Charities in Direct Taxes Code Bill, 2010

Is there any change proposed in the Direct Taxes Code Bill as regards the concept of charity?

Reference to charitable trusts and institutions will be replaced by the expression non-profit organisation in the Code. But definition of charitable purpose in Sec. 2(15) of the Income-tax Act is the same under Sec. 103 of the Direct Taxes Code, 2010. Sec. 2(15) of the Income-tax Act, 1961, had undergone drastic amendment by the Finance Act, 2008, primarily intended to bar exemption for those charitable institutions with the objects of "advancement of any other object of general public utility", if they are in an activity charging cess, fee or any other consideration presumed to be business, even though such activity may be incidental to its objects.

The effect of the same may well be that institutions to promote Gandhian ideal of ahimsa, promotion of arts and music, promotion of language and literature, community centres, promotion of safe driving and road sense, animal welfare, promotion of sports, widow marriage, running a public park, running a newspaper, promotion of civic consciousness and promotion of research falling under the object of general public utility will all lose exemption, if they charge fees for some minor service or sell booklets pertaining to such objects, though incidental to such objects. The entire income including income from investments would also be liable for tax.

There have been representations for at least shifting the new restraints in the amendments from the definition of charitable purpose in Sec. 2(15) to Sec. 13, so that liability will be limited to such income from business sparing at least income from investments from corpus fund. This unfair amendment to law would be carried over in the proposed Code. There is need for review of this unfair provision in the new Code.

Will there be a change in the method of computation of income of charitable organisation?

The present law expects the method of computation to accord with generally accepted principles of accounting. But Sec. 92 of the Code would prescribe a method of computation.

While providing for cash system of accounting, it requires gross receipts as reduced by the outgoings to be adopted as income of the year. But then, gross receipts, as defined, will take into account voluntary contributions excluding corpus donations and loans, while including all the incomes from other voluntary contributions, income from business incidental to permitted objects like relief of the poor, education and medical relief, besides sale proceeds of capital assets. The permitted outgoings are expenses on running the charity, but excluding capital expenditure and amounts applied outside India unless permitted by notification. Since capital receipts are taken into account, denial of capital expenditure would not be in order, but such capital expenditure which is exclusively for earning income and those capital expenses matching capital receipts would be allowable, so that it should only be capital gains that should be part of total income. The unexpended income, which is permitted for accumulation for three years in Sec. 94(f) of the Code cannot exceed the limits of either 10 per cent of gross receipts or 15 per cent of total income, whichever is higher. There is relaxation of the earlier proposal in permitting accumulation for three years as against the present five years, which itself was reduced from ten years. The unexpended excess over this limit will be taxable at 15 per cent.

Are the conditions relating to investments and bar on any personal benefit continued in the Code?

The investment regulations under Sec. 11(5) of the Income-tax Act, 1961, are continued in Sec. 95 of the Code. Similarly, the bar against use of any of the assets or income for the benefit of interested persons under Sec. 13 of the present Act is continued under Sec. 97 of the Code.

Are there any changes in registration proceedings?

The procedure for registration presently under Sec. 12A and 12AA are repeated under Sec. 98 of the Code.

It is reported that there is an innovative provision for taxing the net worth of a charitable institution on its cessation or on its non-qualification as a non-profit organisation. What is its purpose?

Sec. 101 of the Code would provide for taxing the entire net worth of a non-profit organisation at 30 per cent, if it converts or merges with a form of organisation ceasing thereby to be a non-profit organisation or fails to distribute its assets on dissolution to any other non-profit organisation within a period of three months. The purpose is to withdraw the exemption, which had been allowed and which is presumed to be now part of net worth, as unexpended income.

It may be correct to withdraw exemption availed on amounts, when it ceases to be available for charitable purposes only if the entire net worth consisted of such exempted amount. Only that part of unexpended amount on which exemption was allowed and which is continuing as part of net worth and not the initial corpus or corpus donations or tax paid amounts forming part of net worth, should be vulnerable. There is no logic in taxing the entire net worth.

What is the treatment of anonymous donations?

Tax on anonymous donations in excess of 5 per cent of total donations or Rs.1 lakh, whichever is higher, is liable to tax at 30 per cent under Sec. 115BBC of the present law. This is to be continued under Sec. 100 of the Code.

There is a view that where business itself is held in trust or where it feeds the charity, such income should be exempt. Will that law continue?

The doubt on this point in present law is now proposed to be statutorily resolved under Sec. 102 of the Code so that business in any form would lose the exemption unless such business is incidental to the three objects, namely, relief of the poor, education and medical relief for which it is permitted.

How are public bodies and religious trusts and institutions proposed to be treated under the new law?

The Seventh Schedule of the Code lists the persons, entities or funds, which are not liable to tax. Organisations of public importance listed therein and those which may be notified by the Central Government are exempted under Sec. 90 of the Code. State funds like Prime Minister's National Relief Fund and public institutions now exempt like Coffee Board, Provident Funds and authorities created by the State or Central Act now exempt under Sec. 10 are listed for exemption under this Schedule.

As for religious organisations, regulatory authorities for administration of public religious and charitable trusts, endowments (including maths, temples, gurudwaras, wakfs, churches, synagogues, agiaries or other places of public religious worship) are exempt.

Entry 39 of the Seventh Schedule would exempt public religious trusts and institutions, subject to the conditions that they are registered under the Code and registered under the State Act, if any, and they apply the income wholly for public religious purposes, maintaining books of accounts and complying with investment regulations as are applicable for other charitable institutions without any benefit to any interested persons.

The main constraints on non-religious public institutions requiring application of income as computed in the manner specified in the statute within the specified time limit would have no application. Anonymous donations would also not suffer tax in the hands of such public religious trust.

How is the tax computed for a charitable institution?

A non-profit organisation which is denied exemption should ordinarily be taxable at normal rate as in the case of Association of Persons or a society.

If, however, it is a non-profit organisation recognised as such, but has not been able to utilise its income, subject to accumulation for three years, the tax could be at 15 per cent on amounts in excess of basic exemption limit of Rs.1 lakh vide para (C) of Part I of the First Schedule in the Code.

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Source: The Hindu

Capital versus revenue expenditure

Capital expenditure consists of the expenditure incurred to bring in to existence a new identifiable asset or to clear off an existing liability.

Accounting Standard 10 (dealing with fixed assets) lays down three situations to determine if an expenditure is capital in nature:

Where, as a result of an expenditure i) a new identifiable asset is created; ii) the life of an existing asset is increased beyond its original estimated economic life; or iii) profitability of the entity is increased.

As a result, the asset account is to be debited and carried to balance-sheet under the head 'fixed assets'. Where a liability is cleared off, the reduced value is carried to the balance-sheet.

The frequency or value of the expenditure does not determine whether the expenditure is capital or revenue in nature. There could be non-recurring revenue expenditure or a recurring capital expenditure.

Inaugural expenditure is revenue in nature, which happens only once in the lifetime of the entity, whereas if an entity keeps on adding facilities, or computers or furniture, it would be recurring expenditure which is capital in nature.

Similarly, it is not necessary for capital expenditure to be of a high value. It could be of small value, say, a motor for a machine or an accessory for a fixed asset (such as a computer table or a fluorescent lamp).

If a CD player is bought to fit in a car, it would be capital expenditure, but if heavy expenditure such as on overhauling of machinery, painting a car and changing its upholstery, etc., is incurred, it does not qualify as capital expenditure.

Capital becomes revenue

There are provisions in the Companies Act to treat capital expenditure as revenue, where the unit value of an asset is less than Rs 5,000. Accordingly, if an entity buys 20 air-coolers, each costing less than Rs 5,000, it is justified in debiting the entire cost of such coolers to profit and loss account in the year of purchase.

However, provisions of this nature do not exist in the Income Tax Act.

Concept of materiality

The concept of materiality comes into operation while dealing with capital expenditure of small value. In fact, purchase of CDs, pen drives, calculators, even books qualifies to be capital expenditure by nature of the transaction and going by the terms of AS 10. But based on the concept of materiality, they are expensed out through the profit and loss (P&L) account.

Fixed asset

A fixed asset is one which is held and used by the entity in the course of its revenue generation. The entity does not deal in those items. A motorcar or an apartment would be fixed asset for the buyer, while it constitutes a current asset to the dealer or builder. A fixed asset need not be immovable. There could be

movable fixed assets (such as a motorcar). Ownership and exclusiveness are essential to constitute a fixed asset. It is permissible to have a joint ownership of a fixed asset.

At times, entities might be required to bear the expenditure in providing a facility, but the ownership vests with others. It is possible for an entity being asked to bear the cost of poles for transmission of power to its unit.

The cost of these poles is met by the entity but it does not retain the ownership. Similarly, the entity may be required to bear the cost of laying an approach road to connect it to the main road. The road does not belong to the entity.

There was an instance where a cement manufacturing unit located along a railway track observed its employees losing lives in their effort to cross the track in their hurry to report to work in time. The unit came forward to bear the cost of constructing an over-bridge across the railway track. The bridge was dedicated to the nation. The over-bridge is not the exclusive property of the entity.

It would not be justified in carrying such expenses as fixed assets in their financial statements since exclusive ownership does not exist. There is no ownership or sense of belonging to the facility provided.

Extraordinary item?

If such expenditure is normal in the course of business, such as laying a pipeline or to erect poles, which is incidental to setting up of the facility, it would not be an extraordinary item as per the terms of AS 5. But, the over-bridge is certainly not in the normal course of the business and qualifies to be an extraordinary item. Therefore, whether or not such expenditure constitutes an extraordinary item depends on the given circumstances and varies on a case-to-case basis.

AS 10 does not permit such expenditure (not resulting in creation of an asset) to be disclosed as fixed asset. Such expenditure is justified to be indicated as a "capital expenditure not resulting in an asset".

Two points merit attention:

A note is to be given about the nature of the asset and a statement that such expenditure does not result in any fixed asset.

The capital expenditure to be amortised over the period over which the entity derives benefit out of such capital expenditure or over a period of five years.

In the above example, the entity would not be justified in disclosing the expenditure incurred on the over-bridge as a fixed asset in its financial statements. The utility of the over-bridge to the entity is for a long duration. In such a situation the cost should be written off over a period of five years.

It would not be proper to disclose it as miscellaneous items to the extent not written off.

Source: The BusinessLine