Diploma in Financial Management & Accountability

- a joint initiative of TISS & FMSF

Course Material

Project Fund Accounting
Paper – V

Module - III
Faculty – Sanjay Patra

UNIT - 10. LEGAL FRAMEWORK AND FUND ACCOUNTING

Learner's Objectives:

- **To understand the legal implications which necessitate the use of fund accounting**
- **To understand the amendments made in the Income Tax laws on corpus donations**

10.1 INTRODUCTION

Fund accounting is generally dependent on the laws and statutes of the country. For instance, in India neither there is any legal requirement nor there are any accounting standards, which make fund accounting a statutory requirement. Fund accounting therefore, is a legally optional requirement. It becomes very important to understand the legal implication which necessitate the use of fund accounting. The legal requirement may not impose separate books of account or reports for various funds but funds which are legally created have to be distinctly managed as per the provision of the law. Some of such issues are discussed here in this chapter.

10.2 PROJECT GRANTS OR RESTRICTED FUNDS

A project grant received to be applied on specific activities is a restricted fund. There is lot of confusion whether, such grants should be treated as income or not. In any case, it will form a part of a project fund. The normal practices is to treat all such grant as income and the expenditure thereof is treated as application. But the correct legal procedure will be to keep such fund in the account of the donor and expenditure are made from that particular account. Any surplus or deficit in this account is transferred to the income and expenditure account at the end of the project period.

The Income Tax Act provides that all voluntary contribution except corpus contribution should be treated as income. But a specific or restricted contribution is not a voluntary contribution if it comes attached with a condition. Project grants are considered as specific or restricted contribution because the amount has to be utilized as per the conditions of the project/grant agreement. Therefore, the grant is not freely available to the organization to be utilized for charitable purposes. It is bound by the contractual obligations of the project/grant agreement.

Project grants should not be considered as income for the purposes of section 11(1) of the Income Tax Act and should be transferred to a separate account of the donor from where it should be spent for its pre-determined purposes. Any surplus remaining should revert back to the donor or should be treated as income after obtaining approval from the donor.

In *Society For Integrated Development In Urban And Rural Areas (SIDUR). v. DCIT* [2004] 90 ITD 493 (Hyd.), the issue came up before the regular bench of the tribunal in Hyderabad. The exemptions were forfeited by virtue of section 13(1)(c). The assessee contended that for the purposes of computing income various project grants received from foreign donors could not be included in the income liable to tax, as such receipts would not be considered as income for the purposes of section 11. It was held that project grants did not form a part of the income of the assessee nor they form a part of the corpus. Voluntary contributions covered by section 12 are those contributions freely available to the assessee without any stipulation, which the assessee can utilise towards its objectives according to its own discretion and judgment. Tied-up grants for a specified purpose would only mean that the assessee which was a voluntary organisation, had agreed to act as a trustee of a special fund granted by donor with the result that it need not be pooled or integrated with the assessee's normal income or corpus. The tribunal relied on the findings of *Nirmal Agricultural Society v. ITO* [1999] 71 ITD 152 (Hyd.).

In *Sukhdeo Charity Estate v. CIT*(1984) 149 ITR 470 Raj, the issue of whether specific grants were income or not was also discussed. It was observed that if the motive and intention of the donor play an important role in the utilization of the donation then it cannot be considered as voluntary in nature. The word *"voluntary"* in its very inception connotes the absence of any obligation on the part of the donor.

In the above case the court ruled that a grant received for specific purposes cannot by any stretch of imagination be said to be income as envisaged by section 12(1). Because the word *'voluntary'* in its very inception connotes the absence of obligation on the part of the donor.

There is a lot of confusion in this regard. Many NGOs treat such donation as income for the purposes of section 11. The difficulty arises when they are unable to spend such contribution in the year of receipt as per the stipulation of the project agreement. For example a full 3 year grant received in the first year. Now, if such grant is treated as income in the year of receipt then 85% of it has to be utilised in that year itself. But the project agreement allows only 33% to be utilised in the first year. The assessee has to accumulate the income under section 11(2). There is no legal necessity for invoking section 11(2) when the grant by virtue of the project agreement was not available to the assessee for utilisation.

The above instance is of a specific grant where the instruction of the donor have to be complied with, therefore it cannot be treated as voluntary contribution. Such contribution should be kept in the donor account by applying principles of fund accounting. The application of such funds should be made from the donor/project account, so created. Such grant/contribution should not be included for the purposes of computing the total income under section 11.

The project agreement or the *'letter of intent/instruction'* from the donor is of paramount importance. The assessee has to prove that the donation was not

voluntary in nature. In other words, the donation was not available for utilization as per the will and judgment of the assessee/NGO.

To sum up:

The above discussions relating to projects grants whether income or not could be summarised as under:

(*i*) Most project grant are specific or restricted contribution to be utilised as per the terms of the project/grant agreement. Therefore, it is not considered as voluntary contribution.

(ii) Specific contribution or restricted grants are not considered as income for the purpose of section 11(1).

(iii) If the motive and intention of the donor play an important role in the utilization of the donation then it cannot be considered as voluntary in nature. The word *"voluntary"* in its very inception connotes the absence of any obligation on the part of the donor.

(iv) The project agreement or the *'letter of intent/instruction'* from the donor is of paramount importance. The assessee has to prove that the donation was not voluntary in nature.

10.3. CORPUS FUND

Under the Income Tax Laws, corpus donation is not considered as income to be computed for the purpose of availing exemption. It may be noted that corpus donation is a part of income but is not included while computing the income available for exemption. Because, corpus is not included in income for computational purposes, it is not required to be spent and can be accumulated indefinitely.

In the light of the above, corpus donation can be directly transferred to the corpus fund without any legal liability to spend but the legal implication needs attention. Because, if the exemptions available under section 11 of the Income Tax Act are forfeited by virtue of some violations committed by the NGO then even the corpus donation received will become taxable. It brings to a very ironical situation where in case of forfeiture, the restricted project grants will

not become taxable. In other words, what is considered as (corpus) tax free and totally safe would become taxable and on the other hand the restricted project grants, which are considered as a part of income will not become taxable.

10.4. AMENDMENTS MADE IN INCOME TAX LAWS W.E.F. 01.04.1989 ON CORPUS DONATION

According to section 11(1) (*d*), any voluntary contributions received by a trust or an institution created wholly for charitable or religious purposes with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the total income. Section 11(1)(*d*) was introduced by Direct Tax Laws (Amendment) Act, 1989, with effect from 1-4-1989. Prior to it, section 2(24) (*iia*) provided the exemption for corpus donations. But with effect from 1-4-1989, the words *"not being contribution made with a specific direction that they will form part of the corpus of the trust or institution"* were deleted from section 2(24) (*iia*). The effect of this shift of exemption implies that corpus donation earlier was not a part of the total income, but now it is considered as a part of income.

As discussed above, section 11(1) (d) was introduced w.e.f. 01-04-1989 and simultaneously section 2(24) (iia), which defines the term *'income'* was amended and corpus donation were included within the ambit of the taxable income on which a charitable organisation can claim exemption. As far as the exemption of corpus donation is concerned it was available even prior to 01-04-1989. But with this amendment, corpus donation which was not a part of taxable income has now become a part of the taxable income but enjoys exemption by the virtue of section 11(1)(d).

This amendment seems harmless as it has not affected the taxability and exemptions of charitable organisations. But, in case a charitable organisation looses exemptions by virtue of violations under section 13(1) then corpus

income will also be included in the total income, which may be subjected to tax. Therefore, technically under the current laws corpus donations are a part of the income even though specifically exempted and in the event of any contravention even corpus donation may be subjected to tax.

Fund accounting becomes very important in clearly segregating various corpus and restricted funds so that the legal implications in case of forfeiture or in the normal circumstances can be handled properly.

To sum up :

(i) With effect from 1-4-1989 the words *"not being contributions made with a specific direction that they will form part of the corpus of the trustor institution"* were deleted from section 2(24) (*iia*). The effect of this shift of exemption implies that corpus donation earlier was not a part of the total income, but now it is considered as a part of total income. But, it is not considered as a part of income for the purposes of section 11.

(ii) In case a charitable organisation looses exemptions by virtue of violations under section 13(1) then corpus income will also be included in the total income, which may be subjected to tax. Therefore, technically under the current laws, corpus donations are a part of the income even though specifically exempted and in the event of any contravention even corpus donation may be subjected to tax.

(iii) Corpus donations should come with a specific direction from the donor. Such specific direction should be in writing and should not be general in nature.

(iv) Income collected through donation boxes are not covered even if the boxes are marked "donation towards corpus".

(v) Corpus donation is a receipt of capital nature, therefore, it does not come under the purview of section 12 which covers voluntary contributions.

(vi) A corpus donation is not required to be spent and can be accumulated indefinitely. But there is no bar on application of such fund for charitable purposes.

10.5. INVESTMENT IN SPECIFIED SECURITIES ONLY

Under the Income Tax laws in India, all NGOs have to invest their fund in specified securities under section 11(5) of the Income Tax Act. While making investment decision in context of a fund it should be kept in mind that if any fund are invested in non-specified securities then the entire exemption would be lost. In other words even if a negligible amount is invested in securities which are not permitted then the entire income of the previous year will be subject to tax. However, the list of securities and asset provided under section 11(5) is wide enough to cater to the needs of various types of funds. For instance, deposit in bank account is permissible and investment in immovable properties is also permissible. The current list of securities permitted are as under :

(*i*) investment in savings certificates as defined in clause (*c*) of section 2 of the Government Savings Certificates Act, 1959 (46 of 1959), and any other securities or certificates issued by the Central Government under the Small Savings Schemes of that Government;

(*ii*) deposit in any account with the Post Office Savings Bank;

(*iii*) deposit in any account with a scheduled bank or a co-operative society engaged in carrying on the business of banking (including a co-operative land mortgage bank or a co-operative land development bank).

Explanation.—In this clause, "scheduled bank" means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a

subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970), or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve Bank of India Act, 1934 (2 of 1934);

(*iv*) investment in units of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963);

(*v*) investment in any security for money created and issued by the Central Government or a State Government;

(*vi*) investment in debentures issued by, or on behalf of, any company or corporation both the principal whereof and the interest whereon are fully and unconditionally guaranteed by the Central Government or by a State Government;

(*vii*) investment or deposit in any [public sector company]:

[Provided that where an investment or deposit in any public sector company has been made and such public sector company ceases to be a public sector company,—

(*A*) such investment made in the shares of such company shall be deemed to be an investment made under this clause for a period of three years from the date on which such public sector company ceases to be a public sector company;

(*B*) such other investment or deposit shall be deemed to be an investment or deposit made under this clause for the period up to the date on which such investment or deposit becomes repayable by such company;]

(*viii*) deposits with or investment in any bonds issued by a financial corporation which is engaged in providing long-term finance for industrial development in India and [which is eligible for deduction under clause (*viii*) of sub-section (1) of section 36];

(*ix*) deposits with or investment in any bonds issued by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes and [which is eligible for deduction under clause (*viii*) of sub-section (1) of section 36];

(*x*) deposits with or investment in any bonds issued by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for urban infrastructure in India.

Explanation.—For the purposes of this clause,—

(*a*) "long-term finance" means any loan or advance where the terms under which moneys are loaned or advanced provide for repayment along with interest thereof during a period of not less than five years;

(*b*) "public company" shall have the meaning assigned to it in section 3 of the Companies Act, 1956 (1 of 1956);

(*c*) "urban infrastructure" means a project for providing potable water supply, sanitation and sewerage, drainage, solid waste management, roads, bridges and flyovers or urban transport;]

(*xi*) investment in immovable property.

Explanation.—"Immovable property" does not include any machinery or plant (other than machinery or plant installed in a building for the convenient occupation of the building) even though attached to, or permanently fastened to, anything attached to the earth;]

(xii) deposits with the Industrial Development Bank of India established under the Industrial Development Bank of India Act, 1964 (18 of 1964);]

(*xiii*) any other form or mode of investment or deposit as may be prescribed.

Self- Assessment Exercise

1. **Is there any legal necessity or requirement for NGO to follow Fund accounting?**
2. **What does a 'voluntary contribution' mean?**
3. **Which section of the Income Tax Act covers voluntary contributions and what are it implications?**
4. **State whether specific contribution or restricted grants are considered as income or not?**
5. **If the motive and intention of the donor plays an important role in utilization of the donation, will it be considered voluntary or not? Give reasons.**
6. **Briefly state the amendments made in income tax laws on corpus donations.**
7. **How is fund accounting important in segregation of corpus and restricted funds?**
8. **What is the effect if a charitable organisation looses its exemption by virtue of violation under section 13 (1)?**
9. **Is their any specific requirement that the donor has to comply with regard to corpus donations?**
10. **Does corpus donation fall within the purview of voluntary contributions?**
11. **What provisions are contained in section 11 (5) of the Income Tax Act, 1961?**
12. **What would happen in case an NGO invest in securities which are not permitted by the Income Tax Act?**