Taxation Issues and Planning for NGOs/NPOs

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There is a general misconception that being an NGO automatically implies that it does not exist for profit and hence is immune to all taxation provisions whether it is Income Tax, Sales Tax or Service Tax. This lack of knowledge about relevant taxation aspects may land NGOs in serious trouble. For the purposes of taxation, NGOs, Trusts and Companies formed under Section 25 of the Companies Act are generally one and the same. This article delves into various taxation issues related to the NGOs.

NGOs play a very important role in the development of any economy and can be very effective in reaching the target groups in the areas where even the government cannot reach. With the government vacating some areas for private sector entrepreneurship to flourish and contribute to a high growth rate propelled by economic reforms, there has been a paradigm shift in the functioning of NGOs. This shift is particularly visible in the ways the NGOs mobilise funds today and these include not only aid and grants from within and outside but also the charging of money from people who can afford to pay for various goods and services of the NGOs. No one is exempt from taxation laws of the land and, as such, a careful understanding and implementation mechanism of the relevant laws is necessary to avoid unexpected and unintended charge of tax at a later date, which some times may put the survival of institution at risk and may give a bad name to its office-bearers.

Non Governmental Organisations (NGOs) are sometimes also called Non-Profit Organisations (NPOs) because of the general belief of the public, and many times even of creators, that being an NGO automatically implies that it does not exist for profit and hence is immune to all taxation provisions whether it is Income Tax or Sales Tax or Service Tax. Because of this misconception, many times NGOs land in serious trouble and even have to forgo their legitimate right of certain benefits.

For the purposes of taxation, NGOs, Trusts and Companies formed under section 25 of the Companies Act are generally one and the same thing.

Provisions Relating to Income Tax

An NGO may be formed either as a Trust, as an Association of Persons (AOP) or as a Body of Individuals (BOI). The Income Tax Act 1961, while defining the word 'person', recognises AOPs and BOIs as a separate entity whereas trusts are covered in the residuary clause of 'every artificial

juridical person'. For the purposes of taxation under the Income Tax Act, income derived from property held under a trust wholly for charitable or religious purposes enjoys exemption from tax by virtue of section 11 of the Act.

Section 11(1) consists of four sub-sections. Sub-sections (a), (b) & (c) refer to 'income derived from property held under trust' whereas sub-section (d) in addition to the word 'trust' refers to the word 'institution' as well. In effect, exemption under section 11 is available not only to trusts, institutional settlements and endowments but also to a company incorporated under section 25 of the Companies Act 1956 without a profit motive, or a society formed under Societies Registration Act 1860, provided the purpose of the company or society is for charitable, public or religious purposes.

The word 'charitable purpose' is defined by an inclusive definition under section 2(15). By going through the inclusive definition route, legislature has left the field open to the trustee to pursue the activities of their choice.

By virtue of section 13(1)(b), trusts created or established for the benefit of any particular religious community or caste are not eligible for exemption from tax. Explanation 2 to section 13 provides that trusts created for benefits of scheduled castes, backward classes, scheduled tribes or women and children are not considered as one 'created or established for the benefit of any particular religious community or caste'.

To be eligible to get the exemption under section 11, the first step is to apply for registration with the commissioner in accordance with section 12A, read with rule 17A.

As held by *ITAT- Lucknow in [2005] 142 Taxman 11*, once a registration certificate under section 12A is issued, the department is bound to give effect to the same and, in case departmental authorities conclude in any subsequent year that the assessee had violated provisions of section 12A, they could cancel said registration, but existing benefit thereof cannot be denied.

Exemption is available only if not less than 85 per cent of income sought to be exempted is applied to such charitable or religious purpose. Explanation 2 to section 11 allows some relaxation to this condition with certain restrictions.

Exemption from application to the extent of 15 per cent of income is to be computed on 'commercial' basis and not on 'total income' as computed under the Income Tax Act. This concept has been dealt with in detail by a special bench of ITAT Mumbai in the case of *Bai Sonabai Hirji Agiary Trust Vs. ITO reported in [2005] 272 ITR 67/ 93 ITD 70*.

Business for Profit by Trusts/NGOs

There is no restriction to a trust for running a business. Profits earned from that business would be liable to tax under the head 'Income from business or profession'. However, by virtue of section 11(4A), if such business is 'incidental to the attainment of the objectives of the trust' or 'the institution', profits derived from that business would also be eligible for exemption. Whether a business is 'incidental to the attainment of the objectives of the trust' or 'the institution' or not is a question of fact and can be decided on a case-to-case basis. Section 11(4A) specifically requires books of accounts of such business to be maintained separately. The condition of application of the income to the extent of 85 per cent for charitable or religious purposes will apply to such business also. If the transactions relating to business activities are merged with the charitable activities, it will create complications—and even benefits of exemption from tax to trust from incomes other than from business

activities will also be difficult to quantify.

The law is now well settled by the decision of Apex Court in *ACIT Vs. Thanthi Trust [2001] 247 ITR 785* wherein it was held that: "All that section 11(4A) requires for the business income of a trust or institution to be exempt is that the business should be incidental to the attainment of objectives of the trust or institution. A business, whose income is utilised by the trust or the institution for the purposes of achieving the objectives of the trust or institution, is surely a business which is incidental to the attainment of the objectives of the trust."

Exemption Under Section 11 vis-à-vis Section 10

NGOs not holding property under trust and formed as AOPs/BOIs can enjoy exemption by virtue of different clauses of Section 10 and more particularly under sub-sections 23B and 23C. The exemption available under these clauses is separate from and is in addition to the exemption granted under section 11. In respect of income covered by any of these clauses, the trust, association or institution would be entitled to exemption even if the same income also falls under section 11 and the conditions for exemption under that section are not fulfilled. Most of the education and medication activities run by NGOs can claim the exemption under section 10(23C).

Vital distinction between an exemption under section 11 and under section 10 is that under section 11 it is the activities that are in focus whereas in section 10, both the institution and activities are in focus.

According to the ratio of judgement in the case of *Saurashtra Education Foundation Vs. CIT [2005] 273 ITR 139 (Gujrat)*, the word "educational institution" referred to in Sections 10(23C) (iiiab), (iiiad) and (iiiae) contemplate a narrower concept and mean an institution imparting formal education in an organised and systematic training, where the institution would be accountable to some authority and where there would be teachers. Mere association with educational activities does not make an NGO eligible for exemption under sections 10(23C).

Educational institutions referred to in section 10(23C) should exist 'solely for educational purpose and not for the purposes of profit'. The word solely clearly implies that educational purpose must be the sole objective for which the institution exists. As held in *CIT Vs. Maharaja Sawai Mansingh Ji Museum Trust [1987] 33 Taxman 279 (Rajasthan)* solely means exclusively and not 'primarily'.

In *U.S. Srivastava Educational Memorial Society Vs. ACIT [2005] 142 Taxman (ITAT-Lucknow) 11*, the deed of the society included other objectives besides the objective of providing education. However, none of the other objectives were pursued during the year. The only source of income was fees from students and expenditures indicated that the same was for running the school. On these facts it was held that the assessee-society existed solely for educational purposes and was entitled to exemption under section 10(22) (now covered in subsection 23C). As held by the apex court in *Aditanar Educational Institution Vs. Addl.CIT [1997] 224 ITR 310/ 90 Taxman 528* the availability of exemption under this section is to be evaluated each year to find out whether institutions existed during the relevant year solely for educational purposes and not for the purposes of profit.

To fulfil the condition of 'not for the purposes of profit', it is necessary to place appropriate wordings in the charter of the institution i.e. its Memorandum and byelaws. The Memorandum and byelaws should include declaration of any dividend and distribution of any assets to members both during the continuance of the institution and at the time of dissolution.

Incomes of AOPs formed to promote and protect the interests of its members—and which do not cater to the need of any outsider—are exempt from tax on the ground of mutuality. Three conditions which establish the doctrine of mutuality are referred to in a recent judgement of Allahabad High Court in the case of *CIT Vs. J.K.Organisation [2005] 144 Taxman 560*. The conditions are: (i) the identity of the contributors to the fund and the recipients from the fund, (ii) the treatment of the company, though incorporated as a mere entity for the convenience of the members and policyholders, in other words, as an instrument obedient to their mandate, and (iii) the impossibility that contributors should derive profit from contributions made by themselves to a fund which could only be expended or returned to themselves. The subject AOP was registered under the Trade Unions Act 1926 and its rules provided that in case of dissolution the surplus would be distributed among members. On this ground, the assessee was held to be exempt from tax on the ground of mutuality.

Tax Audit For NGOs

Most of the NGOs, many a time, unknowingly or without intention indulge in businesses also. For example, NGOs active in education may be running bookshops in or around their schools, or NGO hospitals may be running pharmacies. These types of activities, though incidental to the main object of the Trust/NGO, constitute business and therefore require maintenance of separate books which should be subject to audit under section 44AB. Institutions not doing so are exposed to penalties under section 271B of the Act.

Fringe Benefits Tax (FBT) to NGOs

By virtue of the definition of the word 'employer' in section 115W, every company, AOP, BOI or artificial juridical person is liable to FBT. However, persons holding registration under section 12A or eligible for exemption from tax under section 10(23C) are not deemed to be employers for the purposes of FBT, hence not liable to pay that tax.

Provisions Relating to Service Tax

Till the Finance Act 2005, most of the NGOs, not being 'commercial concerns' were exempt from charging service tax. The Finance Act 2006 has substituted references in the Finance Act, 1994 to the expression 'commercial concern' in relation to 17 taxable services, with the term 'person' or 'any person'. The implication of this is quite wide and now even a non-profit making entity, say a charitable trust or a company registered under section 25 of the Companies Act, is liable to pay tax and is eligible to take credit of such tax paid on its input services. Thus, if any of the activities of an NGO falls under any of the services covered in clause 105 of section 65 of Finance Act 1994, care should be taken to ascertain service tax implications.

Educational institutions with a requirement to write examinations to obtain a degree or certificate awarded by any agency created by law are entitled to exemption from service tax under section 65(27) of the Finance Act, 1994.

By virtue of explanation to clause 106 to section 65 of the Finance Act, 1994, *"any testing or analysis for the purpose of determination of the nature of diseased condition, identification of a disease, prevention of any disease or disorder in human beings or animals"* is not liable to service tax. Thus, charges levied by pathological labs run by NGO hospitals do not attract service tax.

Provisions Relating to Sales Tax/VAT

VAT has been implemented by almost all the States and Union Territories—except Uttar Pradesh and Tamil Nadu. Sooner or later these states will also fall in line as any state can afford

to remain isolated with tax reforms only on its own perils. Businesses run by NGOs are also liable to charge tax and are eligible to take tax credit under respective state VAT laws.

Several large corporate houses in India run educational or medical institutions near their place of operations, and more particularly at their plant locations situated in remote areas where providing these facilities is necessary to retain employees as part of total living conditions. In order to maintain relations with residents of local areas, and also in zeal to discharge their Corporate Social Responsibility (CSR), persons from general public are also allowed education or treatment in these institutions. At times, these activities are run by corporates under the umbrella of specifically formed trusts or institutions. Deficit arising out of operations of these institutions is met by the parent organisations, i.e. business/industry.

With CSR becoming a buzzword, courts have recognised that CSR activities run near business places are unavoidable and are a part of business. After introduction of VAT, it makes a strong case to merge these activities with the main business. With this, expenditures incurred for running these activities will become part of mainstream business expenditure and organisations will become eligible to take credit of state VAT/service tax paid on a host of inputs in physical or intangible forms. What is bad is tax evasion and not planning. Paying honest taxes to the ex-chequer is also a kind of good CSR, but by carefully planning the affairs, savings of such expenditure can be deployed and canalised to the desired direction.

Financial Accounting Standards for NGOs

Proper accounting and presentation of financial statements is a very important challenge for NGOs. This is because there is not enough guidance and material available for NGOs to follow for preparation of their financial statements.

Till date, the Central Government has notified two Accounting Standards, back in 1996, relating to (i) disclosure of accounting policies and (ii) disclosure of prior period and extraordinary items and changes in accounting policies.

Unlike Accounting Standards issued by ICAI, Accounting Standards notified under the Income Tax Act are applicable to NGOs/Trusts also. It is recommended for NGOs to follow the Accounting Standards issued by ICAI, as far as applicable, to maintain creditability of their accounts before taxation authorities.

Asia Pacific Philanthropy Consortium (APPC), an informal network of grant–making philanthropic institutions and organisations has done a remarkable job in developing Financial Accounting Standards for NGOs.

Conclusion

With the role of governments gradually shrinking from the day-to-day life of citizens, NGOs will play a greater role in fulfilling that gap. With their large coverage and appeal, citizens—and many times governments and businesses—approach them at the time of crises. With their increasing role in society, responsibility in terms of public trust and also larger sums on their disposal, NGOs need to be more professional in planning their affairs. Development, interpretation and litigation about taxation are never ending processes and NGOs are not immune from this. They also have to live with taxes and relevant procedures and complications. ❐