Social Sector Hotline

November 20, 2013

DELHI HC LAYS DOWN LITMUS TEST FOR CHARITABLE ACTIVITIES CARRIED OUT BY NOT-FOR-PROFIT ENTITIES

- An element of trade is important to determine business activity of a residual category charitable entity.
- Merely charging certain fee or levy is no proof of profit orientation or profit intent.
- Collection of token fee in the course of charitable activity to cover costs or to gain operational scalability does not amount to conducting business.

The Delhi High Court ("**Delhi HC**") recently held, in the case of M/s. GS1 India ("**GS1**"/ "**Petitioner**")[1], that amendments made to the definition of 'charitable purpose' under Section 2(15)[2] of the Income-tax Act ("**ITA**") vide the Finance Act, 2008 does not disqualify any residual category (general public utility) charitable entity from conducting business activity which is intrinsically connected with the charitable activity and the same does not result in denial of tax exemption status by the tax authorities.

BACKGROUND

GS1 is a 'not-for-profit' society duly registered under the Societies Registration Act, 1100% and promoted by the Ministry of Commerce and Industry, Indian Institute of Packaging, Federation of Indian Export Organizations , Agricultural and Processing Food Products Export Development Authority, Federation of Indian Chamber of Commerce and Industry (FICCI), Associated Chambers of Commerce and Industry of India (ASSOCHAM), Bureau of Indian Standards (BIS), Confederation of Indian Industry (CII), Spices Board and Indian Merchants' Chambers. GS1 is involved in promotion, propagation, spreading awareness and knowledge about global coding identification system (GS1 standards), research and development into these global standards; and providing education in universities and colleges regarding these standards. GS1 acquired intellectual property rights ("**IPR**") with respect to bar coding system from GS1 Global Office, Belgium and permitted use of these IPR by the third parties under a license agreement for initial registration ("**license agreement**") and involved a subsequent annual registration fee.

GS1, registered as a charitable entity under the residuary clause of section 2(15) of the ITA i.e., *general public utility* was granted exemption under Section 12A and under Section 10(23C) for the purposes of income tax assessment year 1996-1997 onwards. In 2008, Director of Income Tax (Exemption) denied the said registration on the grounds that such activities were in nature of trade, commerce or business and income earned from the use of IPR for consideration (royalty income) was significantly higher than the direct costs. Further, the petitioner did not maintain separate books of accounts for business/commercial activity which was in violation of specified conditions of Section 10(23C)(iv) of the ITA. In this regard, the petitioner approached the Delhi HC to issue mandamus directing the tax authorities to grant registration.

THE RULING

The issue mainly related to whether the income earned by GS1 under the license agreement can be said to be charitable in nature and whether GS1 would be entitled to get an exemption in respect of such income specifically in light of the amendments in Section 2(15) of the ITA.

With respect to amendments in the aforesaid section, the first proviso[3] states that if the entity is engaged in activity of trade, business or commerce or rendering of service for consideration, regardless of the use of such consideration, it shall not be considered as an entity for charitable purpose ("**2008 amendment**").

The subsequent retrospective amendment states that the first proviso shall not apply if the receipts mentioned therein are INR 10 lakhs (now INR 2.5 million)[4] or less ("**2010 amendment**").

With regard to the scenario prior to 2008 amendment, the Delhi HC applied the test of predominant object of activity enunciated by the Supreme Court in *ACIT v Surat Cloth Manufacturers Association*[5], to determine whether the primary object of the activity involved in carrying out the object of general public utility is to subserve the charitable purpose or to earn profit. In case where the predominant object of the activity is to carry out charitable purpose and not to earn profit, it does not lose its character of a charitable purpose merely because some profit arises from such activity. Therefore, money earned from business held under trust or otherwise to feed charity would not disentitle or negate the claim of engagement in charitable purpose defined under Section 2(15) of the ITA.[6]

The Central Board of Direct Taxes vide Circular No.11/2008 ("**Circular**") emphasized that the 2008 amendment is only applicable to residual category charitable entity when it carries on any activity in the nature of trade, commerce or business; and to determine whether such activity is commercial will be decided on its own facts and no generalization is possible. However, the tax authorities, in the context of the above Circular[7] denied tax exemption on the premise that the charitable activity was only a mask to cover business activities of the charitable entity.

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For the application of Section 2(15) to charitable entity engaged in "any other object of general public utility", the courts have earlier held 'profit motive' and 'an element of reciprocity in business transactions' as important elements that could be factored into while understanding the scope of economic activity undertaken by such entity.[8] The Delhi HC, keeping in view the aforesaid determinants, explained that a business activity has an important pervading element of self-interest, whilst charity or charitable activity is the anti-thesis to activities undertaken with a profiteering motive. To determine whether the residual category charitable entity is engaged in any business activity, the issue of self-enrichment and self-gain should be carefully looked into. A small contribution by way of fee should not emulate the transaction or the given activity to be commercial in nature.

The Delhi HC laid down the 'charitable activity test' to determine whether the legal terms "trade, commerce, or business" in Section 2(15) means activity with a view to make or earn profit. The four indicators as laid down by the court are: (a) profit motive is a critical factor to discern whether an activity is business, trade or commerce; (b) charitable activity should be devoid of selfishness or illiberal spirit; (c) the underlying propelling motive is not for commercial exploitation but general public good; and (d) fee charged if any should be nominal and based on commercial principles.

Applying the above tests, the Delhi HC opined that a mere levy of fee is neither reflective of business aptitude nor indicative of profit oriented intent. The Delhi HC held that when the propelling motive is not to earn profit but "general public good", the charitable entity will fail the business test and meet the touchstone of charity. The Delhi HC further held that merely charging fee on IPR sans profit motive does not amount to commercial exploitation. Moreover, when the fee charged is commensurate and based on commercial or business principles, the charitable activity test is fulfilled. The Delhi HC ruled that as the primary or pre-dominant activity is charitable in nature, the nominal fee charged is important for covering operational costs of the petitioner. Thus, keeping in view the 'charitable activity test' it was held that the business activity of the petitioner is integral to its charitable purpose and the question of requirement of separate books of accounts for the business activity seemed redundant.

ANALYSIS

With the changing role of not-for-profit entities from being players of the vanilla philanthropy to becoming game changers in the country's social and economic growth; they are assuming the role of catalysts in various fields like social enterprise, social innovation, institutional philanthropy and newer forms of corporate engagements through corporate social responsibility and social business are evolving. However, the existing framework governing these entities is not encouraging as the essence of traditional form of charity-functioning governs the mind-set of tax authorities.

Whether the scope of trade, commerce or business involved in charitable activities is commercial, quasi-commercial or purely charitable in nature, is a debatable topic and tax authorities tend to deprive entities engaged in philanthropy from claiming exemption on income when trade or business is carried out under the guise of charity.

Section 2(15) facilitates the optimum mix of various forms of charitable activities under the umbrella of dominant category i.e. the first five limbs of the aforesaid section; it also provides for a residual category which prescribes advancement of any other object of general public utility as a charitable activity. The amended Section 2(15) and the Circular, have clarified the circumstances in which a residual category charitable entity is treated as a business entity. While the dominant category is a much narrower group of charitable entity with a distinct nature of work, the residual category is more like an accumulation of various charitable activities with no clear distinction between main and ancillary objectives. However, to fall within the ambit of the residual category, the entity should not have any separate, independent or incidental activity which could be classified as business. The business activity should be intrinsically woven into the charitable activity undertaken by such an entity.

Thus, the decision of Delhi HC is a welcome relief for residual category charitable entities and an acknowledgment of the changing scale of operations without the fear of losing tax exemption. The charitable activity test articulated by the Delhi HC has come at a right time and shall guide in differentiating between 'business entity' and 'charitable entity engaged in business activities' to feed charity.

– Rahul Rishi & Ankita Srivastava
You can direct your queries or comments to the authors

[1] *M/s GS1 India v. Director Income Tax (Exemption)*, 2013-TIOL-772-HC-DEL-IT

[2] "charitable purpose" includes relief of the poor, education, medical relief, preservation of environment including watersheds, forests and wildlife and preservation of monuments or places or objects of artistic or historic interest, and the advancement of any other object of general public utility:
Provided that the advancement of any other object of general public utility shall not be a charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity:
Provided further that the first proviso shall not apply if the aggregate value of the receipts from the activities referred to therein is [twenty-five lakh rupees or less] in the previous year;

[3] The proviso to section 2(15) reads as:
"**Provided** that the advancement of any other object of general public utility shall not be charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity."

[4] By Finance Act, 2011 the amount therein is now increased to INR 2.5 million with effect from April 1, 2012.

[5] (1980) 121 ITR 1 (SC)

[6] ibid

[7] CBDT Circular No. 11/2008, F.No. 134/34/2008-TPL dated 19.12.2008

[8] *ICAI v DIT (E)*, [2012] 347 ITR 99 (Del.)

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based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

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