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## Non-profit Entities: An Indian Perspective

### INTRODUCTION

Non-profit Entities (“NPE”) have never been thought of as competitive entities. Unlike business enterprises which focus on provision of products and services for a profit, the primary objective of non-profit entities is to support or to actively engage in activities of public or private interest without any monetary profit purpose. NPE’s are active in a wide range of areas, including the environment, humanitarian aid, social issues, health care, research and other endeavors.

Today’s global economy demands more from a NPE due to increased competitiveness. The very success of these entities is motivating other socially oriented people/corporates/institutions to venture into this field and compete for grants. As a consequence, the grant of money and contributions are becoming harder to come by. The NPE’s need to rethink pragmatically to explore the best structure for themselves and especially contemplate the aspects of foreign funding and the various tax benefits in respect of the activities undertaken by them.

Therefore, choosing an appropriate structure becomes a critical issue. Our December newsletter provides an overview of the three broad legal forms *viz.* trusts, a society and a section 25 company available under the Indian legal system, the differences amongst them regarding their structure and formation as well as the various tax benefits available to them. Finally, it touches briefly on the circumstances in which a foreign funding may be allowed.

#### 1 Forms of NPE

##### 1.1 Trusts

*Trust* is basically defined as an obligation annexed to the ownership of the property which

arises out of a confidence reposed in and accepted by the owner for the benefit of another, or of another and the owner.<sup>1</sup>

The person who reposes or declares the confidence is the “*author of the trust*”, the person who accepts the confidence is the “*trustee*” and the person for whose benefit the confidence is accepted is the “*beneficiary*” while the subject matter of the trust is the “*trust property*” or “*trust money*.” The “*beneficial interest*” of the beneficiary is his right against the trustee as owner of the trust property and the instrument by which the trust is declared is the “*instrument of trust*”.

#### A. Public and private trusts

Private trusts are established for the benefit of certain specific individuals and are governed by the provisions of the Indian Trust Act. In contrast, public trusts are formulated for the benefit of society at large and thus they cater to the benefit of a substantial segment of public. They are of a permanent character, irrevocable and the provisions of the Indian Trust Act are not applicable to them.

There is no central law governing public charitable trusts, although most states have a “Public Trusts Act.” Certain trusts which might appear to be public charitable trusts are in fact private trusts. In particular, a trust for the benefit of group of persons, however, numerous, whose common and distinguishing quality is their relationship to a particular individual or individuals does not as a general rule constitute a public charitable trust, even though its purpose is such that it would have been a valid charitable trust if the range of potential beneficiaries had extended to the community at large

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<sup>1</sup> Section 3 of the Indian Trust Act.

or a section of it.<sup>2</sup> Thus, the section or the community sought to be benefited must be sufficiently defined and identifiable by some common quality of a public or impersonal nature. For example, if a trust has been formed to benefit a selected group like employees of a company, then it cannot be classified as “public charitable trust” because it lacks the quality of being public in nature.

As per section 2(15) of the Income-Tax Act (“ITA”)<sup>3</sup>, “charitable purpose” includes relief of poor, education, medical relief and the advancement of any other object of general public utility. The law recognizes no purpose as charitable unless it is of a public character.

Typically a public charitable trust must register with the office of the Charity Commissioner having jurisdiction over the trust (generally the Charity Commissioner of the state in which the trustees register the trust) in order to be eligible for tax-exemption. One or more persons can form a public charitable trust.

In general, Indian citizens serve as trustees; however there is no specific prohibition against non-natural legal persons or foreigners serving in this capacity. It is important that every trustee performs his duties diligently including maintenance of records and accounts required for taxation. In case of such non-compliance, the authorities under the respective acts may withdraw exemptions both under income-tax and foreign contribution to ensure strict adherence with the legalities involved.

## 1.2 Society and its characteristics

A society is an association of persons (generally unincorporated) who are united together by mutual consent to act jointly for some common purpose. It is governed by the Societies Registration Act, which is a national legislation.

A society must be formed by a minimum of seven or more persons who are eligible to enter into a contract, for any of the following purposes: (a) grant of charitable assistance, (b) to promote science,

literature, or the fine arts, (c) for promoting education, (d) the foundation or maintenance of libraries or public museums and galleries of paintings and other works of art, collections of natural history, and (e) mechanical and philosophical inventions, instruments, or designs.<sup>4</sup>

### A. Registration of society

Members of a society have voting rights. Individuals, institutions or both and foreigners can be the members of a society. The charter documents of a society are memorandum of association and the rules and regulations which must be filed with the Registrar of Society along with other documents.<sup>5</sup> A very nominal fee is charged by the authorities for registering a society.<sup>6</sup>

### B. Management of funds and accounts of a society

The members of the governing body of a society must ensure that its funds are utilized appropriately for the purpose for which the society is formed and accounts should be maintained in proper order. The accounts are required to be duly audited by a chartered accountant.<sup>7</sup> In a society though the accounts are placed before the governing body for their approval yet they are subject to the supervision by the registrar of societies. The members can inspect the accounts and annual report of the society at any time.

### C. Meetings

A society must convene an annual general meeting. Usually, the governing body delegates the management of day-to-day affairs to a managing committee duly selected by them. Unlike trusts, the societies must annually file with the registrar a list of

<sup>4</sup> Section 20 of the Societies Registration Act.

<sup>5</sup> Attested affidavit detailing the name of the society and that the deponent is a subscriber to the memorandum, details as to the work to be undertaken on registration, a no objection certificate from the appropriate authority etc.

<sup>6</sup> Section 3 of the Societies Registration Act. The fee shall depend upon the State where the society is to be registered.

<sup>7</sup> The respective state societies registration acts provide for provisions with respect to accounts, general meetings, balance sheet, annual list of members to be filed etc.

<sup>2</sup> Oppenheim Vs Tobacco Securities Trust Co Ltd., (1951) AC 297, (1951)1 All ER 31. HL.

<sup>3</sup> Section 2(15) of the ITA.

members with their names, addresses and occupation.<sup>8</sup>

#### **D. Dissolution**

Unlike trusts, societies may be dissolved. Dissolution must be approved by at least three-fifths of the society's members.<sup>9</sup> Upon dissolution and after settlement of all debts and liabilities, the funds and property of the society may not be distributed among its members, as they do not have any proprietary or beneficial interest therein. Rather, the remaining funds and property must be given or transferred to some other society, preferably one with similar objects as the dissolved entity.

### **1.3 Section 25 Companies**

The Companies Act, 1956 permits certain companies to obtain a not-for-profit status. Such companies are termed as "section 25 companies" based on the section dealing with them. These companies may be formed for "promoting commerce, art, science, religion, charity or any other useful object."

#### **A. Prior approval for formation**

The procedure for incorporating a section 25 company is the same as that of a private company with the distinction that prior permission is required from the central government for its incorporation. In order to obtain the prior approval, the promoters must submit all the application materials to the Regional Director, Department of Company Affairs. The application must include copies of the proposed memorandum of association and articles of association, as well as a number of other documents including a statement of assets (in case of a company already registered but which requires conversion into a section 25 company), details of the promoters and of the proposed directors and a brief description of the work proposed to be done upon incorporation. Minimum two individuals or promoters are sufficient to initiate the process of incorporation.

<sup>8</sup> Section 4 of the Societies Registration Act.

<sup>9</sup> Section 13 of the Societies Registration Act.

#### **B. Conditions and exemptions**

Section 25 deals with the power of the Central Government to dispense with the word "Limited" in the name of charitable or other companies upon the fulfillment of certain conditions and to grant a license to such an entity once it is satisfied about certain conditions *viz.*:

- (a) The object of the company is to promote commerce, art, science, religion, charity or any other useful objects;
- (b) The profits, if any, earned in carrying out the object and other income are proposed to be applied only for promoting its objects; and
- (c) The company intends to prohibit the payment of dividend to its members.

Such an entity enjoys many other exemptions from the operative provisions of the Companies Act either in whole or to a specified extent. For example, in order to convene an annual general meeting a section 25 company can give a lower notice period of 14 days as opposed to 21 days that applies for other companies.

Like a society (but unlike a trust), a section 25 company may be dissolved. Upon dissolution and after settlement of all the debts and liabilities, the funds and property may not be distributed among its members. Rather, the remaining funds and property must be given or transferred to some other section 25 company, preferably one having similar objects as the dissolved entity.

### **2. Tax Law in respect of NPE's**

The ITA, which is a national legislation, governs tax exemption of NPE's. Any income<sup>10</sup> of a NPE established for a charitable purpose is exempt from paying income-tax if it fulfills the criterion provided under the ITA. The tax perspective for NPEs is divided under two main heads and their key aspects are highlighted below:

<sup>10</sup> Section 2 (24) of the ITA defines "income" which includes (i) profits and gains; (ii) dividend; (iii) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes or by an association or institution referred to in section 10 clause (21) or clause (23), or by a fund or trust or institution referred to in clause 23 (C) (iv) or (v).

## 2.1 Tax exemptions for NPE's

Income derived from the property of a NPE which is held wholly for charitable or religious purpose enjoys tax exemption under the ITA.<sup>11</sup> However, NPE's established for the benefit of any particular religious community or caste are not eligible for exemption from tax.<sup>12</sup>

In order to avail the income-tax exemptions, a NPE must secure registration under the provisions of ITA.<sup>13</sup> The application for registration<sup>14</sup> should be accompanied by the document evidencing the creation of NPE (trust deed, certificate of registration or incorporation, as the case may be).

The exemption will be available only if at least 85% of the income of the NPE is actually applied towards the charitable purpose for which it is established.<sup>15</sup> The surplus income up to a maximum of 15% of the total income may be accumulated for specific projects<sup>16</sup> for a period ranging from 1 to 5 years. Further, its income or property should not be used or applied for the benefit of a founder, trustee or any person who may have contributed in excess of Rs.50,000 (\$1265 approx)<sup>17</sup> in such an entity.<sup>18</sup>

## 2.2 Tax deduction to the donors

Under the ITA, the donors can avail tax benefits in respect of their contributions. Section 80G of the ITA entitles donors to a 100% deduction for the donations made to specified government funds/charities and a 50% deduction for donations to non-governmental charities/funds. However, there is

a restriction on the aggregate of deductions available to the donor.<sup>19</sup>

Donations to a NPE are exempt from the taxable income of the donor if the concerned authority (Commissioner of Income-Tax) approves the NPE.<sup>20</sup> Though no time limit is prescribed for submitting the application, it is in the interest of the NPE as well as the donors that the application along with the other documents<sup>21</sup> is furnished as soon as the charity is established. Further, the NPE must fulfill the following conditions:

- (i) The NPE must be established for a charitable object and not merely for the benefit of any particular religious community or caste.
- (ii) The instrument of trust/institution, or the rules governing the society should not provide for the transfer or application of the whole or any part of its income or assets for non-charitable purposes.
- (iii) It should maintain regular accounts of receipts and expenditure.
- (iv) NPE must be approved by the Commissioner of Income-Tax as discussed in 2.1 above.
- (v) The income of the NPE must be exempt under the provisions of certain sections.<sup>22</sup> However, this condition shall not apply where an NPE derives income from a business that is incidental to the attainment of its main objects provided that it maintains separate books and account in respect of such business

<sup>11</sup> Section 11 of the ITA wholly exempts the income of NPE provided its purpose is charitable or religious.

<sup>12</sup> Section 13(1)(b) of the ITA.

<sup>13</sup> Section 12 of the ITA.

<sup>14</sup> This application is to be made in Form 10A.

<sup>15</sup> The NPE has until 12 months following the end of the financial year to comply with this requirement.

<sup>16</sup> Such accumulation of income must be in accordance with section 11(5) of the ITA which details the various modes of investing or depositing the money such as post office savings bank, investment in the units of Unit Trust of India, deposits with the Industrial Development Bank of India etc.

<sup>17</sup> 1 USD = 39.5 INR.

<sup>18</sup> Section 13(3) of the ITA.

<sup>19</sup> Under section 80G (4), the deduction for donors must not exceed 10% of the donor's total gross income, else the amount in excess of 10% shall be ignored for the purpose of computing the aggregate of the sums in respect of which the deduction is to be allowed.

<sup>20</sup> The application is to be made in Form 10 G according to Rule 11AA.

<sup>21</sup> These include copy of registration granted by the income-tax authorities, notes on the activities of the charitable organization since its inception or during the last three years, whichever is less, copies of the account of the charitable organization since its inception or for the last 3 years, whichever is less.

<sup>22</sup> Under section 80G it is essential that the income of a NPE must be exempt under Sections 11, 12 or 10(23AA) or 10(23C) of the ITA in order to obtain approval under the provisions of ITA. All the conditions under ITA (as stated in 2.1) that entitle any NPE to tax exemptions must be fulfilled.

and the donations received by it are not used (directly or indirectly) for the purpose of such business.

### 3. Foreign contribution with respect to NPE's

All charitable entities functioning in India must register themselves under the Foreign Contribution (Regulation) Act (“FCRA”) prior to receiving any foreign contributions/funding. The permission is granted by the Ministry of Home Affairs after verifying the necessary documents.

*Foreign contribution* refers to donations in cash or in kind. It also includes any foreign security as well as any other currency, be it Indian or foreign. However, it excludes personal gifts whose market value in India on date of such gifts is Rs. 1,000 (\$25.30 approx) or less. For the avoidance of doubt, a donation, delivery or transfer of any article, currency or foreign security shall be deemed to be foreign contribution when received by any person from any foreign source, whether directly or indirectly, through one or more persons.

#### 3.1 Checklist for the receipt of foreign contribution

Funds collected by an Indian citizen in a foreign country on behalf of a NPE registered in India and funds received in India in any currency (whether Indian or foreign) are considered as foreign contributions. NPE's wishing to accept foreign contributions must:

- Register with the Central Government;<sup>23</sup>
- Agree to accept contributions through designated banks;
- Maintain separate books of accounts with regard to all receipts and disbursements of funds; and
- Report annually to the Ministry of Home Affairs regarding the amount of the foreign contribution received including the source, manner of receipt, the purpose for which it

was intended and the manner in which it was utilized.<sup>24</sup>

Non-compliance of any provisions of FCRA can lead to imprisonment and/or financial penalties or even withdrawal of the right to receive foreign exchange. In case of offences by companies, trusts, or societies, its management is held liable.

### CONCLUSION

There is a need for individuals and globally-minded enterprises to make a commitment to India's non-profitable sector. NPE's can play a significant role but clearly, there is a maze of administrative paperwork in the formation and running a NPE which can act as a deterrent. The numerous legal compliances require careful monitoring.

*(Safeena Mendiratta)*

<sup>23</sup> The application has to be made in Form FC-8 as per Foreign Contribution (Regulation) Rules

<sup>24</sup> Section 6(1) of FCRA. Also, rule 6 of the Foreign Contribution (Regulation) Rules which provides intimation as to the receipt of foreign contribution to be given in Form FC-3 in duplicate within 4 months of the closure of the year.

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