

# AccountAble™

## IN THIS ISSUE

### What is Charitable Purpose?

- 1. Relief of the Poor
- 2. Education
- 3. Yoga
- 4. Medical Relief
- 5. Environment
- 6. Art or History
- 7. General Public Utility

### Business Activities

pg 1	Incidental	pg 3
pg 1	<b>Business under 7th Limb</b>	pg 3
pg 1	1. Integral	pg 3
pg 1	2. Limit On Receipts	pg 3
pg 2	<b>Implications</b>	pg 3
pg 2	1. Prime charity	pg 3
pg 2	2. Rainbow charity	pg 4
pg 2	3. Mixed charity	pg 4
pg 2	<b>Conclusion</b>	pg 4

In most of the countries across the world, NPOs are exempt from Income Tax. Many countries also provide them with other incentives, such as a tax rebate on donations to charitable and religious organisations. All this is done mainly to encourage the spirit of charity. It is also justified because NPOs are often more efficient and effective in promoting welfare of the society.

Since charitable organisations are exempt from tax, many others would also like to get classified as charitable, and escape paying tax. To prevent this, the law lays down strict norms and procedures.

In India, tax exemption for charitable and religious organisations is available through section 10(23C) and section 11 of the Income Tax Act, 1961. Charitable organisations include schools, hospitals, NGOs, etc.

To be eligible for the exemption, a charitable organization should spend its money on 'charitable purposes'. This issue of AccountAble discusses the concept of 'charitable purpose' as modified by Finance Act 2015.

### WHAT IS CHARITABLE PURPOSE?

Charitable purpose is defined<sup>1</sup> in the Income Tax Act itself. According to this, seven types of activities are considered charitable:

- 1. Relief of the Poor

- 2. Education
  - 3. Yoga
  - 4. Medical Relief
  - 5. Preserving the environment
  - 6. Preserving monuments, artistic or historic objects
  - 7. Any other object of general public utility.
- These are called seven limbs of charitable purpose. Let us look at these in more detail.

#### 1. RELIEF OF THE POOR

Any activities which directly help the poor, such as food, shelter, clothing, emergency help, etc. fall under this category. The activities must be targeted at economically poor communities.

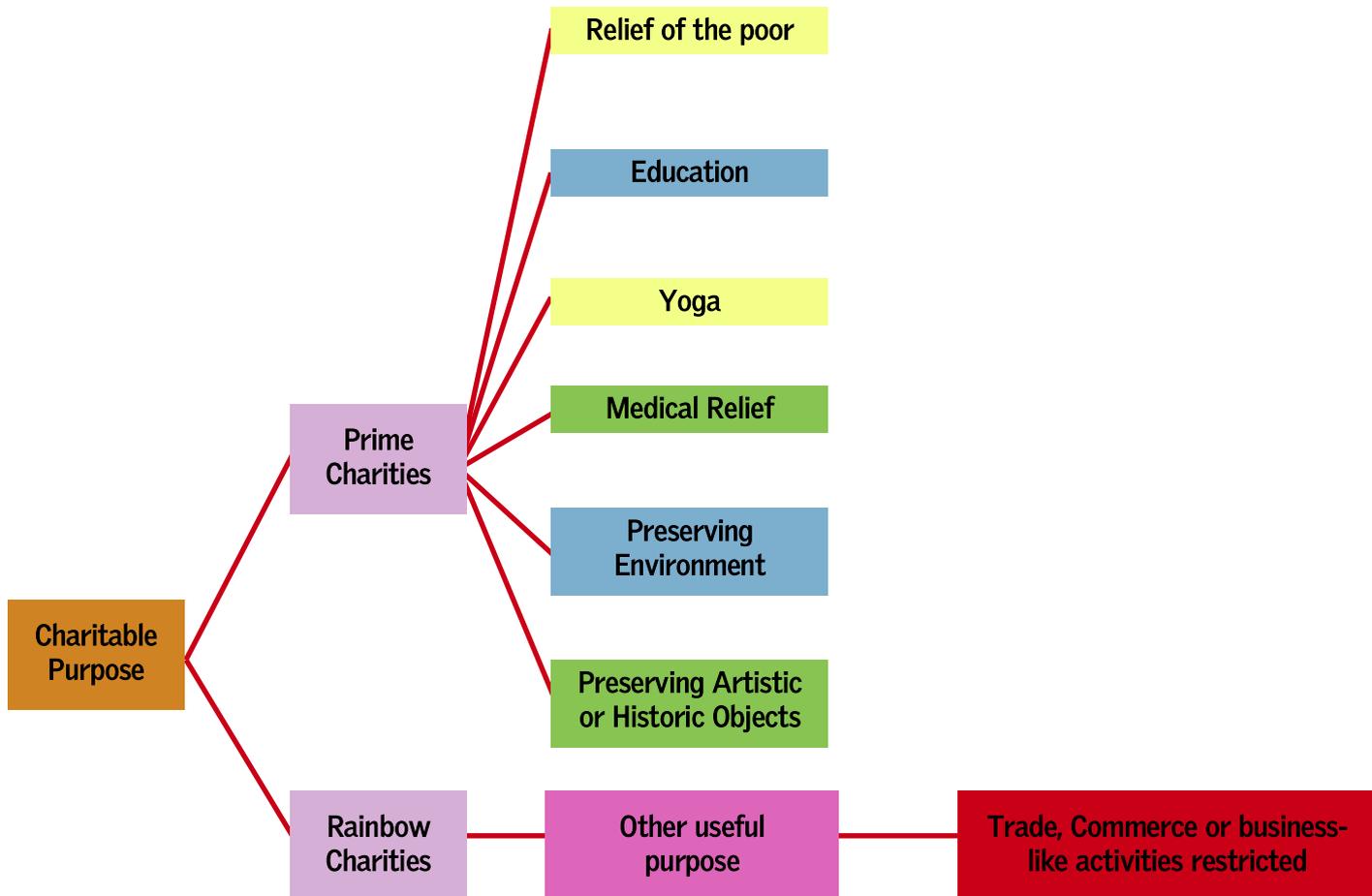
#### 2. EDUCATION

The word education has a very wide meaning in ordinary usage. For tax exemption, this is mainly limited to formal schooling, training or imparting of knowledge, without a profit motive.

#### 3. YOGA

There are many forms of yoga, ranging from purely spiritual (oneness with divine) to the totally mathematical (addition). Sec. 2(15) apparently refers to yoga as a discipline of breathing, meditation and exercises for well-being and health.

<sup>1</sup>Sec. 2(15): 'Charitable purpose' includes relief of the poor, education, yoga, medical relief, preservation of environment(including water-sheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historical interest, and the advancement of any other object of general public utility...."



#### 4. MEDICAL RELIEF

This covers establishment of clinics, hospitals, etc. to cater to the needs of the physically or psychologically ill.

#### 5. ENVIRONMENT

Activities for preservation of environment, including watershed management, protection of forests, wildlife, etc. are covered under this.

#### 6. ART OR HISTORY

This covers preservation of monuments, buildings, and objects of historic or artistic interest.

#### 7. GENERAL PUBLIC UTILITY

The first six are fairly specific. However, the seventh category, called the rainbow category, is very wide and open. It can include any activity which is seen as useful and worthy of promotion by the society. A large number of modern NGOs, which are engaged in non-traditional activities such as advocacy, empowerment, social justice, and other civil

society initiatives, get their exemption under this seventh limb.

#### BUSINESS ACTIVITIES

What happens if an NGO is also doing some business activities to achieve its goals? These are permitted, provided three conditions are met:<sup>2</sup>

1. Separate books of account should be kept for the business activities.
2. If the charity accepts donations under sec. 80G, these must not be used for business.
3. The business activity must be incidental to the charitable purpose.

The first two are fairly clear. Let's look at the third one.

<sup>2</sup> Sections 2(15), 11(4A), 80G(5)

### INCIDENTAL

This condition is essential for all business-like activities of all exempt organisations.<sup>3</sup> It also covers all seven limbs of charitable purpose. What does incidental mean?

Any activity that is secondary to the main activity is incidental. This means that the main purpose should not be to run the business itself. Examples include fund-raising through charity dinners, events, sale of products, etc. However, whether a business activity is incidental or dominant depends on actual facts of the case.

What happens if you sell products and issue a donation receipt for these under sec. 80G? If this is discovered, it might land you in more trouble.<sup>4</sup> You should therefore ensure all business receipts are tracked and accounted separately.<sup>5</sup>

### BUSINESS UNDER 7th LIMB

If you have business activities under the 7th limb, you must comply with two additional requirements.

#### 1. INTEGRAL

The business income must be generated 'in the course of actual carrying out of' seventh limb activities. It is not enough that the business activity is secondary or indirectly connected to your charitable purpose.

Is this very difficult? Not really. In real life, most NGOs with seventh limb activities, get business receipts while promoting their objects. For example, if you earn income from training, then most likely you are training people in some publicly beneficial activity. Similarly, if you rent out your conference hall to another NGO, it would be easy to show that this promotes your objectives. However, if you were to hire out to hall to a commercial enterprise, this might be more difficult. Similar problems might arise if you rent your premises to a commercial entity.

#### 2. LIMIT ON RECEIPTS

Your gross receipts from business activities must be limited to 20% of total annual receipts. This may be more complicated than it sounds.

Firstly, what does 'gross business receipts' mean? This does not mean profits from the business. This means the gross fees or sales during the year. This would also include related receipts, such as reimbursed expenses. For example, if you were to organise a training program for

a donor, then the total contract value, including fees, travel of participants, boarding, lodging, venue hire, etc. would be included.

Secondly, what does total annual receipts mean? This includes all receipts from grants, donations, fees, sales, interest, rent, etc.

What is the complication then? The problem is with predicting the total receipts for the year. Sometimes an anticipated grant may be delayed. You may not be able to raise as much donations as you had planned. And if your total receipts are lower, then your business receipts should also be smaller.

The use of word 'receipts' may also create some confusion. Some NGOs do not show grants as income. Others may be following accrual basis, where unspent grants are reduced from income. In all cases, the 20% limit should be based on the receipts as shown in Receipts & Payments Account.

### IMPLICATIONS

What happens if you fail the above tests? This depends on who you are and how badly you fail.

#### 1. PRIME CHARITY

Let's say your activities fall only under the first six limbs. You would qualify as a prime charity. This means your business receipts need not be integral.

Now, if the tax department finds that your business is not incidental to the charitable purpose, but dominant, then it might deny your tax exemption totally. This can be catastrophic. However, this is rather unlikely. If the Assessing Officer takes this position, you will probably get some relief in appeal.

However, it is more likely for the department to find that though the trust is charitable, the business activity does not meet sec. 11(4A) conditions. In such cases, the department will compute your business profits, and then levy tax on that. Your main charitable income from grants and donations will remain unaffected.

<sup>3</sup> Whether under sec. 10(23C)(iv) or sec. 11

<sup>4</sup> You must ensure donations are not used for business activities. You should also issue a certificate to the donor confirming this. Sec. 80G(5)(i)

<sup>5</sup> Sec. 11(4A), read with sec. 80G(5)(i)

## 2. RAINBOW CHARITY

A rainbow charity is one which advances only 'other objects of general public utility'. Many modern NGOs fall in this category. These may include human rights organisations, civil rights advocacy organisations, animal rights or welfare organisations,<sup>6</sup> research organisations, training organisations, resource organisations, promotion of arts, music, etc. Organisations dedicated to working with women or children may also fall in this category, unless they focus only on the poor.

As discussed earlier, these organisations must face a more difficult test for business activities. The business receipts must be earned in the course of advancing their charitable purpose. These must be less than 20% of total receipts.

If such an NGO fails the test, it would be a disaster for the NGO. The entire receipts of the NGO, including those from grants and donations, would

be treated as business receipts. The department would calculate the profits and levy a tax on these.

## 3. MIXED CHARITY

A charity with some prime and some rainbow activities will be affected only partially. The income from rainbow activities will be treated as business income. Other income related to prime activities will remain unaffected.

## CONCLUSION

Increasing number of NGOs are looking at new, unconventional ways of generating resources. This has blurred the lines between charitable and business activities. This will also increase adverse assessments and litigation. Therefore, you must make sure you understand these provisions properly. Failure to do so may get you a nasty shock from the income tax officer.

<sup>6</sup> Domesticated animals. Charities working on wildlife will be covered under fifth limb

**What is AccountAble:** Each issue of 'AccountAble' covers a different topic related to NPO regulation or accounting and is posted/ emailed to about 3,000 persons in NPOs, Agencies, CSR Departments, Corporate Foundations and audit firms. AccountAid encourages re-production or re-distribution of 'AccountAble' in workshops or NPO newsletters for non-commercial use, provided the source is acknowledged.

**AccountAble through e-mail:** AccountAble is available through e-mail, without any charge. To subscribe, visit [www.AccountAid.net](http://www.AccountAid.net) and click on 'AccountAble by E-mail'.

**AccountAble on the Web:** All the past issues of 'AccountAble' are available on our web-site [www.AccountAid.net](http://www.AccountAid.net).

**AccountAid Capsules:** Short items of information on NPO accounting and regulation. To subscribe, visit [www.AccountAid.net](http://www.AccountAid.net) and click on 'AccountAid Capsules'.

**Interpretation of law:** Law discussed here is valid as of 31-Aug-15. However the interpretation is of a general nature. Please consult your advisors before taking any important decision.

**Questions and doubts?** AccountAid provides complimentary advice to implementing NPOs and NPO auditors on matters related to accounting or financial regulation. You can send your questions by e-mail ([query@accountaid.net](mailto:query@accountaid.net)) or letter. You can also discuss these over the phone.

**Comments:** AccountAid India, 55-B, Pocket C, Siddharth Extension, New Delhi-110 014; Phone: 011-2634 3128; Phone/Fax: 011-2634 3852; e-mail: [query@accountaid.net](mailto:query@accountaid.net)

Text © AccountAid™ India: विक्रम सचंत् २०१२ भाद्रपद १, September 2015 CE

Printed and published by Ms. Renu Agarwal for AccountAid India, New Delhi (Ph. 26343128) at PRINTWORKS,

W-11, Okhla Industrial Area, Phase 2, New Delhi 110 020

**Content:** Shri Sanjay Agarwal

**Editing:** Ms. Soumyasree Mullick

**Design:** Ms. Moushumi De

For private circulation only.