

# Standards & NORMS

An initiative of FMSF

Vol. III Issue 3, April 2010

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## APPEAL TO FINANCE MINISTER ON DIRECT TAX CODE FOR NPOs

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### OPENING REMARKS

**1.01** Hon'ble Sir, through this appeal we humbly point out certain harsh and unsustainable clauses in the proposed Direct Tax Code (DTC) about NPOs. If the proposed clauses are enacted, then irreparable damage will be inflicted on the NPO sector. There are certain clauses which are not only irrational but are unconstitutional and against the very spirit of the proposed Direct Tax Code.

**1.02** A brief summary of the key recommendations is provided for a quick review. The same recommendations have been explained a little elaborately as well.

### NPOs TO BE TAXED ON THE BASIS OF RECEIPT & PAYMENT

**2.01** The taxable income of the NPO shall be determined on the basis of the actual gross receipt and gross payment during the year. This provision defies principles of natural justice. For instance, the proposed clause (g) of section 89 is as under :

**“the amount of any incoming, realization, proceed, donation or subscription, received from any source.”**

**2.02** The above clause implies that any incoming whether income or not shall be treated as income which is not fair.

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**2.03** Further, the actual receipts and actual payments shall determine the taxable income. For instance, if an NPO receives grant in the month of March, it will be taxed if it is unable to spend it within that month. Currently NPOs are allowed 5 years time to spend the grant received. There is an urgent need that the 5 year application clause is restored in the DTC. It may be noted that the 5 year clause itself is on the lower side. Prior to 1st April 2002, it use to be 10 years.

**2.04** The Government is taking a very myopic view of the role of NPOs in development and inclusive growth process. There are many long term processes which NPOs handle. Therefore, having a provision which compels fund utilisation within a month or two is unfair.

**2.05 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. This Clause is trying to tax what is exempt for all other assesseees, therefore should not be taxed at the hands of NPOs also.*

**2.06** *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 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.*

**2.07** *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 assesseees they should also be permitted to have their own method of accounting.*

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### **NPOs NOT ALLOWED TO PROTECT THEIR CORPUS OR MODEST SAVING FOR FUTURE**

**3.01** The proposed 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.

**3.02** 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.

**3.03** It is absolutely necessary that certain amount of funds are permitted as accumulation so that the NPOs can sustain themselves in the long run and their corpus is protected.

**3.04 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 for future sustainability.*

## **NPOs WILL NOT BE PERMITTED TO CLAIM DEPRECIATION**

**4.01** 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.

**4.02** 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.

**4.03 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.*

## **BUSINESS ACTIVITY OF AN NPO**

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

**5.02** 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.

**5.03** This is a proposal in the right direction. However, after this change

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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*’.

**5.04** 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.

**5.05** 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.

**5.06 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**

**6.01** 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.

**6.02** 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.

**6.03 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 COMMERCIAL ORGANISATION**

**7.01** 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.

*It is absolutely necessary that the depreciation and other non cash expenditure are permitted to NPOs on par with other assessees.*

**7.02** 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.

**7.03** 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.

**7.04** 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.

**7.05 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.

### **COMPULSORY ACTIVITY EVERY YEAR**

**8.01** 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%.

**8.02 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**

**9.01** The proposed DTC is very harsh against NPOs and does not create an environment for encouraging the charity

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create an enabling  
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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.

**9.02** 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.

**9.03 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**

**10.01** 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 assesseees, therefore should not be taxed at the hands of NPOs also.

**10.02A** 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 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.

**10.03** 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 assesseees they should also be permitted to have their own method of accounting.

**10.04** 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 for future sustainability.

**10.05** 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.

**10.06** 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.

**10.07** 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.

**10.08** 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.

**10.09** 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.

**10.10** 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.

**10.11** 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.

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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  
**FINANCIAL MANAGEMENT SERVICE FOUNDATION**  
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