

Resource support on NGO Governance, Accounting and Regulations

# Standards & NORMS

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## CASE LAWS IN FAVOUR OF NGOs ENGAGED IN MICRO FINANCE



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### INTRODUCTION & OVERVIEW

1.01 The recent amendments in the definition of 'charitable purpose' under section 2(15) have far-reaching implications on the business income of charitable organisations. It may be noted that the NGOs engaged in advancement of any other object of general public utility, are

not allowed to have even incidental business activity beyond Rs.10 lakh turnover. Therefore, it becomes important to know the impact of the amendments on activities of certain NGOs which are similar to commercial activities, particularly NGOs engaged in microfinance and lending activities. In this issue, we shall discuss the circumstances under which an NGO engaged in microfinance can still be treated

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as a charitable organisations. Before we go into the details, here is a quick recap of the amendments and its implications:

**1.02** The definition of ‘charitable purpose’ can be divided into 6 parts, viz. (i) relief of poor, (ii) education, (iii) medical relief, (iv) preservation of environment, (v) preservation of monuments or places or objects of artistic or historic interest, (vi) 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 sixth 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 preservation of environment & preservation of monuments shall not be hit by this amendment.

**1.03** 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 sixth 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 sixth category of NGOs will lose the charitable status. However, the Finance Act, 2010 has provided some relief to the sixth category NGOs as NGOs having business activities to the extent of rupees ten lakh (receipt) will not be affected.

**1.04** There is 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,

***There is 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.***

it will lose its charitable status and the entire income will become taxable.

**1.05** It is pertinent to note that all other NGOs (other than the NGO coming under the sixth 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.

**1.06** 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 five categories of NGOs.

**1.07** 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 sixth 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.

**1.08** 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
- 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 sixth object, then it would not be considered as a charitable purpose, if the receipts from such activities exceed rupees ten lakh per annum.

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

**1.10** It may also be noted that the current amendments are prohibiting business activity and not *profit making*. In other words such sixth category NGOs may still have some profit through various sources of income generation other than business or commercial activity. Therefore, going by various case laws activities such as

- charity shows,
- rent from property,
- income from Kalyana Mandapam or conferences facilities,
- business involving poor/ beneficiaries etc.
- sale of books without profit motive
- organising workshop and seminars etc.

shall still be permissible and valid. The CBDT has issued an explanatory circular in this regard (please refer to Std. & Norms Vol.

***The NGOs engaged in microfinance activity shall have to prove that the interest charged by them is reasonable and therefore, the activity is charitable in nature.***

III, Issue 1, April 2010 for details. This can also be downloaded from our website [www.fmsfindia.org](http://www.fmsfindia.org)) The circular categorically denies even incidental business or commercial activities for the sixth category NGOs.

**1.11** Microfinance activity may get impacted. The NGOs engaged in microfinance activity shall have to prove that the interest charged by them is reasonable and therefore, the activity is charitable in nature. It may be noted that if the NGO proves the MFI activity is charitable in nature, then the MFI activity will not be treated as a commercial activity at all.

**1.12** It may further be noted that microfinance as an incidental business activity and a charitable activity are two different issues. An NGO shall be exempted only if it is engaged in microfinance as a charitable activity. If an NGO is engaged in microfinance as an incidental business activity, then it will be subjected to the recent amendments to section 2(15) and such microfinance activity should be only a small portion of its overall activities.

**1.13** Incidental business activities such as employing indigent women for stitching or tailoring, marketing products of the beneficiaries or greeting cards etc, shall be considered as activities towards achievement of the primary purpose of relief to poor and therefore, should not

be treated as business activity, as was decided by Supreme Court in *Thiagarajar Charities and Thanti Trust case (supra)*.

1.14 The amendment to the Section 2(15) shall apply from the assessment year 2009-10.

### RECENT CASE LAWS IN FAVOUR OF NGOS ENGAGED IN MICROFINANCE

2.01 The Visakhapatnam, Income Tax Appellant Tribunal in the case *Spandana (Rural & Urban Development Organisation) Vs. ACIT* [2010] 40 DTR 153 (Visakha)(Trib) held that microfinance activity is a charitable activity as it alleviates poverty and also benefits socio-economically weaker sections of the society.

2.02 The Tribunal held that the Microfinance activity was charitable in nature because of the following reasons :

- (i) The loan is advanced to weaker sections of the society to meet their urgent needs.
- (ii) Even if reasonable or slightly higher interest is charged, it cannot be held uncharitable because the cost of recovery is very high and the possibility of bad debt is also high.
- (iii) The funds are given without any surity or guarantee.

Some relevant extract from the case are provided as under :

*Microfinance activity requires an organised sector for procuring a loan from the banks or other financial institutions for its disbursement/ advancement of loan to poor or weaker sections of the society in which the assessee has to incur a lot of expenditure. Moreover, when a loan*

***It was held that microfinance activity is a charitable activity as it alleviates poverty and also benefits socio-economically weaker sections of the society.***

*was given to the poor women, they do not have any surety or guarantee to stand and most of the times the loan could not be recovered from them and that aspect is also to be taken into account by the assessee while granting a loan to the poor woman. Suppose a loan was given to some of the poor women and they would not be in a position to repay the loans what the assessee will do. He cannot enforce the recovery of the loan by other means and ultimately he has to write off the loan. Meaning hereby, in these types of microfinance activities most of the times the assessee could not recover the loans granted to the poor women as no one stood as the guarantor for them at the time of advancement of the loan. No doubt assessee is that charging higher rate of interest from the poor women or the downtrodden or socio-economically weaker section of the society. The reason behind is that most of the time the assessee could not recover the loan from these poor and weaker sections of the society, besides incurring heavy expenditure in maintaining the organised sector. These poor and weaker sections happily agreed with the assessee for loan at higher rate, because they could not get advancement of certain funds by the assessee to other organisations who were also engaged in similar type of activities are concerned, by advancing a fund on interest to other organisations, assessee has accomplished its object of microfinance to the socio-economically weaker sections of the society and also to*

alleviate poverty beside collecting the interest on the advancement loan. Moreover, this fund was advanced for a shorter period and the assessee has also earned an interest thereon which was utilised in micro financing activity to the poor people. By joining hands with the banks or financial institutions for procuring funds/loans for its advancement to poor or needy people exemption under section 11 cannot be denied. While rejecting the claim of the assessee, the Revenue has not taken into account these factors that by doing this activity, assessee is helping the needy people or the socio-economically weaker sections of the society as no one is going to finance them to meet their requirements. By doing this, the assessee is at least helping the poor and weaker sections of the society in meeting their urgent needs.

**2.03** Similar views were taken in the case *ADIT(E) Vs. Bharatha Swamukhi Samsthe* [2009] 28 DTR 13 (Bangalore Tribunal) where it was held that the work of lending money to poor women for income generating activities was charitable in nature as there was nothing on record to show that the interest charged by the assessee was exorbitant. The following extract from the case is crucial to understand the statutory and judicial interpretations in this regard :

*It is not in dispute that the assessee's work is lending money to the poor women for income generating activities. The loan given to project members are borrowed from bank; The beneficiaries are poor families. If the women in the assessee's project have to borrow money from the money lenders they have to pay many times higher interest than what the assessee has charged. It is also not in dispute that the assessee incurs financial costs for obtaining loans from banks. The assessee also have to make payment towards salaries and other administrative activities of the Trust. There is nothing on record to suggest that the assets and income of the trust*

***It was held that the work of lending money to poor women for income generating activities was charitable in nature as there was nothing on record to show that the interest charged by the assessee was exorbitant***

were available for the personal benefit of the trustee and the board members. These are only used for micro credit to poor women for their poverty alleviation and for the benefit of the socio-economically weaker sections of the society. The AO has not substantiated its findings that the work of the trust is not charitable and the interest charged by the assessee is exorbitant. The AO placed nothing on record to show that the assessee is charging exorbitant interest. The AO may justify the exorbitant rate of interest charged, in case the poor ladies in question have option to avail credit at lower interest from other sources. In case, the credits are available at lower interest to the poor women in question than they were free to avail the same. There was no compulsion over parties to avail credit at higher rate of interest. In case they have option to avail loan at lower rate of interest. The assessee can carry out its activities on after charging marginal higher rate of interest to run its activities. The assessee is running seminar in rural area to make the poor ladies aware of the scheme and to encourage their participation. All these things need some expenditure. Initially, the assessee was in loss and it is only in the year under consideration some surplus is with the assessee trust. The facts and circumstances show that the assessee is carrying out its charitable activities and the surplus funds are used for charitable purposes. So, the CIT (A) was justified in holding that the assessee is engaged in charitable activities and qualify for exemption under section 11.

**2.04** The Bangalore Tribunal concluded that borrowing money from banks and providing loans to poor women for their poverty alleviation can be said to be engaged in charitable activities entitled for exemption under section 11.

*That borrowing money from banks and providing loans to poor women for their poverty alleviation can be said to be engaged in charitable activities entitled for exemption under section 11.*

### **CASE LAW AGAINST MICROFINANCE AS A CHARITABLE ACTIVITY**

**3.01** It is relevant to study the case where decision was taken against the NGO proposing microfinance activity. In the case *Janalakshmi Social Services Vs. DIT* [2009] 33 SOT 197 (Bangalore Tribunal) it was held that a society lending money to a particular group of vegetable traders at high interest rate was not eligible for 12A registration. However, in this case also the Tribunal observed that the assessee can be considered as a charitable organisation, in future, provided it carries on Microfinance activity to help the poor at reasonable rate of interest. The following extract is relevant in this regard.

*Therefore, looking to the activities carried out by the assessee company and as noticed by the learned DIT(E), we feel that the learned DIT(E) was justified in refusing registration. However, this will not debar in applying a fresh registration in case the assessee company carries out micro financing activities and helps the poor people by providing finance at the reasonable rate. It may carry out microfinance as a business as well as a charitable object. With this observations, we feel that the learned DIT(E) was justified in not allowing registration to the assessee-company for the year under consideration.*

**3.02** In the light of the various case laws discussed it seems that microfinance *per se* cannot be considered as a business

or commercial activity. The department has to prove that the rate of interest is exorbitant or the activity is being done on commercial basis. It may further be noted that microfinance as an incidental business activity and a charitable activity are two different issue. An NGO shall be exempted only if it is engaged in microfinance as a charitable activity. If an NGO is engaged in microfinance as an incidental business activity then it will be subjected to the recent amendments to section 2(15) and such microfinance activity should be only a small portion of its overall activities.

### **BUSINESS ACTIVITIES INVOLVING POOR AND BENEFICIARIES**

**4.01** The Supreme Court in case *Thiagarajar Charities v. ACIT* [1997] 092 TAXMAN 152 (SC), has held that businesses involving the poor beneficiaries cannot be said as business or activity for profit. The apex court provided two reasons (i) the business is only a 'means' of achieving the 'object' of the trust; it is a medium through which the 'objects' are accomplished. (ii) the business - corpus - property held under trust - produces or

results in income, *like any other property*. In the light of this landmark decision, it seems that business activities involving the beneficiaries and done only with the motive of providing relief to the poor, cannot be considered as business at all.

**4.02** The issues of business activity involving poor beneficiaries were also considered by the Supreme Court in the case of *Asstt. CIT v. Thanthi Trust* [2001] 247 ITR 785, wherein the Hon'ble Supreme Court held that even the business of weaving cloth and stitching clothing by employing indigent women undertaken by the NGO, carries on the business in the course of actually accomplishing its primary object of affording relief to the poor and it would qualify for the exemption under section 11.

## **CBDT CIRCULAR ON MONEY LENDING ACTIVITY**

**5.01** The Microfinance activity may be hit by the recent section 2(15) amendments. In the Departmental Circular No. 100 [F.No. 195/1/72-IT(A-1)] dated 24.01.1973 the issue of money lending and interest bearing loan has been discussed (**Annexure 1**). This circular is in context of loan given to students for higher education. It has been clarified that even interest bearing loan given to the students would be treated as activity towards advancement of the objectives, provided giving interest bearing loan is not the only activity of the organisation. From the circular the following issues are apparent :

- (i) Interest bearing loan *per se* is not necessarily a commercial activity

***Microfinance Institutions solely existing for providing interest bearing loans may not be treated as charitable activities unless such institutions prove that these activities are towards relief of poor at reasonable interest.***

unless the sole objective of the organisation is to provide interest bearing loan. In that case it will be treated as money lending activity.

- (ii) If a portion of activity of an NGO involves providing interest bearing loan to needy beneficiaries, it may still be considered as an activity towards advancement of charitable objectives and may not be treated as business activity at all.
- (iii) Even loan taken for the purposes of trust can be repaid as valid application and such loan may be used for advancing loan to needy beneficiaries.

**5.02** The circular was issued in context of educational loan for higher studies. This circular provides the ratio and the legal rationale for treatment of microfinance activity as charitable activity or money lending activity. Microfinance Institutions solely existing for providing interest bearing loans may not be treated as charitable activities unless such institutions prove that these activities are towards relief of poor at reasonable interest. Therefore, unless the interest rates are reasonable it may not be treated as charitable activity.

CIRCULAR : NO. 100 [F. NO. 195/1/72-IT(A-I)], DATED 24-1-1973.

**Repayment of debt incurred for purposes of trust/loans advanced by educational trusts to students for higher studies - Whether amounts to application of income**

1. Section 11 requires 100 per cent of the income of a charitable and religious trust to be applied for religious and charitable purposes to be entitled to the exemption under the said section. Two questions have been considered regarding the application of income :
  1. Where a trust incurs a debt for the purposes of the trust, whether the repayment of the debt would amount to an application of the income for the purposes of the trust ; and
  2. Whether loans advanced by an educational trust to students for higher studies would be treated as application of income for charitable purposes.
2. *The Board has decided that repayment of the loan originally taken to fulfil one of the objects of the trust will amount to an application of the income for charitable and religious purposes. As regards the loans advanced for higher studies, if the only object of the trust is to give interest-bearing loans for higher studies, it will amount to carrying on of money-lending business. If, however, the object of the trust is advancement of education and granting of scholarship loans as only one of the activities carried on for the fulfilment of the objectives of the trust, granting of loans, even if interest-bearing, will amount to the application of income for charitable purposes. As and when the loan is returned to the trust, it will be treated as income of that year.*

Reference Book : **Taxation of Trust and NGOs with FCRA and FEMA, 5th Edition 2010** by **Manoj Fogla**, published by TAXMANN Publications, New Delhi

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