

AccountAble™

Income Tax Exemption u/s 11

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Income Tax Exemption

An Income Tax exemption means exemption from paying income tax. This means that an exempt organisation does not have to pay income tax on its income.

NGOs and charitable or religious organisations are exempt from income tax. To get this exemption, they must fulfil certain conditions. These conditions vary depending on the category of exemption sought.

Who can be exempted u/s 11?

A basic exemption under section 11 is available to all NGOs¹. To get this exemption, following conditions must be met:

1. The NGO should have been formed for public charitable purpose. Also its assets should be held under a trust or other legal obligation. Most NGOs automatically fulfill this condition.

¹ The Income Tax Act is not concerned with form of organisation. The same treatment is provided to public trusts, societies, sec. 25 companies, and even to charitable funds set up by companies, etc.

2. It must spend 85% of its income on its objects. This is easier than it sounds and is discussed in more detail separately.
3. It must keep its money in one of the approved modes.
4. It must furnish an audit report in form 10B, if its income is more than Rs.50,000 in a particular year.
5. Its funds or assets should not be used for personal benefit of key persons².
6. It should not distribute its surplus (or net assets, on dissolution) to its members.
7. It must register itself under section 12A³.



This exemption is available on a continuous basis, provided the NGO continues to meet exemption requirements.

Let us now look at some of these conditions in more detail:

1. Public Charitable purpose

What is the exact meaning of charitable purpose⁴? NGOs often follow a developmental approach – do they qualify for exemption?

² See AccountAble 52 for more on this.

³ See AccountAble 15 for details

⁴ According to section 2(15) of the Income Tax Act: "Charitable purpose" includes relief of the poor, education, medical relief and the advancement of any other object of general public utility;'

Charitable or developmental?

The Income Tax Act does not use the term NGOs at all. Therefore, all NGOs obtain their exemption as 'charitable organisations'. Some people feel annoyed with this.

However, when the law refers to 'Charitable organisation', it means an organisation which has 'charitable objectives'. This means an organisation which helps the poor, sick, needy or helpless.

An organisation with charitable objectives need not follow a charity approach to its work. Charity approach normally means distributing relief supplies, food, blankets, etc. The approach can be developmental instead, which is currently preferred by many NGOs.

In this issue, we have used the word 'NGO', as it is more easily understood these days.

What about IGP activities?

What happens if the NGO is selling something and makes a profit? Or if it starts a business? Will it lose its exemption?

No. In 1984, the Income Tax Act was changed to allow NGOs to get into profit-making activities. However, there are two conditions:

1. The business must be 'incidental' to achieving the main objects of the NGO;
2. Separate books of account⁵ are kept for the business.

What happens to the profits generated by the business? These can not be distributed to members of the NGO. These should be used in the NGO's work itself.

⁵ Cash book and ledger

2. Minimum Spending Requirement



Under the Income Tax Act, an NGO is required to spend at least 85% of its income each year. This is called minimum spending requirement. In USA, trusts are required to distribute at least 5% of their assets each year⁶.

The objectives of both the provisions are similar – to prevent parking of business funds in charities set up by business groups.

Spend at least 85%...

This clause was introduced to prevent business groups from misusing the tax exemption. How would they do that? Let us say that a business group called 'Profit-makers' has earned a profit of 100 crores during the year. To avoid income tax on this, it had previously set up a Trust called 'Tax Shelter'. Donations to Tax Shelter are 100% deductible from income. Profit-makers then makes a donation of Rs. 60 crores to Tax Shelter Trust. Its taxable income will reduce to Rs.40 crores, and the Government will lose about Rs.21 crores in taxes.

What will Tax Shelter do with the money? It could keep the money in its bank for the time being.

However, because there is a requirement that Trust should spend at least 85% of its income, this loophole can not be used.

Unable to spend 85%?

This gives rise to several problems. What happens if we receive our income at the end of the year? Or we receive it

⁶ In USA, charities have tended to be wealth-based rather than income-based. This means that they don't have to raise funds each year for their spending, which comes from the endowments that they hold. Therefore, the requirement has been made asset-based, rather than income-based.

in the middle of the year and are not able to spend it before year-end?

Income Tax Act provides an escape clause for such situations. It allows you to carry forward such income and spend it next year. For this purpose, you should make an application to the Assessing Officer on plain paper⁷ and file it with the Income Tax Return⁸.

Income not received in the year

In some cases, the full income is not actually received during the year. How can we spend 85% of such income then?

Such income can be spent in the year in which it is actually received. Or it can be spent in the next year.

For example, an NGO's accounts show Rs. 5,00,000 as income in the year 2003-04. Of this actually only Rs.3,00,000 has been received in 2003-04. Balance amount is due. What will happen to its tax position?

Total Income	5,00,000
Less: 15% allowed to be set apart	-75,000
Balance	<u>4,25,000</u>
Less: Actually spent in the year	2,50,000
Shortfall	<u>1,75,000</u>
Less: amount not realised	2,00,000
Taxable income	<u>Nil</u>

Now suppose that the amount of Rs.2,00,000 is realised in the year 2005-06. Will it be taxed? No. The NGO will be allowed to spend it in the year of receipt (2005-06) and in the next year (2006-07).

⁷ Or the organisation's letterhead

⁸ If filing of the return is delayed for some reason, you can file the application independently.

It will have to pay tax only if it is unable to spend the full Rs.2,00,000 in those two years.

Laws are generally found to be nets of such a texture, as the little creep through, the great break through, and the middle-sized are alone entangled in.

-William Shenstone

Long-term projects

NGOs often enter into multi-year agreements with donor agencies. These may run for 3-5 or even more years. In some cases, the donor agency may disburse the full project-funding in the first year itself.

Obviously the NGO can not spend the full money in first year or in the following year. What happens then?

The Income Tax Act allows NGOs to accumulate such income for a particular project. They can spend it over the next five years or less.

For this purpose, the NGO must pass a resolution. It should also fill up form 10. Both should be filed along with the Income Tax return.

No grants from accumulated funds

One peculiar condition was introduced from financial year 2002-03. According to this, accumulated funds must be spent directly by the assessee NGO. These can not be used to make grants to other NGOs. If you make grants to other NGOs, then you must make these out of fresh receipts for the year or out of carry forward balance from previous year.

Why has this peculiar condition been introduced? The story titled 'A win-win deal' may give you a clue.

A Win-Win Deal...?

On page 2, we saw how Profit Makers donated Rs.60 crores to a group trust called 'Tax Shelter Trust' and saved a lot of tax. But then the Government introduced this provision that you must spend at least 85% of your income to remain tax-exempt.

Was that a problem for Profit Makers? Not at all. They simply accumulated the funds for various specific purposes such as health and education. Then they waited for a suitable opportunity.

Soon came along an enterprising educationist-cum-business man, named 'Principal' who wanted to set up a profit-making school. Mr. Principal had enough cash for the building, but it was mostly unaccounted money. So he went to Profit Makers. They gave him a grant of Rs.2 crores for the school building by cheque. As an 'appreciative gesture', Mr. Principal gave them back a couple of suitcases containing 2.04 crores in cash.

What will Profit Makers do with this cash? They will probably use it for a family wedding or for a vacation in Tahiti.

By introducing the new clause of 'no grants from accumulated funds', the Government hopes to stop this practice.

Corpus donations

What happens if you receive a corpus donation? As we all know, corpus donations are not to be spent, but have to be invested, so that the resulting income can be used.



Income Tax allows you to set these aside permanently. These are excluded from income. Therefore, the minimum expenditure requirement does not apply to donations received as corpus⁹.

⁹ Some international donors, particularly American agencies, use the term 'endowment'. From a financial point of view, this is similar to a 'corpus'. However, sometimes the word causes problems with Assessing Officers. Therefore, if possible, request the donor to add the word 'corpus' also when making an endowment grant.

Related Account-Able Issues:

15: Income Tax Registration

16: Income Tax Return

52: Key Person Transactions and Income Tax

67: Corpus

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अकाउण्टेबल हिन्दी में 'लेखा-योग' के नाम से उपलब्ध है।

Interpretation of law:

Interpretation of law

given here is of a general nature. Please consult your advisors before taking any important decision.

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