

# AccountAble™

144. Taxing NPOs - The Proposed Tax Code

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The Government has released a new Tax Code this month for discussion. If the Code is passed as law, it will be applicable from the coming financial year (2010-11) or from the next financial year (2011-12). And it may make many NPOs financially unsustainable.

In this issue of AccountAble, we discuss how your finances may be affected, if this code becomes a law in March 2010:

### Are you Really an NPO?

The code lays down tougher conditions for proving that an organisation is an NPO<sup>2</sup>. NPOs will need to prove that they have been established for public benefit. They also need to show that they have been active during the year, and the public has actually benefited from this. This may be difficult if the ITO is unsympathetic.

### Permitted Welfare Activities

The term 'Charitable Purpose' will be replaced by 'Permitted Welfare Activities'<sup>3</sup>. Thus, the emphasis of the law would shift from 'purpose' to 'activities'. While the sub-clauses of permitted welfare activities remain unchanged for the time being, the language has been narrowed. For instance, only an activity involving the relief of the poor will be a permitted welfare activity. Similarly, the phrase 'medical relief' has been narrowed to 'provision of medical relief'. 'Education' has been widened to 'advancement of education'.

### Incidental Business Activity

Any business-like activity should now be carried on while actually undertaking the welfare activity<sup>4</sup>.

This may create difficulties. So far, most people thought that it was sufficient if the business was not the main activity or objective. This may now change. For instance, if you sell greeting cards or

handicrafts, you may have to prove that these were made by the beneficiaries themselves.

Also this will be allowed only if you are involved in relief of poor, medical relief, education, and preservation of environment or monuments. This will leave a lot of modern NPOs out.

### Spend or Deliver



Presently, an NPO would pay tax @ 30% if it failed to spend 85% of the income. However, the law allows carry-forward and accumulation of the deficit in spending. In practice, therefore, it is rare to witness an NPO that pays tax.

This may now change. The code now proposes that all NPOs must spend 100% of their receipts each year. If there is any shortfall, they have to pay tax of 15%<sup>5</sup>. This taxable income essentially con-

<sup>1</sup> Direct Taxes Code Bill, 2009

<sup>2</sup> Non-Profit Organization

<sup>3</sup> Sec.96 (g); <sup>4</sup> Sec. 96 (a)

<sup>5</sup> Sch. 1, paragraph C, read with Sec. 87

sists of unspent funds for the year and capital gains. Also, you cannot make a provision for unspent grants, as income will be calculated on cash basis<sup>6</sup>.

This will create serious problems for NPOs. If an NPO is unable to spend its grant income in the same year due to operational reasons, it will face a tax liability. If the grant is received late, say in March, the NPO will again face a tax liability. Further, if an NPO is to use up all the cash by end of March, how will it continue its operations in April?

Similarly, a donor agency, which gives grants to other NPOs, will end up paying tax unless it disburses all funds by March. Alternatively, it will need to create a tax-paid fund or a Corpus for working capital.

### Deficit Financing?

What happens if the outgoings are more than the inflow in a particular year? A deficit will result. However, there seems to be no provision for carrying this forward to the next year.

What does this mean? If an NGO borrows money from outside, or from its corpus to support a project in FY 1, a deficit will result. When it gets the grant income in FY 2, and repays the loan (or replenishes the Corpus), it will end up with a surplus, so far as Income Tax is concerned. It will then have to pay a tax of 15% on this 'surplus'!

### Taxable Income

The formula for calculating taxable income in a financial year will be: *Taxable Income = (gross welfare receipts - gross outgoings) + Capital gains from financial assets*

These components are explained below:

#### Gross Welfare Receipts

Definition of income of an NPO has never been clear from the Income Tax Act. This has led many tax advisers to exclude grants from income, treating these as a contract liability. The tax code sidesteps this by emphasizing gross receipts<sup>7</sup>. These will consist of:

1. Voluntary contributions
2. Rent
3. Income from incidental business activity
4. Sale consideration of an investment asset<sup>8</sup> or a business capital asset
5. Income from investments

6. Any incoming, realization, proceeds, donation or subscription.

The last clause is wide enough to include all kinds of grants and other contractual receipts. Receipt of loans, borrowings and advances have been excluded from the definition of gross receipts.

#### Gross Outgoings

These will consist of<sup>9</sup>:

1. Contributions earmarked for Corpus
2. Payments related to fund-raising, incidental business activity or for earning any receipts
3. Payments for welfare activities
4. Payments for capital assets
5. Payments to other NPOs for similar welfare activities

It also appears that NPOs are no longer required to spend their money in India alone. They can expand their welfare activities to other countries as well.

In addition to the above, notified<sup>10</sup> NPOs can claim deduction for money spent outside India on activities promoting certain types of international welfare.

#### Capital Gains

These will be calculated in the normal manner, on the basis of sections 44 to 53.

#### The Theory of Relativity

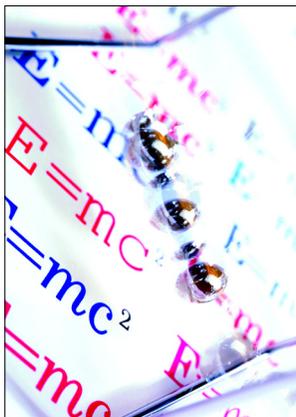
These provisions have been retained<sup>11</sup> without any major change. Payment of reasonable salary etc. to interested person working for the organisation will continue to be allowed<sup>12</sup>.

#### Investing in the Share Market

A positive development is allowing NPOs to invest directly in the share market. This has been done by introducing a list of prohibited investments, in place of prescribed investments. An NPO can invest its funds in any mode, except those prohibited under section 91<sup>13</sup>. The restrictions are mainly on investing in an associated concern, as explained below.

#### Associated Concerns

The Code has introduced the concept of associated concerns in the context of NPOs. Associated concerns have been



<sup>6</sup> Sec. 88 (2); <sup>7</sup> Sec. 89

<sup>8</sup> "investment asset" means any capital asset which is not a business asset; [Sec. 284(151)]

<sup>9</sup> Sec. 90; <sup>10</sup> Sec. 90 (g); <sup>11</sup> Sec. 96 (f); <sup>12</sup> Sec. 92

<sup>13</sup> Sec. 91

defined in section 96(c)<sup>14</sup> read with section 113.

Two concerns will be treated as associated, if:

1. One of them holds ten percent of the voting shares or interest in the other;
2. Any other person or concern holds ten percent of the voting shares in both the concerns;
3. One of them has given loan to the other concern worth 26% of the total asset value (of the other);
4. One of them has guaranteed 10% of the total loans of the other;
5. One of them appoints more than 1/3 of the board members in the other concern;
6. One of them is wholly dependent on the brand name etc. of the other;
7. 2/3 of the supplies of one concern are controlled by the other concern;
8. One concern is able to influence the prices or terms of goods supplied by the other concern;
9. Both are controlled by the same individual or their relatives or HUF;
10. Any other prescribed mutual interest.

Why has this complex definition been introduced? The general idea is that an NPO should not invest its funds in an associated NPO<sup>15</sup> or business organization. It is difficult to say how this will affect work of NPOs. NPOs running banks or micro-finance schemes may possibly be affected adversely.

### Donor Incentives

Once the new code comes into force, 100% deductibility for donations to projects approved under section 35AC will end. This is likely to hit several large NPOs which are trying to raise funds for program sustainability within India.

However, all non-religious NPOs (approved under section 95<sup>16</sup> [sic]) will be eligible to offer 50% tax deductibility<sup>17</sup> to donors. Such donations will remain limited<sup>18</sup> to 10% of the gross total income of the donor.

An NPO engaged in scientific or statistical research may also offer 125% tax deductibility (as at present) after necessary approvals<sup>19</sup>.

### Tax on Anonymous Donations

In 2006, the Government had imposed a tax of 30%



on anonymous donations, to be paid by the recipient NPO. The code makes no reference to this. Apparently, the tax will no longer be applicable.

### Other Formalities

#### Form of Organisation

All forms of organisations can get the status of an NPO<sup>20</sup>. This also includes a trust set up within another organisation<sup>21</sup>. The tax treatment of religious NPOs will continue to be the same as charitable NPOs.

#### Accounting on Cash Basis

All NPOs will be required to prepare accounts for welfare activities on cash basis for tax purposes<sup>22</sup>. Income from incidental business activities is included within the welfare activities<sup>23</sup>. Therefore, accounting for the business shall also be on cash basis. This will also create a conflict with ICAI recommendation<sup>24</sup> that an NPO carrying on any business activity should maintain accounts on accrual basis.

#### Future Outlook

The Government has consistently acknowledged the contribution made by the NPO sector to public good.



<sup>14</sup> Sec. 96 (c); <sup>15</sup> Sec. 91

<sup>16</sup> Possibly refers to Sec. 93, as Sec. 95 does not deal with approvals

<sup>17</sup> Sec. 16, Part C, entry 6

<sup>18</sup> Sec. 72(2); <sup>19</sup> Schedule 16, part A

<sup>20</sup> Sec. 96 (d); <sup>21</sup> Sec. 96(d), read with Sec 96(h)

<sup>22</sup> Sec. 88 (2)

<sup>23</sup> Sec. 88(1)(a), read with Sec. 89(1)(c)

<sup>24</sup> Please see pg. 4, Accountable 6: Indian Accounting Standards, available at [www.accountaid.net](http://www.accountaid.net)

### Chart of Key Changes

Attribute	Present Law	New Code
Defining Characteristic	Charitable Purpose	Permitted Welfare Activities
Contributions to Corpus	Exempt	Fully Deductible
Carry forward of unspent funds	Allowed	Taxable
Minimum Spending Requirement	85%	100%
Accumulation for 5 years	Allowed	Taxable
Tax Rate	30%	15%
Payments to key persons	Reasonable payments allowed	Reasonable payments allowed
Investment	Mutual Funds, Scheduled Banks etc.	Allowed in all forms, except associated concerns
Business activities for select NPOs <sup>25</sup>	Permitted if incidental to attainment of charitable objectives	Permitted if carried on in course of actual welfare activity
Unrelated Income-generating activities	Not allowed	Not allowed
Anonymous Donations	Taxable @ 30%	Not taxable
Donor Incentive	50% - 100% deductibility	50% deductibility

On the other hand, it is worried about the exemptions being used as a tax-shelter by tax-evaders. Therefore, a certain tightening of the provisions is understandable.

At the same time, such tightening should meet the test of practicality. It should also be consistent with Government policy for the Voluntary Sector, as recently announced in 2007.

It appears that some of the provisions have been drafted without realizing the resultant difficulties for NPOs. NPOs therefore need to open a dialogue with the Government on this issue, while keeping their fingers crossed.

<sup>25</sup> NPOs engaged in activities listed under items 1-5 of charitable purpose/ permitted welfare activity

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**Interpretation of law:** Interpretation of law given here is of a general nature. Please consult your advisors before taking any important decision. The Code discussed in this issue is not yet law.

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