] 20 taxmann.com 702 (Ahd.) where the Managing Trustees were paid much higher in comparison to the Principal and other staff whose activities were confined to their rank while these Trustees had versatile experience, administrative and managerial skill and by their unstinted efforts and far-sightedness they were managing students, carrying on other administrative work, coordinating with Government agencies, higher payment made to them could not be doubted. It was further held that since these Trustees had to commute on day-to-day basis to various Government agencies, and other allied places which were scattered all the over vast city of Ahmedabad, this cannot be branded at any stretch of imagination that Trustees had been provided with excessive amenities such as vehicles etc.

In the case of *ACIT v. Idicula Trust Society* [2012] 21 taxmann.com 144 (Delhi - Trib.) it was held that Assessing Officer cannot subjectively conclude that the salaries paid are unreasonable without providing any sound basis or evidence and also cannot apply Section 40A(2)(a) which provides that an assessee incurs any expenditure in respect of which payment has been made or is to be made to any person referred to in clause (b) of this sub-section, and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is also considered by him to be excessive or unreasonable shall not be allowed as a deduction. Thus, under Section 40A(2)(a), if an assessee made payments for availing benefit, services or any facility from the person mentioned in sub-clause (b) of Section 40A(2) and similar type of benefit, service type of benefit, service or facility could be availed from the open market at a cheaper rate then the excess amount considered by the Assessing Officer is to be disallowed to the assessee out of his business expenditure. Now, the income of the assessee is not being computed as a business income. The Tribunal observed that the assessee was a Charitable Institution and its income should be computed under Sections 11, 12 and 13. Clause (b) of section 40A(2) provides six categories of assessee along with list of persons who could be associated with the assessee. In this clause, no reference is being made to an assessee, who is a Society or Trust and whose income is to be assessed as per Sections 11, 12 and 13. Because a similar mechanism has been provided there in Section 13(1)(ii) and 13(3), it appears that the Assessing Officer has made reference to this section unnecessarily. Some relevant extract is as under:

“A bare perusal of section 13(1)(c)(ii) would suggest that whatever has been stated in Sections 11 and 12 with regard to providing certain benefits to the assessee would not be available on the amounts which have been extended directly or indirectly for the benefit of any person referred to in sub-section (3) of Section 13, meaning thereby, if an assessee had extended any undue benefit to the person mentioned in sub-clause (3) of Section 13 then those amounts would not be considered as application of income for the purpose of fulfilment of objects of the society and benefit of sections 11 and 12 would not be available to the assessee on those amounts. Thus, Section 13(3)(1)(c)(ii) is analogous to Section 40A(2)(a) and Section 13(3) is an analogous to sub-clause (b) of Section 40A(2). The Commissioner (Appeals) has rightly observed that restriction is applicable to those amounts which have been applied directly or indirectly for the benefit of any person referred to in subsection (3). It will not lead to any conclusion that assessee would lose its charity status. In other words, if a small amount is to be disallowed that would not disqualify to enjoy the status of charity.

It is necessary to examine whether the assessee has extended any undue benefit directly or indirectly to the persons referred to in sub-section (3). As far as the salary paid to two persons 'T' and 'A' (Rs. 8,16,000 and Rs. 7,20,000) is concerned, it is found that a similar salary was paid in assessment years 2005-06 to 2007-08. In assessment years 2005-06 and 2006-07, Assessing Officer made the disallowance and the Tribunal has upheld the deletion of disallowance. Thus, the issue is squarely covered by the order of the Tribunal. As far as the salary paid to 'J' is concerned, the salary of Rs. 55,000 per month has been paid. Assessing Officer disallowed the salary to the extent of 2/3rd. The Commissioner (Appeals) has considered the order of the Tribunal in assessment years 2003-04 to 2006-07 wherein salary in the case of 'J' has been partly disallowed. It was brought to notice that in the assessment year 2007-08, the Assessing Officer has allowed the total salary paid to 'J' and the salary was of Rs. 55,000 per month. It is further found that in this year, Assessing Officer has independently not brought any evidence which can show how much salary a person having qualification equivalent to 'J' could fetch in the open market. What are the rates of salary paid by other institution to a person who is teaching as well as managing the school."

In the case of *Arvind Bhartiya Vidhyalya Samiti v. Assistant Commissioner of Income-tax, Circle-4, Jaipur* [2008] 173 Taxman 119 (Jp.)(Mag.) it was held that reasonable salary and rent paid to persons referred to in Section 13(3) shall be said to be a deemed application for benefit of such persons. In the case of *CIT, Faridabad v. Idicula Trust Society, Faridabad* [2014] 45 taxmann.com 158, the High Court of Punjab and Haryana held that where all members of assessee-trust were engaged in whole time management activities of Trust and as regular time teachers and were being paid salaries from earning of these schools and were not being paid any extra salary for management work, there was no violation of the provisions of Section 13(2)(c) and the assessee was entitled to benefit of exemption under section 1.

In the case *PNR Society for Relief & Rehabilitation of the Disabled Trust Vs. DDIT (ITAT Ahmedabad)*, ITA No. 2729/Ahd/2010, Date of Order: 14/ 08/2014 the assessee was a charitable trust registered u/s. 12AA of the Act. The assessee trust paid remuneration of Rs 4,80,000/- to Shri Anantbhai K. Shah who was a full time Secretary and Trustee of the assessee trust. The Assessing Officer disallowed the deduction claimed for above payment on the ground that the services rendered by Shri Anantbhai K. Shah were a duty of him as a trustee and the remuneration paid to him being violative of provisions of Section 13(1)(c) and 13(3)(cc). The Assessing Officer also opined that remuneration of Rs 4,80,000/paid to said Shri Anantbhai K. Shah cannot be treated as application towards objects of the trust and therefore, he disallowed the entire amount of Rs 4,80,000/- and treated the same as taxable income in the hands of the assessee charitable trust. Authorized Representative of the assessee contended that in view of the provisions of Section 13(2)(c), no disallowance of remuneration paid to the trustee which is not more than the fair market value can be made, and therefore, the Revenue was not justified in making arbitrary disallowance. He also pointed out that similar remuneration was paid to the same trustee in earlier years also which was accepted and allowed by the Department. The Authorized Representative of the assessee submitted that Shri Anantbhai K. Shah was qualified in B.A. (Sp.) degree in Sociology passed in 1962 from Gujarat University which was the only specialized degree in field of sociology. He has vast experience of over 45 years in the field of social working and developing institutions in this field. He has been awarded with the following awards for his achievements and his noble services in the field of helping handicapped people particularly children:

- Rajiv Gandhi Manav Seva Award – 1998
- Felicitated by former Prime Minister of India Late Shri Morarji Desai
- Nagardas Doshi Smarak Nidhi Trust Award – 1997
- Alpalwala Award – 2007





He has been declared as “Man of the Year” – 2006 by “The Week”. The assessee trust is engaged in various activities for relief and rehabilitation of disabled persons such as prevention and early intervention, polio eradication, corrective surgery polio/cataract/cleft lip congenital heart defect, research, training course, workshop for artificial limbs, aids, technology transfer, physio-occupational therapy centre, AT &T Technological park centre etc. The Authorized Representative of the assessee further submitted that Shri Anantbhai K. Shah was a full time Secretary in the assessee trust. He was engaged full time in the activities of the trust. Therefore, by no stretch of imagination it can be held that annual remuneration of Rs 4,80,000/- paid to said Shri Anantbhai K. Shah was more than the fair market value of his services rendered to the assessee trust.

It was held that the revenue could not bring any material to controvert the submissions of the Authorized Representative of the assessee. We find that the total receipts of the assessee trust were to the tune of Rs.443.24 lakhs during the year under consideration and the activity undertaken by the assessee trust was to the tune of Rs. 469.87 lakhs. Thus, the remuneration of Rs. 4,80,000/- which is about 1% of the total value of activities of the trust for looking after which the same was paid, cannot be said to be excessive or unreasonable.

Further, we find that the Departmental Representative could not controvert the submissions of the assessee and the remuneration was permissible.



**WHETHER ENTIRE EXEMPTION WILL BE LOST FOR VIOLATION UNDER 13(1)(C)**

In the case *ITO Vs. Virendra Singh Memorial Shiksha Samiti* [2009] 18 DTR (Trib.) 502 (Lucknow) allegations were made by the IT Department that the assessee-society was disentitled from getting exemption under section 10(23C), as some benefit was imparted to the Founder of the Trust. It was held that in the first place, there was no evidence that such benefit had been imparted to the Founder and secondly, even if it was so, such instances cannot be imported to deny the exemption under section 10(22) / 10(23C). It was further held that mere disallowance of certain expenses cannot become basis for denying exemption under Section 10(22) / 10(23C).

The aforesaid judgement will be equally applicable to the exemption under Section 11 of the Act. Therefore, it is clearly established that even if some benefit has been imparted to the Founder of the trust, such instance cannot disentitle the assessee from the benefit of exemption under Section 11 of the Act.

In the case *Arvind Bhartiya Vidhyalya Samiti Vs. ACIT* [2008] 115 TTJ 351 (Jp.) It was, inter alia, held in this case that even if there was some misutilization of the funds / mismanagement by the Trustees, or minor discrepancies are there, these cannot disentitle the assessee from the exemption under Section 10(22) or Section 10(23C) of the Act. The aforesaid judgement will equally apply to the exemption under Section 11 of the Act. Therefore, even if there is some mis-utilization of the funds / mismanagement by the Trustees or there are minor discrepancies, these cannot disentitle the assessee from exemption under Section 11 of the Act.

In the case *Dy.CIT Vs. Cosmopolitan Education Society* [2000] 244 ITR 494 (Raj.) allegations were made against the society that there was misutilization or mis-management of the income / funds of the Trust and accordingly, the exemption under Section 10(22) of the Act was denied to the assessee. It was, inter alia, held that if there was any mis-utilization or mis-management of the income / funds of the society, action could be taken against the members of the society and the benefit under Section 10(22) could not be denied to the society. It was also held in this case that in view of the judgement of the Supreme Court, in the case of *Aditnar Educational Institution Vs Addl.CIT* [1997] 224 ITR 310 (SC), an overall view is to be taken without being hyper technical in granting exemption under Section 10(22) of the Act. The aforesaid judgement will equally apply to the exemption under Section 11 of the Act. Therefore, if there is some misutilization or mis-management of the income / funds, the exemption under Section 11 of the Act, cannot be denied to the assessee Trust. In view of the aforesaid legal precedents, it is clearly established that only the relevant income falling within the mischief of section 13(1)(c) / 13(1)(d) will lose the benefit of exemption under Section 11 of the Act and the balance of the total income of the trust will remain eligible for the benefit of exemption under Section 11 of the Act. In other words, violation of Section 13(1)(c) / 13(1)(d) cannot lead to denial of exemption under Section 11 of the Act, to the total income of the Trust.

V. In the present context, it is also significant to note that the burden of proof lies on the Revenue to prove that Section 13 applies in a case.

Adobe Photoshop Clip Image is to bid to be export- Contrary Case

The Kerala High Court, in the case of *Agappa Child Centre Vs CIT* [1997] 226 ITR 211 (Ker) provided a very contrary ruling which effectively has been nullified by preponderance of

judicial pronouncement throughout the country. In this case, the trust purchased a refrigerator for its own use. However, before the completion of the trust buildings, the trust kept the said refrigerator at the residence of the managing trustee of the trust. The ITO refused exemption to the trust under Section 11 of the Act, on the ground that use of refrigerator by the managing trustee was violation of the provisions of Section 13(2)(b) of the Act. The aforesaid conclusion of the Assessing Officer was upheld by the CIT(A), the Tribunal, as well as the High Court.

My aforesaid view has received support from the recent judgement of Karnataka High Court, in the case of *CIT Vs Fr.Mullers Charitable Institutions* [2014] 363 ITR 230 (Karn). It was held in this case that perusal of Section 13(1)(d) of the Act, makes it clear that it is only the income from such investment or deposit, which has been made in violation of Section 11(5) of the Act, that is liable to be taxed and violation of Section 13(1)(d) does not result in denial of exemption under Section 11 to the total income of the assessee trust. The aforesaid judgement of Karnataka High Court is based on the judgement of Bombay High Court, in the case of *DIT(E) Vs.Sheth Mafatlal Gagalbhai Foundation Trust* [2001] 249 ITR 533 (Bom).

In the present context, the provisions of Section 164, particularly Section 164(2) and proviso thereto, are also relevant. It may also be stated here that in view of the proviso to Section 164(2) and Circular No.387, dt.6.7.1984, issued by the CBDT, all the legal precedents applicable to the violations under Section 13(1)(d) of the Act, will equally apply to the violations under Section 13(1)(c) of the Act. Before proceeding to deal with the relevant legal precedents in support of the aforesaid stand, it would be appropriate to refer to the relevant provisions of Sections 13 and 164 of the Act, along with relevant Circular of the CBDT. The same are discussed as follows:

## I. SECTIONS 13(1)(C), 13(1)(D) AND 13(2) OF THE ACT.

In the present context, the provisions of Sections 13(1)(c), 13(1)(d) and 13(2) of the Act, are relevant. The same are discussed as follows:

### 1. Provisions of sections 13(1)(c) of the Act

For the sake of ready reference, the relevant part of Section 13(1)(c) of the Act, is reproduced as follows:

**“13. Section 11 not to apply in certain cases.** (1) Nothing contained in Section 11 or Section 12 shall operate so as to exclude from the total income of the previous year of the person in receipt thereof—

- (c) in the case of a trust for charitable or religious purposes or a charitable or religious institution, any income thereof—
  - (i) if such trust or institution has been created or established after the commencement of this Act and under the terms of the trust or the rules governing the institution, any part of such income enures, or
  - (ii) if any part of such income or any property of the trust or the institution (whenever created or established) is during the previous year used or applied, directly or indirectly for the benefit of any person referred to in sub-section (3) :”

*From the aforesaid provisions of Section 13(1)(c)(ii), it may be seen that if any part of income or any property of the trust is applied directly or indirectly for the benefit of any trustee, etc, then the benefit of exemption under Section 11 of the Act, will not be available to the trust, in respect of such income.*

## **2. Provisions of Section 13(1)(d) of the Act.**

For the sake of ready reference, the relevant part of Section 13(1)(d) of the Act, is reproduced as follows:

**“13. Section 11 not to apply in certain cases.** (1) Nothing contained in Section 11 or Section 12 shall operate so as to exclude from the total income of the previous year of the person in receipt thereof—

- (d) in the case of a trust for charitable or religious purposes or a charitable or religious institution, any income thereof, if for any period during the previous year—*
  - (i) any funds of the trust or institution are invested or deposited after the 28th day of February, 1983 otherwise than in any one or more of the forms or modes specified in sub-section (5) of section 11; or*
  - (ii) any funds of the trust or institution invested or deposited before the 1st day of March, 1983 otherwise than in any one or more of the forms or modes specified in sub- section (5) of section 11 continue to remain so invested or deposited after the 30th day of November, 1983; or*
  - (iii) any shares in a company, other than—*
    - (A) shares in a public sector company;*
    - (B) shares prescribed as a form or mode of investment under clause (xii) of sub-section (5) of Section 11, are held by the trust or institution after the 30th day of November, 1983:”*

From the aforesaid provisions of Section 13(1)(d), it may be seen that if the conditions laid down there under are not fulfilled, then the trust will lose the benefit of exemption under Section 11 of the Act, in respect of income referred to therein.

## **3. Provisions of Section 13(2) of the Act.**

In the present context, section 13(2) of the Act is also relevant. For the sake of ready reference, section 13(2) of the Act, is reproduced as follows:

**“13. Section 11 not to apply in certain cases.**(2) Without prejudice to the generality of the provisions of clause (c) and clause (d) of sub- section (1), the income or the property of the trust or institution or any part of such income or property shall, for the purposes of that clause, be deemed to have been used or applied for the benefit of a person referred to in sub-section (3),—

- (a) if any part of the income or property of the trust or institution is, or continues to be, lent to any person referred to in sub-section (3) for any period during the previous year without either adequate security or adequate interest or both;*
- (b) if any land, building or other property of the trust or institution is, or continues to be, made available for the use of any person referred to in sub-section (3), for any period during the previous year without charging adequate rent or other compensation;*

- (c) *if any amount is paid by way of salary, allowance or otherwise during the previous year to any person referred to in sub-section (3) out of the resources of the trust or institution for services rendered by that person to such trust or institution and the amount so paid is in excess of what may be reasonably paid for such services;*
- (d) *if the services of the trust or institution are made available to any person referred to in sub-section (3) during the previous year without adequate remuneration or other compensation*
- (e) *if any share, security or other property is purchased by or on behalf of the trust or institution from any person referred to in sub-section (3) during the previous year for consideration which is more than adequate;*
- (f) *if any share, security or other property is sold by or on behalf of the trust or institution to any person referred to in sub-section (3) during the previous year for consideration which is less than adequate;*
- (g) *if any income or property of the trust or institution is diverted during the previous year in favour of any person referred to in sub-section (3): Provided that this clause shall not apply where the income, or the value of the property or, as the case may be, the aggregate of the income and the value of the property, so diverted does not exceed one thousand rupees;*
- (h) *if any funds of the trust or institution are, or continue to remain, invested for any period during the previous year (not being a period before the 1st day of January, 1971), in any concern in which any person referred to in sub-section (3) has a substantial interest."*

From the aforesaid provisions of Section 13(2), it may be seen that in respect of various circumstances referred to in clauses (a) to (h) thereof, the income or property of the trust or institution or any part of such income or property shall, for the purposes of Section 13(1)(c) and 13(1)(d), be deemed to have been used or applied for the benefit of the trustee, etc. It clearly implies that Section 13(2) is nothing but an extension of Section 13(1)(c) / 13(1)(d).

## II. SECTION 164(2) OF THE ACT.

In the present context, the provisions of Section 164(2) are also relevant, which are reproduced as follows:

***"164. Charge of tax where share of beneficiaries unknown.*** (2) *In the case of relevant income which is derived from property held under trust wholly for charitable or religious purposes, or which is of the nature referred to in sub-clause (iia) of clause (24) of Section 2 or which is of the nature referred to in sub-section (4A) of Section 11 tax shall be charged on so much of the relevant income as is not exempt under Section 11 or Section 12, as if the relevant income not so exempt were the income of an association of persons : Provided that in a case where the whole or any part of the relevant income is not exempt under Section 11 or Section 12 by virtue of the provisions contained in clause (c) or clause (d) of sub-section (1) of Section 13, tax shall be charged on the relevant income or part of relevant income at the maximum marginal rate."*

From the aforesaid provisions of Section 164(2), it may be seen that in the case of relevant income referred to therein, tax shall be charged on so much of the relevant income, as is not exempt under Section 11 or 12, as if the relevant income not so

exempt were the income of an association of persons (AOP). It clearly implies that only that part of the relevant income which is not exempt under Section 11 or Section 12 is brought to tax, as the income of an AOP and the balance of income of the charitable trust / institution, will remain exempt. Further, as per the proviso to Section 164(2), where the whole or any part of the relevant income is not exempt under Section 11 or Section 12, by virtue of the provisions of Section 13(1)(c) or Section 13(1)(d), tax shall be charged on the relevant income or part of relevant income, at the maximum marginal rate. In view of the aforesaid proviso to Section 164(2), the Courts have held that in case of violation of the conditions under Section 13(1)(c) or 13(1)(d) of the Act, only the relevant income or part of such relevant income is liable to be taxed at maximum marginal rate. It is also held that the violation of Section 13(1)(c) or 13(1)(d) does not result in denial of exemption under Section 11, in respect of the total income of the assessee. In other words, only the non-exempt income, in view of the provisions of Section 13(1)(c) / 13(1)(d) would fall in the tax-net and the other income of the charitable trust / institution would remain exempt under the provisions of Section 11 of the Act.

### III. RELEVANT PART OF CIRCULAR NO.387, DT.6.7.1984 [152 ITR (ST) 1]

In the present context, paragraph 28 of Circular No.387, dt.6.7.1984, issued by the CBDT, under the heading “Levy of income-tax at maximum marginal rate in the case of charitable and religious trusts which forfeit tax exemption” is very relevant. For our purpose, paragraph 28.6 of the aforesaid Circular is relevant, which is reproduced as follows:

*“28.6 It may be noted that new sub-section (1A) inserted in section 161 of the IT Act, which provides for taxation of the entire income received by trusts at the maximum marginal rates is applicable only in the case of private trusts having profits and gains of business. So far as public charitable and religious trusts are concerned, their business profits are not exempt from tax, except in the cases falling under clause (a) or clause (b) of section 11(4A) of the IT Act. As the maximum marginal rate of tax under the new proviso to section 164(2) applies to the whole or a part of the relevant income of a charitable or religious trust which forfeits exemption by virtue of the provisions of the IT Act in regard to investment pattern or use of the trust property for the benefit of the settlor, etc., contained in section 13(1)(c) and (d) of that Act, the said rate will not apply to the business profits of such trusts which are otherwise chargeable to tax. In other words, where such a trust contravenes the provisions of section 13(1)(c) or (d) of the Act, the maximum marginal rate of income-tax will apply only to that part of the income which has forfeited exemption under the said provisions.”*

As per the aforesaid paragraph 28.6 of the aforesaid Circular, where such a trust contravenes the provisions of Section 13(1)(c) or 13(1)(d) of the Act, the maximum marginal rate of income-tax will apply only to that part of income, which has forfeited exemption under the said provisions.

*From the aforesaid discussion, it is clearly established that a legal precedent which applies in relation to violation of the provisions of Section 13(1)(d), will equally apply in relation to violation of the provisions of Section 13(1)(c), also.*



#### IV. THE RELEVANT LEGAL PRECEDENTS

*There are a number of legal precedents in support of the aforesaid stand, including the aforesaid judgements of Karnataka and Bombay High Courts. The same are discussed as follows:*

1. *CIT Vs Fr. Mullers Charitable Institutions* [2014] 363 ITR 230 (Karn) In this case, the assessee, a charitable trust, for the AYs 2000-01 and 2001-02 claimed exemption under Section 11. The Assessing Officer noticed that the assessee had advanced a sum of Rs.30 lakhs during the AY 2000-01 and a sum of Rs.50 lakhs during the AY 2001-02, respectively, to a company which was running a Kannada daily. According to the Assessing Officer, advancing of such a huge amount was in violation of Section 11(5). Further, as per Section 13(1)(d), the trust shall not be entitled for exemption under Sections 11 and 12 of the Act. Accordingly, the Assessing Officer assessed the aforesaid advances to tax. However, the CIT was of the opinion that in view of violation of Section 11(5), the entire income of the trust ought to have been assessed, as the trust was not entitled to any exemption under Sections 11 and 12 of the Act and the CIT revised the order passed by the Assessing Officer.

On appeal, the Tribunal, after considering the matter in detail and on examining Sections 11, 12, 13(1)(d) and Section 164(2) of the Act, inter alia, held that the order passed by the CIT was contrary to section 164(2) of the Act and the entire income of the assessee could not be assessed.

On appeal by the Revenue before the High Court, one of the substantial question of law admitted was whether the Tribunal was correct in holding that when a part of income is held to be violative of the provisions of Section 13(1)(d), only to the said extent, maximum marginal rate of tax is to be levied and not for the whole income, more particularly when there was violation of the provisions of Section 11(5) of the Act.

**It was held by the High Court that a reading of Section 13(1)(d) of the Act, makes it clear that it is only the income from such investment or deposit which has been made in violation of section 11(5) of the Act, that is liable to be taxed and that the violation of Section 13(1)(d) does not tantamount to denial of exemption under Section 11 to the total income of the assessee. Accordingly, the appeals of the IT Department were dismissed.**

In the aforesaid case, the Karnataka High Court has placed reliance on the judgement of the Bombay High Court, in the case of *DIT(E) Vs Sheth Mafatlal Gagalbhai Foundation Trust* [2001] 249 ITR 533 (Bom). Besides, a reference has also been made to the judgement of Delhi High Court, in the case of *DIT(E) Vs Agrim Charan Foundation* [2002] 253 ITR 593 (Del). In this context, the following observations of the Hon. High Court, on page 238 of the Report are very relevant:

*“We are in respectful agreement that the views expressed by the Bombay High Court as well as the Delhi High Court for violating Section 11(5) of the Act and the entire income of the Respondent trust cannot be assessed for the tax” [Emphasis added] Thus, it was made very clear that where the whole or part of the relevant income is not exempted under Section 11, by virtue of violation of Section 13(1)(d) of the Act, tax shall be levied on the relevant income or part of the relevant income, at the maximum marginal rate. However, violation of Section 13(1)(d) does not result in the denial of exemption under Section 11, to the total income of the assessee.*

2. *DIT(E) Vs Sheth Mafatlal Gagalbhai Foundation Trust* [2001] 249 ITR 533 (Bom). In this case, according to the Assessing Officer, on account of violation of Section 11(5) of the Act, the assessee forfeited exemption under Section 11, in respect of its entire income, viz. dividend income plus interest income, whereas according to the assessee, they were entitled to claim exemption and they were entitled to continuance of exemption in respect of interest income, though they had forfeited the right to claim exemption vis-a-vis the dividend income, as the assessee continued to hold the shares in a non-Government company even after 31.3.1993.

On appeal, the CIT(A) came to the conclusion that the assessee was not entitled to the benefit of exemption under Section 11, in respect of the entire income.

**On further appeal, the Tribunal came to the conclusion that in view of Section 164(1), the income receivable by the trust was the relevant income. That a portion of such relevant income only would suffer tax because of the violation of the condition of investment prescribed under Section 11(5). The Tribunal found that non-fulfilment of such condition could not deprive the trust of the exemption of its other income, which had been granted to it in the earlier years. Hence, the Tribunal allowed the appeal of the assessee.**

Against the aforesaid judgement of the Tribunal, an appeal was filed by the Department before the High Court. The following question was raised before the Hon.High Court:

*“Whether violation of section 11(5), r.w.s.13(1)(d), by the assessee trust attracts maximum marginal rate of tax on the entire income of the trust”.*

The Counsel of the IT Department contended that in view of section 164(2), the forfeiture of exemption for breach of section 11(5) would result in imposition of tax on the maximum marginal rate, as if the assessee was an association of persons (AOP). He further contended that the entire income of the Trust was liable to be charged to tax under maximum marginal rate, on the basis of such income accruing to an association of persons. On the other hand, the Counsel for the assessee contended that the requirement of investment for specified securities under section 11(5) results in an income to the trust which is receivable by the trustees and it is called relevant income under section 164(1). He further contended that a portion of such relevant income in the present case would suffer tax because the condition of investment as prescribed under section 11(5) had not been fulfilled. But nonfulfillment of such condition could not deprive the trust of the exemption of its other income, which had been granted in earlier years. He further contended that in this connection, the proviso to section 164(2) is very important. According to him, the Legislature has clearly contemplated that in a case where the whole or part of the relevant income is not exempt under section 11, by virtue of violation of section 13(1)(d), tax shall be charged on the relevant income or part of the relevant income at the maximum marginal rate. In this connection, he also relied upon Circular No.387, dt.6.7.1984, issued by the CBDT [152 ITR (St) 1]. It was held by the High Court that section 164(2) refers to the relevant income which is derived from property held under trust wholly for charitable or religious purposes.

**If such income consists of severable portions, exempt as well as taxable, the portion which is exempt is to be left out and the portion which is not exempt is charged to tax as if it is the income of the association of persons.**



Therefore, a proviso was inserted by the Finance Act, 1984, with effect from 1.4.1985, under which in cases where the whole or any part of the relevant income is not exempt under section 11 or section 12, because of the contravention of section 13(1)(d), then tax shall be charged on such income or part thereof, as the case may be, at the maximum marginal rate. **In other words, only non-exempt income portion would fall in the net of tax, as if it was the income of an association of persons.** It was further held by the High Court that as per proviso to section 164(2), it is, inter alia, laid down that in cases where the whole or part of the relevant income is not exempt by virtue of section 13(1)(d), tax shall be charged on the relevant income or part of the relevant income at the maximum marginal rate. The phrase “relevant income or part of relevant income” is required to be read in contradistinction to the phrase “whole income” under section 161(1A). This is only by way of comparison. Under section 161(1A) which begins with a non-obstante clause, it is provided that where any income in respect of which a person is liable as a representative assessee consists of profits of business, then tax shall be charged on the whole of the income, in respect of which such person is so liable at the maximum marginal rate. Therefore, reading the aforesaid two phrases show that the Legislature has clearly indicated its mind in the proviso to section 164(2), when it categorically refers to forfeiture of exemption for breach of section 13(1)(d), resulting in levy of maximum marginal rate of tax only to that part of income, which has forfeited exemption. It does not refer to the entire income being subjected to maximum marginal rate of tax. This interpretation is also supported by Circular No.387, dt.8.7.1984 [152 ITR (St)1]. It was also held that in law, there is a vital difference between eligibility for exemption and withdrawal of exemption / forfeiture of exemption for contravention of the provisions of law. These two concepts are different. They have different consequences. In the circumstances, it was held that there was merit in the contention of the assessee that in the present case, the maximum marginal rate of tax would apply only to the dividend income from shares in Mafatlal Industries Ltd and not to the entire income.

Accordingly, the aforesaid question was answered in the negative, that is, in favour of the assessee and against the Department. It is, therefore, clearly established that the Bombay High Court approved the judgement of the Tribunal to the effect that nonfulfillment of condition of investment prescribed under section 11(5) of the Act, could not deprive the trust of the exemption of its other income, which had been granted to it in the earlier years. In other words, it is clearly established that violation of section 13(1)(d) does not tantamount to denial of exemption under section 11 to the total income of the assessee.

3. *Jamsetji Tata Trust Vs JDIT (E)* [2014] 101 DTR (Trib) 305 (Mum) It was, inter alia, held in this case that violation of section 13(1)(d) and section 13(2)(h) deprives exemption only to the income from investments not permitted under section 11(5) and not to the entire income of the trust, if the other income of the trust, otherwise fulfils the condition for exemption. Therefore, the exemption under section 11 is available to the assessee only in respect of income, to the extent the same is derived in conformity to section 11 and applied during the year for the purposes of the trust. While reaching the aforesaid conclusion, the Hon. Tribunal has followed the judgement of Bombay High Court, in the case of *DIT(E) Vs Sheth Mafatlal. Gagalbhai Foundation Trust* [2001] 249 ITR 533 (Bom). It may also be stated here that in the aforesaid judgement, the Tribunal has also followed the earlier judgement of Mumbai Bench of the Tribunal, in the case of *Gurdayal Berlia Charitable Trust Vs ITO* [1990] 34 ITD 489 (Bom). It was held

in this judgement that non-fulfilment of the condition of investment under section 11(5) cannot deprive the trust of exemption of its other income, which has already been granted to it in the earlier years. The non-fulfilment of the condition under section 11(5) would only make a portion of the relevant income as specified under section 164(1), liable to tax. It was further held that in such a case, the provisions of section 164(2), along with the proviso thereto, would come into operation and only such income would be brought to tax at the maximum marginal rate, which cannot be treated as exempt by virtue of non-fulfilment of the condition of investment under section 11(5) of the Act.

4. *CIT Vs. Red Rose School* [2007] 163 Taxman 19 (All.) It was, inter alia, held in this case that the language used in section 12AA for the registration of a trust, only requires that activities of the trust or the institution must be genuine, which, accordingly, would mean that they are in consonance with the objects of the trust / institution and are not mere camouflage, but are real, pure and sincere and are not against the objects of the trust. The profit earning or misuse of the income derived by charitable institution from its charitable activities may be a ground for refusing exemption only with respect to that part of the income, but cannot be taken to be a synonym to the genuineness of the activities of the trust or institution [Paragraph 34 on pages 32 and 33 of the Report] It may, thus, be seen that as per the aforesaid judgement of the Allahabad High Court, the misuse of the income derived by the charitable institution from its charitable activities may be a ground for refusing exemption only with respect to that part of income and not the whole of the income of the trust / institution.