Tax Matters

Issue No. 2022/11 Date: 5 November 2022

The team at JMP Advisors is pleased to bring to you a gist of some of the significant developments in the direct tax space during October 2022:

Income tax rulings

- **For periods prior to the Financial Year ('FY') 2020-21 as well, employees contribution towards provident fund ('PF') needs to be deposited by the employer on or before the due date of deposit as stated in the relevant statute**

  - Checkmate Services P. Ltd. v. CIT[1]

  The issue under consideration was whether a deduction is allowable to the taxpayer where the employees' contribution in terms of the Employees Provident Funds and Miscellaneous Provisions Act, 1952 ('EPF'), the Employees State Insurance Act, 1948 ('ESI') or any other provident or superannuation fund are deposited into the account of employees, beyond the due date stipulated in the relevant statutes.

  The Supreme Court ('SC') observed that employers have to deposit the employee's contribution towards EPF/ESI on or before the due date for availing of deduction.

  Sections 32 to 37 of the Income-tax Act, 1961 ('the Act') deal with permissible deductions which are dependent upon fulfilment of prescribed conditions failing which the taxpayer loses the right to claim a tax deduction for such expenditure. Section 43B of the Act was introduced as an additional condition to ensure that such eligible expenditures are allowed as deduction only if the outstanding amount had been **paid on or before the due date for filing the return of income irrespective of the year in which such expenditure had been incurred**.

  Any sum paid by the taxpayer as an employer by way of contribution towards any fund is allowed as a deduction under section 36(1)(iv) of the Act. Section 2(24)(x) of the Act, deems any sum received by the taxpayer from its employees as a contribution to any fund, to be the income of the taxpayer. It is allowed as a deduction as per section 36(1)(va) of the Act if such an amount is deposited on or before the due date as stipulated in the relevant statute.

  The Finance Act, 1989 amended section 43B of the Act whereby the taxpayer's own contribution to PF (i.e. employer's contribution) was allowed only if it is deposited on or before the due date as stated in the relevant statute. In other words, the due date for payment of employee's contribution as well as the taxpayer's own contribution became the same. By the Finance Act, 2003, this amendment was nullified as the objective of the

[1] Civil Appeal No. 2833 of 2016

provision was to ensure that taxpayers do not claim expenditure without payment for the same and delay in making payment of statutory dues for a long time and claim expenditure on accrual basis. It was noticed that this intent was served as section 43B allowed a deduction on payment basis. Hence, to avoid genuine hardship faced by taxpayers from FY 2003-04, taxpayer's own contribution was allowed in the year in which the payment was made irrespective of the year in which the liability is incurred.

The distinction between a taxpayer's liability in the case of employer's contribution and employee's contribution is crucial. The former i.e. employer's contribution is to be paid out of taxpayer's own income whereas the latter is deemed as taxpayer's income unless the conditions imposed by Explanation to section 36(1)(va) are satisfied i.e. depositing such amount received or deducted from the employee on or before the due date under the relevant statute.

Section 43B gives some leeway to the taxpayer that as long as the contribution is deposited beyond the due date stated in the relevant statute, but before the date of filing the return, the deduction is allowed. However, this relaxation cannot apply to the amounts that are deducted from the employee's salaries and held in trust by the employer. These amounts will be deemed to be the income of the taxpayer with the object of ensuring that they are paid off within the due date stated in the relevant statute.

Thus, employee's contribution towards PF, etc. needs to be deposited as per the law laid down by the SC as stated above, in order to claim deduction.

JMP Insights *– In the given case, the SC had struck down the contrary decisions of various High Courts ('HCs') as well as another SC decision in case of Commissioner of Income Tax v. Alom Extrusions Ltd. (2010) 1 SCC 489. The SC observed that in Alom Extrusions case, the provisions of section 2(24)(x) and section 36(1)(va) were not considered. SC's observation will affect many taxpayers, who had claimed a deduction on employee's contribution, by treating the due date for filing tax returns as the due date for purpose of section 36(1)(va) of the Act.*

Explanation 2 to section 36(1)(va) was inserted by the Finance Act, 2021 to clarify that the provisions of section 43B of the Act shall not apply and shall be deemed never to have been applied for the purposes of determining the 'due date' under section 36(1)(va) of the Act. It also introduced Explanation 5 to section 43B of the Act clarifying that the provisions of section 43B of the Act shall not apply and shall be deemed never to have been applied to a sum received by the taxpayer from any of his employees to which section 2(24)(x) of the Act applies. This amendment is effective from FY 2020-21.

- **SC discards 'predominant object test' and interprets 'General Public Utility' ('GPU') in case of charitable institutions**

    - ACIT (Exemptions) v. Ahmedabad Urban Development Authority[2]

The SC has pronounced a landmark decision concerning definition of 'charitable purpose' stated in section 2(15) of the Act and specifically in the context of charities that are registered with the object of GPU.

The issue before the SC involved a batch of appeals filed by organisations from different fields or industries including authorities, corporations or bodies established by statute, statutory regulatory bodies, trade promotion bodies, sports associations, etc. that are considered to be charitable institutions engaged in the advancement of GPU.

The SC clarified that a charitable institution advancing GPU cannot engage itself in any trade, commerce, or business, or provide services for a cess, fee or consideration except:

i. for such activities that are connected to the achievement of its object of GPU; and

ii. the receipts from such activities do not exceed the quantified limit as specified in the Act (20% of total receipts).

The SC has defined what constitutes *'engaging in trade, commerce, or business, or services in relation thereto'*. It is held that activities where the fees, cess or the consideration charged is on a cost to cost basis or nominally above cost, it should **not** be considered as trade, commerce or business. It is only when the consideration charged is substantially higher than the cost, it can be considered that charitable institutions have engaged in any trade, commerce, or business and in order to claim exemption, the breach of quantitative thresholds needs to be analysed.

The intent behind the SC judgement is to restrict charities formed with an object of general public utility from engaging in business, trade or commerce for objects other than those for which they were formed. SC through this judgement has excluded activities carried out at cost or with nominal mark-up from definition of trade, commerce, or business. However, if significant profits are charged, it would amount to business and second proviso to section 2(15) would apply to such receipts.

The SC provided some illustrations to explain its point:

The example of Gandhi Peace Foundation disseminating Mahatma Gandhi's philosophy (in Surat Art Silk) through museums and exhibitions and publishing his works, for nominal cost, ipso facto is not business. Likewise, providing access to low-cost hostels to weaker segments of society, where the fee or charges are recovered to cover the costs plus nominal mark-up; or renting marriage halls for low amounts, again with a fee meant to

[2] CIVIL APPEAL NO. 21762 OF 2017 and Miscellaneous Application no. 1849 of 2022 In Civil appeal no. 21762 of 2017

cover costs; or blood bank services, again with fee to cover costs, are not activities in the nature of business.
Publishing a book on Gandhi, or in the case of the marriage hall, charging significant amounts from those who can afford to pay, by providing extra services, far above the cost-plus nominal mark-up would mean that such activities are in the nature of trade, commerce, business or service in relation to them. The receipts from such latter kind of activities where higher amounts are charged, should not exceed the limit indicated by the second limb of the proviso to section 2(15).

The SC further observed that section 11(4A) of the Act must be interpreted harmoniously with section 2(15). The requirement in section 11(4A) of the Act of maintaining separate books of account is also in line with the necessity of demonstrating that the quantitative limit prescribed in the proviso to section 2(15) has not been breached.

By applying the amended Income Tax provisions and examining the overall facts and purpose of the charitable institutions, the SC has decided on the eligibility of exemption for various associations, corporations, regulatory bodies, etc.

JMP Insights *– The SC, through this judgment has neither precluded any taxpayer advancing GPU from claiming any exemption nor the taxing authorities from denying any exemption in case of non-compliance with the provisions of the Act. The authorities must analyse the facts of the taxpayers on an annual basis to determine the eligibility to exemption and whether the activities amounts to 'trade, commerce, or business'. Where such activities are in nature of trade, commerce or business, then it must be examined on an annual basis, whether the quantitative threshold as specified in the Income tax provisions are complied with.*

Many sports associations, clubs and societies, business chambers etc. operating in India are earning income from various commercial activities which is usually claimed to be tax exempt. Such institutions have different benchmarks for mark-ups. What would qualify as a nominal mark-up and annual scrutiny of financial statements to determine if the mark-ups are nominal could be a significant ground of disagreement between the taxpayers and the Revenue Authorities.

In response to a clarification sought by the Revenue Authorities on the applicability of this decision to past assessment years, the SC, vide its order dated 3 November 2022 has held that the judgement shall apply for the assessment years which were before the SC. Wherever the appeals were decided against the Revenue Authorities, they were to be treated as final. However, reference to future applications has to be understood in the context, the Revenue Authorities will apply the law declared in the judgment.

- **SC construes 'solely' under section 10(23C) strictly and prospectively for educational institutions**

  - New Noble Educational Society v. CCIT[3]

The issue involved before the SC was on rejection of the taxpayer's application for grant of tax exemption under the Act. The Andhra Pradesh HC denied exemption under section 10(23C) to the taxpayer on the following two grounds:

(i) the educational institution did not exist 'solely' for purpose of education; and

(ii) it was not registered under applicable state regulations.

The SC held that as per provisions of section 10(23C) of the Act, educational institutions existing 'solely' for educational purposes and not for purpose of profit means that such institutions cannot have objects which are unrelated to education or educational activities.

The SC observed that the seventh proviso to section 10(23C), as well as section 11(4A), refers to profits that may be 'incidentally' generated or earned by the charitable institution. The same applies only to those institutions which impart education or are engaged in activities connected to education. The SC observed that imparting education through schools, colleges and other such institutions would be regarded as charity. That apart, there could be activities such as providing textbooks, bus facilities to children, and summer camps for special educational courses like computer education which can be regarded as 'incidental' to providing education. Where the educational institution provides its premises to others for conducting workshops or seminars or educational courses and outsiders are permitted to enroll in such seminars, then the income generated from such activity cannot be considered as a part of the education or activity incidental to imparting education.

Where the objective of the institution appears to be profit-oriented, such institutions would not be entitled to approval under section 10(23C). At the same time, where surplus accrues in a given year or set of years per se, it is not a bar, provided such surplus is generated in the course of providing education or educational activities.

While considering applications for approval under section 10(23C), the Prescribed Authority is free to call for the audited accounts or other such documents for recording satisfaction where the society, trust or institution genuinely seeks to achieve the objects which it professes. The focus of such inquiry at the stage of granting registration should be on the nature of the activities and income earned therefrom and not the proportion of income.

It was held that wherever registration of trust or charities is obligatory under the state or local laws, the organisation seeking approval under section 10(23C) should also comply with provisions of such state laws. This would enable the Prescribed Authority to ascertain the genuineness of the trust, society etc. This reasoning is reinforced by the recent insertion of another proviso in section 10(23C) with effect from 1 April 2021.

[3] ('SC')] (Civil Appeal Nos. 6418 & 9108 of 2012 and 3793, 3794 & 3795 of 2014)

JMP Insights *– This judgement veers away from its previous SC judgements in the case of Queens Educational Society v. CIT [(2015) 372 ITR 699] and American Hotel & Lodging Association, Educational Institute [(2008) 301 ITR 86] which had interpreted the term 'solely' to mean 'dominant'. The SC in this decision has held that declaring that the word 'solely' must be given a literal interpretation since the intent of the legislature is clear that tax exemptions should be granted to only those institutions that engage in imparting education or educational activities. In the decision of Loka Shikshana Trust v. CIT [(1975)101 ITR 234], the SC had clarified what education connotes in that clause is the process of training and developing the knowledge, skill, mind and character of students by formal schooling.*

Since the present judgment has departed from the previous rulings regarding the meaning of the term 'solely', the SC have directed that the law declared in the present judgment shall operate prospectively, in order to avoid disruption and to give time to institutions likely to be affected to make appropriate changes and adjustments.

Further, by insertion of new proviso to section 10(23C), wherever registration of the trust or charities is obligatory under state or local laws, the concerned institution seeking approval under section 10(23C) should also comply with provisions of such state laws, enabling the concerned Authority to ascertain the genuineness of the trust.

- **Taxpayers need to pay 20% of disputed tax liability; not total demand to obtain stay on the demand notice issued by Revenue**

    - eBay Singapore Services Pvt. Ltd. v. DCIT Mumbai[4]

In accordance with the Central Board of Direct Taxes ('CBDT') instructions on stay of tax demand, 20% of the demand is to be paid by the taxpayer, if an appeal is to be preferred by the taxpayer. The Mumbai Tribunal examined the issue of computation of 20% of demand and held that once the tax officer takes a view that in terms of the CBDT instructions, 20% of the demand is to be paid by the taxpayer, balance demand can be stayed during the pendency of the appeal, such computation of 20% has to be with respect to total disputed tax liability and not with reference to total demand outstanding as specified in the notice of demand issued under section 156 of the Act.

JMP Insights *– This ruling is welcome clarification for the taxpayers where tax paid by way of tax deducted at source or advance tax exceeds 20% of the disputed tax liability. The taxpayers are required to pay 20% of the disputed tax liability and not 20% of the entire demand at the time of filing the appeal.*

[4] SA No. 122/Mum/2022 In ITA No. 2378/Mum/2022

DID YOU KNOW?

The CBDT has released a draft common income tax return ('ITR') in tandem with international best practice seeking inputs by 15 December 2022. This is proposed to reduce the complexity of filing the ITR and easing the compliance of filing of the ITR.

The taxpayers will get an option to file either the new proposed common ITR or the existing ITR-1/ ITR-4. Further, the existing ITR-7 will continue.

Should you wish to discuss any of the above issues in detail or understand the applicability to your specific situation, please feel free to reach out to us on coe@jmpadvisors.in.

JMP Advisors Private Limited

12, Jolly Maker Chambers II, Nariman Point, Mumbai 400 021, India
T: +91 22 22041666, E: info@jmpadvisors.in, W: www.jmpadvisors.com

About JMP Advisors

JMP Advisors is a leading professional services firm that offers advisory, tax and regulatory services. The vision of JMP Advisors is to be 'The Most Admired Professional Services Firm in India'. It aims to be the best as measured by the quality of its people and service to clients. The firm has a merit-based culture and operates to the highest standards of professionalism, ethics, and integrity. Jairaj (Jai) Purandare, the Founder Chairman has almost four decades of experience in tax and business advisory matters and is an authority on tax and regulation in India. Jai was Regional Managing Partner, Chairman-Tax and Country Leader-Markets & Industries of PricewaterhouseCoopers India. Earlier, Jai was Chairman of Ernst & Young India and Country Head of the Tax & Business Advisory practice of Andersen India.

JMP Advisors offers advice in international taxation, domestic taxation, transfer pricing, mergers and acquisitions, Goods and Services Tax (GST), business laws and exchange control regulations and foreign investment consulting. We specialize in fiscal strategy and policy foresight and are also trusted advisors to high net worth families. Our team at JMP Advisors takes pride in being the best at what matters most to clients-technical expertise, innovative solutions, consistent, high quality service, reliability, and ease of doing business.

JMP Advisors has been recognized as a leading Tax firm in India in the International Tax Review (Euromoney) World Tax Directory for all successive years since incorporation, including the World Tax and Transfer Pricing 2023 Directory.

Disclaimer

This material and the information contained herein is of a general nature and is not intended to address specific issues of any person. Any person acting on the basis of this material or information shall do so solely at his own risk. JMP Advisors Private Limited shall not be liable for any loss whatsoever sustained by any person who relies on this material or information.

© JMP Advisors Pvt Ltd 2022