Resource support on NGO Governance, Accounting and Regulations

Standards & NORMS

An initiative of FMSF

Vol. III Issue 5, June 2010 *For private circulation only*

NPOs - MAJOR ISSUES NOT ADDRESSED IN REVISED DIRECT TAX CODE

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OPENING REMARKS

1.01 The Finance Ministry has released a revised discussion paper on the proposed Direct Tax Code. The Revised Discussion Paper (herein after called *Revised DTC*) has addressed some concerns of the NPO Sector. However, most of the harsh and unsustainable clauses in the proposed Direct Tax Code (DTC) about NPOs are still there. If the proposed DTC is enacted, then the NPO sector will be very adversely impacted. There are certain clauses which not only lack rational basis but are against the very spirit of the proposed Direct Tax Code.

1.02 The Revised DTC has discussed and emphasised on various marginal and smaller issues without touching the key and primary issues affecting the NPO sector. The Revised DTC has provided some neglible relief such as :

(i) No re-registration required

(ii) 10% of gross receipts or 15% of income will not be taxed provided it is spent in next 3 years. In other words 85% of income or 90% of gross receipts will be taxed even after the legitimate accumulation, if not spent during the year. (*Kindly see illustration in next page)*

(iii) Religious organisations are also included.

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(iv) The term "Charitable Purpose" has been retained, earlier it was coined as "permissible welfare activity".

(v) basic exemption limit has been provided, surplus in excess of limit shall be taxed.

(vi) NPOs have to follow the cash basis of accounting.

(vii) The government can notify some NPO as exempt entity.

It is unfortunate that most of the key issues have not been addressed. The revised discussion paper has not provided any considerable relief to the NPO sector. Some of the very serious but untouched provisions of the proposed DTC are discused as under.

THE GOVERMENT IS CONFUSED REGARDING APPLICATION & ACCUMULATION OF INCOME

2.01 The Revised DTC has reaffirmed that the NPOs have to apply 100% of their income for charitable purposes. The current provision of 15% indefinite accumulation has been withdrawn. The revised DTC does not permit NPOs to save or accumulate even a single rupee. In other words, 100% of the income has to be utilised. Traditionally NPOs have been allowed 25% as accumulation for future. After 1st April 2002 NPOs are being permitted 15% as accumulation for future.

2.02 Even Supreme Court has held that it is reasonable to have upto 15% of surplus in a year for future and expansion. Kindly see the case of *P.A. Inamdar & Ors. vs. State of Maharashtra & Ors*.[2005] AIR 3226 SC, [2005] SCC 537 SC.

2.03 The revenue authorities seem to have misunderstood the difference between indefinite accumulation and accumulation for future application. The revised DTC unfortunately talks about 15% accumulation (10% of gross receipt) for future application, which is totally out of context. There is no reason why NPOs should not be allowed to apply 100% of income in future, if for legitimate reasons, they are unable to apply in the current year. Further they deserve to save some income for future expansion and even to negate inflation.

The revenue authorities seem to have misunderstood the difference between indefinite accumulation and accumulation for future application.

Illustration : If an NPO receives Rs.1 lakh in the month of March and is unable to spend it in the current year, then the tax treatment under the current law and the proposed law will be as under :

Under Current law : The NPO will be allowed to transfer Rs.15,000/- to its corpus indefinitely. Further the remaining Rs.85,000/- can be accumulated for 5 years i.e. the NPO has to apply Rs.85,000/- within the next 5 years. There will be no tax liability.

Under the proposed code : The NPO will not be allowed to accumulate anything. It will be allowed to accumulate only Rs.10,000/- (being 10% of the gross grant received), even this Rs.10,000/- has to be applied within 3 years. The remaining Rs.90,000/- will be taxed @15%.

The proposed provision is extremely harsh and unfair - there is an urgent need for providing legitimate allowances.

2.04 ***Recommendation :*** *The proposed section 88(2) should be amended and the existing provision of 85% application during the year should be restored. The proposed clause compels NPOs to spend 100% of income/receipts and does not allow to save even a single rupee. At least 15% of income should be allowed as indefinite accumulation for future sustainability and to negate inflation.*

2.05 *A Sub section may be added to the proposed section 90 of DTC providing that the NPOs (i) Can accumulate the gross income subject to 100% utilisation in the next 5 years, (ii) if the funds are received at the fag end of the year or are not available for utilisation due to some other reason, then the same can be spent in the succeeding year and it will be deemed to have been spent in the previous year.*

NPOs WILL NOT BE PERMITTED TO CLAIM DEPRECIATION

3.01 The proposed DTC does not allow depreciation as an expenditure against receipts from permitted welfare activities. This is a highly unfair and legally unsustainable proposal. It is erroneously presumed that no corpus assets or capital asset shall be used for permitted welfare activities, which is not a correct assumption.

3.02 It is absolutely necessary that the depreciation and other non cash expenditure are permitted to NPOs on par with other assessees. The rationale of discriminating NPOs is unfounded, unfair and unsustainable.

3.03 ***Recommendation :*** *The proposed Section 88(2) should be amended and the word "outgoings" should be replaced with the word "application for permitted welfare activity" and the condition for cash basis of expenditure should be deleted. NPOs should be allowed all legitimate expenditures, whether cash or non cash.*

Now since the new code has redefined the incidentality of business, no NPO can engage in unrelated business activities. Therefore, there is no need for prohibiting one category of NPOs from engaging in business activity,

BUSINESS ACTIVITY OF AN NPO

4.01 Presently the incidental business activity is allowed under the Income tax Act for the specified category of NPOs.

4.02 The proposed Code has restricted the coverage of incidental business activity and has allowed only those business activities which are carried on while actually undertaking the welfare activities.

4.03 This is a proposal in the right direction. However, after this change there is no need to deprive the sixth category NPOs from engaging in business activities. The current law and the proposed code prohibit business activities in case of NPOs engaged in '*Advancement of any other general public utility*'.

4.04 Now since the new code has redefined the incidentality of business, no

NPO can engage in unrelated business activities. Therefore, there is no need for prohibiting one category of NPOs from engaging in business activity, since in any case all categories of NPOs have to engage in incidental business activities only. If the business activity is incidental, then there is no reason why all NPOs shall not have the benefit.

4.05 The direct tax code has already taken a understandable step by providing under section 96 that business shall be treated as incidental only if it is carried on in the course of implementing welfare activities. After this amendment there is no need to deprive NPOs engaged in '*Advancement in any other object of general public utility*' from engaging in incidental business activities.

4.06 ***Recommendation*** *: Clause (b) to section 96 of the proposed DTC should be deleted. Because no NPO should be allowed to have business which is not incidental and all NPOs should be allowed business if proved incidental to charitable purposes.*

EXEMPT INCOME AS PER SIXTH SCHEDULE

5.01 As per section 9 of the code, total income for a financial year of any person shall not include any of the income mentioned in the Sixth Schedule. It may be noted that the Sixth Schedule specifies various exempt incomes including agricultural income. Such income shall not be considered as a part of income and therefore should not be subject to 100% application during the year.

5.02 The term 'person' defined under the act includes Non-Profit Organisation. Hence the income mentioned in Sixth Schedule should also be exempt even in the hands of NPO. The NPOs should not be compelled to pay tax on those receipts which are tax free for all other assessees.

> ***The NPOs should not be compelled to pay tax on those receipts which are tax free for all other assessees.***

5.03 ***Recommendation*** *: Clause (g) to section 89 of the proposed DTC should be amended to exclude exempted income and receipts which can not be treated as income.*

CONVERSION OF AN NPO INTO COMMERICAL ORGANISATION

6.01 Under section 94 it is provided that if the NPO :

(i) Converts itself into an organisation which does not qualify for exemption

(ii) Ceases to be an NPO in the financial year and any two financial year out of the preceding four years.

(iii) Fails to transfer, on its dissolution, assets to another NPO.

then it shall be liable to be taxed at the rate of 30% of its net worth.

6.02 This provision seems to be out of context and very harsh as it proposes to tax the entire networth accumulated over the years. It may be noted that accumulated networth is never considered as income. For some assessees, it may be subject to wealth tax but not income tax. Therefore, something which normally is not within the purview of income should not be subjected to tax at maximum marginal rate. Further, since all surpluses are subject to tax at 15%, a portion of the networth will be taxed twice because all accumulation of the NPOs need not necessarily be tax free. Therefore it will result in double taxation.

6.03 It may further be noted that such provisions will be attracted if the NPO is not allowed exemption in three financial years. In other words, such NPO would have already paid taxes on the entire income during these years and again the networth will be subjected to tax, which will result in double taxation.

6.04 The NPOs who once enjoyed total exemption now will be subjected to double taxation. This can not be the intent of the government and Tax authorities.

6.05 ***Recommendation*** *: Section 94 of the proposed DTC should be deleted as the other provisions of DTC will take care. In other words, if an NPO ceases to be charitable, then automatically it will be taxed as an Association of Person (AOP). There is not need for Section 94, since under the Indian Laws no public charity can convert itself into a commercial organisation. Its assets in any case have to be given to another valid charitable organisation even in case of dissolution. An NPO can not register under the Income Tax Act if its objects permit conversion into a commercial entity.*

The NPOs who once enjoyed total exemption now will be subjected to double taxation. This can not be the intent of the government and Tax authorities.

COMPULSORY ACTIVITY EVERY YEAR

7.01 The proposed code u/s. 96(d)(v) provides that all NPOs are compulsorily required to have welfare activities every year. If an NPO does not have welfare activity then it will not be considered as an NPO for that year. Further, if such NPO does not have activity in two out of four preceding years then its entire networth will be subjected to tax at the rate of 30%.

7.02 ***Recommendations*** *: Section 96(d)(v) should be deleted because if the NPO does not have any activity, its income in any case will be taxed because it would not have utilised the required percentage of income during the year. On the contrary, if the NPO does not have any income, then there is no reason to tax.*

NPOs CAN NOT DO BUSINESS AND BUSINESS CAN NOT SUPPORT NPOs

8.01 The proposed DTC is very harsh against NPOs and does not create an environment for encouraging the charity sector. The law says that most of the NPOs

can not do business and business can not support NPOs. On one hand, the government is very harsh and severe on business activity of NPOs and on the other hand the proposed DTC does not allow tangible incentive to the donors to support NPO sector. The maximum benefit permissible to the individual donors in case of most of the NPOs would be 50% under Section 72 read with Part C of the 16th Schedule. The existing provisions like Section 35AC have been deleted.

8.02 The government should create an enabling environment for participation of the corporate sector and business houses into the NPO sector. That can only happen if the donation is allowed as expenditure at the hands of the donor, both for individuals and corporates.

8.03 ***Recommendation :*** *The Section 72 and 16th schedule of the proposed DTC should be appropriately amended in order to provide 100% deduction to the donors in case of donation to legitimate NPOs. The proposed DTC should encourage flow of funds from business and corporate sector to smaller NPOs working at the grassroots. 100% deduction to donors should not be a niche facility available to only big and influential NPOs.*

SUMMARY OF RECOMMENDATIONS

9.01 *The proposed section 88(2) should be amended and the existing provision of 85% application during the year should be restored. The proposed clause compels NPOs to spend 100% of income/receipts and does not allow to save even a single rupee. At least 15% of income should be allowed as indefinite accumulation for future sustainability and to negate inflation.*

9.02 *A Sub section may be added to the proposed section 90 of DTC providing that the NPOs (i) Can accumulate the gross income subject to 100% utilisation in the next 5 years, (ii) if the funds are received at the fag end of the year or are not available for utilisation due to some other reason, then the same can be spent in the succeeding year and it will be deemed to have been spent in the previous year.*

9.03 *Clause (g) to section 89 of the proposed DTC should be amended to exclude exempted income and receipts which can not be treated as income. This Clause is trying to tax what is exempt for all other assessees, therefore should not be taxed at the hands of NPOs also.*

9.04 *The proposed section 88(2) should be amended to allow both cash and accrual basis of accounting. The rationale of singling out NPOs for cash basis of expenditure is unfounded and unfair. Like other assessees they should also be permitted to have their own method of accounting.*

9.05 *The proposed Section 88(2) should be amended and the word "outgoings" should be replaced with the word "application for permitted welfare activity" and the condition for cash basis of expenditure should be deleted. NPOs should be allowed all legitimate expenditures, whether cash or non cash.*

9.06 *The Section 72 and 16th schedule of the proposed DTC should be appropriately amended in order to provide 100% deduction to the donors in case of donation to legitimate NPOs. The proposed DTC should encourage flow of funds from business and corporate sector to smaller NPOs working at the grassroots. 100% deduction to donors should not be a niche facility available to only big and influential NPOs.*

9.07 *Clause (b) to section 96 of the proposed DTC should be deleted. Because no NPO should be allowed to have business which is not incidental and all NPOs should be allowed business if proved incidental to charitable purposes.*

9.08 *Clause (g) to section 89 of the proposed DTC should be amended to exclude exempted income and receipts which can not be treated as income.*

9.09 *Section 94 of the proposed DTC should be deleted as the other provisions of DTC will take care. In other words, if an NPO ceases to be charitable, then automatically it will be taxed as an Association of Person (AOP). There is not need for Section 94, since under the Indian Laws no public charity can convert itself into a commercial organisation. Its assets in any case have to be given to another valid charitable organisation even in case of dissolution. An NPO can not register under the Income Tax Act if its objects permit conversion into a commercial entity.*

9.10 *Section 96(d)(v) should be deleted because if the NPO does not have any activity, its income in any case will be taxed because it would not have utilised the required percentage of income during the year. On the contrary, if the NPO does not have any income, then there is no reason to tax.*

9.11 *The Section 72 and 16th schedule of the proposed DTC should be appropriately amended in order to provide 100% deduction to the donors in case of donation to legitimate NPOs. The proposed DTC should encourage flow of funds from business and corporate sector to smaller NPOs working at the grassroots. 100% deduction to donors should not be a niche facility available to only big and influential NPOs.*

Annexure

EXTRACTS FROM THE REVISED DISCUSSION PAPER ON DTC

TAXATION OF NON-PROFIT ORGANISATIONS

1. Chapter XV of the Discussion Paper on the Direct Taxes Code (DTC) deals with taxation of non-profit organizations. The Code uses the phrase „permitted welfare activities instead of the phrase "charitable purpose" used in the current legislation to define the activities to be pursued by these organisations. Permitted welfare activities has been defined to mean any activity involving relief of the poor, advancement of education, provision of medical relief, preservation of environment, preservation of monuments or places or objects of artistic or historic interest and the advancement of any other object of general public utility. Advancement of any other object of general public utility will not include 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 fee or for any other consideration, irrespective of the nature of use, application or retention of the income from such activity.

1.1 The Discussion Paper mentions that while trusts and institutions established for charitable purposes have generally enjoyed tax exemptions, the following shortcomings have been observed in the exemption regime:-

(a) The exemption regime is complex, overlapping and dissimilar since it varies across institutions based on their activities.

(b) The provisions fail to meet the test of efficiency as they provide different conditions for institutions carrying on similar activities.

(c) The provisions also do not meet the test of equity as the compliance cost for an institution varies depending upon the provision of law under which the exemption is granted.

(d) The concept of income of such an institution has been the subject matter of litigation. Should gross receipts of the institution or the net income of the institution be reckoned as the income? This question has been the subject matter of extensive debate.

(e) A vexed issue is whether the institution should be allowed to accumulate income not applied or utilized for charitable purposes and how the accumulation should be treated.

(f) There is unending dispute whether a business is incidental to attainment of the objectives of the institution or not, since the income from incidental business is exempt from tax.

1.2 The DTC proposes a new tax regime for all trusts and institutions carrying on charitable activities. The salient features of the new regime are as under:-

(a) An organization shall be treated as a non-profit organization if,-

(i) it is established for the benefit of the general public;

(ii) it is established for carrying on permitted welfare activities;

(iii) it is not established for the benefit of any particular caste;

(iv) it is not established for the benefit of any of its members;

(v) it actually carries on the permitted welfare activities during the financial year and the beneficiaries of the activities are the general public;

(vi) it does not intend to apply its surplus or other income or use its assets or incur expenditure, directly or indirectly, for the benefit of any interested person;

(vii) any expenditure by the organisation does not enure, directly or indirectly, for the benefit of any interested person;

(viii) the funds or assets of the organisation are not used or applied, or deemed to have been used or applied, directly or indirectly, for the benefit of any interested person;

(ix) the surplus, if any, accruing from its permitted activities does not enure, directly or indirectly, for the benefit of any interested person;

(x) the funds or the assets of the non-profit organisation are not invested or held in any associate concern or in any prescribed form or mode;

(xi) it maintains such books of account and in such manner, as may be prescribed;

(xii) it obtains a report of audit in the prescribed form from an accountant before the due date of filing of the return in respect of the accounts of the business, if any, carried on by it; and the accounts relating to the permitted welfare activities and

(xiii) it is registered with the Income-tax Department under the Code.

(b) The tax liability of a non-profit organisation shall be 15 per cent. of the aggregate of the following:-

(I) the amount of **surplus** generated from the permitted welfare activities; and

(II) the amount of capital gains arising on transfer of an investment asset, being a financial asset;

Surplus generated from permitted welfare activities;

The amount of surplus generated from the permitted welfare activities shall be the **gross receipts** as reduced by the **outgoings**.

The **gross receipts** shall be the aggregate of the following:-

(i) The amount of voluntary contributions received during the financial year;

(ii) Any rent received in respect of a property consisting of any buildings or lands appurtenant thereto;

(iii) The amount of any income derived from a business which is incidental to any of the permitted welfare activities;

(iv) Full value of the consideration received from the transfer of any investment asset, not being a financial asset;

(v) Full value of the consideration received from the transfer of any business capital asset of a business incidental to its permitted welfare activities;

(vi) The amount of any income received from any investment of its funds or assets; and

(vii) All other incomings, realizations, proceeds, donations or subscriptions received from any source.

The amount of **outgoings** shall be the aggregate of-

(i) voluntary contributions received during the financial year by the non-profit organisation made with a specific direction that they shall form part of the corpus of the non-profit organisation;

(ii) the amount actually paid during the financial year for any expenditure, excluding capital expenditure, incurred wholly and exclusively for earning or obtaining any "gross receipts";

(iii) the amount actually paid during the financial year for any expenditure, excluding capital expenditure, on the permitted welfare activities;

(iv) the amount of capital expenditure actually paid during the financial year in relation to-

  (A) any business capital asset of a business incidental to any of the permitted welfare activities; or

  (B) any investment asset, not being a financial asset.

(v) any amount actually paid during the financial year to any other non- profit organisation engaged in a similar permitted welfare activity;

(vi) any amount applied outside India during the financial year if the amount is applied for an activity which tends to promote international welfare in which India is interested and the non-profit organisation is notified by the Central Government in this behalf.

(c) The surplus generated from permitted welfare activities will be determined on the basis of **cash system of accounting**.

(d) Capital gains arising on the transfer of an investment asset, being a

financial asset, will be computed in accordance with the provisions under the head “Capital gains”.

(e) A non-profit organisation will be prohibited from investing any of its funds or holding any of its asset in any associate concern or in any prescribed form or mode.

(f) It will be **mandatory for every non-profit organisation to register with the Income-tax Department** by making an application to the Chief Commissioner or Commissioner concerned. The registration, once granted, shall be valid from the financial year in which the application is made till it is withdrawn.

(g) The donations made to a non-profit organisation will be eligible for deduction in the hands of the donor at the appropriate rates.

(h) The income of any trust or institution recognised/registered under the religious endowment Acts of the Central Government or the State Governments shall be fully exempt from income-tax. However, donations to such trusts or institutions will not enjoy any deduction in the hands of the donor.

2. A number of inputs have been received regarding the proposed regime –

(i) The Code provides for fresh registration of NPOs after introduction of DTC. This will lead to increase in the compliance cost for NPOs and also substantially increase the workload of the income-tax department.

(ii) The status of public religious institutions in the DTC is not clear as the DTC exempts the income of only such religious trusts which are registered under a religious endowments legislation of the Central or a State Government. However, there are many states where such legislation does not exist or even if it exists, it does not cover all religious institutions.

(iii) The status of partly religious and partly charitable institutions is not clear under the Code.

(iv) Instances have been cited where NPOs receive grants at the end of the financial year or are unable to spend due to reasons beyond their control. In the absence of any window for carry forward of surplus for use in the subsequent years, taxation of the surplus of income over expenditure will be harsh.

(v) The phrase „charitable purpose should be used instead of „permitted welfare activity in order to emphasize the charitable intent of the activities rather than permitting of certain specified welfare activities. This will ensure greater clarity and will minimize litigation as the phrase has been in use for long.

(vi) Only cash system of accounting is stipulated for NPOs, whereas under the existing provisions of the Income-tax Act, 1961 NPOs can follow either cash or mercantile system of accounting. The option of choosing one of the systems should be allowed.

3. The issues have been examined and having considered the concerns, the tax regime for NPOs is proposed to be modified to provide that-

(a) NPOs already registered under the Income-tax Act, 1961 and holding valid registration on the date on which DTC comes into effect, would not be required to apply for fresh registration under the DTC. However, they would be required to provide additional information to facilitate the administration of the new provisions.

(b) The income of a public religious institutions will be exempt subject to fulfillment of all the following conditions:

(A) it shall be registered under the Code.

(B) the trust/institution shall apply its income wholly for public religious purposes;

(C) it shall be registered under the state law, if any;

(D) it is established for the benefit of the general public;

(E) the trust / institution shall file the return of tax bases before the due date;

(F) it shall maintain books of account and obtain an audit report from a qualified accountant in case its gross receipts exceed a prescribed limit;

(G) the funds or the assets of the trust / institution shall be invested or held, at any time during the financial year, in specified permitted forms or modes; and

(H) the funds or the assets of the trust / institution shall not be used or applied or deemed to have been used or applied, directly or indirectly, for the benefit of interested person.

Donations to these institutions will not be eligible for any deduction in the hands of the donor.

(c) Partly religious and partly charitable institutions will also be treated as NPOs if they are registered under the Code. Their income from public religious activity will be exempt subject to the fulfillment of the following conditions

(i) the trust deed / memorandum of the institution shall contain a clause specifying the application of its gross receipts in a pre-determined ratio between charitable and religious activities;

(ii) it shall maintain separate books of account and separate financial statements in respect of religious and charitable activities;

(iii) it shall fulfil the conditions stipulated in clause (b) above.

In respect of income from charitable activities, the income of the trust / institution will be liable to tax in the manner provided for NPOs if they fulfill the

conditions prescribed in the Code. Donations to such trust / institution will not be eligible for deduction in the hands of the donor.

(d) To address the concern that an NPO would not be able to spend the entire receipts during the financial year itself, it is proposed that upto 15% of the surplus or 10% of gross receipts, whichever is higher, will be allowed to be carried forward to be used within three years from the end of the relevant financial year.

(e) Donations by an NPO out of its accumulated surplus to another NPO will not be considered as application for the charitable purpose.

(f) The definition of the phrase „permitted welfare activity is on the same lines as what is currently used for the phrase 'charitable purpose'. Accordingly, to maintain continuity and minimise litigation, the phrase 'charitable purpose' will be retained in place of 'permitted welfare activity'.

(g) A basic exemption limit will be provided and the surplus in excess of such limit will be subject to tax.

(h) It is proposed to retain the cash system of accounting since it is simple to follow and easy to administer.

(i) It is also proposed that the Central Government shall be empowered to notify any non-profit organization of public importance as an exempt entity.

Reference Book : **Taxation of Trust and NGOs with FCRA and FEMA** by **Manoj Fogla**, published by TAXMANN Publications, New Delhi

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Published by **Mr. Sanjay Patra** on behalf of
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