

ISSUES ON ASSESSMENT OF CHARITABLE TRUSTS

Whether deficit (excess application) of earlier years can be set off against surplus of subsequent years?

Excess application of income in earlier years should be considered as application out of the income of the current year for the purposes of Section 11 of the Income-tax Act, 1961 (the Act). Section 11 of the Act states that income derived from property held under trust is to be excluded for the purposes of computing income of the trust for the purpose of assessment to the extent to which such income is applied to charitable or religious purposes in India. This Section now here limits or states that the income should have been applied for charitable or religious purposes only in the year in which the income has arisen. The word 'applied' here means 'put to use to meet expenses for charitable/ religious purpose'. Application takes place in the year in which the income is adjusted to meet the expenses (even if expenses have been incurred in an earlier year). Further as income of trust is to be computed on commercial basis, it is but natural that excess expenses incurred in earlier year have to be adjusted against income of subsequent year and it will have to be regarded as application of income in the subsequent year in which such adjustment has been made having regard to the benevolent provisions contained in Section 11 of the Act.

In *CIT v. Maharana of Mewar Charitable Foundation* (1987) 164 ITR 439 (Raj), their Lordships of the Rajasthan High Court held that if the expenses for charitable and religious purposes have been incurred in the earlier year and the said expenses are adjusted against the income of a subsequent year, the income of that year can be said to be applied for charitable and religious purposes in the year in which the expenses incurred for charitable and religious purposes had been adjusted. Adjustment of excess expenditure against income of following year would amount to application of income for charitable purpose.

This view was reiterated by the Gujarat High Court in *CIT v. Shri Plot Swetambar Murti Pujak Jain Mandal* (1995) 211 ITR 293 (Guj) and by the Madras High Court in *CIT v. Matriseva Trust* (2000) 242 ITR 20 (Mad). In these cases it was held and observed that where on charitable and religious purposes had been incurred in an earlier year, such expenditure if adjusted against the income of the subsequent year, the income of that subsequent year can be said to have been applied for charitable or religious purposes in the year in which the expenditure was incurred. It was also held that income derived from trust property has to be determined on commercial principles and the application of such commercial principles also warrants the conclusion that the expenditure incurred in an earlier year can be set off against the income of the subsequent year.

In *Trustees of Balkan-Ji Bari* (1979) 10 CTR (Trib.) 22, the Bombay Bench of the Tribunal upheld the assessee's contention that it should be allowed the adjustment of excess amount spent towards charitable purposes in the earlier years against current income to determine the funds available with the assessee for the purpose of Section 11(1) of the Act.

Under Section 11 (1)(a) the income from property held in trust for charitable purposes is exempt to the extent it is applied for such purposes in India. It is not necessary that the amount must be spent in the year in which the trust has derived income from property held in trust. This view has also been taken in the case of *Siddaramana Chettiar Trust vs. CIT* 96 ITR 275 (Mysore). In the case of *Chotanagpur Diocesan Trust vs. ITO* 19 ITD 175 (Patna) IT Appellate Tribunal has taken the view that it is not necessary that the amount to be spent on charitable purposes must be out of income earned during the previous year only. Even if the amount is spent out of income of the earlier year, the excess amount spent in the earlier years will be allowable for set off against the income in the subsequent years. In this case the Tribunal has stated that the emphasis of the section is on spending of the income and not on confining to the source of the amount spent or what income is earned during the previous year.

In the case of *CIT vs. Sacred Heart Church* 278 ITR 180 (Guj), the High Court held that adjustment of expenses incurred by a trust for charitable purposes in any earlier year against the income earned by the trust in the subsequent year will amount to applying the income of the trust for charitable purposes in the subsequent year in which adjustment has been made. In other words, if a trust has incurred expenditure exceeding the income of an earlier year, the excess of the expenditure incurred in an earlier year can be adjusted against the surplus of the subsequent year and this surplus in the subsequent year will not be liable to tax if the excess amount spent in the earlier years together with the expenditure incurred in the year in which there is a surplus exceeds 85 per cent of the income of the subsequent year.

In the case of *CIT vs. Institute of Banking Personnel Selection* 264 ITR 110 (Bom), the A.O. disallowed the claim for carry forward of deficit of the earlier years for adjustment against the surplus of the subsequent years on the ground that such carry forward loss was applicable only to income under the head "Profits & Gains of Business" and was not permissible in case of income under Sections 11 to 13 of the Income-tax Act. The Bombay High Court held that income derived from the trust property is to be computed on commercial principles. Accordingly, adjustment of expenses incurred by the trust for charitable purposes in the earlier years against the income earned by the trust in the subsequent year will have to regard as application of income of the trust in the subsequent year. The High Court has also held that the depreciation debited in the books should be treated as expenditure for this purpose.

In the case of *Gem & Jewellery Export Promotion Council vs. ITO* (68 ITD 95) IT Appellate Tribunal Mumbai has held that where the assessee has made excess application of income in the earlier years, such excess should be considered as application out of the current year for the purpose of Section 11. IT Appellate Tribunal Mumbai has also held in this case that the income of the trust is to be computed on commercial principles.

If capital expenditure is incurred as application of income, whether it disentitles the assessee to claim deferred expenditure on the same asset by way of depreciation?

For the purpose of determining the income of the Trust eligible for exemption under Section 11, income arising from property held under Trust constitutes the income of the Trust. It will mean income from property, business, dividends, interest on securities or other interest. In other words, the income for the purpose of Section 11 is the income as per the accounts of the Trust. It means, income in the commercial sense, without reference to the heads of income specified in Section 14, i.e. the book income and not total income as defined in Section 2(45), 'being the total amount of the income computed in the manner laid down in the Act'. This position is confirmed in *CIT v. Trustees of H.E.H. Nizam's Supplemental Religious Endowment Trust* (1981) 127 ITR 378 (A.P.), *CIT v. Rao Bahadur Calwala Cunnan Chetty Charities* (1982) 135 ITR 485 (Mad.) and *CIT v. Estate of V. L. Ethiraj* (1982) 136 ITR 12 (Mad.). This position is also confirmed by the CBDT vide its Circular No. 5-P (LXX-6) dated 19th June, 1968.

The concept of commercial income necessarily envisages deduction of depreciation on assets of the Trust. This view is supported by the following decisions. Even as depreciation on assets of Trust is to be deducted for the purpose of calculating income of a Trust. This is because of the fact that the concept of commercial income necessarily envisages deduction of depreciation on assets of the Trust. The Tribunal has decided in some cases that even reasonable depreciation on assets and interest on Sinking Fund or Repairs Reserve are to be deducted. [*Balkan- Ji- Bari* (1979) 2 Taxman 377 (Bom.)]

The Bombay High Court has rejected the reference application of the Income Tax Department in the case of *CIT v. Framjee Cawasjee Institute* (1993) 109 CTR 463, holding that the answer to the question whether depreciation was allowable to a charitable Trust was self-evident, even if the capital value of the assets on which depreciation was claimed had been allowed as a deduction under Section 11 as an application of income for religious or charitable purposes. Once again in *CIT v. Institute of Banking Personnel Selection (IBPS)* 264 ITR 110, the Bombay High Court held that depreciation should be allowed even on assets, the cost of which had been allowed as exempt under Section 11 in the preceding years. The Bombay High Court also held that depreciation should be allowed even on assets received on transfer from another charitable Trust on which no cost was borne by the assessee Trust.

Other High Courts which have also taken the view that depreciation is deductible are the Karnataka High Court in the case of *CIT v. Society of the Sisters of St. Anne* (1984) 146 ITR 28 and the Madhya Pradesh High Court in the case of *CIT v. Raipur Pallottine Society* (1989) 180 ITR 579.

In *CIT v. Seth Manilal Ranchhoddas Vishram. Bhovan Trust* (1992) 105 CTR (Guj) 303 it was held that depreciation should be allowed while computing such income under Section 11(i)(a). Many times Assessing Officers take the stand that "provision of computation of income under Section 11 does not contain any

provision which may entitle an assessee to claim weighted deduction for any expenses incurred.” This statement is not acceptable as Section 11 provides that the income of the trust is to be computed on commercial basis i.e. as per normal accounting principles. Normal Accounting Principles clearly provide for deducting depreciation to arrive at income. Now, the income so arrived at (after deducting depreciation) is to be applied for charitable purpose. Capital expense is application of the income so determined. So there is no double deduction or double claim of the same amount as application. Thus depreciation is to be deducted to arrive at income and it is not application of income. In support of their stand, the department relies on the decision of the Supreme Court in *Escorts Ltd.* 199 ITR 43.

However in this case the issue before the Supreme Court was that whether both depreciation under Section 32 and capital expenditure on scientific research under Section 35(1)(iv) can be claimed as deduction. Reference to this decision cannot be drawn as in *Escort's* case both were deductions under the head 'business income' whereas in case of a charitable trust depreciation is a deduction to arrive at income and capital expenditure is application of such income. The aforesaid decision of *Escorts Ltd.* cannot be applied to determine taxable income for a trust as the provisions to determine taxable income of the trust are totally different and normal provisions for computing income under five heads cannot be applied.

Whether repayment of loan can be treated as application of income?

Repayment of loan is to be treated as application based on following favourable decisions and CBDT Circular. In *CIT v. Janmabhumi Press Trust* (2000) 242 ITR 457 and 703 the Karnataka High Court held that the repayment of a debt incurred by the trust for construction of the building, which in turn would augment its income, should be treated as application of the income of the trust for charitable purposes. In this respect, the Court followed the view earlier taken by the Madras High Court in *CIT v. Kannika Parameswari Devasthanam & Charities* (1982) 133 ITR 779 and the Kerala High Court in *CIT v. St. George Forana Church* (1988) 170 ITR 62.

Circular No. 100 dated 24th January, 1973 (1973) 88 ITR (St.) 66

Ques: Where a trust incurs a debt for the purposes of the trust, whether the repayment of the debt would amount to an application of the income for the purposes of the trust?

Ans: The loan was taken by the trust to fulfill the objects of the trust. Therefore, the repayment of the loan will amount to an application of the income for charitable and religious purposes. In the case of *CIT v. Maharana of Mewar Charitable Foundation* (1987) 164 ITR 439, the Rajasthan High Court has considered the Circular and held as follows:

“In the Circular dated 24th January, 1973, the Central Board of Direct Taxes has considered the question to whether where a trust incurs a debt for the purpose of the trust, the repayment of the debt would amount to an application of income for the purposes of the trust. In the said circular, the Central Board of Direct Taxes has expressed the view that the repayment of the loan originally taken to fulfill one of the objects of the trust will amount to an application of the income for charitable and religious purposes. In other words,

according to the said circular, if the trust wants to spend more money on charitable and religious purposes, then, in a particular year, it can take a loan and the said loan can be repaid out of the income of the subsequent year and the repayment of the said loan out of the income of the subsequent year would amount to application of income for charitable and religious purposes under Section 11(1)(a) of the Act”.

Also in a recent decision of 2009 in the case of *DDIT (E) v. Govindu Naicker Estate* (Mad) 227 CTR 283 it was held that repayment of loan is to be treated as application under Section 11.

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