

# Standards & NORMS

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## **DIRECT TAX CODE For NPOs**

**RE-REGISTRATION NOT REQUIRED**

**CASH BASIS OF ACCOUNTING EXCEPT  
FOR SECTION 25 COMPANY**

**ALL RECEIPTS EXCEPT LOAN OR  
CORPUS DONATION ARE PART OF INCOME**

**15% OF INCOME CAN BE ACCUMULATED  
FOR FUTURE APPLICATION**

**'NO ACTIVITY' FOR 3 YEARS WILL  
RESULT IN TAXATION  
OF NETWORTH**

**ANY SURPLUS WILL  
BE TAXED @ 15%**

**ANONYMOUS DONATION  
TO BE TAXED @30%**

**100% BENEFIT TO DONOR  
WITHDRAWN**



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# DIRECT TAX CODE FOR NPOs

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## OPENING REMARKS

**1.01** The Union Cabinet has approved the proposed Direct Tax Code. However, there are some harsh clauses in the Direct Tax Code (DTC) about NPOs. If the proposed DTC is enacted, then the NPO sector will be very adversely impacted.

**1.02** Few key highlights of the proposed DTC are as under :

- (i) No re-registration required
- (ii) 10% of gross receipts or 15% of income, whichever is higher, 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 if not spent during the year.
- (iii) If any income is received in the last month of the financial year, then it will not be treated as surplus and will not be taxed.
- (iv) Religious organisations are also included.
- (v) The term “Charitable Purpose” has been retained, earlier it was coined as “permissible welfare activity”.
- (vi) basic exemption limit has been provided, surplus in excess of limit shall be taxed.
- (vii) NPOs have to follow Cash Basis of accounting. However section 25 companies can follow mercantile basis of accounting.
- (viii) The government can notify some NPO as exempt entity.
- (ix) All receipts except loan and corpus donation shall be considered as part of income.
- (x) Any surplus from receipt and cash expenditure during the year will be taxable @15%
- (xi) NPOs can not transfer any amount to their corpus without paying taxes. Currently 15% of income can be accumulated indefinitely.
- (xii) If the NPO is unable to spend the income during the year, then it can only accumulate 15% of income to be spent in the next 3 years.

(xiii) The funds or assets shall not be used for the benefit of interested persons, whether directly or indirectly.

(xiv) Anonymous donation will be exempted to the extent of 5% or 1 lakh rupees whichever is higher. The remaining amount will be taxed @30%.

Some of the serious but untouched provisions of the proposed DTC which are likely to have adverse impact are discussed as under.

## **APPLICATION & ACCUMULATION OF INCOME**

**2.01** The proposed DTC has re-affirmed that the NPOs have to apply 100% of their income for charitable purposes. The current provision of 15% indefinite accumulation has been withdrawn. 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. As per present law, NPOs can transfer 15% to their corpus every year. If the NPO is not able to spend the remaining 85%, then it can accumulate and spend it in next five years. However, the proposed code has totally deleted the privilege of 15% saving every year. It has further restricted accumulation to future years to the extent of 15% only, which can be applied in the next 3 years.

**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 proposed provision implies that every year 100% of income has to be applied for charitable purposes and if the NPO is not able to apply 100%, then it can only accumulate 15% to be applied in next 3 years. This provision will create hardship to NPOs engaged in long term projects. For

*This provision will create hardship to NPOs engaged in long term projects. For instance, in a rehabilitation project the NPO may receive contribution for constructing houses which can not be completed in one year.*

instance, in a disaster rehabilitation project the NPO may receive contribution for constructing houses which can not be completed in one year. Therefore, even if the government wants the NPOs to apply 100% of their income for charitable purposes, there is no reason why the NPOs should not be permitted some additional time if the circumstances so required.

**2.04 Recommendation:** *The Government should consider allowing some reasonable income for future sustenance. Accordingly the proposed DTC should be amended and the NPOs should be allowed at least 10% as indefinite accumulation for future sustainability and to negate inflation.*

**2.05** *The Government should also allow reasonable time for execution of projects which can not be completed within one year. A provision may be added to allow the NPOs to accumulate the gross income (in deserving cases) subject to 100% utilisation in the next 3 years.*

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

**3.01** The proposed DTC does not allow depreciation as an expenditure towards charitable purposes. This is a unfair and a 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 expenditures are permitted to NPOs on par with other assesseees. The rationale of discriminating NPOs is unfounded and unfair.

**3.03 Recommendation:** *The Government should allow the NPOs to protect the erosion in capital and assets by allowing legitimate depreciation. The proposed DTC 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**

**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

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*The Government should allow the NPOs to protect the erosion in capital and assets by allowing legitimate depreciation.*

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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 Recommendation :** *The above proposed provision in 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.

**5.03 Recommendation :** *The DTC should allow those exemptions which are otherwise available to other assessees, like agricultural income etc.*

### **CONVERSION OF AN NPO INTO COMMERCIAL ORGANISATION**

**6.01** 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 harsh as it proposes to tax the entire networth accumulated over the years. This provision also assumes that the entire networth has been created out of the exempted income. The networth may includes initial and capital contribution by members which in any case is exempt from 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%, the NPO may have created networth by legitimately paying taxes in the past. In such circumstances taxing the

*The NPO may have created networth by legitimately paying taxes in the past. In such circumstances taxing the networth will result in double taxation.*

networth will result in double taxation. Therefore, portion of the networth will be taxed twice because all accumulation of the NPOs need not necessarily be tax free.

**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 :** *The proposed DTC should be amended and only the portion of the networth created out of exempted income should be subjected to tax.*

### **COMPULSORY ACTIVITY EVERY YEAR**

**7.01** The proposed DTC provides that all NPOs are compulsorily required to have

welfare activities every year. If an NPO does not have charitable 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 :** *This provision should be deleted. 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 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%. The existing provisions like Section 35AC which allow 100% incentive to the donor 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 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 NPOs.*

Reference Book : **Taxation of Trust and NGOs with FCRA and FEMA, 5th Edition 2010** by **Manoj Fogla**, published by TAXMANN Publications, New Delhi

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