

Implications arising from Amended Definition of Charitable Purpose

Serial No.	Adverse Implication of Amended Section 2(15)	Problems being Faced	Request Being Made
1	No Opportunity Provided to Eschew Activities not covered by amended definition of 'Charitable purpose'.	<p>1. Substantial lack of awareness of the change in the definition.</p> <p>2. Some time is required to eschew the activities not covered by the amended definition. <u>This implies transferring of staff to a new entity and this has Provident fund implications; land and building provided by government for specific purposes and hence obtaining fresh sanctions from the government e.g. hostels for children women in distress, working women, or community halls etc.</u></p> <p>3. No opportunity to eschew activities not covered by the amended definition. There are many old charitable institutions, which have been functioning for a long time and are adversely affected.</p>	<u>Grant a moratorium of three years</u> before implementing the change in the definition of charitable purpose so that the charitable institutions can eschew activities not covered by the amended definition of charitable status.

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2.	Adverse Impact on Multi Objective Charitable Institutions	1. There are a large number of charitable institutions undertaking multiple objectives i.e. relief to the poor education / medical activities and also any other object of general public utility and receive fee, cess or other consideration towards the advancement of any other object of general public utility. Such organizations will loose their charitable status even with regard to the first three limbs i.e. relief of the poor, education and medical relief.	1. <u>Permit multiple objective charitable institutions to retain their charitable status for the activities relating to relief to the poor, education and medical relief</u> and any activities related or incidental thereto should continue to be assessed as charitable activities. 2. <u>Such institutions be asked to maintain separate books of account for undertaking activities covered under the advancement of any other object of general public utility and for which any fee, cess or for any other consideration is received. Such activities can be taxed separately.</u>
3.	Grants Do Not Permit Payment of Taxes	1. Once the charitable organization loses its charitable status it will have to pay tax on the income received as grant and pending full utilization during the year e.g. grants received from the government, from the European union, UN agencies etc. 2. There is no money to pay taxes out of such grants.	1. <u>Granting a moratorium of three years</u> before implementing the change in the definition of charitable purpose so that the charitable institutions can eschew activities not covered by the amended definition of charitable status and 2. <u>Permit multiple objective charitable institutions to retain their charitable status and the activities relating to relief to the poor, education and medical relief</u> and any activities related or incidental thereto should continue to be assessed as charitable activities. 3. <u>Tax the fourth limb where fees are charged once the above is permitted.</u>

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4.	Cancellation of Registration u/s 12A as a Charitable Institution	1. Where an organization has undertaken activities of general public utility and charged a fee or other consideration, then such activity would not be a charitable purpose. The next step by the income tax department would be to cancel the 12A registration u/s 12AA(3) of the Income tax Act 1961. <u>In the next year when the institution ceases to undertake any activity of general public utility for a fee it will have to once again seek registration u/s 12A, whereas this could be denied since in the previous year the income tax department has already taken an adverse stand and cancelled its 12A registration.</u>	1. Permit the charitable institution to retain its charitable status registration u/s 12A though tax can be levied.
5.	Levy of Penalty	1. When an organization is not held to be covered by the definition of charitable purpose, tax would be levied and then penalty would be levied and penalty proceeding will be initiated.	1. Since this change is for the first time and there is lack of awareness, penalty should not be levied. 2. <u>Granting a moratorium of three years</u> before implementing the change in the definition of charitable purpose so that the charitable institutions can eschew activities not covered by the amended definition of charitable status will help. 2. <u>Permit multiple objective charitable institutions to retain their charitable status and the activities relating to relief to the poor, education and medical relief</u> and any activities related or incidental thereto should continue to be assessed as charitable activities. This would greatly help.

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6.	Adverse Impact Where the Memorandum of Association has General Public Utility Objectives	1. A large of number of charitable institutions have multifarious objectives and some of these objectives relate to undertaking BUT such organizations may not be actually undertaking objectives of general public utility for a fee. The income tax department has always contested object clauses in matters relating to section 10(23C) and there is unnecessary litigation. Here again a large number of charitable institutions would be faced with litigation.	1. Permit charitable organizations to have the charitable status if they do not actually undertake objects of general public utility for any fee, cess or other consideration. In such a situation the objects clause need not be amended.

Conclusion: In view of the above the difficulties being faced by genuine charitable organizations need to be addressed and that they should not be put to hardships and taken through litigation. In the absence of any grace period most of the charitable organizations are being adversely affected. The level of awareness amongst the charitable organizations about the change in the definition of "charitable purposes" is quite low at this stage and it would only be fair if first awareness is created for which a grace period of three years is required. It would be appropriate to penalize errant organizations that 'wear the mask' rather than all charitable organizations, which render services by raising resources on their own. In charging some fees or consideration the persons or stakeholders making the payment derive a stake or self satisfaction in the development work or are able to access facilities at very nominal charges, which would otherwise be difficult to access.

IMPLICATIONS ARISING FROM AMENDED DEFINITION OF CHARITABLE PURPOSE

The Finance Act, 2008 w.e.f. 1-4-2009 has amended the definition of 'charitable purpose' under section 2(15) which has far reaching implications on the voluntary sectors. An explanatory Circular No. 11/2008, New Delhi, the 19th December, 2008; F. No.134/34/2008-TPL, has also been issued in this regard. However, there are some concerns which need considerate attention:

ADVERSE IMPACT ON A PARTICULAR CATEGORY OF CHARITABLE INSTITUTIONS

The definition of 'charitable purpose' is divided into 4 parts, viz. (i) relief of poor, (ii) education, (iii) medical relief, (iv) advancement of any other object of general public utility. The Finance Act, 2008 w.e.f. 1-4-2009 has excluded the fourth limb organisations i.e. advancement of any other object of general public utility, from engaging in any trade, commerce or business related activity. The NGOs exclusively engaged in the field of education, medical relief and relief of poor will not be hit by this amendment. There is an unqualified and open prohibition of incidental business activities only for the fourth limb NGOs. The NGOs which fall in the fourth limb shall be affected even if they are engaged in education, medical relief and relief to poor. Commercial activities can happen in all categories of NGOs including education and medical sector, it is not clear why only the fourth limb has been identified.

THE AMENDMENT IS NOT IN CONSONANCE WITH THE LEGISLATIVE INTENT

The legislative intent was to prevent entities which are misusing the exemptions available under Income Tax Act by doing commercial activities under the garb of charity. Some relevant portion from the memorandum explaining the provisions of the Finance Bill, 2008 are as under :

"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."

In our opinion the charity exemptions are prone to misuse in all spheres including medical and educational sector. It would be highly unfair and unjust to assume that commercial entities are misusing the charitable status only as the fourth category NGOs engaged in advancement of any other public utility. However, the fact remains that commercialisation is happening through educational and medical institutions. There are judicial instances where educational institutions have been considered as commercial entities. 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. Therefore, the correct approach would be to identify those NGOs which engaged in business with profit motive and to evade tax, in all the four limbs. And not to deprive genuine NGOs from incidental business activities which is integral to its charitable objectives.

CERTAIN BUSINESS ACTIVITIES WHICH SHOULD BE TREATED AS EXCEPTIONS

The Hon'ble Finance Minister had promised on the floor of the Parliament that genuine NGOs will not suffer and their concerns shall be addressed through an explanatory circular. However, the circular has not provided the list of activities which shall not be treated as commercial in nature. This amendment will affect many genuine NGOs where such activities are an integral part of their development work. For example, **a small Gandhian NGO which works on the principle of Swaraj and manufactures and sells indigenous products will be treated as a commercial entity.** There is an immediate necessity to provide clarification on the implication of this amendment. The above mentioned explanatory circular has also not provided the activities which should not be considered as business in context of NGOs. It is important that the following activities should be treated as permissible :

- Marketing indigenous and other products manufactured by beneficiaries and communities.
- Income of rural self-reliant NGOs.
- Income from Consultancy related with expertise incidental to charitable work.
- Income/Rent from properties and infrastructure
- Income from Training and Capacity Building.
- Income from one time activities such as charity shows, etc.

THE AMENDMENTS SEEM TO BE AGAINST CONSTITUTIONAL PROVISIONS

The constitutional validity of the amendment section 2(15) and the explanatory circular thereof seriously comes into reckoning, even though the judicial precedence generally is in favour of revenue and provides considerable leeway of discrimination with regard to economic and tax laws. *In Shri Ram Krishna Dalmia vs. Justice S.R. Tendolkar AIR 1958 SC 538*, the Supreme Court laid down the principles with regard to judging the Constitutional validity of various statutes. It stated that generally there is a presumption in favour of the constitutionality of enactment and the burden is upon someone who challenges it to prove that there is a clear violation. However, it further laid that in case of discrimination in favour or against any class, the presumption of constitutionality cannot be carried to the extent of holding that there must be some undisclosed and unknown reasons for subjecting individuals or corporations to hostile or discriminating legislation. If we study the impact of the amendment and the circular it is clear that the fourth category NGOs can not have

even incidental business activity, which is contrary to the explanation provided in the first para i.e. to deprive only the entities engaged in commercial activities. This position taken by CBDT seems to be in conflict of article 14 of the Constitution which does not permit generalised discrimination. Because the fourth category of NGOs is the residual category and all NGOs other than the first three category shall fall in it, therefore, it cannot be considered as a *specific class* to be discriminated. Moreover, the intent of the amendment is to stop commercial entities from claiming tax exemptions but the result is that all the genuine NGOs are also denied incidental business activities which are permissible for the first three category of NGOs. These amendments in effect are targeting an undefined residual class for definite reasons. The entire fourth class has been targeted under the premise that there might be some commercial and masked entities. The reasons for presuming that commercial entities are there only in the fourth category have also not been provided. In the Supreme Court in *Arun Kumar vs. Union of India (2006) 286 ITR 89 (SC)* reiterated that a liberal interpretation should always be made in favour of the statute in order to avoid constitutional invalidity. However, it also made it clear that discrimination under article 14 of the Constitution should be under a classification based on intelligible differentia which is otherwise legal, valid and permissible. In the instant case of the business income of NGOs there seems to be no apparent basis of classifying the open ended residual fourth category as a definite class for discrimination. For example, this amendment will affect huge organisation like Board for Control of Cricket in India (BCCI) and at the same time it may also impact a small Gandhian NGO which works on the principle of Swaraj and manufactures and sells indigenous product, considering both of them as one class and at the same time making the first three categories of NGOs (including medical and educational institutions) the privileged class does not seem to be constitutionally sustainable and legally intelligible.

THE IMPLICATIONS OF THE AMENDMENTS ARE VERY HARSH

Under the current provisions even an insignificant amount of incidental business activity will result in forfeiture of the entire exemptions. It is very unfair and harsh, rather only the business income should be brought to tax. In this regard it is important that the following safeguards are provided :

Only the business income shall be brought to tax by enacting a section similar to section 115-BBC. It may be noted that NGOs having anonymous donations are required to pay taxes to that extent under section 115BBC. In other words, NGOs doing incidental business activities should be taxed on their business income only and should be treated as charitable organisations. An NGO which is found to be a masked entity should be subjected to cancellation of 12A registration. **It may be noted that even without these amendments a masked entity registration can be cancelled under section 12AA.**

The CBDT should also consider setting a limit or percentage upto which incidental business activities can be conducted. Currently even an insignificant amount of business activity will render the entire organisation as commercial in nature.