

# AccountAble™

Key person Transactions & Income Tax

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NGOs are exempt from paying income tax. This exemption recognises that NGOs do good work. They work for the benefit of the society. Therefore they need not pay income tax.

This is a very valuable and attractive concession. There are many business-people and professionals who pay large amounts of income tax. Also, the content of their work is similar to that done by many NGOs.

For example, a doctor may run a clinic for personal income. An NGO may run a similar clinic for needy people. The doctor would have to pay income tax. The NGO will not have to pay taxes.



Most of us do not like to pay taxes. This applies to the doctor also. Is it possible for him / her to run the clinic disguised as an NGO?

Yes and no. This can be done and has been done in the past.

## Transactions with key persons

Imagine that this doctor wanted to set up and use an NGO to avoid income tax. The first thing he or she will do is to ensure her control over the NGO. This will allow him or her to manipulate the transactions for personal gain.

Income Tax people, therefore, keep a close eye on payments to people who may be in a

position to control the NGO. For convenience, we call them 'Key Persons'.



The tax provisions are designed to catch the wicked. But to catch the wicked, innocent people will also have to be frisked. This causes misery but is probably unavoidable.

How to make sure that we do not end up looking like the wicked?

For this, we need to understand three things: 1. Who may be a key person, 2. What transactions are covered, 3. How use of assets is restricted

## 1. Who is a key person

According to the Act, following persons<sup>1</sup> are treated as key persons:

- ⇒ **Author of the Trust:** the person who set up the Trust initially; also known as settler
- ⇒ **Founder(s) of the society:** The persons who signed the Memorandum of the Society are normally known as founders.
- ⇒ **Key Donors:** Any person whose cumulative<sup>2</sup> contribution to the trust or society exceeds Rs.50,000
- ⇒ **Members of the HUF:** If the Trust was set up by an HUF, then all members of the HUF. Similarly, if the key donor is a HUF, then members of the HUF

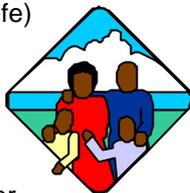
<sup>1</sup> Section 13(3)

<sup>2</sup> from the start-up of the NGO till end of current financial year

➤ **Trustees, Managers:** This includes Chief Functionary, Executive Director, Director, Secretary, office bearers.

➤ **Close relatives:** Any relative of any of the above five categories. 'Relative' means<sup>3</sup>:

- ☺ Spouse (husband / wife)
- ☺ Brother or sister, their children (nephew / niece)
- ☺ Brother-in-law or sister-in-law, their children
- ☺ Any lineal ascendants (parents, grandparents...) or descendants (children, grandchildren...) – this includes stepchildren and parents-in-law.



➤ **Associated Concerns:** Any company, business, or firm in which any of the above six categories have a 'substantial interest'. Substantial interest means that they should be holding 20% shares or they should be entitled to 20% profits of the business.

## 2. What type of payments are covered

These payments are listed in section 13(2):

Type of payment	Yardstick
Money or property of NGO is lent to key person	Whether sufficient security has been taken  Whether enough interest / compensation is being charged
Salary or allowances paid to key person by NGO	Whether these are reasonable <sup>4</sup> or high

<sup>3</sup> Exact definition is given in explanation 1 to section 13(3)

<sup>4</sup> 'Reasonable' is not defined. Salary in an alternative job can be a benchmark.

Type of payment	Yardstick
Services of NGO provided to key person	Whether enough remuneration was charged
Purchase of property (or shares / investments) from key person	Whether amount paid was too high
Sale of property (or shares / investments) to key person	Whether amount charged was too low
Income or property of NGO diverted to key person	Does not apply where the total value of property / income is One thousand rupees or less

## 3. Use of assets

Similar restrictions apply on use of NGO's assets by key persons. Following cases are mentioned in section 13(2):

Nature of use	Yardstick
Land, building or other property of NGO used by key person	Whether enough rent or compensation was charged
Funds of the NGO are invested in key person's concern (business or company)	Up to 5% of capital of key person's concern can be invested <sup>5</sup>

## Penalty

What happens if the Department finds a payment or transaction objectionable? The NGO can lose its income tax exemption under section 11 for the year. This means that it will have to pay income tax.

**Remember that section 13 does not prohibit payments to key persons.** It comes into play only when these payments may be unreasonably high.

<sup>5</sup> But even this may attract disqualification under section 13(1)(d)

However, the restrictions under these clauses are very complex and open to dispute. It would be better to avoid such payments / transactions, except where clearly necessary or justifiable (such as salary).

From 1<sup>st</sup> April 2000, there has been a small relaxation in case of hospitals and schools run by NGOs. The key persons<sup>6</sup> are allowed to use these facilities without affecting the exemption of the NGO.

## Audit Report

All NGOs with income<sup>7</sup> above Rs.50,000 in a year have to get an audit report for Income Tax. This report is in form 10B. Parts II and III of the report deal with these questions. The auditor has to report if any of the above things has happened.

This is not an easy task for auditors. The following gems show the conflict between professional expectations and need to keep the client happy:



Question <sup>8</sup>	Audit Comment
Did the NGO lend any money or property to a key person?	A secured loan of Rs.10,00,000 has been given by the Trust to the treasurer for ten years. The loan is secured against an equitable mortgage of the Trust office building in Pune. The rate of interest on this loan is 10% p.a. recoverable at the end of loan tenure along with the principal.
Are key persons using any NGO assets for personal purpose	None. The Managing Trustee has also confirmed in writing that the Trust ambulance is not being used everyday for ferrying her children to and from school.  Further, the four- room apartment provided to her is meant for use as office after main

<sup>6</sup> Associated concerns are still not allowed to use these facilities

<sup>7</sup> Income includes grants

<sup>8</sup> Reworded in simple English. Check part II of form 10B for exact requirements

Question <sup>8</sup>	Audit Comment
	office is closed in the evening.  In view of this, question of charging rent or compensation charged does not arise.
Has the NGO paid any salary or allowance etc. to a key person	No payment has been made to any such person by way of salary or allowance. The Managing Trustee is being paid a token honorarium of Rs. 3,000 only <sup>9</sup> .
Whether any services of the NGO have been provided to key persons	None. As the Trust does not provide gardening services to its beneficiaries, it can not be said that using the Trust staff to maintain Chief Functionary's lawn falls within this clause.
Has the NGO purchased any property / shares or investments from a key person	The trust has purchased 500 square yards of prime quality scrub-land at Lonavala from the Secretary at a very low price of Rs.15,00,000. This is only 50% of the price for a similar piece of land in Vashi.
Has the NGO sold any property / shares or investments to a key person	During the year 97-98, the Trust has sold one of its very old vehicles (Tata Safari) as its warranty period had expired. The Trust has already received a post-dated <sup>10</sup> cheque for Rs.4,00,000 as full and final payment.
Was any income or property of the NGO diverted to key persons?	None, so far appears from explanations given to us
Whether the income or property of the NGO was used for the benefit of key persons in any other way	None. The Treasurer has also explained that the refrigerator is moved to his house during summers only in view of power cuts in the area where Trust office is situated. The same is moved back to main office during winters when the power situation improves.

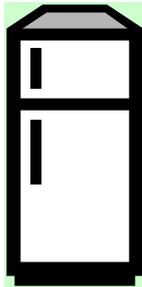
<sup>9</sup> Per day?

<sup>10</sup> Dated 31 December 2005?

## The unfortunate ones...

Has anyone lost tax exemption due to this? Yes, two examples from Current Tax Reporter are:

- ❑ Chandrika Educational Trust, Kerala lost its exemption for assessment years (a.y.) 73-74 and 74-75 because it had invested Rs.5,000 in Chandrika Enterprises. Some of the Trustees and their relatives had substantial interest in Chandrika Enterprises. Incidentally, the auditors had failed to bring this out in the audit report.
- ❑ Agappa Child Centre, Kerala purchased a refrigerator for Rs.5,445. This was kept at the residence of its Managing Trustee at Kottayam. The NGO explained that the refrigerator was kept there for use of its Swedish donors. They also said that the office of the NGO functioned for some time from the Trustee's residence. Therefore the refrigerator was kept there. Later when the building was completed, the refrigerator was shifted to office. The Department rejected both the arguments. It said that the refrigerator appeared to be purchased for use of the Trustee. Later the Kerala High court confirmed this. As a result, the NGO lost its exemption for a.y. 1980-81.



## Precautions...

It seems most NGOs get into trouble due to lack of knowledge. If you don't want to create legal history, think of the following steps:

- ❑ Start a register of key-persons. The register should be available to your accounts people.
- ❑ Track contributions of regular donors, especially if they work with you in other ways.
- ❑ Check the register yourself periodically. Does it include all your large donors (above Rs.50,000 in total, till date)? Think about your relatives, associates. Should any of them be listed here?
- ❑ Make sure that your accounts people understand section 13.
- ❑ If you want to pay any person who is associated with the Trust, consult your auditors before you do it.
- ❑ For transactions with key persons, take extra care about paper work. Make sure that the payment / charges are reasonable.
- ❑ Request your auditors to be tough when they look at section 13 payments. This can serve as an early warning system. Remember: it is easier to face the auditors rather than the Income Tax department.

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

AccountAid India also offers 'QuestionAble' (a complimentary service for NGOs) – answers to practical questions on this and related topics.

Your questions, comments and suggestions can be sent to AccountAid India, 55-B, Pocket C, Siddharth Extension, New Delhi-110 014; Phone: 011-2634 3128; Ph. Fax: 011-2634 6041; e-mail: [accountaid@vsnl.com](mailto:accountaid@vsnl.com);

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