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IMPACT OF FINANCE ACT 2008 ON BUSINESS ACTIVITIES OF NGOs

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OVERVIEW OF THE AMENDMENTS FROM A LAYMAN'S PERSPECTIVE

1.1 The Finance Act, 2008 w.e.f. 1-4-2009 has amended the definition of 'charitable purpose' under section 2(15) which may have far reaching ramifications, a brief overview of the resulting scenario is as under :

1.1.1 The definition of 'charitable purpose' can be divided into 4 parts, viz. (i) relief of poor, (ii) education, (iii) medical relief, (iv) advancement of any other object of general public utility. However, the Finance Act, 2008 w.e.f. 1-4-2009 has excluded any trade, commerce or business related activity by any trust or NGO engaged in the fourth category i.e. advancement of any other object of general public utility, from the purview of 'charitable

purpose'. In other words an NGO exclusively engaged in the field of education, medical relief and relief of poor shall not be hit by this amendment.

1.1.2 Therefore, w.e.f. 01.04.2009 it seems that income from trade, commerce or business pertaining to those NGOs which are coming under the fourth category of 'charitable purpose' shall not be treated as charitable activity and the entire exemption of such Trust will be lost. Consequently such organisations will not be eligible for any exemption under section 11 or other provisions which provide exemptions towards charitable purpose. It may be noted that the issue of incidentality of business will not be relevant to such group of NGOs whether the business activity is incidental or not, shall be of no consequence,

as this fourth category of NGO will lose the charitable status.

1.1.3 There is a confusion that only the business income of NGOs shall become taxable at the rate of 30%. It is clarified that once an NGO is hit by this provision it will lose its charitable status and the entire income will become taxable.

1.1.4 It is pertinent to note that all other NGOs (other than the NGO coming under the fourth category) can have business related activity as permitted under section 11(4A), and other provisions pertaining to business activities shall be applied without any changes.

1.1.5 Hitherto the law was very liberal with regard to the business activities of NGOs and even income from unrelated businesses (for example, publishing newspapers) held by them was eligible for exemption if the entire income was used for charitable purposes. The law will continue to remain liberal for the first three categories of NGOs.

1.1.6 It is important to note that the exclusion of trade or business related activities is discriminatory and will apply to only a particular group of NGOs or Trusts as discussed above. It is not clear why a particular group of NGOs will be discriminated even though the registration provides an *on par* status to all NGOs. The resulting scenario denotes an unfair legal situation where even an incidental business activity of the fourth category NGO will render forfeiture of the charitable status. On the other hand, for other NGOs even unrelated business activities might be permissible. The constitutional validity of such unfair provision needs to be verified.

1.1.7 Newly inserted proviso to section 2(15) lays down the 'specified activities'. They are :

- Carrying on of any activity in the nature of trade, commerce or business (hereafter referred to as 'the trade');
- or

It is clarified that once an NGO is hit by this provision it will lose its charitable status and the entire income will become taxable.

- Carrying on of any activity of rendering any service in relation to the trade, for a fee or cess or any other consideration.

The proviso further lays down that if the specified activities are carried on in pursuit of the fourth object, then it would not be considered as a charitable purpose.

1.1.8 It may be noted that NGOs or trusts engaged in the fourth objective shall continue to be eligible under section 11 unless they engage in trade or business related activity.

1.1.9 It may also be noted that the current amendments are prohibiting business activity and not *profit making*. In other words such fourth category NGOs may still have some profit through various sources of income generation other than business. Therefore, going by various case laws activities such as sale of greeting cards, charity shows, rent from property, income from Mandaps or conferences facilities shall still be permissible and valid. The Finance Minister has promised that genuine NGOs will not face any hardship and explanatory circular in this regard is expected to be released by the CBDT. Only after the explanatory circular in this regard it will be clear what kind of activities would not be treated as business activities for NGOs.

1.1.10 Other charitable organisations such as chamber of commerce, professional associations, etc shall not be affected by the amended provisions unless they are specifically charging fees towards promotion

of trade or commerce. The activity of Chamber of Commerce, Port Management etc *per se* are considered as charitable activities, therefore, if some surplus are generated in the normal course of their operations they will not be affected by the amendments.

1.1.11 All Trusts or NGOs pursuing the fourth objective need to analyse their activities and find out the activities for profit, if any, related with business, trade or commerce. The normal legal precedence is to make the law effective from the first day of the Assessment Year, therefore, when the Act says *w.e.f.* 01.04.2009 then the implication is that all business activities need to be stopped *w.e.f.* 1.4.2008 to retain the status as charitable organisation. In this context it may be noted that the Finance Act was passed in the month of May 2008 and therefore, for the current year there is no option provided to the NGOs to take remedial measures if the law becomes effective from 01.04.2008. The intent of the statute could not have been to impose this provision retrospectively without providing any opportunity for remedial measures. Normally the amendments apply from the beginning of the Assessment Year, but since this change is in the definition of *charitable purpose*, the applicability, in our opinion, should be from 01.04.2009 because the old definition of charitable purpose will remain effective till 31.03.2009. A suitable clarification from the government/CBDT is necessary in this regard.

CHANGES MADE BY FINANCE ACT, 2008 W.E.F. 1-4-2009

1.2 The Finance Act, 2008 *w.e.f.* 1-4-2009 has amended the definition of 'charitable purpose' under section 2(15) and consequently certain specific group of NGOs will not be allowed to have any business activity whether incidental or otherwise, the amended section is as under :

The trade or business related activity carried out in relation to the other three categories of charitable purpose would still remain charitable in nature.

"charitable purpose" includes relief of the poor, education, medical relief, and the advancement of any other object of general public utility :

Provided *that the advancement of any other object of general public utility shall not be a charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity;*

1.2.1 The proviso in italics above has been inserted by the Finance Act 2008. In effect the above amendment has excluded the residual category of trusts from carrying on any kind of trade or business related activities.

2008 AMENDMENTS ARE SOFTER THAN THE 1961-1984 POSITION

1.3 The current amendment in some sense are taking the law back to the legal position of the period between 1961 to 1984. It may be noted that when the act was enacted in 1961 the definition of charitable purpose stood as under :

"Charitable purpose" includes relief of the poor, education, medical relief, and the advancement of any other object of general public utility *not involving the carrying on of any activity for profit.*

1.3.1 The words '*not involving the carrying on of any activity for profit*' were added in 1961 which were not there in the 1922 act. Secondly, the words were added only to the fourth limb of the definition of the charitable purpose. In other words, only the activities towards advancement of general public utility should not involve carrying on any activity for profit. For the other three limbs medical, education and relief to poor profit making activity was permissible. This position was again reverted back to 1922 level by the amendments made by the Finance Act 1983 w.e.f. 1-4-1984 when the words '*not involving the carrying on of any activity for profit*' were omitted and the fourth limb i.e. advancement of general public utility was brought on par with the other three limbs of the definition of charitable purpose. Now the current amendment has brought back the legal position to a period prior to 1-4-1984. As a matter of fact, on a strict analysis the current amendments are in a diluted form because the words '*not involving the carrying on of any activity for profit*' have not been re-enacted. In other words, profit making is still permissible provided it should not come from activities related with trade business and commerce. In the past, various types of income making activities have not been held as business activities such as *Charity Shows* or running *Kalyan Mandapam*, rental income from property or even *Printing and Selling new year cards*. Such activities once out of the purview of business/commercial income should still be considered permissible even after this amendment which was not possible prior to 1-4-1984.

EXPLANATORY STATEMENT AND LEGAL INTENT

1.4 The stated legal intent is to deny exemption of purely commercial and business entities which wear a mask of a charitable organisation. It needs to be seen to what extent

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these amendments prove appropriate in context of the intended objectives. The memorandum explaining the provisions of the Finance Bill, 2008, read as under :

"Section 2(15) of the Act defines 'charitable purpose' to include relief of the poor, education, medical relief, and the advancement of any other object of general public utility.

It has been noticed that a number of entities operating on commercial lines are claiming exemption on their income either under section 10(23C) or section 11 of the Act on the ground that they are charitable institutions. This is based on the argument that they are engaged in the 'advancement of an object of general public utility' as is included in the fourth limb of the current definition of 'charitable purpose'. Such a claim, when made in respect of an activity carried out on commercial lines, is contrary to the intention of the provision.

With a view to limiting the scope of the phrase 'advancement of any other object of general public utility', it is proposed to amend section 2(15) so as to provide that 'the advancement of any other object of general public utility' shall not be a charitable purpose if it involves the carrying on of –

- (a) any activity in the nature of trade, commerce or business, or
- (b) any activity of rendering of any service in relation to any trade, commerce or business.

for a fee or cess or any other consideration, irrespective of the nature of use or application

of the income from such activity, or the retention of such income, by the concerned entity.

1.4.1 It is also worthwhile to note the following relevant extracts from the reply of the Finance Minister to debate in the Lok Sabha on 29-4-2008 on Finance Bill, 2008 :

"6, Clause 3 of the Finance Bill, 2008 seeks to amend the definition of 'charitable purpose' so as to exclude any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature or use of application, or retention, of the income from such activity. The intention is to limit the benefit to entities which are engaged in activities such as relief of the poor, education, medical relief and any other genuine charitable purpose, and to deny it to purely commercial and business entities which wear the mask of a charity..... I once again assure the House that genuine charitable organisations will not in any way be affected. The CBDT will, following the usual practice, issue an explanatory circular containing guidelines for determining whether an entity is carrying on any activity in the nature of trade, commerce or business or any activity of rendering any service in relation to any trade, commerce or business. Whether the purpose is a charitable purpose will depend on the totality of the facts of the case. Ordinarily, Chambers of Commerce and similar organisations rendering services to their members would not be affected by the amendment and their activities would continue to be regarded as "advancement of any other object of general public utility."

CHARITABLE PURPOSE, BUSINESS ACTIVITY AND PROFIT MOTIVE

1.5 In the light of the amendments made by the Finance Act, 2008 w.e.f. 1-4-2009 it

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has become imperative to carefully understand the differences and implications of the scope of charitable purpose, business activity and profit motive. The legal scenario in this regard could be as under :

1.5.1 A particular class of NGOs will lose their recognition as a charitable organisation if they have any activity in the nature of trade, commerce or business irrespective of whether it is incidental activity or not. The NGOs coming under this category are those which are pursuing advancement of any other object of general public utility. Therefore, section 11 to 13 will not apply to such NGOs.

1.5.2 Business or trade activities of other NGOs pursuing any of the three objectives (i) relief of poor, (ii) education, (iii) medical relief will not affect the charitable nature of such NGOs and therefore, section 11 to 13 will apply accordingly. Though under section 11(4A) only incidental business activity is allowed, but there is a strong judicial precedence including Supreme Court rulings where even unrelated businesses held as property of the trust are treated as incidental provided the entire income is applied for charitable purposes. Ironically, the amendments made by The Finance Act, 2008 w.e.f. 1-4-2009 do not seem to be affecting this position and eligible NGOs shall enjoy a *status quo* as far as the law pertaining to business income is concerned.

1.5.3 In the definition of 'charitable purpose' the words "*not involving the carrying on any activity for profit*" were deleted by The Finance Act, 1983 w.e.f. 1-4-1984. Therefore, business or profit making activity *per se* are not excluded from the overall scope of charitable purpose. But the debate still remains that 'profit motive' and 'activity for profit' are two different notions and the existence of the former may affect the charitable nature of the NGO, and therefore, may also endanger the exemptions available under section 11. In a recent case *Vodithala Education Society v. ADIT (Exemptions) II, Hyderabad* : [2008] 20 SOT 353 (HYD.) it was held that assessee had collected money over and above fee prescribed by concerned authority for admission of student, such an amount of capitation fee was a clear case of sale of education by assessee and, therefore, it could not be considered as charitable institution under section 2(15) because the purpose of the organisation as a whole was to make profit.

1.5.4 Satisfying the criteria of 'charitable purpose' is the fundamental pre-requisite for the purposes of income-tax registration and availing the exemptions under section 11 of the Income-tax Act, 1961. The amendment made by The Finance Act 2008 will have wide implication on a large number of Trusts and NGOs which are coming under the fourth arm of 'charitable purpose' i.e. *the advancement of any other object of general public utility*. Now onwards the scope and interpretation of the clause *the advancement of any other object of general public utility* shall become one of the most important issue as far as the taxation and exemption of Trusts and NGOs is concerned.

1.5.5 Further it should be noted that section 11(1), under which NGOs get exemptions, envisages a NGO wholly for charitable purposes. Therefore, if any portion of its activity does not satisfy the definition of charitable purpose, then the entire income will be subjected to tax.

In a recent case it was held that assessee had collected money over and above the fee prescribed by concerned authority for admission of student, such an amount of capitation fee was a clear case of sale of education by assessee and, therefore, it could not be considered as charitable institution under section 2(15)

PROFIT IS NO LONGER A RELEVANT FACTOR

1.6 The words "*not involving the carrying on of any activity for profit*", were not there in the 1922 Act and were added for the first time only when the new Act was enacted in 1962, and after 22 years, these words were again deleted by Finance Act, 1983, w.e.f. 1-4-1984 consequently, the old legal position was restored, i.e. profit making was no longer considered as a prohibited activity. The profit generated by a charitable organisation shall not, in principle, affect its charitable nature. However, if the motive primarily is to generate profit, then the charitable nature can be questioned. As discussed earlier in this chapter in *Vodithala Education Society v. ADIT (Exemptions) II, Hyderabad* : [2008] 20 SOT 353 (HYD.) it was held that assessee had collected money over and above prescribed by concerned authority for admission of student, such an amount was to be classified as capitation fee and it could be said that assessee's case was a clear case of sale of education by assessee and, therefore, it could not be considered as charitable institution under section 2(15) because the purpose of the organisation as a whole was to make profit.

1.6.1 Even after the amendments of 2008, the existence of profit shall not affect any NGO including the aforesaid fourth category NGOs. But if there is an outright motive to earn profit then it can be questioned and all category of NGOs may lose exemptions. And if there is a business activity then only the fourth category of NGOs will lose exemption.

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SUPREME COURT IN THANTHI TRUST AND GUJARAT MARITIME CASE

1.7 In the case *Asstt CIT Vs Thanti trust (2001)247 ITR 785(SC)*, the Supreme Court had given a landmark decision wherein it was held that if the income generated from a business is totally used for charitable purposes then such business should be considered as incidental. In this case, the assessee was having the business of publishing newspaper and the entire income was used for charitable purposes.

1.7.1 The delicate issue to understand here is that newspaper publication as a charitable activity is not permissible, but if such business is held as a property under trust, then it is permissible. The Finance Act, 2008 w.e.f. 1-4-2009 has made a very fundamental change by excluding a group of Trusts from engaging into trade and business related activities. Therefore, those trusts which are pursuing the fourth category of objects under 'charitable purpose' i.e. advancement of any other object of general public utility are debarred from having any trade or business related activity. The issue to understand here is that a particular group of trusts or NGOs have been excluded *ab initio* (that is from the very beginning) before section 11(4) or (4A) become relevant.

1.7.2 Therefore, in our opinion the legal and judicial position (as taken in *Thanti case*) should remain intact as far as the business or

trade related income is concerned, even after the amendments made by Finance Act, 2008 w.e.f. 1-4-2009. The controversy is around the nature of charitable purpose which a trust is pursuing if it does not fall in the category of (i) relief of poor, (ii) education, (iii) medical relief, then any trade or business related activity whether incidental or not shall result in revocation of the entire exemption.

1.7.1 Therefore, after this amendment if *Thanti Trust* is having activities which falls in the fourth category i.e. *advancement of any other object of general public utility* then it will no longer be considered as a charitable organisation. Similarly, in a recent case *CIT vs. Gujarat Maritime Board* [2008] 214 CTR (SC) 81, 295 ITR 561 (SC) it was held that the income earned and deployed for the development of the minor ports in India was a charitable activity and therefore, the Gujarat Maritime Board would continue to remain a 'charitable trust'. Now after the amendment if *Gujarat Maritime Board* is holding independent business activity whose profit feed the charitable work then the exemption will be lost. On the other hand if some profits are generated during the normal course of its charitable activity, then its charitable existence will remain intact. Because *Gujarat Maritime Board* is clearly a fourth category charitable organisation. The same analysis will be different for a medical, educational or an NGO engaged in relief for poor, who are not hit by the recent amendments.

BUSINESS PURPOSE VS ACTUAL BUSINESS ACTIVITY

1.8 It should be noted that the amendments have been made in the section defining charitable purpose, therefore, even if the fourth category NGO has in its objectives a clause pertaining to business activities, then also the provisions of section 2(15) will be attracted. In other words, NGOs need to amend their object clause and delete the business related clauses from their Memorandum of Association or Trust Deeds to avoid the attraction of section 2(15). Because there will be a possibility of questioning the charitable nature of an NGO even if it does not have any actual business related activities.

NGOs HAVING MIXED PURPOSES

1.9 In the case of NGOs having mixed purposes e.g. working both on education and advancement of any other public utility, even if a small portion of the activity falls in the fourth category of charitable purpose the recent amendments will be attracted which means the NGO stands to lose its Income Tax exemption.

THE PROCESS OF LOSING CHARITABLE STATUS

1.10 As discussed earlier the explanatory circular is yet to be released and there is no clearcut guideline regarding the legal process through which an NGO would lose its charitable status. It seems that once section 2(15) is violated, the NGO automatically loses its charitable status. But nothing has been spelt out regarding providing an opportunity of being heard.

1.10.1 Under section 12AA(3) the Commissioner of Income Tax (CIT) has the power to cancel the registration if the activities

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are not genuine or not being carried out in accordance with the objects of the trust. The provision of Section 12AA(3) is as under :

Where a trust or an institution has been granted registration under clause (b) of sub-section (1) and subsequently the Commissioner is satisfied that the activities of such trust or institution are not genuine or are not being carried out in accordance with the objects of the trust or institution, as the case may be, he shall pass an order in writing cancelling the registration of such trust or institution:

Provided that no order under this sub-section shall be passed unless such trust or institution has been given a reasonable opportunity of being heard

1.10.2 The section does not specifically cover the situation where the objects cease to remain charitable from a particular date. This is an anomaly because a valid charitable organisation deserves an opportunity of being heard before its charitable status is revoked. Therefore, NGOs may face hardship during assessment itself where the income tax officer may treat them as Association of Person (AOP)/individual assessee subject to normal tax on the entire income. That will be possible only if it is conclusively settled that the NGO is engaged in business activities or its object clause contain activities involving business, trade and commerce.

STEPS TO BE TAKEN BY NGOS

1.11 All NGOs should verify the object clause as per the Memorandum of Association or the Trust Deed, if there is any clause about carrying on business activities then such clause should be amended.

1.11.1 A separate organisation should be floated for carrying on business activities, even if such activities are incidental to the purposes of society.

1.11.2 Before making any divestment of business activity it would make sense to wait for the explanatory circular to be issued by CBDT which is expected by the end of this year. This circular will provide the list of activities which will not be considered as business activities.

1.11.3 Going by the statute and various case laws, activities such as

- rent from properties
- income from conference halls
- income from one time activities such as charity shows, etc.
- professional service related with expertise incidental to charitable work, etc

shall not be considered as business income. However, absolute legal clarity will come only after the release of the explanatory circular.

CONCLUDING REMARKS

1.12 The recent amendments seem to be arbitrary and unfair towards genuine NGOs working at the grassroot. The problem in our country is that the same set of law apply for all categories of NGOs, right from a village level organisation to a national level organisation. This amendment may affect huge organisation like Board for Control of Cricket in India (BCCI) and at the same time it may also impact a small Gandhian

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NGO which works on the principle of Swaraj and manufactures and sells indigenous products. It is very important that immediate remedial statutory measures are taken. For instance, the Government may consider exempting, say, incidental business income upto 5 or 10 lakh per year which will save thousands of genuine NGOs from possible harassment. Further depriving one whole class of NGOs only under an apprehension that there are certain commercial organisations in disguise of NGOs, defies natural justice and the constitutional validity of such amendment needs to be questioned.

Reference Book : **Taxation of Trust and NGOs with FCRA** by **Manoj Fogla**, published by TAXMANN Publications.

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